

ESG
INCORPORATION
IN SECURITISED
PRODUCTS:
THE CHALLENGES
AHEAD

THE SIX PRINCIPLES

PREAMBLE TO THE PRINCIPLES

As institutional investors, we have a duty to act in the best long-term interests of our beneficiaries. In this fiduciary role, we believe that environmental, social, and governance (ESG) issues can affect the performance of investment portfolios (to varying degrees across companies, sectors, regions, asset classes and through time). We also recognise that applying these Principles may better align investors with broader objectives of society. Therefore, where consistent with our fiduciary responsibilities, we commit to the following:

- 1 We will incorporate ESG issues into investment analysis and decision-making processes.
- 2 We will be active owners and incorporate ESG issues into our ownership policies and practices.
- 3 We will seek appropriate disclosure on ESG issues by the entities in which we invest.
- 4 We will promote acceptance and implementation of the Principles within the investment industry.
- 5 We will work together to enhance our effectiveness in implementing the Principles.
- 6 We will each report on our activities and progress towards implementing the Principles.



PRI's MISSION

We believe that an economically efficient, sustainable global financial system is a necessity for long-term value creation. Such a system will reward long-term, responsible investment and benefit the environment and society as a whole.

The PRI will work to achieve this sustainable global financial system by encouraging adoption of the Principles and collaboration on their implementation; by fostering good governance, integrity and accountability; and by addressing obstacles to a sustainable financial system that lie within market practices, structures and regulation.

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- Fatima Hadj, Responsible for ESG in Securitised Products and Private Debt, DWS Group
- Robert McDonough, Director of ESG and Regulatory Initiatives, Angel Oak Capital Advisors
- Luka Miodragovic, Portfolio Manager, BlueBay Asset Management
- Tina De Baere, Head of ESG and Macro Strategy, Cairn Capital
- Steve Ezzes, Managing Director, Newmarket Capital
- Laurence Kubli, Portfolio Manager, Muzinich & Co
- Brian McNamara, Managing Director, MacKay Shields
- John Di Paolo, Principal, PGIM Fixed Income
- Elizabeth Crawford, Portfolio manager, Co-Head of Securitised Products, TCW

The following individuals were interviewed for this report or contributed to its analysis:

- Kevin Lennon, Head of European Credit Research, Alcentra
- Deborah Shire, Head, Structured Finance, AXA Investment Managers
- Serge Dema, Head of CLO Investments, Structured Finance Division, AXA Investment Managers
- Xavier Boucher, Head of Corporate & Leveraged Loans, AXA Investment Managers
- Janet Oram, Head of European ABS, BlackRock
- Sean Brooks, Mortgage Backed Security Analyst, Brandywine Global Investment Management
- John Bastoni, Securitised Products Trader, Breckinridge Capital Advisors
- Robert Fernandez, Director of ESG Research, Breckinridge Capital Advisors
- Timothy Coffin, Director of Sustainability, Breckinridge Capital Advisors
- Lily Wang, CFA, Director, Deutsche Bank
- Desiree Fixler, Group Sustainability Officer, DWS, formerly Head of Impact Investing, ZAIS Group
- Murray Birt, ESG Strategist, DWS
- Kevin Petrovcik, Managing Director, Invesco
- Matthew O'Sullivan, Head of Asia Pacific Origination, M&G
- Stephen Liberatore, CFA, Portfolio Manager, Head of ESG/Impact, Global Fixed Income, Nuveen
- Alessia Falsarone, Head of Sustainable Investing, Fixed Income, PineBridge Investments
- Henry Huang, Portfolio Manager, Structured Products, PineBridge Investments
- Olga Chernova, CIO, Sancus Capital Management
- Peter Hajjar, Head of Cash and Structured Credit Research, State Street Global Advisors
- Eric Arentsen, formerly Managing Director, Fixed Income, TCW Group
- Mark Hsu, Lead Structured Products Analyst, Multi-Sector Fixed Income - Investment Grade, Wells Fargo Asset Management
- Matthew Grimes, CFA, Head of Money Market Credit, Wells Fargo Asset Management
- Tom Lyons, Head of Climate Change Investment Research, Wells Fargo Asset Management
- Greg Handler, CFA, Co-Head of Mortgage and Consumer Credit, Western Asset Management

EXECUTIVE SUMMARY

ESG incorporation in securitised products lags other fixed income sub-asset classes and is in its infancy – largely due to the complex nature of the market. However, investor interest is growing.

The discussion is quickly evolving from *why* to *how*, as investors grapple with two problems:

- (1) building a rigorous framework for assessing ESG factors in mainstream securitised products and enhancing credit risk assessment beyond traditional fundamental analysis;
- (2) promoting standards within the nascent ESG securitisation market – as attested by the rising number of ESG-labelled securitised products¹ – to ensure its veracity.

- **Negative screening remains the most widely adopted incorporation approach for European ESG-labelled Collateralised Loan Obligations (CLOs).** The legal documentation accompanying them is not harmonised; CLO managers’ ESG evaluation processes are vague; and – for now – little price differential versus mainstream products exists.
- **The securitisation market is fast evolving across other products³ too, with increasing green, social and sustainability issuance.** Many deals refer to the International Capital Market Association’s green, social and sustainable principles, respectively, or the United Nations Sustainable Development Goals.
- **A lack of adequate data to conduct ESG due diligence** is the main challenge preventing many investors from systematically integrating ESG factors in their securitised products analysis.

KEY REPORT FINDINGS

- **Client demand, risk management and a desire to have a more positive environmental and societal impact** are driving ESG considerations in securitised products.
- **Regulation is also influencing investor behaviour**, as lawmakers focus on improving ESG disclosure and standardisation throughout financial markets. Although most changes are occurring in Europe, investors are also monitoring other regions, including the United States.²
- **Investors’ fixed income ESG policies are expanding, but they are not tailored to securitised products.** Most investors are exploring how they can adapt and apply the ESG incorporation practices used with other types of debt instruments to these products.

The report’s evidence is focused on CLOs. It is easier to scrutinise the ESG factors relevant to their underlying corporate loans than to the various loans that are linked to RMBS, CMBS and ABS, despite the latter products occupying the larger market share.

The PRI will continue to test these findings within the industry and broaden our regional analysis, as the importance of securitised products in sustainable finance is likely to grow. We intend to focus more on RMBS, CMBS and ABS and will expand our research to credit rating agency (CRA) practices. Finally, we will facilitate investor engagement with several stakeholders, including banks, CRAs, ESG information providers, legal counsellors and arrangers.

ESG information wanted by investors

CLOs	CMBS	RMBS and ABS
<ul style="list-style-type: none"> ■ CLO manager corporate governance information and information on how ESG issues are managed in its business operations ■ Stricter exclusion criteria ■ More disclosure on CLO manager’s commitments, which should be more stringent ■ More information on underlying loans and corporate borrowers ■ Increased CLO manager ESG data disclosures in trustee portfolio reports 	<ul style="list-style-type: none"> ■ Sponsor ESG information in deal documentation ■ Marketing materials should include how originators address ESG issues in loan underwriting processes ■ Deal documentation should highlight how environmental risks, including climate change, can affect underlying properties 	<ul style="list-style-type: none"> ■ Marketing materials should include how originators address ESG issues in loan underwriting processes ■ Deal documentation should be complete and address potential ESG concerns in how servicers operate ■ Deal documentation should include specific ESG risks that could affect transactions ■ Portfolio files should feature environmental information on underlying assets

1 Strictly speaking ESG-labelled CLOs do not exist but this has become a widely used term in the industry and by the media, referring to CLOs that exclude certain industries based on selected ESG criteria.

2 See [Appendix 2](#) for more detail.

3 Such as asset-backed securities (ABS), residential and commercial mortgage-backed securities (RMBS and CMBS respectively).

FOREWORD

The Securitised Products Advisory Committee (SPAC), which I chair, was convened at the start of 2020. The interviews that form the basis of this report were conducted in the spring of that year (that is, at the onset of the COVID-19 pandemic).

Since then, two major factors have escalated the importance of ESG issues on the agenda of securitised product investors:

- The pandemic has significantly boosted corporate funding needs that bank loans, by themselves, cannot fully meet. It has also increased the focus on social risks, including scrutiny of how lenders treat borrowers.
- The regulatory landscape continues to evolve, with rapid changes occurring primarily in the European Union, which is targeting an ambitious 55% reduction of greenhouse gas emissions by 2030, in China, which aims to become carbon neutral before 2060, and in the US, with the new administration re-joining the Paris Agreement.

These factors have raised the urgency of addressing the industry shortfalls that this paper highlights. Securitised products will have an important role in financing the post-COVID-19 recovery, especially supporting small- and medium-sized companies and lending to consumers at all points of the credit spectrum.⁴ Indeed, the EU authorities' COVID-19 response package includes regulatory amendments to facilitate increased securitisation, recognising that soundly structured securitised products can diversify economic funding whilst freeing up banks' non-performing loan exposures.⁵

Furthermore, institutional investors will have to establish detailed strategies and transitional frameworks to decarbonise their portfolios and meet increasing disclosure requirements. For them to do so successfully, engagement between investors and other stakeholders must improve, starting with the banking sector, to define and harmonise ESG loan criteria.



Fatima Hadj

Chair, PRI Securitised Products Advisory Committee
Responsible for ESG in Securitised Products and
Private Debt, DWS Group

Finally, on a personal note, I would like to advocate for more gender diversity across all stages of the securitised products chain, including at the borrower, originator, portfolio manager and investor level.

It has been a privilege for me to chair the SPAC's work and I thank my committee colleagues for their collaboration and the PRI for its guidance.

⁴ ICMA (2016) [The importance of securitisation for jobs and growth in Europe](#), and the Council and Parliament of the European Union (2017) [Securitisation: improving the financing of the EU economy](#).

⁵ European Commission [Securitisation](#), and European Commission (2020) [Coronavirus response: Making capital market work for Europe's recovery](#).

ABOUT THIS PAPER

This report explores to what extent investors consider ESG factors when investing in securitised products. It highlights current market practices and the hurdles that need to be addressed for ESG factors to be considered more systematically in the risk assessment and pricing of these products and their underlying assets.

It adds to the fixed income work that the PRI started in 2013, which has expanded from looking at ESG incorporation in corporate and sovereign bonds to private and sub-sovereign debt.⁶

The report focuses on US and European securitised products, whose underlying assets are loans or other types of credit instruments that generate future cash flows, and to which most PRI signatories that report on their investment activities in this asset class have exposure.

It does not cover products that are linked to commodities or financial assets such as equities, security indices, interest rates, foreign currencies and synthetic securitisations.⁷ Readers looking to familiarise themselves with private debt more broadly should refer to the PRI's 2019 report, [Spotlight on responsible investment in private debt](#). Anyone new to responsible investment concepts should refer to the PRI's series of guides, [An introduction to responsible investment](#).

The paper draws on the experience of advisory committee members and other market participants that were interviewed about their ESG incorporation practices by The Smart Cube (TSC), a consultant appointed by the PRI that also contributed to desk-based research.⁸

6 The PRI's fixed income resources can be found at www.unpri.org/fi.

7 These represent a fraction of the market and have diminished significantly since the global financial crisis and the sub-prime mortgage scandal.

8 [Appendix 1](#) contains the questionnaire that was used to conduct the interviews.

OVERVIEW OF SECURITISED PRODUCTS MARKET

KEY MESSAGES

- ESG incorporation in securitised products significantly lags other fixed income sub-asset classes.
- The market is evolving with the emergence of ESG-labelled securitised products: European ESG CLOs have proliferated, while the green, social and sustainability-labelled issuance of other products is also developing.
- Investors are looking at how to build frameworks to assess ESG factors across all securitised products and to determine whether ESG-labelled securitised products are genuine.

Through [Principles 1 and 3](#), PRI signatories commit to incorporating ESG issues into their investment decision-making processes, as well as seeking appropriate disclosures from investee entities.

They do so to improve the risk management of their investments, to meet the long-term interests of their beneficiaries and to be better aligned with broader societal objectives.

However, ESG incorporation in securitised products significantly lags other fixed income sub-asset classes and is in its infancy (see Figure 1), largely due to the complex nature of the market.

