BUY-SIDE DEMANDS ON ESG DATA AND DISCLOSURE IN SECURITISATION GROW

Australia's securitisation market may be on the cusp of an environmental, social and governance acceleration. **Clean Energy Finance Corporation**, **Moody's Analytics** and *KangaNews Sustainable Finance* gathered a group of leading securitisation investors to discuss buy-side requirements in this space – finding a need for more, and more granular, data.

PARTICIPANTS

- **Natasha Feder** Portfolio Manager and Structured Credit Analyst FIRST SENTIER INVESTORS
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- **Lillian Nunez** Executive Director, Debt Investments IFM INVESTORS
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MODERATORS

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INVESTOR ESG APPROACH

Levine How important are ESG [environmental, social and governance] considerations to current investment processes, and how has the level of importance evolved? What will the future trajectory be?

NUNEZ ESG has always been a high priority, whether we are looking at a particular sector or individual assets. Over recent years, we have developed a better understanding of ESG by aligning our approach with global leaders on ESG assessment.

We are aware of the detailed conversations needed with firms and the necessary due diligence.

Given we invest across the credit spectrum, we have different approaches for corporate bonds, structured credit and private debt. A listed public company with well-established bonds will typically have considerable marketing material and existing credentials, meaning we are checking for validity.

Structured credit is much smaller in Australia than it is in the northern hemisphere, though we have improved our questioning – in style and substance – with a few key players here.

Perhaps surprisingly, we have made the most progress with private debt. In this sector, typically we are dealing with less information, fewer reporting requirements and less external oversight. In response, we developed an ESG scorecard based on international lines of questioning for each sector. We use the SASB [Sustainability Accounting Standards Board] framework to design sector-based lines of questioning for conversations with management.

Our institutional investors want to know what we are doing and how we are doing it, and they seek data. Our view is that ESG is a natural progression from assessment of credit risk. If we do not consider these factors, they will flow through to credit risk.

FEDER Integrating ESG considerations has been critical in our investment process for many years. ESG analysis and assessment is baked into our internal credit rating, which drives security selection and positioning in a portfolio. We individually score each originator with an ESG risk rating as well as an outlook, then incorporate these factors into the internal credit rating. We believe examining an issuer's ESG risk is just as important as any other material factor in determining default risk.

The overall process has evolved over time alongside industry advancements and, particularly, as data have increasingly become available and reliable. While our assessment process has not changed, the reliability and use of external information has.

We do not apply different processes when reviewing securitisation from unlisted originators. Of course, there is currently more information available for listed companies. But the line of questioning and assessment criteria remain the same. Additionally, while the use of reports available from companies can help inform views, there is no substitute for engaging with companies directly.

Securitisation has always been an interesting area given investors have historically struggled to determine what to assess

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Green securitisations are gaining momentum as we focus on net zero emissions, with issuers, investors and sovereigns increasingly including ESG criteria in both their investment policies and due diligence processes.

Grace Tam, Director CEFC

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Moderators

GRACE TAM
CLEAN ENERGY FINANCE CORPORATION

MARC LEVINE
MOODY'S ANALYTICS

and how to do so. Our internal ESG risk assessment looks at the originator and servicer of the asset as well as the transaction, including the collateral proposed. It is a multipronged assessment that is applied to all securitisation transactions.

With securitisation deals, our ESG focus has historically been on governance. Areas of concern include ownership structure, reinvestment into the business, other business activities, relevant experience of senior management, adherence to regulatory requirements including internal training, and experienced legal and compliance staff.

Social concerns have focused on training and compensation of staff – on- and offshore, to ensure equality – appropriateness and suitability of products for borrowers, and appropriate servicing of underlying loans. This stretches well beyond what is legally required to what makes good business practice for the companies.

Increasingly, we are also focusing on environmental risks such as building codes as well as natural disaster risk such as fires and floods.

■ **KELLY** We were founded as an ESG house so these considerations have been at the core of our identity for decades. Our investment universe is defined by our ethical charter, which includes positive and negative criteria. This makes us aware of ESG risks and opportunities when screening for investments.

We have an in-house ethics research team that assesses potential investments against the charter. This defines the investment universe from which portfolio managers can create asset pools.

