ESG and Securitized Fixed Income

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At Thornburg, we feel a fully integrated investment approach is the most effective way to incorporate ESG factors into securitized fixed income analysis.

Introduction

As environmental, social, and governance (ESG) investing continues to evolve, there are increasing questions among investors about how an ESG framework can be applied to securitized fixed income. Historically, the development of ESG analysis has focused on equities and corporate bonds. The Sustainability Accounting Standards Board (SASB) conceptual framework, which identifies material factors for equity and corporate bond investors to consider when incorporating ESG into security research, does not exist for mortgage-backed issuers and most asset-backed issuers. As such, there is no agreed or standard approach to ESG investing in the securitized market. However, investors are coming to understand that ESG factors are material and relevant to security analysis, particularly for a space that, at $12 trillion in total size, accounts for over 25% of the total public fixed income market in the United States[1].

This paper will explore both the challenges and the progress in identifying and incorporating ESG factors into securitized fixed income analysis. We will discuss the fully integrated ESG framework developed within Thornburg and applied across the entire investment platform, including in the securitized space. We will also highlight the specific considerations across ESG factors for different types of mortgage and asset-backed markets. We affirm that a fully integrated approach, in which ESG material factors are actively identified and assessed as to their impact on a security's risk and/or return, is the most effective application method.

ESG Analysis in Securitized - Challenges and Progress

There have been a number of historic challenges to implementing effective ESG analysis in the securitized market. Issuers provided little or no disclosure of ESG factors that could impact future cash flows. Indeed, most mortgage and asset-backed issuers were and are small, privately held companies that are not accustomed to providing these disclosures. They have had neither the requirements nor the demand from stakeholders to do so. The exception has been asset-backed issuers that also issue in the corporate market – for example, a large auto company with both secured and unsecured debt outstanding. Fortunately, investors are beginning to make issuers of all types more aware of the importance of ESG disclosures in analysis. Today, robust disclosures can attract a larger investor base that can lower the cost of capital for issuers, and ultimately, underlying borrowers.

Another challenge to ESG analysis is understanding the cash flow dynamics of hundreds or even thousands of underlying loans. Traditionally, the ESG corporate focus has centered around how management teams evaluate and manage ESG risks and opportunities. Securitized fixed income is unique in that idiosyncratic risk in individual loans is diversified away, necessitating a more holistic focus on how lending and underwriting standards, and broader social factors, impact security cash flow.

Fortunately, lending and underwriting standards, particularly in the mortgage-backed securities market, improved meaningfully in the years since the global financial crisis. This effectively makes the space more ESG investor friendly. Prior to the global financial crisis, mortgage lenders were able to structure loans with features, such as negative amortization, interest-only, or balloon payments that proved very harmful to borrowers, from both human and financial level perspectives. These practices were the main contributors to the foreclosure crisis that ensued beginning in 2007. The Dodd-Frank Act of 2010 made such lending practices unlawful, and in the non-agency lending space today, there are significantly more due diligence standards and protocols around assessing the borrower's ability to repay their obligations. Further, lending platforms currently exist that focus on historically underserved borrowers in a healthier way, using alternative but effective underwriting approaches with successful track records to assess borrowers' ability to repay.

Identifying ESG Material Factors in Securitized Fixed Income Analysis

We believe an effective ESG securitized framework should center on how the lending process itself ties to ESG considerations. As mentioned earlier, for many sub-markets within securitized, the underlying deal cash flows originate from individuals. Therefore, we aim to understand the issuer's underwriting process for the individual's ability to repay their loans, which can also include influences related to ESG factors. This understanding connects key ESG risks to the overall security analysis to the extent that such factors are material and have an economic impact on bondholder value. As such, we have directly identified, for each securitized sub-market, the environmental, social and governance factors we consider material to underlying cash flow.