While investors are aware of how important responsible investment is overall, they are grappling with two problems:

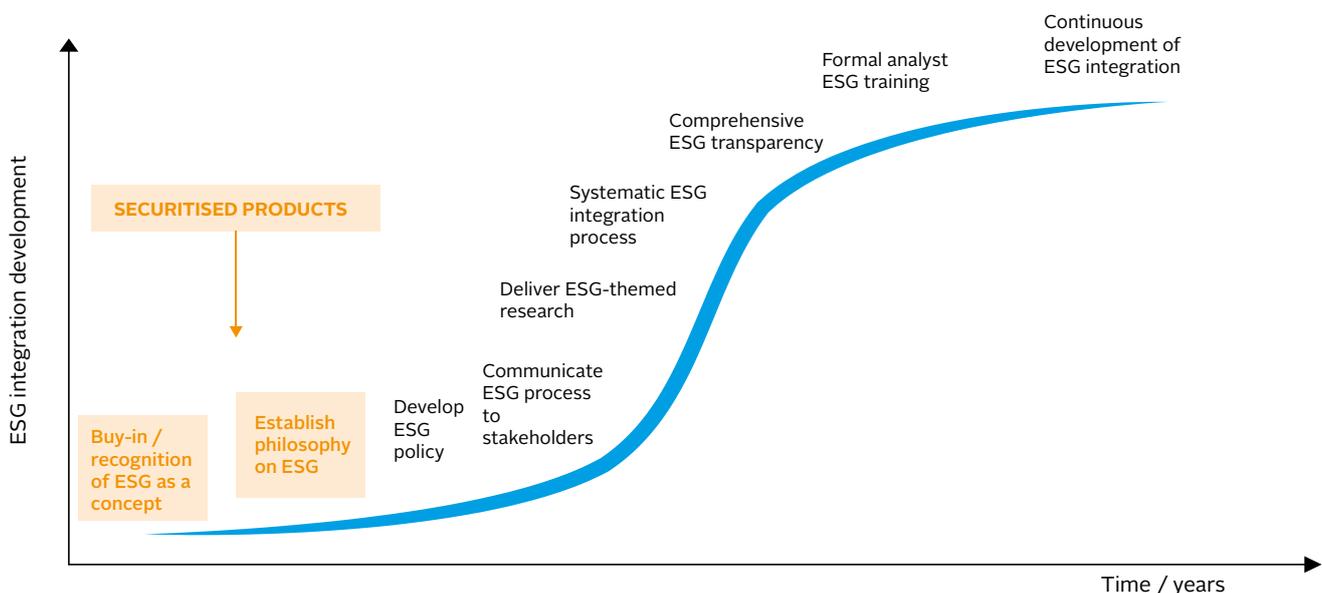
- (1) How to build a rigorous framework for assessing ESG factors in mainstream securitised products and enhancing credit risk assessment beyond traditional fundamental analysis.

- (2) How to promote standards within the nascent ESG securitisation market (as attested by the rising number of ESG-labelled securitised products that have emerged in the last three years – discussed in the *Market size and development* section) to ensure its veracity.

The underlying assets linked to securitised products can vary significantly, from residential and commercial mortgages (RMBS and CMBS, respectively), to pools of corporate loans (CLOs) or consumer products, such as auto loans and credit card receivables, also known as asset-backed securities (ABS).

Some, such as specific corporate borrowers, can be easily scrutinised for ESG factors. Conversely, for loans to large numbers of individuals or non-homogeneous borrowers – in the case of RMBS, CMBS and ABS – it is more difficult, despite these accounting for the largest market share.

Figure 1: ESG incorporation in securitised products is in its infancy



MARKET SIZE AND DEVELOPMENT

Securitized products have existed since the 1970s, when US government-backed agencies started to repackage and sell off pools of residential mortgages. The market has evolved significantly since then; diversifying across developed and emerging geographies and experiencing various swings in popularity.

The US securitized product market is the largest in the world, accounting for over 25% of the country's fixed income market. As of 30 November 2020, it was worth US\$12.4 trillion, as measured by outstanding issuance, with agency-issued MBS⁹ accounting for the largest share within that (see Figure 2).

Figure 2: US securitized product market breakdown – total outstanding bonds as of 30 November 2020. Source: Securities Industry and Financial Markets Association

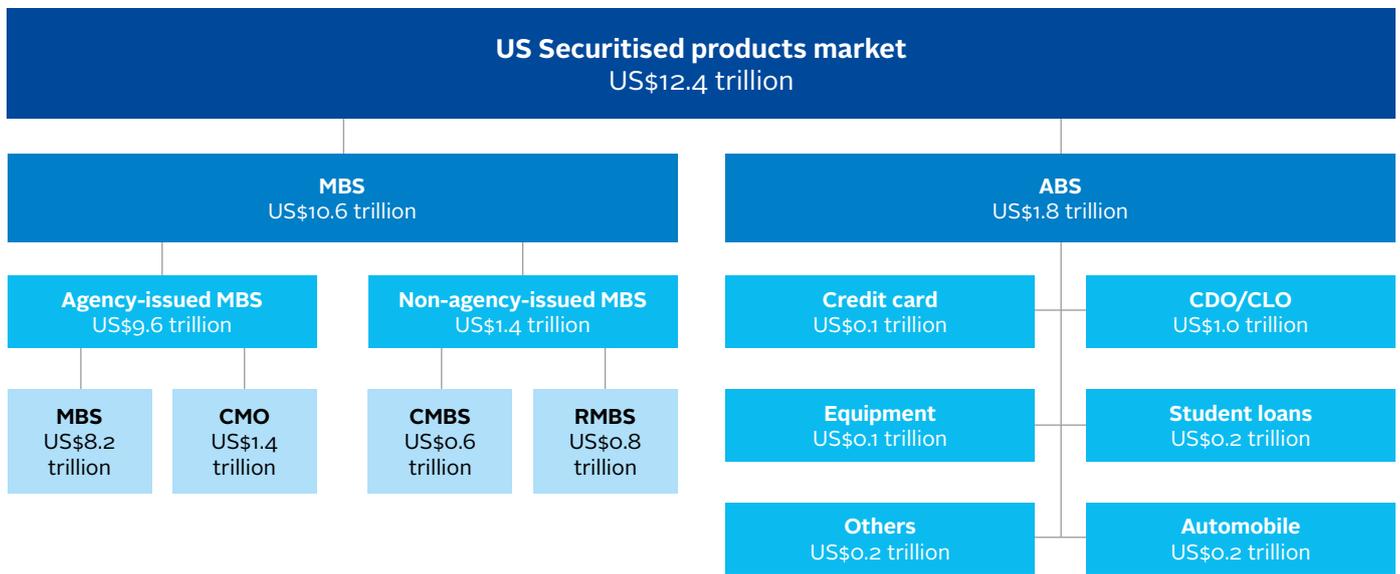
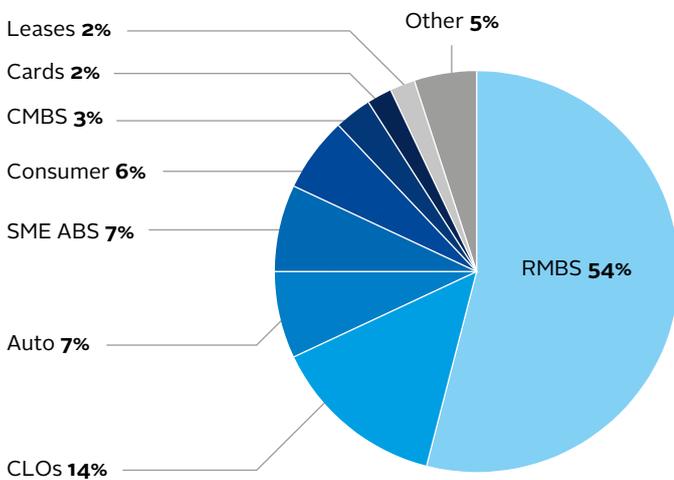


Figure 3: European securitized products market breakdown – total outstanding bonds as of 30 September 2020. Sources: Multiple¹⁰



By comparison, the European securitized product market was worth €1.1 trillion (US\$1.3 trillion) as of 30 September 2020 (see Figure 3).

⁹ Securities that are issued by US government agencies such as Fannie Mae, Freddie Mac, and Ginnie Mae.

¹⁰ Association for Financial Markets in Europe, Citigroup

Since the global financial crisis, new issuance has contracted, but the market has also transformed significantly, with changes that have important governance implications. New regulation has led to increased disclosure requirements for investors, greater credit support at each tranche level, stricter underwriting criteria for underlying collateral and reduced use of pro-forma underwriting. Collectively, these changes have significantly improved investor protection and transparency.

Over the last few years, ESG-labelled securitised products have also started to emerge. Since the first issuance in March 2018, European ESG CLOs have proliferated (see Figure 4), while the green, social and sustainability-labelled issuance of other securitised products has developed more recently across different jurisdictions (see Figure 5). We analyse some of these products later in the report – see [Evidence from European CLOs](#).

Figure 4: European ESG CLOs. Sources: Multiple¹¹

Pricing date	CLO name	CLO manager	Arranging bank	Ticker
01.03.18	Providus CLO I	Permira Debt Managers Group Holdings Ltd	Bank of America Merrill Lynch	PRVD 1X
09.11.18	Providus CLO II	Permira Debt Managers	Morgan Stanley & Co. International plc	PRVD 2X
05.04.19	Bardin Hill Loan Advisors European Funding 2019-1	Bardin Hill Loan Advisors (UK) LLP	Bank of America Merrill Lynch	BHLAE 2019-1X
06.06.19	Fair Oaks Loan Funding I	Fair Oaks Capital Ltd	Deutsche Bank AG	FOAKS 1X
27.06.19	Providus CLO III	Permira Debt Managers	Bank of America Merrill Lynch	PRVD 3X
13.07.19	Toro European CLO 6	Chenavari Credit Partners LLP	Morgan Stanley & Co. International Plc	TCLO 6X
19.07.19	Tikehau CLO V	Tikehau Capital Europe Ltd	Natixis	TIKEH 5X
07.10.19	Rockford Tower Europe 2019-1	Rockford Tower Capital Management LLC	Citigroup Global Markets Ltd	RFTE 2019- 1X
24.10.19	Capital Four CLO I	Capital Four CLO Management K/S	Goldman Sachs International	CFOUR 1X
18.11.19	North Westerly VI	NIBC Bank N.V.	Mitsubishi UFJ Financial Group	NWEST VI-X
28.01.20	Penta CLO 7	Partners Group (UK) Management Ltd	Goldman Sachs International	PIPK20194A
27.04.20	Providus CLO IV	Permira Debt Managers Group Holdings Ltd	Citigroup Global Markets Ltd	PRVD 4X
05.05.20	Bilbao CLO III	Guggenheim Partners Europe Ltd	Citigroup Global Markets Ltd	BILB 3X
14.05.20	Fair Oaks Loan Funding II	Fair Oaks Capital Ltd	J.P. Morgan Securities plc	FOAKS 2X
15.06.20	BBAM European CLO I	BlueBay Asset Management LLP	Credit Suisse Securities (Europe) Ltd	BBAME
31.07.20	Contego CLO VIII	Five Arrows Managers (a Rothschild group company)	Citigroup Global Markets Ltd	CONTE 8X

¹¹ Bloomberg, offering circulars, information subscription services

Figure 5: Other types of ESG-labelled securitised products. Sources: Multiple¹²

Issue date	Profile	Type	Deal name	Deal ticker	Sponsor
30-Jun-16	Green	EUR RMBS	Green Storm 2016	STORM 2016-GRN*	Obvion
01-Jun-19	Green	USD Agency CMBS	Freddie Mac Structured Pass-Through Certificates, Series K-G01	FREMF KGo1*	Freddie Mac
07-Nov-19	Green	AUD RMBS	Pepper Residential Securities Trust No. 25	PEPAU 25X A1GE*	Pepper
06-Feb-20	Green	EUR CMBS	River Green Finance 2019	RGRNF 2020-1	LRC Real Estate Limited
23-Oct-20	Social	GBP CMBS	Sage AR Funding No. 1	SGSHR 1X	Sage Housing (Blackstone majority-owned)
01-Nov-20	Green	USD CMBS	COMM 2020-CX Mortgage Trust	COMM 2020-CX	DivcoWest and CalSTRS JV
01-Jan-21	Green	USD Agency MBS	Fannie Mae Pool # CA8957 3.06% 30yr	FN CA8957*	Fannie Mae
01-Jan-21	Sustainable	USD Agency CMBS	Fannie Mae Multifamily REMIC Trust 2021-M1s	FNA 2021-M1S*	Fannie Mae
24-Feb-21	Social	GBP RMBS	Gemgarto 2021-1	GMG 2021-1X	Kensington

*Multiple deals issued and/or part of a broader issuance programme.

DEVELOPING HOLISTIC RISK ASSESSMENT

For ESG incorporation in securitised products to be effective, a holistic, multi-pronged approach needs to be developed. It needs to account for their complexity – such as having one transaction party occupying multiple roles (e.g. servicer and originator), or funding private entities, which tend to be less transparent (see Figure 6).¹³

Such an approach would include weighing the underlying assets against environmental and social impacts, while also considering an issuer's governance practices and the securitisation documents (see Figure 7).

More transparency is needed throughout the investment chain so that investors have the necessary information to perform robust due diligence on securitised products – whether ESG-labelled or not – and can assess how aligned they are with their portfolio objectives and investment strategies (see Figure 8).

“We look very carefully into the originator, the servicer and the various transaction counterparties, as part of our fundamental analysis.”

European investment manager

¹² Bloomberg, Intex, marketing materials, rating agency presale reports

¹³ See FTSE Russell (2020) [ESG taxonomy for securitised products](#), and PWC Luxembourg (2020) [Parties involved in securitisation transactions](#).