We view ESG labelled deals as in some respect self-nominating as passing our charter. But our process does not change because of labelling. We still look through the label to the issuer, including our in-house team assessing these deals against our ethical charter.

In some situations, we can invest in a green bond or a labelled deal where we would not otherwise invest with the underlying issuer. But we would want to see strict use-of-proceeds language or an ambitious sustainability goal on the transaction.

We need a compelling reason to be in a labelled issue: for instance because it is driving change or because the transaction sits within an issuer narrative about its transition path.

■ **GOODHAND** Late last year we collapsed our final nonethical products, so all our products now come under our sustainability framework. This is a three-step process that looks at negative and positive screening of individual companies based on the sustainability criteria of underlying businesses under our framework.

The framework is overseen by our sustainability committee, which is made up of internal and external members and is governed by our sustainability charter. The committee has oversight of the portfolios and is charged with interrogating portfolio holdings. Engagement is also an important part of our process and its outcomes influence portfolio decisions. Even when specific companies are excluded, it is still possible for us to invest in a transaction on its ESG merits subject to it passing a committee review.

For example, Woolworths was an excluded issuer due to gambling and alcohol revenue, and this exclusion also applied to its green-labelled transaction. With the announcement of the group's divestment from these activities, we decided to seek an exemption from the committee for the labelled security due to the underlying green activities the transaction supported. The committee provided the exemption on the condition that the divestment was completed.

When it comes to individual credit research, our analysts deliver an ESG score as part of the credit review. The score reflects how ESG issues directly affect the issuer's credit fundamentals and metrics. Analyst ESG-integrated credit scores are provided to the portfolio management team and are used in the portfolio construction process.

EXPECTATIONS OF ISSUERS

Tam Over the last 5-10 years, corporates have become more familiar with questions about

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LILLIAN NUNEZ IFM INVESTORS

SCREENING AND *WASHING*

As more issuers and assets enter the sustainable finance arena, scrutiny of potential greenwashing becomes more important. Investors say data and clear reporting standards are key to a transparent market.

TAM How do investors think about greenwashing in securitisation and what can the market do to protect against it?

■ **GOODHAND** Disclosure is key. I also think developments in Europe will soon set the standard for what will be rolled out here. Effectively there are three pillars: the EU taxonomy, sustainable finance disclosure regulation and corporate sustainability report disclosure.

All these standards provide increased disclosure for the finance industry, which helps address the question of greenwashing.

We expect local regulators to increase their focus on ESG disclosure. When we are putting together products with a green label, we will need to disclose why it is classified as an ESG product. Adopting these standards will reduce the greenwashing that is currently going on in the system

TAM If an issuer is calling a transaction environmental or social and an investor does the due diligence, should they be able to uncover anything questionable through disclosures?

■ **GOODHAND** As investors become increasingly focused on ESG [environmental, social and governance] concerns, these questions will become further embedded in conversations with securitisers. As investors move up the curve in their knowledge base they will begin asking more probing ESG questions.

TAM What would happen if an investor bought a transaction on the basis that it met all the screens and mandates but it turned out otherwise?

■ **KELLY** If the issuer's operations proved not to be true to label, there would be divestment. Sustainability-linked bonds are a great example of this. These are often originated with the proviso that the coupon will step up if the issuer does not meet its sustainability targets.

Our investors do not want to be rewarded when an issuer fails to fulfil a promise, and this makes it easier for us to divest the bond in the event it loses the green label. We want to see companies keeping their commitments and would divest if they do not.

TAM Would having an Australian taxonomy, even for something like securitisation definitions to delineate between what is and is not green or social, be helpful?

■ **KELLY** With labelled issuance, often someone provides assurance for the label. We look through these assurances. Our in-house team will do an assessment not based on whether a label has been assigned and signed off by a third party, but purely for itself. A taxonomy would assist their analysis but it would not push it down a particular path to either pre-approval or not investing.

■ **FEDER** We have seen before where investors just buy triple-A because it is triple-A rather than doing the work to investigate whether the rating is justifiable or the credit support is guaranteed.

Similarly, we are concerned that some are buying green-stamped bonds now simply because of the label, which some originators could take advantage of. In this case, the type of investors speaking today could go one way and a small group of other investors could conveniently go another.

