JULY 2021

RESPONSIBLE INVESTMENT IN SECURED FINANCE

ANALYSING ESG RISKS IN SECURED FINANCE MARKETS IS COMPLEX. INSIGHT IS TACKLING THE CHALLENGES HEAD-ON, AND ENCOURAGING TRANSPARENCY ON ESG ISSUES ACROSS SECURED FINANCE MARKETS.

THE CHALLENGES FOR RESPONSIBLE INVESTORS IN SECURED FINANCE MARKETS

Environmental, social and governance (ESG) risks are widely acknowledged by equity and fixed income investors, but analysing such risks in secured finance raises unique challenges.

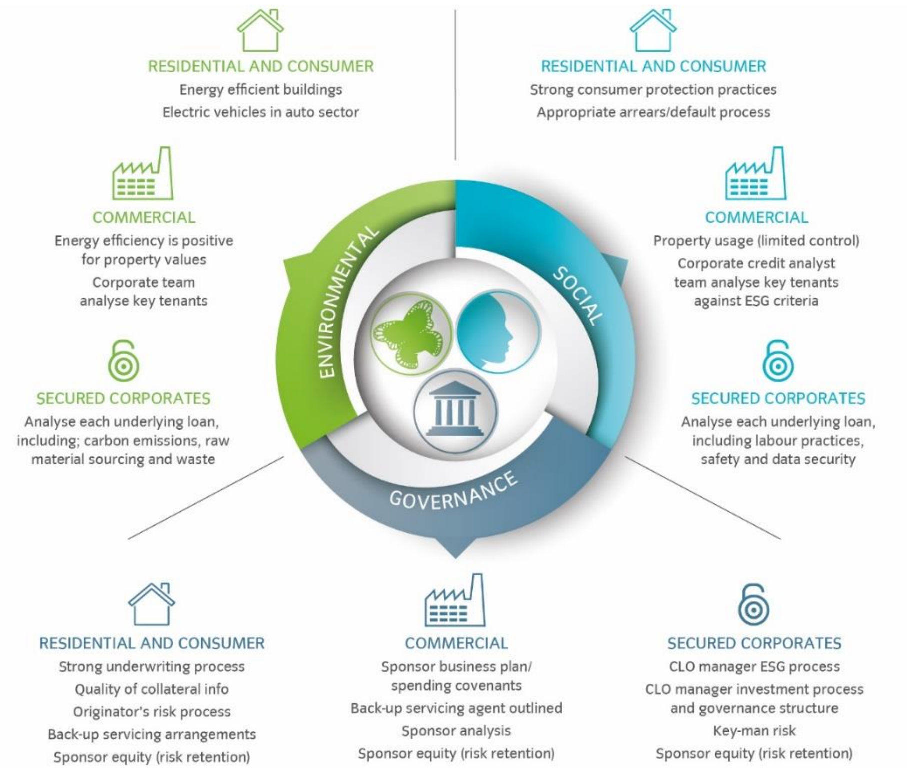
- **Analysing and measuring ESG risks for secured finance securities can be complex**, with many different potential ESG risks to take into account (see Figure 1).
- **There can be many stakeholders in the lifecycle of a secured finance asset, as underlying asset pools may change over time.** For example, the ESG rating of a special purpose vehicle can vary as mortgages are replaced and the environmental quality of underlying houses changes.
- **There is a lack of standardisation and depth in the ESG reporting which issuers complete.** It can therefore be difficult to access relevant and comparable data.

HOW INSIGHT IS SUPPORTING A RESPONSIBLE APPROACH TO SECURED FINANCE

We believe Insight is leading efforts to encourage issuers to consider and disclose ESG risks in secured finance markets.

- **ESG factors are an important part of the rigorous fundamental analysis undertaken on originators**. This includes detailed due diligence both prior to making an investment, as well as on an ongoing basis.
- **Proprietary questionnaires aim to help us better understand the ESG risks.** These are developed for a range of sectors, with more in development. Of the questionnaires we issued in 2020, c.75% elicited responses from public ABS issuers, and 100% for private secured finance transactions (direct lending).
- **We have been working to highlight the need for enhanced ESG reporting.** We have engaged with the International Capital Market Association (ICMA) to encourage local regulators to support greater transparency.

Figure 1: ESG considerations within secured finance market segments



HOW INSIGHT EVALUATES ESG RISKS ACROSS SECURED FINANCE MARKETS

ESG risk varies given the nature of the asset. How we evaluate and respond to ESG risk varies depending on the type of asset.

Consumer loans/mortgages

For securities based on underlying pools of consumer loans (such as credit card debt or auto finance) and residential mortgages, originators vary in their ability to provide ESG data on the underlying assets.