Figure 6: Simplified multi-pronged ESG assessment in securitised products

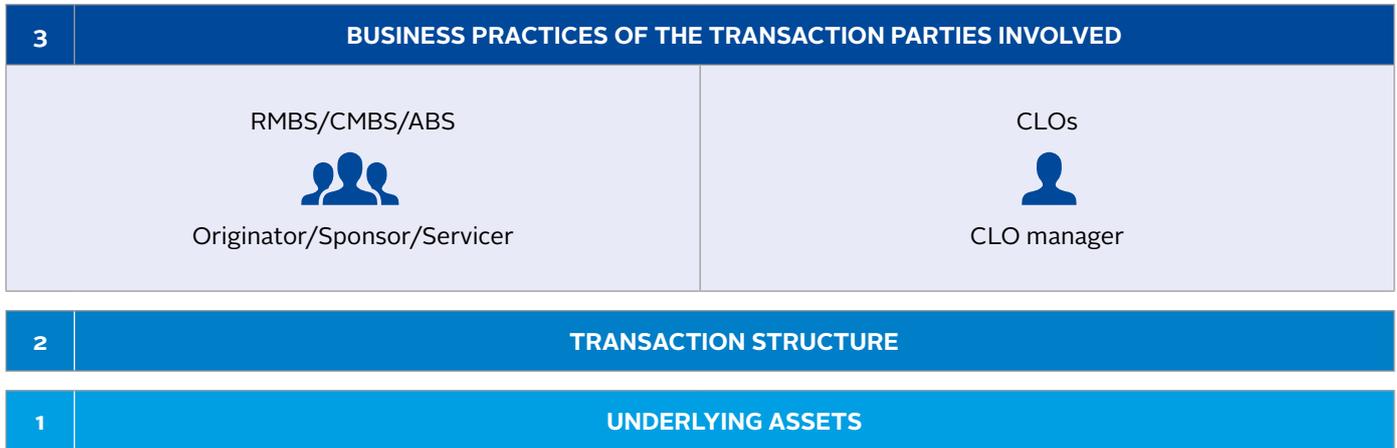


Figure 7: ESG factors that can impact securitised products

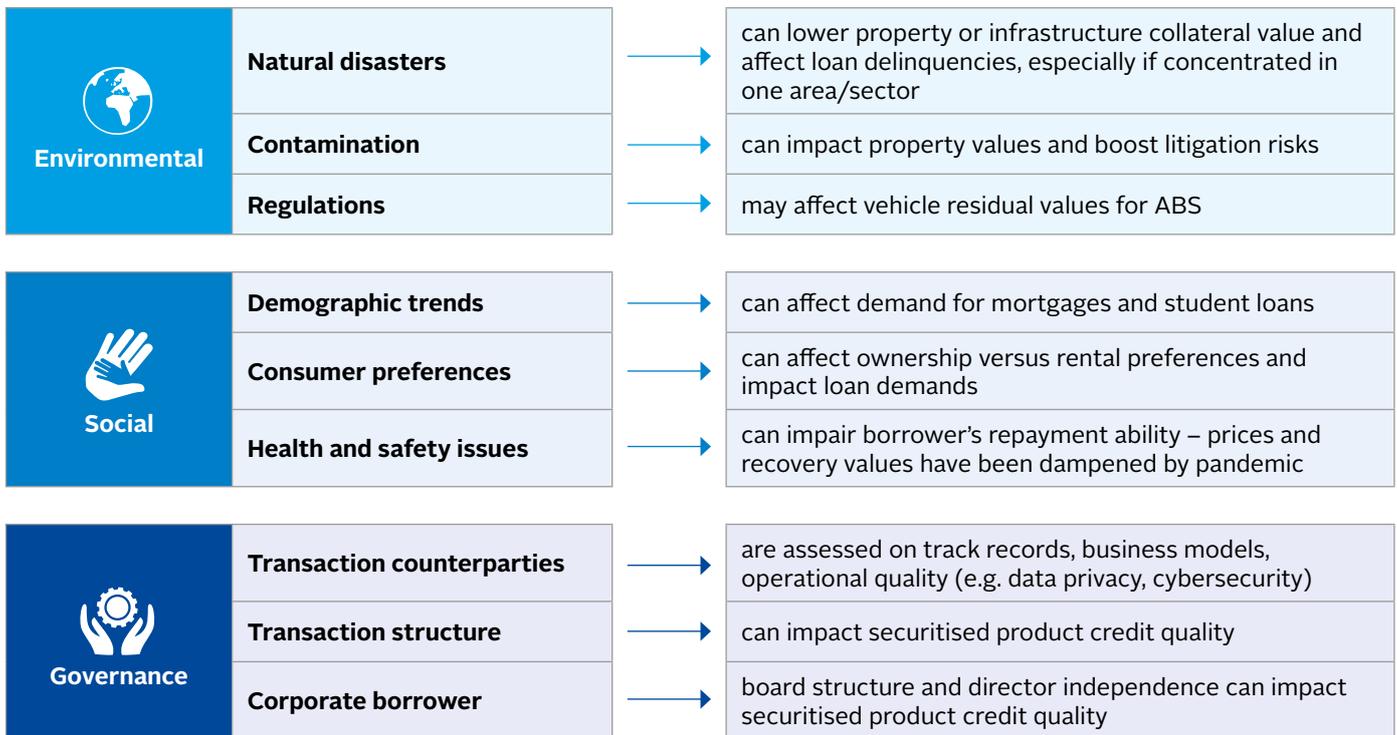
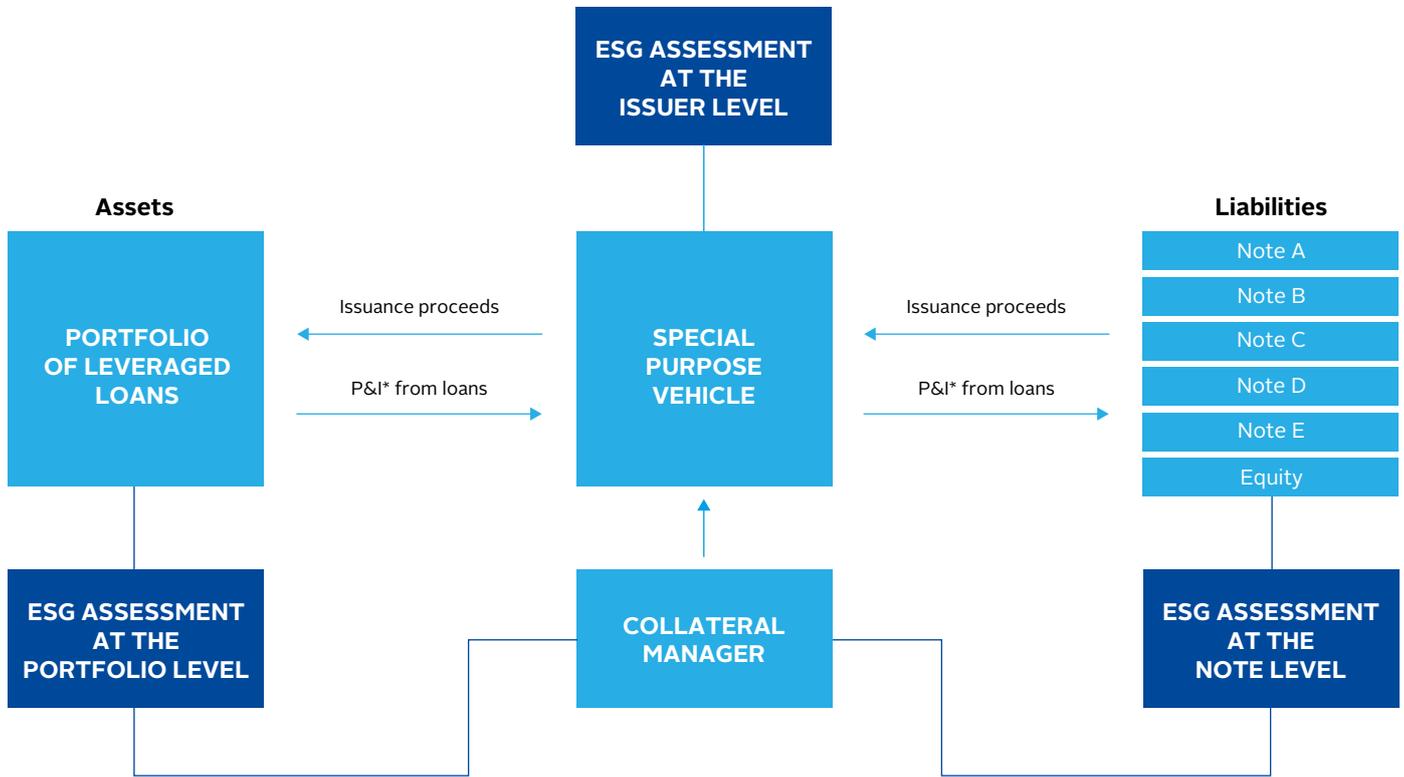


Figure 8: ESG assessment in the CLO structure



* Principal and Interest

CURRENT ESG PRACTICES

KEY MESSAGES

- Firms' ESG policies are increasing but few are tailored to securitised products.
- Client demand, risk management and the desire to have a positive impact are driving investors to start considering ESG factors more systematically in their investment processes.
- Regulation in Europe is another driver but changes in the US and elsewhere are also on investors' radars.
- There is no meaningful price differentiation between mainstream and ESG CLOs for now.
- Credit rating agencies have started signposting ESG factors in their securitised product rating opinions, but investors note that this needs to improve further.

This section highlights current ESG practices among securitised product investors, based on PRI signatory reporting data and interviews with advisory committee members and other market participants. It focuses largely on the European CLO market. It also briefly addresses the role that credit rating agencies play in securitised product investments.

COMMON ESG APPROACHES ACCORDING TO PRI REPORTING

Among PRI signatories, the AUM invested in securitised products has nearly doubled over recent years, from US\$2.6 trillion in 2016 to US\$4.8 trillion in 2020, but it remains a small share of the overall fixed income assets they report on, which totalled US\$44.4 trillion as of 31 March 2020 (see Figures 9 and 10).

Figure 9: Signatory assets invested in securitised products

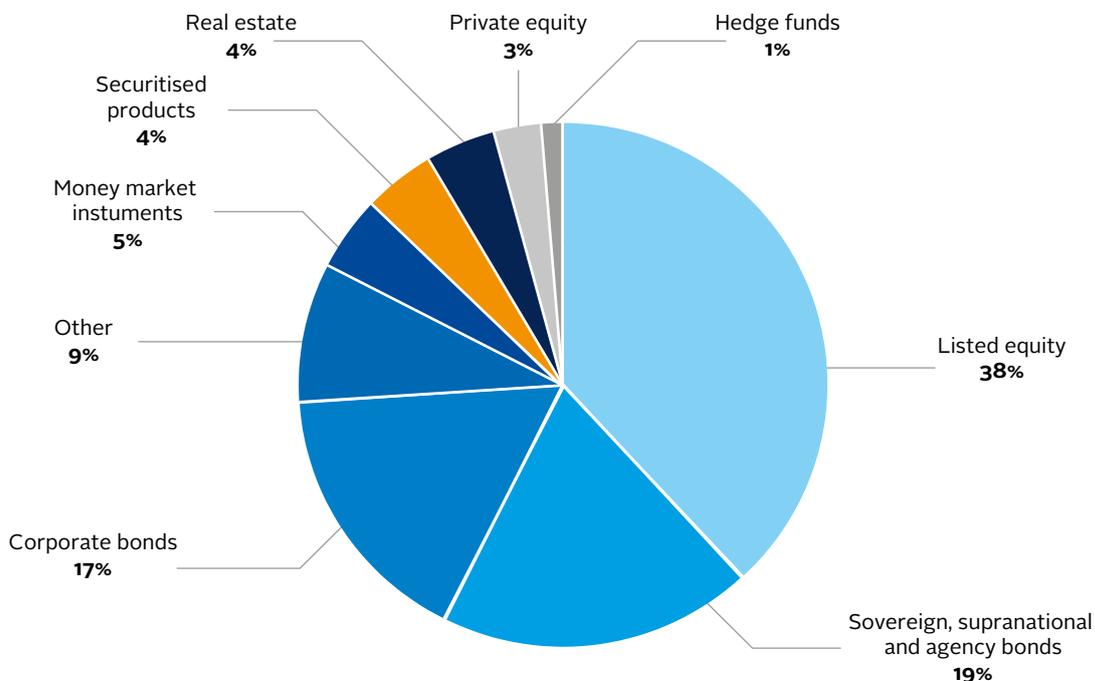
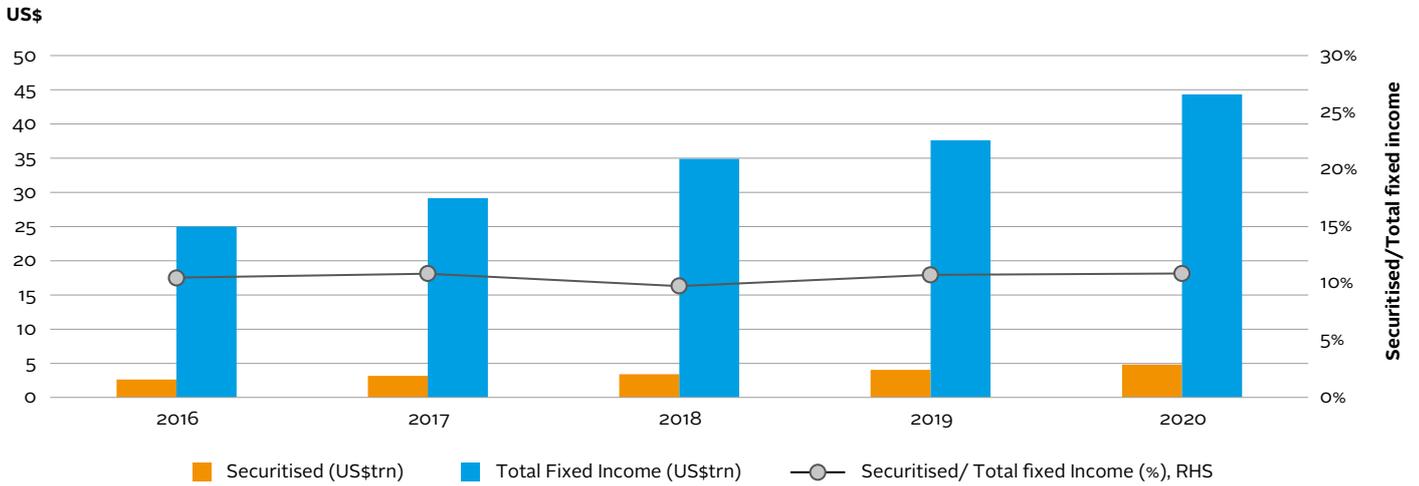