■ **NUNEZ** It is important to do due diligence rather than relying on a taxonomy. I expect we will be able to identify the good issuers this way. Ultimately, the fact they are putting ESG processes and strategies in place will flow through to better credit, and we will be able to identify that this is the case.

ESG issues and we are now starting to see the same in the securitisation space. What is the minimum level of ESG questioning securitisers should be able to answer now?

■ **GOODHAND** We are really in the early stages. It is very rare to see anything specifically addressing ESG at a securitisation roadshow, for instance.

We usually do one-on-ones with specific ESG questions. With securitisation, we focus most specifically on social and governance aspects, for instance on the organisation's responsible-lending practices or how it monitors external relationships like broker networks and, on the governance side, board independence.

This is easier for larger organisations and banks, but it is quite costly for small nonbank originators to run these processes. We expect this to improve over time, but at present it is quite rudimentary.

With individual asset pools, there is very limited ESG information provided to the investor when it is securitised. There is a lot to be done on the regulatory side, in order for RMBS [residential mortgage-backed securities] to help generate more assets in the green space.

■ **KELLY** Securitisation has always been very good at providing a narrative about origination. Issuers can explain how they originate loans, say what is coming through from brokers, break down data on it and provide information on how they manage arrears.

Where we would like to see more information from issuers is on complaints handling, including how many complaints they receive about their origination. With environmental considerations, there is scant data currently for mortgage-backed securities. We have seen a couple of issuers label based on building standards, rather than labelling based on a loan product.

Tam What do investors make of securitisation pools with one or more labelled ESG tranches alongside conventional notes?

■ **KELLY** We would prefer to see something that is attempting to drive change rather than attaching a label to business as usual.

■ **FEDER** We have not bought any ESG labelled securitisation to date. So far, we have not been convinced the labels we have seen are appropriate relative to our standards. We understand this is a new and evolving space so do not begrudge originators and issuers for using the labels that are out there. But, so far, they do not align with the way we think about ESG.

If we are considering a green securitisation, we want it to be environmentally focused the whole way through. We are not looking for a labelled tranche per se, but rather we are looking for solid green features in the underlying collateral pool. It needs to be at the forefront of solving our collective carbon challenge, not just a label on a transaction.

For example, a pool that partly comprises solar panels but is mixed with furniture and cars does not work for us. On the RMBS side, we do not think a house being built after a certain date is necessarily sufficient to warrant a green label.

Our clients expect us to dig deeper, and we are willing to work with originators and issuers to create something we view as appropriately, and truly, green. This may need to be done on a bespoke basis, where we help bring a deal to market for the benefit of our portfolios and investors.

■ **GOODHAND** I slightly disagree on labelled tranches. We view an issuer like Plenti as providing funding that helps with the climate transition and the securitisation of assets allows the originator to provide ongoing finance to climate-related activities such as solar rooftops.

■ **KELLY** We have seen three issuers come to market with ESG-labelled consumer receivable securitisation deals: Plenti is providing loans in the space, hummgroup has a buy-now, pay-later scheme and loans, and Brighte is a dedicated issuer in the space.

We do not view the green-labelled tranches in these deals separately to the rest of the transaction. With transactions that include A1-G and A1 notes, which are the same from a credit point of view and have exposure to the same pool, we prefer not to be herded into a smaller green tranche just because the label is there, and potentially be paid at a lower rate because of the label.

On the other hand, we do view it as providing funding to merchants operating in the space – to operators that are enabling people to make decisions to take the energy transition into their own hands. This is capacity to drive change.

We are aware there are items we would otherwise object to in some pools and we tell issuers about such concerns. However, we are heartened to see Plenti establish a warehouse specific to electric vehicles (EVs) and we would like to see future transactions that include these EVs rather than generic auto lending.

DATA DELIVERY

Levine Would there be value in a framework under which issuers had to report some level of ESG data at asset level regardless of whether they are offering a labelled deal?

■ **GOODHAND** At the moment there is very little being done on the data side but over time we hope to see this change. Originators are often not collecting the data, and this is particularly the case with energy-efficiency data for RMBS.