- We issue a proprietary questionnaire focusing on ESG risks to all originators of securities based on consumer loans or mortgages (see Figure 2) that helps to supplement our existing due diligence framework and issuer engagement.

Commercial real estate loans/mortgages

Commercial real estate (CRE) loans are typically issued on a small number of commercial properties. This means it is can be more straightforward to assess relevant ESG risks. For example, environmental audits on large buildings are typically available for review.

Commercial mortgage-backed securities (CMBS) are similar, although may be based upon a larger pool of commercial mortgages which increases the complexity of any analysis and increases the challenges in getting appropriate ESG data on the underlying pools. There are exceptions, with 'green' CMBS starting to come to market and offering environmental data on the underlying assets.

- For CRE loans and mortgages we review ESG disclosures on the underlying assets which are typically extensive and incorporate this into our investment analysis.
- We have developed new questionnaires for CMBS and CRE originators and are sending these out as new issues come to market.

Collateralised loan obligations (CLOs)

CLOs purchase a pool of senior secured bank loans, made to sub-investment grade businesses. They issue debt in tranches, with differing risk/return profiles derived from the seniority of the claim on the cashflows generated by the underlying loans.

The structure of CLOs means investors usually depend on the originator to provide data on underlying loans, and ESG data is typically limited.

- Given the structure of CLOs our focus is typically on governance for the CLO manager. We intend to encourage greater ESG disclosures across CLO issuance in 2021, following the progress we have made on consumer and commercial loans in 2020. When we review CLO managers, we ask specifically about ESG factors, and whether they have a relevant policy integrated within their credit process. We also aim to discuss examples of loans they have rejected due to ESG concerns. We also assess the underlying loans within the CLO, which will include analysis by our loans team, where appropriate, which incorporates ESG considerations where possible.

Direct lending

Many companies seek to borrow money from non-bank lenders. Such loans are typically illiquid and therefore offer higher yields than more liquid assets, all else being equal.

- For any direct lending, we ask borrowers to provide information on ESG risks to which they are exposed, and how they manage them. If a borrower does not provide this information we decline the loan. Credit analysts and portfolio managers therefore have clear incentives to ensure that borrowers provide the necessary information on ESG factors.

Figure 2: Questionnaire example – key areas covered by our proprietary ESG questionnaire for consumer loans

SEEKING TO IMPROVE ESG DISCLOSURES ACROSS SECURED FINANCE MARKETS

In 2020, we engaged with selected issuers to explore the potential for improved ESG disclosures for securities based on consumer loans and mortgages. We sought to consider how we might encourage the wider industry to move forward on these issues.

These engagements highlighted a number of key challenges:

- Some issuers faced technical challenges in obtaining data across the pool of assets, in particular energy certificates within residential mortgage pools. Originators that have gone through several historical mergers and acquisitions have client information spread across legacy systems.
- Some issuers, despite our engagement, were less willing to bridge these data gaps. One major European auto manufacturer, despite emphasising its ESG credentials at the corporate level, said the lack of demand from investors meant it would not consider incorporating ESG disclosures in its asset-backed securities issuance in the short term.

Global initiative for enhanced ESG disclosures

Although we continue to engage with originators more widely, we recognised that by engaging with other asset managers we could accelerate this process. We therefore raised the issue with the Asset Management and Investors Council (AMIC) at the ICMA and proposed a joint initiative with other major global asset managers to agree and develop key performance indicators on ESG issues and to engage with local regulators on these topics.

An initiative focusing on this issue was announced in March 2021.[1] The key priorities include:

- standardisation of ESG disclosures
- annual reporting of material ESG risks
- ESG support for market participants
- creation of 'green' standards
- increased collaboration between industry and regulators

IMPORTANT INFORMATION

RISK DISCLOSURES

Investment in any strategy involves a risk of loss which may partly be due to exchange rate fluctuations.

ESG questionnaires and the ESG approaches shown are a valuable input into our credit research process alongside other factors we consider when assessing risks and opportunities in investments to define an appropriate valuation. The use and impact of our ESG questionnaires and approaches in specific investment strategies will vary, potentially significantly, depending on the nature of the asset class and the structure of the investment mandate and/or transaction involved.

FIND OUT MORE

Institutional Business Development
businessdevelopment@insightinvestment.com
+44 20 7321 1552

European Business Development
europe@insightinvestment.com
+49 69 12014 2650
+44 20 7321 1928

Consultant Relationship Management
consultantrelations@insightinvestment.com
+44 20 7321 1023

@InsightInvestIM
company/insight-investment
www.insightinvestment.com

[1] For more information, please see https://www.icmagroup.org/News/news-in-brief/icma-amic-statement-on-esg-transparency-of-asset-backed-securities/