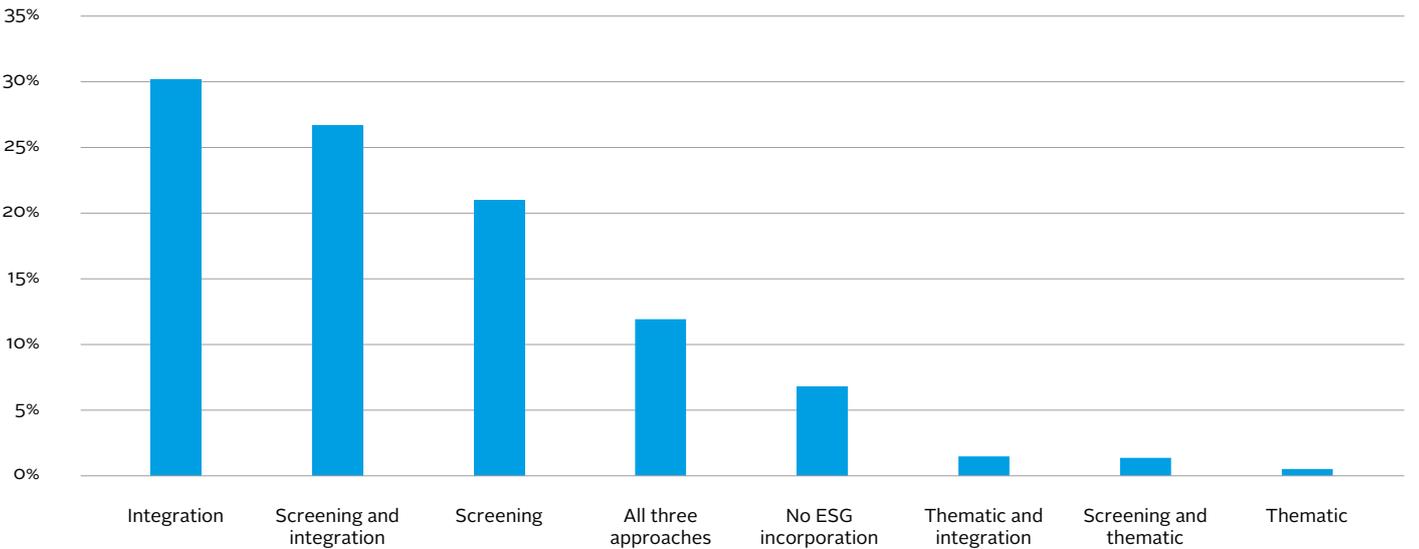
Figure 10: Signatory assets invested in securitised products vs fixed income



Of the 2000 signatories that reported on their investment activities to the PRI in 2020, only 215 indicated how they incorporate ESG factors into their securitised product investments.¹⁴ Integration and screening approaches – either alone or in combination – were the most popular (see Figure 11).¹⁵

However, as signatories do not specify which securitised products (RMBS, CMBS, ABS or CLO investments) these approaches cover, it is difficult to determine whether this accurately reflects wider trends in this market.

Figure 11: ESG incorporation approaches reported by PRI signatories (based on 215 respondents)

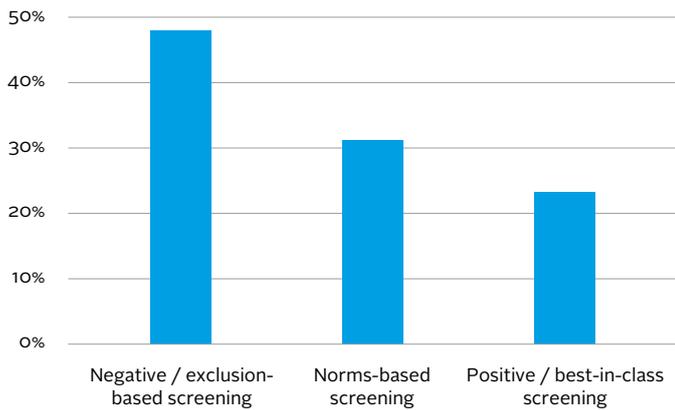


¹⁴ See <https://www.unpri.org/signatories/reporting-and-assessment> for more detail on the PRI's reporting and assessment processes.

¹⁵ Information on the terms and definitions used in the PRI's Reporting Framework can be found in the [glossary](#).

Almost half of the signatories that implement screening use a negative or an exclusion-based approach (see Figure 12), a trend also reflected in our interview findings.

Figure 12: Types of screening conducted for securitised products (based on 143 respondents)



INTERVIEW OBSERVATIONS

INTERVIEW PARTICIPANTS

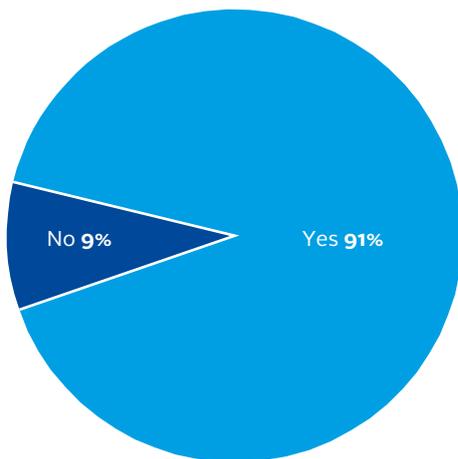
The Securitised Products Advisory Committee and 14 additional market experts were asked to share their current ESG practices and the challenges they face to further their responsible investment approaches. Unless stated otherwise, the questions received responses from 22 organisations of varying sizes. The interviews were conducted in early 2020. Participants are listed in the [Acknowledgments](#). The questionnaire can be found in [Appendix 1](#).

ESG INCORPORATION

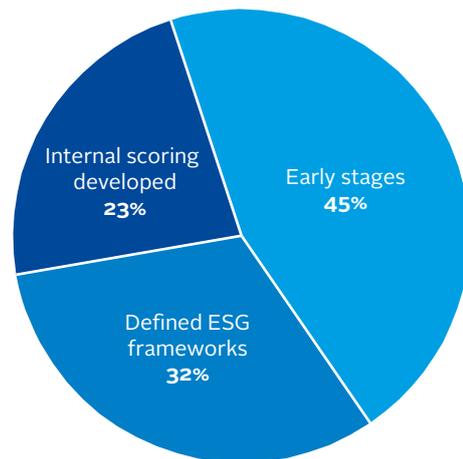
Around 90% of the participants indicated that they have started incorporating ESG factors into their investment decision-making processes systematically. However, this varies considerably in practice, as demonstrated in Figure 13.

Figure 13: Does your firm incorporate ESG factors in its assessment of securitised products?

Percentage of respondents that have started incorporating ESG factors systematically



Degree of systematic ESG incorporation



Whilst screening remains the most common ESG incorporation approach (see [Evidence from European ESG CLOs](#)), a few market practitioners have also started looking at ESG integration practices, such as:

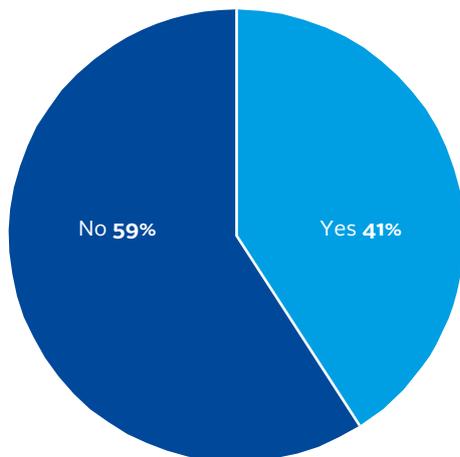
- embedding ESG factors into bottom-up, risk-reward assessments;
- modelling prepayment speeds using external climate risk data;
- conducting scenario analysis based on publicly available ESG data; and
- establishing internal ESG scoring frameworks.

DEDICATED ESG TEAM

Around 40% of participants have a dedicated team that assesses ESG factors across securitised products, while the majority have an investment team that incorporates ESG factors into traditional analysis (see Figure 14). Some indicated that having a dedicated team has merits, as it allows investment managers to better analyse a range of ESG information. However, the benefit of this arrangement depends on how well that team can influence the investment research and decision-making process.

Regardless of the approach taken, there is an increasing appreciation in the investment industry that ESG analysis can complement and enhance traditional fundamental analysis. The more advanced investment managers consulted are building their ESG capacity, recognising that analysts need to be better equipped and have more expertise.

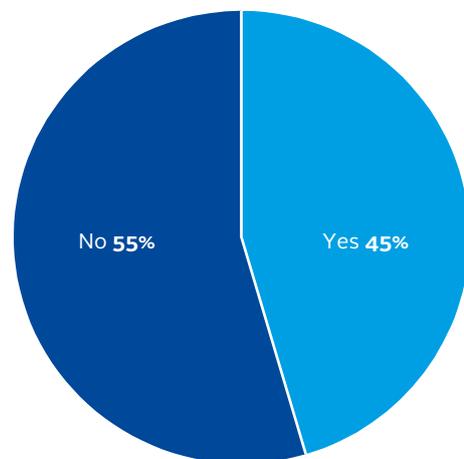
Figure 14: Does your firm have a dedicated ESG team?



PRODUCT-SPECIFIC ESG POLICIES

Most respondents have not yet established ESG frameworks that are tailored to securitised products. Some have developed ESG-focused principles at a firm level (see Figure 15), while others are exploring how they can adapt and apply some of the ESG incorporation practices used with other types of debt instruments.

Figure 15: Does your firm have a publicly available ESG policy?



Some investors are beginning to create review templates for securitised products to frame risk assessment in a more holistic way, thus laying the building blocks of a systematic ESG approach (see Figure 16). Others are starting to shape their analysis by addressing some of the questions listed in Figure 17.

Figure 16: Example of securitised credit ESG dashboard. Source: TCW

COMMON ELEMENTS OF SECURITISED CREDIT REVIEW	ESG CONSIDERATIONS		
	E	S	G
Sponsor (and/or issuer) business and background reviews			
Sponsor business model and operation			•
Sponsor experience and/or background		•	•
Sustainability of sponsor business model	•	•	•
Sponsor capitalisation review			•
Specific deal purpose	•	•	•
Lender origination practices, underwriting criteria and secured property			
Appropriateness of debt product and/or lending criteria		•	•
Origination approach		•	•
Lender underwriting policy		•	•
Broader lending consistency and/or underwriting exceptions		•	•
Clear title/security interest		•	•
Broader use of loan proceeds		•	•
Secured property quality and sustainability	•	•	•
Review debt repayment/refinancing ability		•	•
Appropriate insurance	•	•	•
Environmental reviews and/or inspections complete	•		
Any respective mitigating factors for exceptions	•	•	•
Prudent valuations		•	•
Business practice related to positive/negative environmental screening	•		
Securitisation deal structure and transaction parties			
Special purpose vehicle			•
Roles and responsibilities of transaction participants			•
Risk retention requirements met			•
Structured credit protections			•
Unique structural features			•
Appropriate environmental risk disclosures	•		
Pool diversification and/or specific geographic risks	•		
Financial reporting requirements			•
Structure and cash flow waterfall			•
Representations and warranties			•
Servicer quality and background		•	•
Servicing standards		•	•
Servicer relationship to deal parties and/or any conflicts of interest		•	•
Additional investor action reviews			
Investor questions about originations to accommodate green lending	•	•	•
Investor questions about servicing practices		•	•
Review rating agency reports	•	•	•
Other			
Considerations not listed above	•	•	•

Figure 17: Sample questions included in ESG review template for securitised products

 Environment	Do underlying assets give rise to or face heightened environmental impact and risk?
	Do underlying assets have positive environmental benefits?
 Social	Do originators underwrite loans based on ability to repay or for excessive profit?
	Are origination practices biased towards any group?
	Do underlying assets have social benefits?
	Do underlying assets serve disadvantaged communities?
	Has the originator conducted a formal third-party disparate impact ¹⁶ study?
	Is the collateral pool diversified by industry and geography?
 Governance	Is servicer staffing adequate to meet borrowers' needs? How are staff trained and compensated?
	Is the governance structure properly documented?
	Does the securitisation structure and related transaction documentation provide adequate investor protection?
	Is there appropriate oversight and administration by an independent trustee and auditor?
	Does the trustee provide accurate, timely and detailed reporting of collateral performance, debt repayment and structural functioning?

DRIVERS OF ESG INCORPORATION

Although ESG incorporation in securitised products has significantly lagged other fixed income asset classes, the gap may close relatively quickly in the coming months.

PRI signatories' broader understanding of responsible investment practices continues to grow, while the number of resources available to facilitate ESG incorporation in debt instruments is increasing (see [Next steps](#) for more detail).