It would be good to see regulatory change requiring all homes being sold to carry an energy-efficiency rating. Currently the ACT [Australian Capital Territory] requires all homes being sold to carry an energy rating. This allows the originator to capture data that can be provided to investors once the loans are securitised. This also applies to recording green star ratings or energy-efficiency ratings on new buildings.

Over time, this will assist us to analyse the underlying pools and make sure we have evidence that assets are truly meeting the standards securitisers talk about. It is something we want to see but it is definitely not there yet.

■ **FEDER** While regulatory change may accelerate more consistent reporting standards, we have seen this happening organically in the market. We have been talking to originators about why specific ESG information is not included in valuation reports, for example – and they have all admitted they could ask for and collect it. We suspect a lot of them simply do not have the requisite systems in place to collect much of the data.

We hope peer pressure and demand from investors drives change: it may start forcing originators to collect more data. Overall, through engagement with other investors in this space, we are encouraging originators to collect more ESG-relevant data on mortgages and the underlying houses.

■ **GOODHAND** We should also recognise that only about 10 per cent of new builds have a NatHERS rating above the current building code standards. This is also about getting the building industry to change, in other words. To get the industry to move, some regulatory change needs to occur. Current building standards are quite low, as far as thresholds go.

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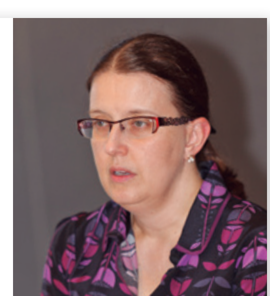
NATASHA FEDER FIRST SENTIER INVESTORS



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> **GAVIN GOODHAND** ALTIUS ASSET MANAGEMENT

FEDER Unfortunately, I think consumers also lack information about what the standards are, what they could be and how much they could save in the long run through up-front investment by builders.

NUNEZ I also agree the data would be helpful for investors – if it were available. We also have to consider the size, scale and influence of the market we are discussing.

RMBS in Australia represents less than 10 per cent of the home-lending market. Policy change concerning valuation and building codes informed by ESG criteria should be aimed at a higher level than the influence we can introduce to securitisation issuers. Of course we can and do ask questions about these issues across all asset classes, but we are still a small market.

I also agree that the systems are not necessarily there to collect the data we all want. There needs to be progress toward providing this that also makes sure it is not greenwashing. This will take time, but it is up to us as investors to put the pressure on and ask questions.

The next stage could be growing concern about whether we are working toward a two-tiered market where new property builds are easier to label. The legacy mortgage pool will always have its own problems, but it should be a matter of dialogue with issuers and getting some form of regulation to facilitate reporting.

There is also an opportunity for this information to be reported in the auto sector, regarding the emissions of vehicles being funded. This all goes to the originator's process. How does it undertake due diligence and what assessment does it make? As investors, though, this is in our control – because we undertake due diligence on each of the originators.

Levine Do investors have specific data points they believe issuers should be thinking about disclosing regarding assets across the ESG spectrum?

NUNEZ We have started to record emissions on a scope-one and scope-two basis. This is difficult for RMBS at this stage, but for other assets we have started analysis and have engaged independent firms to look at our portfolios.

When we consider residential properties, we look at environmental and safety concerns – for example cladding. We do not necessarily have scores or measures that we need to attribute to a particular line-by-line list or portfolio of assets. What we are more concerned with is funds being loaned responsibly, so we look at things like LVR [loan-to-value ratio] surplus income levels, serviceability testing and so forth – but not necessarily whether houses are triple glazed and what the insulation levels are.

Flood risk will be more of an issue after what we have recently witnessed in northern New South Wales and in Queensland. We have to consider whether people are being provided with lending for properties that really should not be on those sites. This is a serious consideration: mortgage insurance providers need to consider whether they will continue to support certain regions in Australia.

Tam Quantitative data are clearly hard to get, but what role can qualitative data play? What do investors ask about things like issuers' own ESG policies or flood risk in their portfolios?

NUNEZ It is not fully there. We ask the questions – it is part of the process – but we do not get fulsome answers and we certainly do not get data at this point. There may be some ABS [asset-backed securities] issuers that can provide this information.

As we progress, and the more we ask questions, the more issuers will realise they probably should answer next time around. Various documents will talk about green policies or ESG more broadly, but they do not necessarily go into detail.