Environmental

Though environmental considerations vary by sub-market, a common material factor is assessing how carbon emissions, and further regulation/legislation to reduce emissions, impact cash flow. For example, in auto ABS, we assess potential recovery values (in case of default) of gas vehicles, given the trend toward higher fuel efficiency and expected increased market share of electric vehicles. Higher gas prices have a detrimental effect on collateral value, as electric vehicles become relatively more attractive in such an environment. Another example is within aircraft ABS, in which aircraft age is a material factor, not just for fuel efficiency but the likelihood that the vessel will

Materiality Level: High; High/Medium; Medium/Low; Low

	FACTORS															
	ENVIRONMENTAL						SOCIAL						GOVERNANCE			
SECURITY TYPE	Emissions	Product Age	Energy Management	Water Management	Ecological Impacts	Geographic Concentration	Human Rights	Customer Privacy	Data Security	Access and Affordability	Customer Welfare	Lending Practices	Business Ethics	Competitive Behavior	Legal & Regulatory	Risk Management
Auto	High	High	High	Low	High/Medium	Medium/Low	Low	Low	Low	High/Medium	High/Medium	High	High	High	High	High/Medium
Aircraft	High/Medium	High/Medium	Medium/Low	Low	Medium/Low	Low	Low	Low	Low	Low	Medium/Low	Low	High/Medium	High/Medium	High	High/Medium
Consumer Loan	Low	Low	Low	Low	Low	Medium/Low	Low	Medium/Low	Medium/Low	High	Medium/Low	High	High	High/Medium	Medium/Low	Medium/Low
Container	Low	Low	High/Medium	Low	High/Medium	Low	High	Low	Low	Low	Low	High/Medium	High	High/Medium	High	High/Medium
Credit Card	Low	Low	Low	Low	Low	Medium/Low	Low	Medium/Low	Medium/Low	High	Low	High	High	High/Medium	Medium/Low	Medium/Low
Equipment	High/Medium	Low	Low	Low	Low	Medium/Low	Low	Medium/Low	Medium/Low	High	Low	High	High	High	High	High
Timeshare	Low	High	High/Medium	High/Medium	Medium/Low	Medium/Low	Low	Medium/Low	Medium/Low	Medium/Low	Medium/Low	High	High	High	High/Medium	Medium/Low
Tower	Low	Low	Low	Low	Medium/Low	Medium/Low	Low	Low	Low	Low	Low	Low	High/Medium	High/Medium	Low	High/Medium
Railcar	Low	Low	Medium/Low	Low	Medium/Low	Low	Low	Low	Low	Low	Low	Low	High/Medium	High/Medium	High	Medium/Low
Rental Car	Medium/Low	High	Low	Low	High/Medium	Medium/Low	Low	Medium/Low	Medium/Low	Medium/Low	Medium/Low	High	High	High	High/Medium	Low
Solar	Low	Medium/Low	Medium/Low	Medium/Low	Low	Medium/Low	Low	Low	Low	Low	Medium/Low	Low	High/Medium	High	High	High/Medium
Student Loan	Low	Low	Low	Low	Low	Medium/Low	Low	Medium/Low	Medium/Low	High	Low	High	High	High/Medium	Medium/Low	Medium/Low
Residential Mortgage	Low	Low	Low	Low	Low	Medium/Low	Low	Medium/Low	Medium/Low	High	Low	High	High	High/Medium	Medium/Low	Medium/Low
CMBS	Low	Medium/Low	High	High	Medium/Low	Medium/Low	Low	Medium/Low	Medium/Low	High/Medium	Low	High	High	Medium/Low	High/Medium	High/Medium

Source: Thornburg.

be re-leased. Impact to disposition value presents risk as the transition to cleaner energy sources continues.

Energy and water management are closely associated with commercial properties, therefore impacting the analysis of commercial mortgage-backed securities (CMBS). Newer, energy efficient buildings will be more desirable to tenants, given the reduced likelihood of costly upgrades necessary to comply with new regulation and building codes. This factor translates to favorable cash flow generation as well as higher property values.