Mirroring the corporate and sovereign bond space, many interview participants¹⁸ acknowledged that they already include some governance factors in their risk analysis and are now being driven to consider ESG factors more explicitly in their investment processes due to:

- client demand;
- risk management;
- a desire to have a more positive environmental and societal impact; and
- regulation.

Client demand

Just over 50% of interview participants said retail and institutional investors are increasingly seeking securitised products with ESG credentials, echoing a trend seen in equity and fixed income markets a few years ago, where client demand led to a broader uptake of ESG incorporation¹⁹.

“The investment management industry is not going to invest [resources] in a product that has no demand. We can put more internal resources into ESG products – including securitised products – if we know a group of clients is receptive [to them].”

US investment manager

¹⁶ Disparate impact is a US legal term referring to employment or educational practices that appear to be non-discriminatory but have a disproportionately negative effect on members of legally protected groups. See <https://www.britannica.com/topic/disparate-impact> for more detail.

¹⁷ For more detail on how PRI signatories have improved their responsible investment practices, see [The evolution of responsible investment: an analysis of advanced signatory practices](#).

¹⁸ This question was answered by 21 respondents. They were able to select multiple answers.

¹⁹ Morningstar (2021) [European Sustainable Funds Landscape: 2020 in Review](#)

Asset owners now expect investment managers to demonstrate how they are integrating ESG factors in their investment processes, reflected in due diligence questionnaires or requests for proposals that increasingly include dedicated ESG sections. This trend is likely to continue as more asset owners join industry wide ESG/ climate initiatives²⁰ and seek to develop and improve their own responsible investment practices.

Risk management

Nearly 50% of participants stated that risk management was driving them to start incorporating ESG factors into their investments. This is positive, as it suggests that ESG factors are no longer perceived as a constraint but are part of investment risk assessment. However, there is still room for improvement – as enhanced risk assessment that includes ESG considerations becomes a more integral part of securitised products analysis and as investors better appreciate the financial materiality of ESG risks. Furthermore, more data is becoming available, making ESG factors more quantifiable.

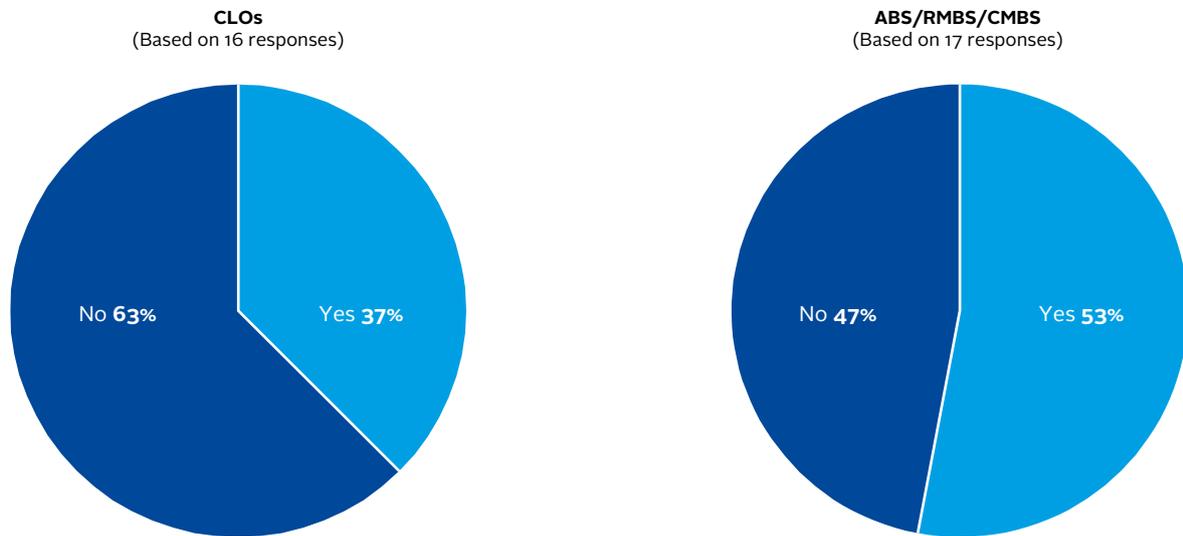
“We have a fiduciary responsibility to our investors to have and maintain the best risk assessment framework possible.”

US investment manager

Positive environmental and societal impact

Nearly 30% of participants said they want their investments to have a positive environmental and social impact. However, many stated that ESG issues did not impact whether an investment was made, particularly in relation to CLOs, where ESG factors are viewed as tail-risk events rather than forming a part of day-to-day investment decisions (see Figure 18).

Figure 18: Are investments rejected solely based on ESG criteria?



“We can help to put ESG factors on the radar of sponsors by making them part of the criteria considered during credit analysis. We do that in a constructive, not punitive, way – that is why we do not decline investments purely based on an ESG score.”

European investment manager

²⁰ For example, the [United Nations-convened Net-Zero Asset Owner Alliance](#), an initiative for asset owners that have committed to transitioning their investment portfolios to net-zero greenhouse gas emissions by 2050.

Regulation

Participants also cited regulation as a factor that is likely to become increasingly important among the drivers behind more systematic ESG incorporation.

Had we conducted our interviews at the start of 2021, regulation would have likely ranked higher. The first provisions of the [EU sustainability-related disclosures in the financial services sector regulation \(SFDR\)](#) came into force in March 2021, as part of the EU Commission's policy focus on sustainable finance and of the EU's ambition to be climate-neutral by 2050. Moreover, there are ongoing efforts at the national level.²¹ Although these regulatory changes are being spearheaded in Europe, their repercussions will have a wider reach, as all financial market participants wanting to operate in the EU will have to comply.

Participants are also monitoring other regions of the world, especially the United States, where the new administration has been sending positive signals regarding its approach to certain environmental and social issues²² (for more detail, see [Appendix 2](#)).

The ramifications of these developments for securitised products are unclear at this stage, but at the very least, they suggest that there could be more regulatory focus on ESG disclosure related to financial instruments.

EVIDENCE FROM EUROPEAN ESG CLOS

These observations relate to the European CLO market, which many interview participants focused on, as these products lend themselves better to the provision of ESG information, given they are linked to underlying corporate loans. We have supplemented these findings with an analysis of offering documents and a comparison of CLOs, conducted on our behalf by Deutsche Bank.²³

Use of negative screening

Many European CLO transactions use negative screening in the eligibility criteria for the underlying assets, overseen by the CLO manager.

Loans to obligors that are engaged in certain industries or activities – such as tobacco or arms – are excluded from these transactions, typically if they derive more than a certain percentage of revenues from such businesses. Maintaining a firm-level exclusion list, often derived from internal and client-driven criteria that can be further adjusted in individual investment cases, appears to be a common practice followed by CLO managers.

However, as exclusions in CLOs are mainly threshold-based, rather than following an absolute approach, it can be difficult to limit exposure to certain industries completely within multi-asset ESG fixed income funds that include securitised products.

CLO manager ESG evaluation processes

The interviews also revealed that investors rely significantly on CLO managers to conduct ESG due diligence, especially in the case of dynamic CLOs (i.e. those whose assets are actively managed on a discretionary basis). As they are responsible for selecting and purchasing loans and creating the capital structure of tranches (with varying risk and return expectations), it is important that CLO documentation is clear, to ensure the systematic incorporation of ESG factors in their investment decisions. A review of the final offering circulars for 16 European CLO transactions – known to include ESG features – from 12 CLO managers, priced between March 2018 and July 2020 (see [Figure 4, p.10](#)), revealed the following:

- Legal documents accompanying the CLO transactions were not standardised. In most cases only one or two key ESG terms were defined. In less than a handful they were extensively defined.
- Many transactions did not outline a specific ESG evaluation process by the CLO managers and the standard care for assessment was variable.
- Five transactions gave CLO managers discretion to *reasonably determine* whether they complied with ESG eligibility criteria, based on the information available to them. This could include considering environmental issues and factors such as the relevant obligor's ESG policy and track record. In another case, the CLO manager had *sole discretion* to determine compliance.
- When narratives offered investors some descriptions of CLO managers' ESG evaluation processes, they were generally vague.
- Apart from such evaluation processes and barring one other case (see [ESG CLOs: An exception below](#)), negative screening was generally the only ESG feature of the transactions, with the most excluded sectors listed in [Figure 19](#).
- Of the CLO transactions that set a revenue materiality threshold to determine what business activities to exclude, only two set the percentage exposure at a meaningful threshold of below 50% (at 10% and more than 30% respectively) – the other deals typically set it at over 50%.

21 For example, France conducted a consultation to tighten Article 29 on ESG and climate change reporting. See [Consultation on the decree under article 29 of the energy-climate law](#).

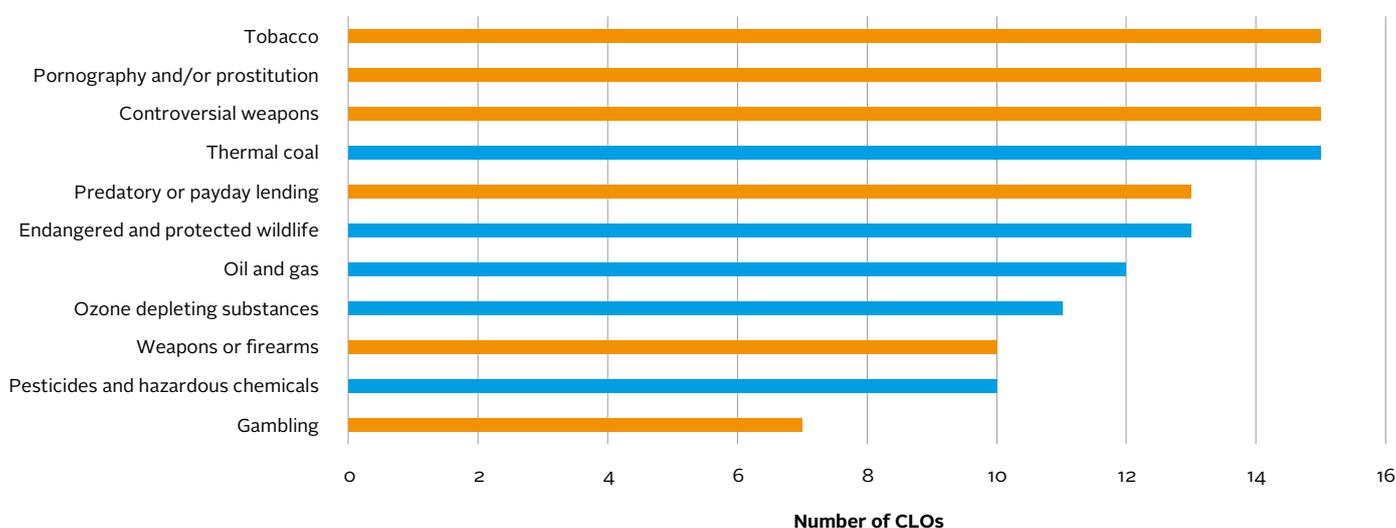
22 This is in stark contrast to the deregulation enacted by previous governments. For example, the removal of risk retention rules when the collateral for CLOs is acquired in the open market. See 9 February 2018 [US Court of Appeals for the District of Columbia Circuit decision](#) for more detail.

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ESG CLOs: AN EXCEPTION

One deal stood out because it added three ESG features to the industry exclusion criteria: diligence/asset monitoring, asset scoring and quarterly reporting. On asset scoring, the CLO manager had sole discretion to assign an ESG industry category and an ESG score to each collateral obligation, using an internal corporate and social responsibility toolkit and ESG checklist. Furthermore, the deal included an extensive description of the ESG approach taken by the CLO manager's overall firm.

Figure 19: Most excluded sectors by European CLOs. Source: Offering circulars



The blue and orange bar colours denote sectors that were excluded because of environmental and social factors respectively.

Lack of ESG premium

Another comparison of European ESG CLOs that were issued between March 2018 and August 2020 versus traditional CLOs, conducted by Deutsche Bank, shows no meaningful price differentiation between them.²⁴

There are potentially several reasons for this:

- The sectors that are excluded from the CLO pool represent a relatively small share of CLOs' investment universe – averaging just 3% according to a [report](#) by Moody's Investors Services – as the exclusion thresholds used are relatively high. Therefore, the portfolio construction for deals with ESG criteria is unlikely to be very different from the traditional European CLO universe.

- ESG criteria are not standardised, so a premium cannot be priced.
- For now, the ESG label refers to the presence of diverse screening criteria and does not link the CLOs to specific (and measurable) environmental or societal outcomes.

These are just preliminary findings, however, and should be interpreted with caution.²⁵

Even if a spread discount versus regular CLO transactions is not yet apparent in ESG CLOs, it may emerge going forward, driven by growing demand for ESG-focused funds and more managers embedding ESG factors within their investment processes. As deal structures become more sophisticated and use increasingly stringent criteria, investors may be willing to pay more for these products.

²⁴ Fifteen CLOs issued in that period mentioned ESG factors in their marketing or offering documents. Deutsche Bank compared the publicly available weighted average discount margin (WADM) of 13 ESG CLOs with the WADM of the 3-month cohort median, which did not show any meaningful price difference. To adjust for the deal age and to make relevant comparisons, they compared each deal to deals issued in the same month along with those issued one month before and after, thereby forming rolling 3-month cohorts for each deal.