This is one thing we and bodies like ASFI [the Australian Sustainable Finance Institute] can consider as our line of questioning on deals progresses. Asking more questions will have a flow-on effect and issuers will start preparing for what we are going to ask.

Levine On flood risk, in an ideal world would investors like to be able to see each of the properties in an RMBS transaction and what the potential flood risk is?

NUNEZ Definitely. We would like to get postcode maps. I know Moody's Analytics provides some geomapping for other things, for instance property price movements.

Flood and fire danger speak to questions about whether houses are in the right location, for instance what is the implication of lending in a zone that is not necessarily protected from these types of climate risks? This will be a growing concern to issuers, particularly where insurance agencies are

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TIM KELLY AUSTRALIAN ETHICAL INVESTMENT

not necessarily providing a full portfolio of lenders' mortgage insurance any more.

■ **FEDER** We have looked at climate-change risk in RMBS for a while, specifically fires and floods. It is difficult to get the appropriate data so a lot of it is literally going through pools postcode by postcode – which is obviously very time-consuming.

It also throws up an interesting question. If investors begin excluding various postcodes and regions, does this have a social impact of increasing mortgage rates for those who are living in what we as investors deem to be high-risk areas? We have not quite worked through the implications if investors were to drive this type of behaviour. But it could be something very important to consider.

■ **NUNEZ** This is my point about creating a two-tiered market. Of course, some people want to live in the bush and here we have to think about whether their properties have the appropriate cladding and so forth to mitigate the risks. But there will be others, perhaps first homeowners, who do not have the capital or equity base to afford the protections.

We want to avoid this kind of situation, which is why it is important to encourage issuers to make sure they are recording data and can deploy some sort of process through the origination when they are lending to someone in a potentially dangerous area.

Levine Are there any other data fields that would be useful?

■ **GOODHAND** On the ABS side, rather than just telling us the size of loans we would also like to see the size of the solar panels and the battery system installed. Then we can properly quantify what is being funded at loan level rather than just at aggregate scale. Home energy-efficiency ratings and the like would be useful for RMBS.

■ **NUNEZ** From my perspective, investors are always comparing deals for relative value. If two or three deals are very similar in origination profile, and collateral and return profile, if one offers additional information on risks and mitigants – and this is clearly articulated and demonstrates an ESG improvement – we are likely to proceed with that deal. This is adding value to the ESG output.

It is up to us to ask questions, but it is up to originators to be forward thinking when it comes to providing information. It is obvious which issuers are future focused and transparent with data. Those that assess and mitigate risks in their origination process will be preferable and more sustainable in the long run.

Levine Using the automobile example again, if a pool included vehicles with internal combustion engines that are not particularly clean would investors look at it more favourably if the issuer at least disclosed this information?

■ **NUNEZ** I think it would be thought of as positive if they disclose: the disclosure is the important part. Ultimately, many other things factor into our decision-making process, and credit risk is of course very important.

On the other hand, if an issuer is emitting a lot and the market starts changing, we need to consider how sustainable this business and collateral will be through the cycle as well. Is the issuer going to come out the other end in a better position or not? Overall, disclosure is positive but it is the first stage.

■ **GOODHAND** Disclosure is extremely important for analysing the key risks of an issuer or pool. It is the underlying risk we focus on that drives an investment decision. For example, we would not invest in the coal industry purely from a credit perspective, given we know coal will eventually be phased out so this industry will have a high level of stranded asset and default risk in the future.

While not an immediate concern, auto pools could face a similar risk in future. It is a matter of investing in pools that are more robust.

■ **KELLY** Disclosing a negative would be viewed favourably but we would not allow something into our investment universe based on honesty alone. Where it would help is in assessing – particularly in the securitisation space for a programmatic issuer – if we can identify a problem subset within the pool. It allows us to see, over time, what the transition is for the originator.

One pool might be a problem, but if we can see the issuer is progressively bringing it down, or at least being consistent with what we are looking for, this can be part of the toolkit. It does not help an individual issue but it lets us know more about the issuer's programme.

■ **FEDER** There is a fear, which I share, that we could end up with investors that are simply not interested in ESG. As a result, we could end up with some originators benefiting from a bifurcation of the investor market. We have seen this in other sectors and are concerned it could happen with securitisation. •