Another material factor is heavy geographic concentration. Loan pools with large exposure, for example, to the state of California, are vetted for proximity to potential wildfires and earthquakes. Similarly, exposure in Florida and Texas is analyzed for collateral in hurricane sensitive areas. Geographic concentration is disclosed on a deal-by-deal basis, and though a large geographical footprint is desirable, it is fairly common to see collateral concentration in one or two states. Environmental risk is heightened if collateral is focused in densely populated areas which can be significantly impacted by one large event. Of course, it is difficult to assess the precise impact to cash flows as a result of natural disasters for which timing and magnitude is uncertain. However, it's important to understand geographic concentration as it impacts nearly every type of securitized sub-market, whether cash flows are backed by hard collateral or not.

Social

It can be reasonably argued that social factors have a direct impact, given the underlying loans in many sub-markets go to individual consumers. Therefore the ability (or inability) to repay can have a meaningful effect on human lives. We believe research into material social factors lies in the analysis of the lending process itself. The goal is to understand issuers' underwriting processes for its effectiveness in assessing consumers' ability to repay. Loan structures which make repayment challenging may cause consumer credit impairment that can have financial reverberations for individuals many years following a default. For an individual, account terms that are not clear and transparent may not be enforceable in court. This risk applies both to residential mortgage loans as well as consumer loans (i.e. home improvement) and credit card payments which flow through to asset-backed securities. Further, legal and litigation risk rises for issuers who engage in less robust underwriting processes, as well as for issuers who engage in aggressive collection practices or charge excessive late fees.

Asset-backed securities which derive cashflow on a corporate level have unique social considerations. For example, container ABS analysis includes due diligence into disclosures on practices that prevent illicit operations such as human or drug trafficking. For whole business securitizations, which typically include fast food business operations, an understanding of labor relations and wage policy can be material if not addressed at a franchisee or corporate level. The common thread is a potential business risk or legal/litigation risk and a subsequent determination of whether these factors are material enough to impact cash flow.

Governance

Governance factors are focused primarily on the issuer's lending and securitization structure, operational considerations, and overall support and disclosure of ESG factors. Issuers with streamlined and centralized credit, funding and collections signal a strong underwriting platform and reduced risk of fraud. In a similar vein, poor securitization reporting increases the risk of weak performance or fraud, which may not be detected quickly. We believe the best approach is to assess whether good governance exists on a deal level and if cash flows are distributed properly.

As mentioned, many issuers provide little or no ESG disclosure. We believe robust disclosure is important to our analysis and we continuously advocate for it with issuers during our due diligence meetings. Rich disclosure helps investors understand, among other factors, if an issuer has positive or negative ESG issues, to evaluate the sponsor management structure, and ultimately determine if there are material risks to the issuer's solvency. To the extent that ESG weaknesses are disclosed, we seek to understand if collateral value can overcome these potential issuer challenges.

Other relevant governance factors include business ethics, competitive behavior, legal and regulatory risks and risk management practices. Governance factors often overlap with environmental and social factors, i.e., good governance itself actively identifies material environmental or social impacts and presumably leads to an effective plan of action.

Case Study #1:

Issuer: LendBuzz
Security Type: Subprime Auto ABS
Primary ESG material factors: Ability to Repay, Treatment of Immigrant/Thin File Consumers

LendBuzz offers auto financing solutions for underserved customers, including immigrants and so-called thin file consumers. i.e., consumer with little or no traditional credit history. In 2021, LendBuzz came to market with an inaugural securitization of subprime auto loans.

The primary material ESG factors in our analysis were assessing ability of underlying borrowers to repay, as well as equitable treatment of immigrants and thin file consumers. Because LendBuzz focuses on underserved customers, their underwriting process is centered around bank account data rather than FICO and debt-to-income ratios. LendBuzz estimated the average borrower earned $65K per year and underwritten loans had a 13% payment-to-income (PTI) ratio, which we determined to be reasonable. Further, LendBuzz puts a 20% maximum limit on PTI, and borrowers make appropriate down payments, with an average loan-to-value ratio of 90% at origination. These factors collectively indicated to us that Lendbuzz's underwriting approach properly assessed customer ability to repay. We also found that by identifying overlooked but credit quality worthy borrowers, LendBuzz was able to offer lower rates than other subprime lenders, thereby directly providing an economic benefit to these borrowers. Additionally, fair treatment to underserved borrowers reduces legal/litigation risks to the issuer.