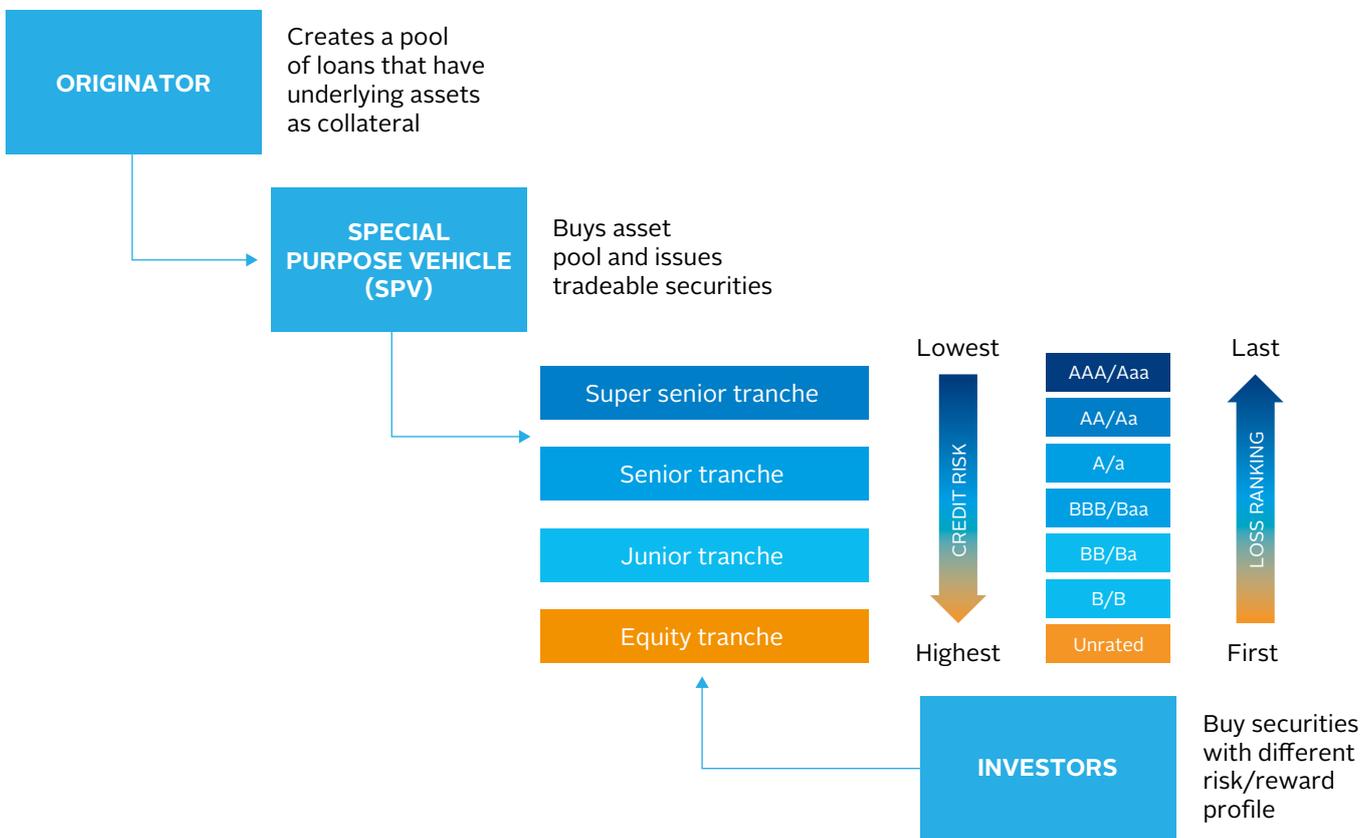
²⁵ The pricing difference is affected by which group the deal is compared with – if a static CLO or a CLO with a shorter reinvestment period was issued among CLOs with longer reinvestment periods in its 3-month cohort, it could appear to have a strong pricing benefit; or if a CLO was issued immediately after the market widened due to COVID-19 it could appear to have a pricing disadvantage. A CLO's WADM could be affected by several other factors not considered in the comparison, including its tenor, the credit enhancement level of the structure or the CLO manager's platform. The 3-month cohort can be constructed based on the pricing date or closing date – this comparison uses the pricing date. Deals that did not have a publicly available WADM were excluded.

CREDIT RATING AGENCIES

Credit rating agencies play an important role in securitised products. Their rating opinions shape the priority payment structure, which determines the order in which creditors would get paid in the event of default (see Figure 20). In turn, some investors may be limited to holding issuance of or above a certain credit rating – due to regulation (e.g. banks, pension and insurance funds), internal by-laws or portfolio hedging requirements.²⁶

CRAs have sharpened their ESG focus in recent years. Since its 2016 launch, 26 CRAs have supported the PRI's [ESG credit risk and ratings initiative](#), while market demand for greater clarity on whether ESG factors drive rating actions and European regulatory scrutiny have also increased.²⁷ Many CRAs have created sustainability teams to work with credit analysts and are expanding their resources and analytical tools – some through the acquisition of ESG data and service providers – to deepen their ESG research.

Figure 20: CRA ratings shape the payment structure of securitised products



However, participants noted that CRA coverage of ESG issues in credit ratings varies significantly across asset classes and is lagging for securitised products, compared to corporate or sovereign bonds. Moreover, most CRA efforts have so far focused on ABS, RMBS and CMBS, rather than on CLOs. Examples of how CRAs are including ESG factors in their securitised product credit risk assessments can be found in [Appendix 3](#).

The PRI will address the steps that CRAs have taken to clarify how ESG factors feature in their securitised product rating methodologies in a separate publication.

²⁶ Voxeu.org (2019) [Credit ratings and structured finance](#)

²⁷ European Securities and Markets Authority (2019) [ESMA advises on credit rating sustainability issues and sets disclosure requirements](#)

CHALLENGES

KEY MESSAGES

- The availability of adequate ESG data represents the main challenge to investors incorporating ESG factors in their securitised product credit assessments.
- Other challenges include the absence of ESG reporting standards for servicers/originators; the diverse pool of underlying assets; and a lack of securitised products coverage by ESG information providers.

Interview participants stated that the onus to investigate prevalent ESG issues in securitised products, particularly ABS, CMBS and RMBS, lies with them – the investment managers – rather than originators, sponsors or loan issuers. This makes the due diligence process cumbersome and difficult.

For responsible investment practices in securitised products to become more widespread, due diligence needs to be conducted throughout the investment chain.

Whether set by industry standards or defined by regulators, ESG parameters need to become deal-breakers, where a lack of adequate assessment by all transaction parties could lead to corporate liabilities, higher credit risk, restricted capital access for borrowers, and negative repercussions on asset valuations for asset owners and investment managers.

This relies on better information disclosure at all transaction levels, including obtaining ESG data on the underlying assets linked to securitised products, which represents a major challenge.

DATA COLLECTION

Practitioners consider the ESG information in current deal documentation, marketing materials and underlying portfolio disclosures insufficient to comprehensively analyse most securitised products.

The tables below highlight what ESG information is available and what investors are looking for, by product type, as well as some of the questions that they are starting to ask (see Figures 21 – 23).

“In securitised products, we see the data gaps everywhere. Many CLO managers, especially in developed markets, have started tracking data surrounding the questions we are asking, but they don’t necessarily give it to us right away as part of their regular disclosure.”

US investment manager

“We try to ascertain ESG-specific factors from the deal documents; however, there is not much standard ESG disclosure in these with respect to environmental and social factors.”

European investment manager

Figure 21: ESG information available to investors

CLOs	CMBS	RMBS and ABS
<ul style="list-style-type: none"> ▪ CLO documents detail the SPV's legal and deal structure, outlining payment priority, portfolio profile tests, collateral quality tests and coverage ▪ Exclusion lists ▪ Disclosures about CLO manager's ESG commitments ▪ Underlying loan portfolios provide an overview of industry exposures and single obligor concentrations ▪ Detailed portfolio reports by CLO trustees (usually monthly) 	<ul style="list-style-type: none"> ▪ Marketing materials usually cover detailed information on the deal sponsor, including its track record ▪ Deal documentation typically outlines structure and specifies deal triggers and tests to protect investors ▪ Underlying property information, including independent third-party valuations ▪ Portfolio-level summaries, valuation reports and due diligence reports undertaken by the arranger, which may identify ESG transaction risks ▪ Underlying portfolio files typically include key collateral characteristics, sometimes include borrower credit metrics 	<ul style="list-style-type: none"> ▪ Marketing materials outline the originator's underwriting criteria – including borrower income verification and affordability testing ▪ Deal documentation may include servicer's arrears policy and collection procedures, loan portfolio restrictions, deal triggers and tests to protect investors ▪ Underlying portfolio files typically include key collateral characteristics, sometimes include borrower credit metrics

Figure 22: ESG information wanted by investors

CLOs	CMBS	RMBS and ABS
<ul style="list-style-type: none"> ▪ CLO manager corporate governance information and information on how ESG issues are managed in its business operations ▪ Stricter exclusion criteria ▪ More disclosure on CLO manager's commitments, which should be more stringent ▪ More information on underlying loans and corporate borrowers ▪ Increased CLO manager ESG data disclosures in trustee portfolio reports 	<ul style="list-style-type: none"> ▪ Sponsor ESG information in deal documentation ▪ Marketing materials should include how originators address ESG issues in loan underwriting processes ▪ Deal documentation should highlight how environmental risks, including climate change, can affect underlying properties 	<ul style="list-style-type: none"> ▪ Marketing materials should include how originators address ESG issues in loan underwriting processes ▪ Deal documentation should be complete and address potential ESG concerns in how servicers operate ▪ Deal documentation should include specific ESG risks that could affect transactions ▪ Portfolio files should feature environmental information on underlying assets

Figure 23: Specific questions related to ESG incorporation by product type

CLOs	CMBS	RMBS and ABS
<ul style="list-style-type: none"> ■ Are ESG exclusion criteria used? ■ Does the CLO manager undertake engagement? ■ Does the CLO manager abide by international principles (e.g. the six Principles for Responsible Investment and the United Nations Global Compact)? ■ How does ESG integration affect portfolio credit selection? ■ When have credit holdings been declined for ESG reasons? ■ How are ESG risks monitored during the investment? ■ Is deal-specific ESG reporting provided post-investment? ■ How are roles and responsibilities regarding ESG issues organised within the CLO manager's company? ■ Does the CLO manager score obligors on ESG issues? ■ Has the CLO manager assessed the impact of climate change on the portfolio? 	<ul style="list-style-type: none"> ■ Do the underlying properties face any ESG risks (e.g. related to carbon regulation or physical climate change) due to their location or type? ■ Are the underlying properties given sustainability scores²⁸ or energy performance certificates? ■ What is the sponsor's ESG policy? 	<ul style="list-style-type: none"> ■ Is loan-level data or portfolio stratification disclosed on a regular basis, including borrower and loan metrics? ■ What is the servicer's approach to vulnerable customers? ■ Are borrowers in financial difficulties treated fairly? ■ Is information on past controversies, in relation to product safety, customer relations and marketing, available? ■ Is data on the environmental performance of underlying assets available (e.g. for car loans, a portfolio breakdown by petrol, diesel, hybrid and electric vehicles)? ■ Can the lender provide information on its business strategy for reducing fleet emissions or improving its products' fuel efficiency?

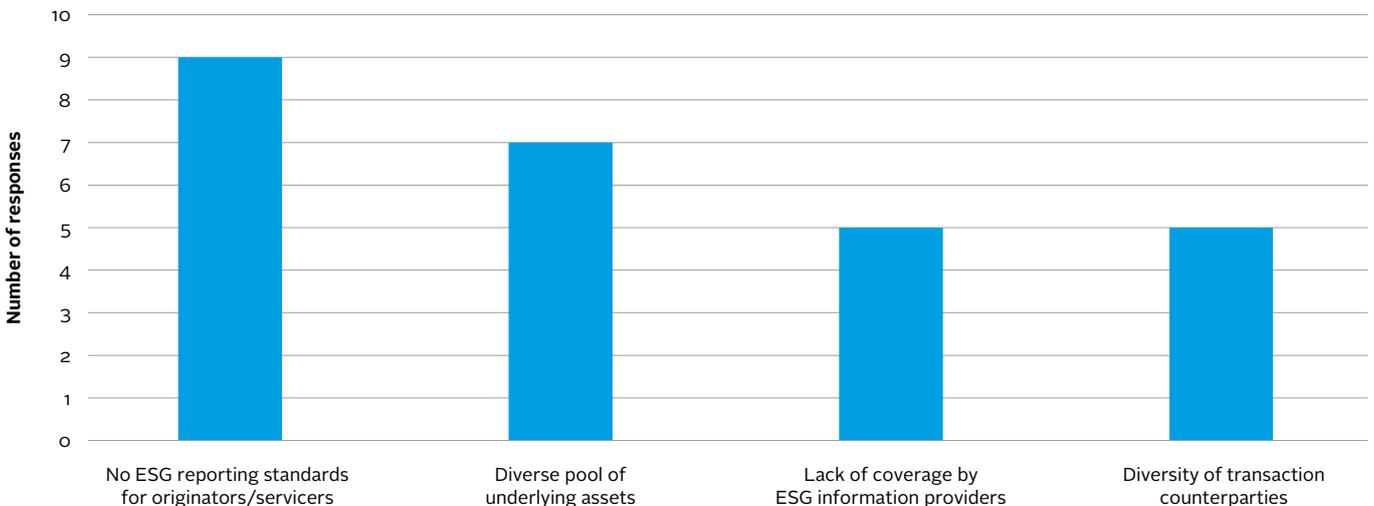
²⁸ For example, [Leadership in Energy and Environmental Design](#) or [Building Research Establishment Environmental Assessment Method](#) certification.

OTHER INVESTOR CHALLENGES

We asked participants to cite other major barriers to implementing ESG considerations when investing in securitised products (see Figure 24). These included:

- **No ESG reporting standards for servicers/originators:** Relevant ESG information on collateral often lacks uniformity and is not comprehensive, especially for non-agency deals. However, some respondents highlighted that alternative methods, such as advanced artificial intelligence and machine learning techniques, could support investors conducting ESG analysis.
- **A diverse pool of underlying assets:** The complexity and diversity of underlying collateral (and the sectors covered) make it difficult to build proprietary ESG frameworks that can be used for assessment.
- **A lack of coverage by third-party ESG information providers:** ESG information providers have limited coverage of securitised products. This is not surprising given that responsible investment originally developed in equities and only recently expanded to debt capital markets. Moreover, the leveraged finance market includes a high proportion of privately owned and small-cap companies that tend to disclose less information. However, this may change, as investor demand for these products is rising.
- **The diversity of transaction counterparties:** Respondents said that getting information on a deal's counterparties – issuers, originators, sponsors, CLO managers, trustees, guarantors and servicers – and assessing their individual practices and policies can be challenging.

Figure 24: Other major challenges to systematic ESG incorporation in securitised products



NEXT STEPS

This report outlines a range of challenges and issues surrounding ESG incorporation in the securitised debt market that need to be addressed. There are clear benefits to doing so, including a likely increase in capital flows, tightening potential within pricing and increased engagement between companies and investors on ESG issues. Ultimately this can drive favourable outcomes for all parties, including asset owners, stimulate real-economy lending to sustainable economic activities and contribute to a post-COVID-19 recovery.

The PRI intends to support securitised credit market participants to improve the quality of their ESG incorporation and the real-world outcomes arising from their investments.²⁹

The steps we outline below look to provide solutions to the primary challenge – data quality, availability and consistency. A combination of robust in-house and third-party data sources is likely to drive investor confidence in ESG incorporation across securitised credit markets. Investment managers have started to develop internal ESG data collection, scoring and rating frameworks, but more action is required.

IMPROVE INVESTOR-ISSUER DIALOGUE AND TRANSPARENCY

In the absence of regulatory mandates to improve the quality and relevance of ESG data disclosure, the PRI will build on two existing initiatives that are applicable to the securitised market. Through the workshop series, [Bringing credit analysts and issuers together](#), we will continue to facilitate dialogue between corporate borrowers, investors and CRAs to improve data disclosure and investor engagement on ESG topics. The PRI has also collaborated with the European Leveraged Finance Association in the development of sector-based [ESG fact sheets](#), which should increase transparency in the leveraged loan market and enable securitised product investors to enhance their analysis.³⁰

STAKEHOLDER COLLABORATION

The PRI will also explore how we can work with other stakeholders in the securitised credit market. This report, and work completed elsewhere, highlight that investors cannot solve the challenges they face alone and that collaboration with the following stakeholders is necessary:

- **Banking industry:** to harmonise ESG loan criteria and build a common framework to assess borrowers' commitments to environmentally and socially sustainable economic activities.
- **CRAs:** to enhance the transparent and systematic consideration of ESG factors in credit risk assessments, given the central role they play across all aspects of securitised products. Through their access to investors, corporate borrowers and significant amounts of underlying information, CRA opinions can increase investor confidence and capital flows into sustainable investment activities.
- **Third-party ESG information providers:** to enhance the availability of independent information, supplementing that provided by CRAs.
- **Legal industry:** to help develop robust, standardised legal documentation with binding obligations that would make the market's ESG adoption more credible. This will increasingly become a focus in Europe, where impending regulatory changes will require greater clarity on what can be designated an ESG-compliant asset or investment.
- **Arrangers:** to effectively market the merits of ESG transactions and influence the behaviour of market participants. Clear evidence from the green bond market shows that there is significant investor demand for these products, which arrangers can demonstrate to investment managers. Increased issuance of ESG securitised products is likely to increase pricing differentiation across the market.

²⁹ The PRI's 2021 Reporting Framework has already streamlined the reporting requirements for signatories, and, for the first time, asks them to report on how they measure the real-world outcomes of their investments, thereby encouraging them to think about the consequences of their allocation decisions. For more detail, see PRI (2020) [PRI's New Reporting Framework: driving positive change in responsible investment](#).

³⁰ PRI (2020) [The ELFA and PRI host ESG workshop for advisers to sub-investment grade companies](#)

BROADEN SIGNATORY UNDERSTANDING

The securitised debt market is largely concentrated in the US and Europe, with a small but growing presence in other geographies, and could become an important funding source for environmentally sustainable activities going forward. The PRI will work with our global signatory base to extend its understanding of ESG incorporation practices in securitised products.

SHARING BEST PRACTICE

The PRI will collect case studies to illustrate how investment managers are addressing client requests and extracting relevant information from issuers, driving progress and showing leading practice.

The PRI welcomes signatory case study contributions and feedback from market participants on this report, as it considers how to support stakeholders in improving data transparency, disclosure and engagement in the securitised products industry. Contact FI@unpri.org to participate.

APPENDIX 1: QUESTIONNAIRE

GENERAL INFORMATION

1. Please describe your role in your current organisation and your area of specialisation in securitised products (CLO/ABS/RMBS/CMBS/others)?
2. Has your organisation started incorporating ESG factors in a systematic manner when assessing/valuing securitised products?
3. If yes, why?
4. Do you or your team conduct the ESG analysis or do you have a dedicated ESG team? If so, how do you interact with it?
5. Do you source the data for the ESG analysis internally or do you use third-party data?
6. Do you have a public document that describes your ESG consideration policy in general and on securitised products specifically? If yes, please provide a copy or a link.

CLO-SPECIFIC QUESTIONS

DATA REQUIREMENTS FOR ESG INTEGRATION

1. What type of data is difficult to find or not available and how do you overcome such data gaps?
2. Beyond data, name two or three significant challenges for incorporating ESG factors in a systematic manner.
3. Do you carry out an ESG analysis on the collateral and if so, how?
4. Do you evaluate the structural components of the SPV from a governance perspective?
5. How do you assess the industry ESG risk (internal assessments, rating agency view, client demand, others)?
6. What ESG factors do you look out for in the deal documentation?
7. Do you engage with CRAs on ESG topics specifically associated with securitised products?
8. Do credit rating opinions disclose the material ESG factors considered transparently and systematically?

STEWARDSHIP

1. What ESG information from CLO managers would be helpful to be disclosed in the transaction documents and report?
2. How do you assess the CLO managers' ESG expertise?
3. Have you declined any CLO investments due to ESG reasons in the past?

ABS/RMBS/CMBS-SPECIFIC QUESTIONS

DATA REQUIREMENTS FOR ESG INTEGRATION

1. What type of data is difficult to find or not available for ESG consideration in ABS/RMBS/CMBS and how do you overcome such data gaps?
2. What ESG factors do you look out for in the deal documentation?
3. At which level do you consider ESG factors (originator, servicer, counterparty)? If you differentiate, what ESG factors do you consider to be relevant at each level and why?
4. Do you focus on the same ESG factors for all types of consumer-focused ABS or do you differentiate by underlying sector, e.g. auto loans, student loans? Do you distinguish whether the loans are prime, near-prime, subprime?
5. What factors and sources of data are evaluated to assess environmental (including climate) risk, societal and governance factors?
6. For ABS/MBS backed by non-static portfolios, how do you monitor ESG factor changes?

STEWARDSHIP

1. Do you engage with originators/servicers/counterparties/CMBS counterparties on ESG issues?
2. When assessing ABS/MBS, to what degree do you find ESG factors applied between collateral, securitised and origination policies?
3. Have you declined any ABS/RMBS/CMBS investments due to ESG reasons in the past?

APPENDIX 2: REGULATORY DEVELOPMENTS

Interview participants pointed to several regulations and initiatives that could affect the relevance of ESG factors in securitised product analysis. A few of these, relevant to Europe and the United States, are listed below. Investors are also scrutinising regulations and policies in other countries, such as China, the UK, Australia and Canada, that support, encourage or require them to consider all long-term value drivers, including ESG factors. For an extensive list, readers should refer to the [PRI's regulation database](#).

EUROPE

Since the EU Commission launched its [action plan on sustainable finance](#) in 2018 and the [European Green Deal](#) in 2019, it has passed several regulations. These include the SFDR and the [EU taxonomy for sustainable activities](#) – a classification system establishing a list of environmentally sustainable economic activities. It is also working towards an [EU green bond standard](#).

In particular, the SFDR requires financial market participants, including investment managers, to publish how they integrate sustainability risks in investment decision making. At the product level, it requires them to disclose how they consider the principal adverse impacts which investee entities may have on sustainability factors.³¹

UNITED STATES

Although in its infancy, the new US administration has already taken several steps which could positively impact responsible investment practices – namely:

- its recommitment to the Paris Agreement;
- its Green New Deal proposal;
- the [SEC](#) has requested public input from investors, registrants and other market participants on climate change disclosure; and
- the [Commodity Futures Trading Commission](#) has established a new climate risk unit.

Even at a state or city level, there have been some interesting developments. For example, 45 of the 100 largest US cities have active and fully formed climate action plans, with many targeting 80% greenhouse gas emission reductions by 2050 in accordance with the Paris Agreement.³²

³¹ Implementing SFDR for securitised products will be particularly challenging, in the absence of a mandate to disclose ESG information by originators/servicers. It also remains unclear if the provisions requiring principal adverse impacts disclosure will apply to a product's underlying assets or to its structure.

³² Brookings Institute (2020) [Pledges and progress: Steps toward greenhouse gas emission reductions in the 100 largest cities across the United States](#)

APPENDIX 3: CRAS AND ESG FACTORS

Below is a summary of how selected CRAs (listed in alphabetical order) consider ESG factors in their credit risk assessment of securitised products.

FITCH RATINGS

We have developed an ESG Relevance Score (ESG.RS) that assesses the credit impact of 14 ESG factors across our rated ABS/CMBS/RMBS and covered bonds (CVB) portfolios (see Figure 25). We assess the transaction structure for environmental and social issues and the transaction originator for governance issues.

We also monitor the ongoing management of the transaction, and any asset substitutions, for governance issues. We assigned approximately 64,232 ESG.RS on 4,588 securitised finance and CVB securities as of January 2021 – just over 2% were assigned an ESG.RS of 5 and approximately 16% a score of 4 in at least one of the 14 categories.

Figure 25: ESG scoring definitions. Source: Fitch Ratings

LOWEST RELEVANCE SCORE		NEUTRAL	CREDIT-RELEVANT TO TRANSACTION	
1	2	3	4	5
Irrelevant to the transaction or program ratings and irrelevant to the sector	Irrelevant to the transaction or program ratings but relevant to the sector	Minimally relevant to ratings, either very low impact or actively mitigated in a way that results in no impact on the transaction or program ratings	Relevant to transaction or program ratings, not a key rating driver but impacts the ratings in combination with other factors	Highly relevant, a key transaction or program rating driver that has a significant, standalone impact

Environmental categories typically do not impact securitised finance and CVB rating analysis but can be material to some US RMBS transactions that are exposed to catastrophe risk. Social categories are highly relevant, predominantly due to underlying consumer-based assets (for example, pending litigation related to US student loan transactions). We do not score securitised and CVB products less than 3 on governance because it is always deemed to be at least minimally relevant.

KROLL BOND RATING AGENCY (KBRA)

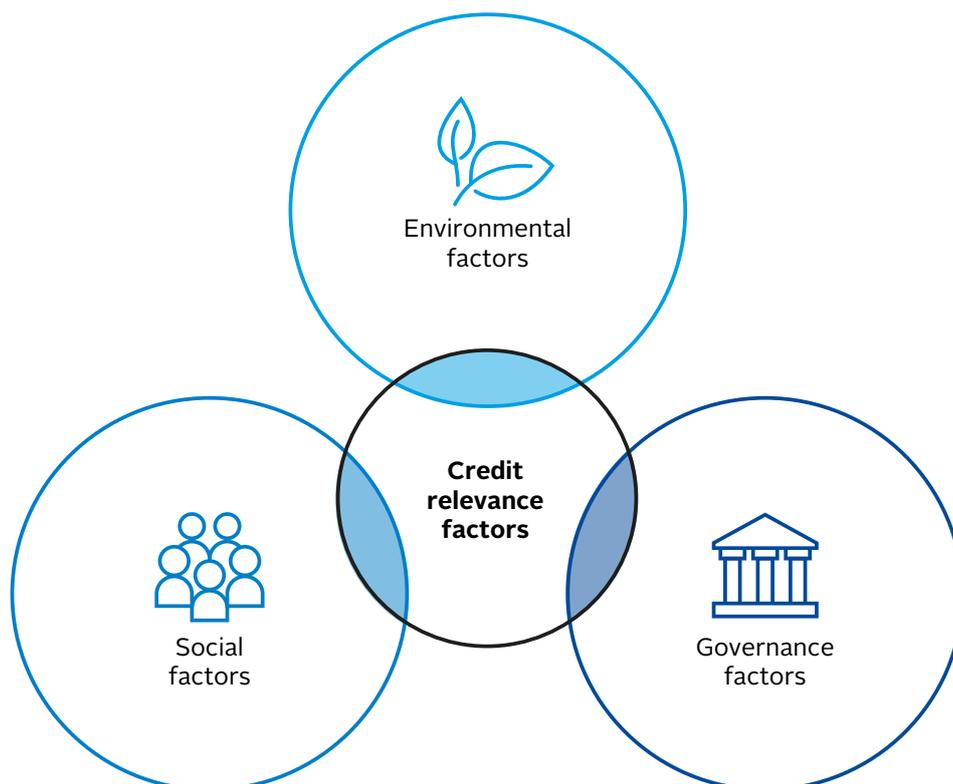
Our priority is to evaluate factors that may meaningfully influence credit analysis (see Figure 26). Some of these may be ESG factors, depending on the securitised asset type. Environmental factors such as increased regulations, contamination, and natural disasters, have the potential to affect asset values and, therefore, our evaluation of credit quality.