Our recommendation was to buy the single-A rated, class A tranche at a spread with attractive relative value versus comparably rated investment-grade corporates.

Case Study #2:

Issuer: AmWest

Security Type: Non-Qualified Mortgage ("Non-QM")

Primary ESG material factors: Ability to Repay, Geographic Concentration

AmWest focuses on borrowers that need a non-QM loan because they can only provide alternative documentation rather than having subprime credit. In late 2021, AmWest came to market with a Non-QM deal that provided potential buying opportunities across the capital stack.

The ESG factors most relevant in our analysis were the ability to repay and geographic concentration. Non-QM borrowers provide alternative documentation for various reasons, mainly due to self-employment but also if the borrower has a short employment history or is purchasing a property for investment purposes. We assessed that the increased risk posed by alternative documentation was mitigated by multiple positive factors. This included low loan-to-value ratios (pool average of 68.7%), good FICO scores (average score of 754, with only 1.5% of the pool below 680), and majority of loans (62%) used to purchase a primary residence. One of our ESG concerns was a 60% concentration in California. This factor increases property risk due to natural disasters such as wildfires and earthquakes. With an attractive spread and robust cumulative loss protection, we determined the B2 tranche offered enough spread to compensate for environmental risks.

We found the security provided attractive relative value versus comparable high yield corporate opportunities and added the position accordingly in portfolios which fit the security's risk/reward profile.

Applying ESG Factors into the Securitized Investment Process

Although the securitized markets are driven by largely different fundamentals than the corporate sector, we believe the process for analyzing ESG should be quite uniform. The way we apply ESG in the securitized sector follows the same foundation as all other ESG fixed income analysis. The evaluation must focus on financial materiality: determine material factors, understand their disclosures and ESG performance as part of the broader security analysis and use these material factors as part of the decision-making process to purchase or sell a security. We define material factors as those important to the issuer's financials and decision-making process, as judged by reasonable investors. The focus on material factors allows us confidence that ESG analysis incorporated into the investment process is robust and repeatable in a way that does not allow for greenwashing.

As stated earlier, one of the challenges of incorporating securitized ESG analysis is the degree (or lack thereof) to which issuers provide ESG disclosures. To tackle this challenge, we engage with issuers on a frequent basis to obtain information we feel is material to ESG analysis. We advocate with all issuers to provide as robust and detailed ESG disclosure as possible. The value we are trying to gain comes from pursuing an understanding of the issuer's process and practices. In fact, this is more important than what can be gleaned from quantitative data only. To the extent that an issuer may be unable or unwilling to share certain information, we assess whether the additional degree of uncertainty is reflected in the bond's pricing.

We believe in the importance of establishing and maintaining a propriety ESG securitized framework, rather than wait for an industry standard to evolve. We utilize an integrated approach, i.e., a process centered around investment professionals conducting their own materiality analysis. Each investment team member executes on this ESG process. The benefit of integration is that investment team members consistently apply the process across the analysis of every security. As such, it keeps the professionals, who know their specific markets the best, responsible for ESG analysis. This integrated approach not only enhances our securitized research but also ensures a robust and consistent ESG process across the entire investing platform.

To conclude, we believe the analysis of ESG material factors in securitized is essential to a full understanding of risk and return. The ability for managers to incorporate an effective process for ESG analysis in securitized we believe will enhance alpha potential as well as allow allocators to fully understand ESG exposures across their entire investment program.

[1] Source: "ESG incorporation in securitized products: The challenges ahead." Principles for Responsible Investing. May 5, 2021.

Important Information