In ABS, various environmental laws and regulations may negatively impact certain industries. For operating assets, the manager's response to such regulations is evaluated. For CLOs, managers may have to target or avoid certain sectors based on environmental or social externalities, which may impact performance.

For CMBS, contamination can impact property values – this is evaluated through the analysis of environmental reports and/or related issuer data. For RMBS, CMBS and certain ABS transactions, collateral can also be adversely impacted by natural disasters, which if uninsured, could lead to loan delinquencies.

As part of our rating process, we consider demographic trends, employment levels, and consumer behaviour, amongst various social factors. Governance analysis typically includes a review of transaction counterparties and structure, with weaker governance provisions or nonstandard features in deal documentation potentially influencing our ratings.

Figure 26: Credit relevancy of ESG factors. Source: KBRA



MOODY'S INVESTORS SERVICE

We typically incorporate ESG considerations across credit ratings³³, although doing so is difficult and entails qualitative judgment, because it must often be inferred from multiple sources, based on reporting that generally is not standardised or consistent.

When assessing environmental risks, we may assess how emissions regulations affect automobile residual values for securitisations backed by automobile leases.

Social factors such as the ageing baby boomer generation will likely increase demand for reverse mortgages, while millennials choosing to rent rather than own, or vice versa, would affect demand for single-family rentals, with implications for RMBS credit quality. Governance risks are largely transaction-driven and can be mitigated by a strong control mechanism in the transaction documentation. An example of our assessment can be found in Figure 27.³⁴

Figure 27: Environmental and social health map in securitised products. Source: Moody's Investors Service

Securitized finance asset class	Total debt in US\$ billion (December 2020)	Overall Environmental Risk Score (December 2020)	Key issue	Overall Social Risk Score (October 2019)	Key issue
ABS - Aircraft	4	Moderate Risk	Future carbon and other air emission regulations could decrease collateral values over time.	Moderate Risk	Aircraft ABS exhibit moderate social risks overall, but socially driven policies and regulations could weaken the profitability of airlines that are lessees in the ABS.
ABS - Auto loans, auto leases, floorplan, car & truck rental	317	Low Risk	Short deal tenors mitigate risks to vehicles' residual value from carbon emissions regulations.	Low Risk	Auto-backed loans and leases securitized in auto ABS are largely decoupled from considerations affecting the sector, but have some exposure to customer relations risks.
ABS - Railcar leasing	<1	Low Risk	Well diversified fleets, but some car types exposed to obsolescence due to changing safety regulations.	n/a	n/a
ABS - Personal loans	59	Low Risk	Overall low exposure; collateral diversification and short asset tenor limit environmental risk.	Moderate Risk	Personal loan ABS have a high exposure to customer relations risk, but their exposure to social risks is moderate overall.
ABS - Credit cards	76	Low Risk	Overall low exposure; collateral diversification and short asset tenor limit environmental risk.	Low Risk	Data security and customer privacy risk are challenges for credit card ABS.
ABS - Small and medium enterprises (SME)	92	Low Risk	Diversification mitigates most risk.	Moderate Risk	SME ABS are moderately exposed to health and safety, responsible production, and demographic and societal trends risks.
ABS - Equipment leases and loans	48	Low Risk	Regulation of waste and pollution, natural capital, and carbon emissions for certain loan/lease pools.	n/a	n/a

³³ Moody's Investors Service (2020) [General Principles for Assessing Environmental, Social and Governance Risks](#)

³⁴ For more detail, see Moody's Investors Service (2019) [ESG – Global Heat map: Social considerations pose high credit risk for 14 sectors, \\$8 trillion debt](#) and Moody's Investors Service (2020) [ESG – Global Heat map: Sectors with \\$3.4 trillion in debt face heightened environmental credit risk](#).

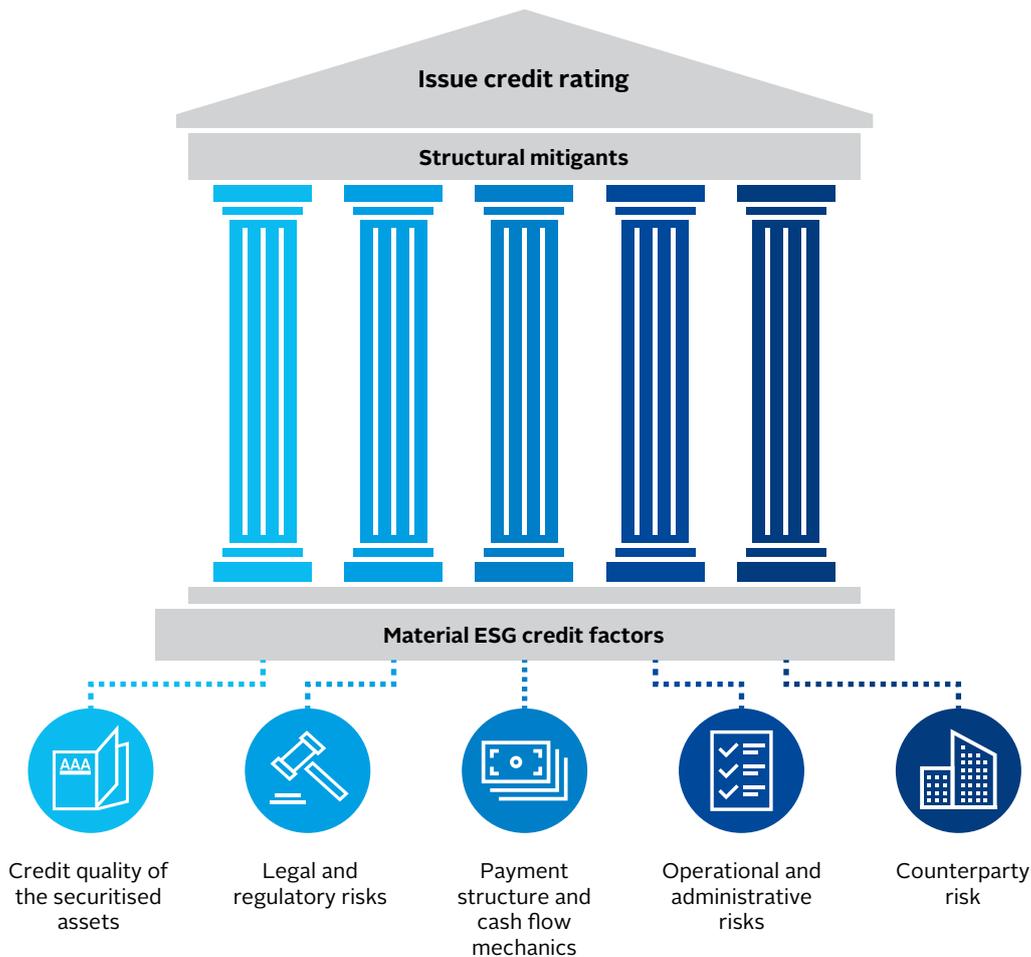
Securitized finance asset class	Total debt in US\$ billion (December 2020)	Overall Environmental Risk Score (December 2020)	Key issue	Overall Social Risk Score (October 2019)	Key issue
ABS - Student loans	222	Low Risk	Overall low exposure; collateral diversification limits environmental risk involving physical climate risk.	High Risk	Significant levels of interest in the student loan burdens of Americans among US and state policy makers will likely continue, resulting in continuing uncertainty for student loan ABS.
ABS - Tobacco settlement	7	Moderate Risk	Further regulation and weather events pose moderate risks for tobacco settlement ABS.	Moderate Risk	Continued shifts in attitudes towards smoking, and further regulation, pose moderate risks for tobacco settlement ABS.
ABS - Utility cost recovery charges	23	Low Risk	Deal structures, true-up mechanisms and medium tenors limit risk.	n/a	n/a
ABS - Wireless towers	11	Low Risk	Low environmental risk.	Low Risk	Social and demographic trends are generally positive for wireless tower ABS, but potential or perceived health risks could influence policies and community activism.
ABS - Other (Solar)	<1	Low Risk	Growth in solar power generation is partly driven by renewable portfolio standard requirements to reduce carbon emissions.	n/a	n/a
CDO & CBO	741	Low Risk	Diversified portfolio limits environmental risk.	Low Risk	Social risks are low because of the diversified nature of the collateral backing CDO/CLO transactions.
CDO & CLO - Project finance and infrastructure assets	6	Moderate Risk	Increased exposure to power-generation projects and the oil and gas sectors in new CDOs elevates environmental risks for overall sector.	Moderate Risk	While concentration increases the sector's risk exposure, risk levels vary depending on the industry composition of the portfolios.
CMBS	399	Low Risk	Collateral diversification limits environmental risks for most CMBS.	Low Risk	Demographic and societal trends are the main social risk facing CMBS.
RMBS	2,645	Low Risk	Diversification of pool collateral mitigates environmental risks, but some deals have regional concentrations.	Moderate Risk	Mortgage loans securitized in RMBS transactions are moderately exposed to demographic and societal trends.

S&P GLOBAL RATINGS

Our rating analysis of securitised products transactions is based on five key pillars (see Figure 28). We only view ESG factors as credit relevant if they are material enough to influence our view of risk for any pillar. Strong ESG credentials do not necessarily indicate strong creditworthiness. Even when relevant to credit quality, they may not impact the credit rating if a transaction's legal and structural features can mitigate them (e.g. credit enhancement, short tenor, deleveraging, concentration limits, eligibility criteria). ESG credit factors that could affect an issuer's (corporate or sovereign) credit rating may not be material to a securitised product credit rating, which is issue specific, and vice versa.

Obligor or geographic concentrations may increase exposure to physical climate risks. Social factors such as high interest rates and affordability considerations, or aggressive collection practices, could increase legal and regulatory risk. Most securitised products transactions have relatively strong governance frameworks because the roles and responsibilities of each transaction party and the allocation of cash flows are well defined, and transactions are structured to isolate the assets from the seller. However, governance weaknesses at the originator or servicer levels could still have a negative rating effect.

Figure 28: ESG factors in S&P securitised finance analytical framework. Source: S&P Global Ratings



CREDITS

AUTHOR:

- Carmen Nuzzo, PRI

CONTRIBUTORS:

- Mayahk Buttan, The Smart Cube
- Rahul Choudhury, The Smart Cube

EDITOR:

- Jasmin Leitner, PRI

DESIGN:

- Alessandro Boaretto, PRI
- Will Stewart, PRI

The Principles for Responsible Investment (PRI)

The PRI works with its international network of signatories to put the six Principles for Responsible Investment into practice. Its goals are to understand the investment implications of environmental, social and governance (ESG) issues and to support signatories in integrating these issues into investment and ownership decisions. The PRI acts in the long-term interests of its signatories, of the financial markets and economies in which they operate and ultimately of the environment and society as a whole.

The six Principles for Responsible Investment are a voluntary and aspirational set of investment principles that offer a menu of possible actions for incorporating ESG issues into investment practice. The Principles were developed by investors, for investors. In implementing them, signatories contribute to developing a more sustainable global financial system.

More information: www.unpri.org



The PRI is an investor initiative in partnership with **UNEP Finance Initiative** and the **UN Global Compact**.

United Nations Environment Programme Finance Initiative (UNEP FI)

UNEP FI is a unique partnership between the United Nations Environment Programme (UNEP) and the global financial sector. UNEP FI works closely with over 200 financial institutions that are signatories to the UNEP FI Statement on Sustainable Development, and a range of partner organisations, to develop and promote linkages between sustainability and financial performance. Through peer-to-peer networks, research and training, UNEP FI carries out its mission to identify, promote, and realise the adoption of best environmental and sustainability practice at all levels of financial institution operations.

More information: www.unepfi.org



United Nations Global Compact

The United Nations Global Compact is a call to companies everywhere to align their operations and strategies with ten universally accepted principles in the areas of human rights, labour, environment and anti-corruption, and to take action in support of UN goals and issues embodied in the Sustainable Development Goals. The UN Global Compact is a leadership platform for the development, implementation and disclosure of responsible corporate practices. Launched in 2000, it is the largest corporate sustainability initiative in the world, with more than 8,800 companies and 4,000 non-business signatories based in over 160 countries, and more than 80 Local Networks.

More information: www.unglobalcompact.org

