STRUCTURED FINANCE ASSOCIATION

SFA Research Corner

An Executive Order Seeks to Lift Pall on ESG Cast by DOL Rule

February 9, 2021

WHAT WE'RE WATCHING

In January, President Biden ordered an immediate review of agency actions taken over the past three years deemed inconsistent with the administration's commitment to "empower ... workers and communities; (and) promote and protect ...public health and the environment." In applying this mandate, the Biden administration will review a controversial Department of Labor (DOL) rule that effectively dissuades employer-sponsored retirement plans that fall under the Employee Retirement Income Security Act of 1974 (ERISA) from investing in ESG funds. The plans impacted include 401(k) retirement plans, which hold an estimated $6.5 trillion in assets. The rule would dampen demand for investments labelled ESG, including certain securitized products, and comes as the asset flows into ESG accelerate. The DOL rule, which became effective on January 12, 2021, requires 401(k) retirement plan fiduciaries "to select investments and investment courses of action based solely on financial considerations relevant to the risk-adjusted economic value of a particular investment or investment course of action." The rule cautions that "[t]o the extent ESG factors, in fact, involve business risks or opportunities that are properly treated as economic considerations themselves in evaluating alternative investments, the weight given to those factors should also be appropriate to the relative level of risk and return involved compared to other relevant economic factors." Investment objectives, the rule continued, "may not subordinate return or increase risks to promote non-pecuniary objectives."

Focus on ESG factors and sustainable investing has increased as asset managers and public companies commit to sustainability. "Sustainable investing is at an inflection point," says Stephanie Mah, Vice President in Structured Finance Research at DBRS Morningstar. "[T]he focus is migrating to the outcomes of ... investment decisions. Initially, ESG concerns were addressed primarily through the lens of exclusionary practices, but the dialogue has been evolving to include more proactive measures with outcomes, including reducing greenhouse gas emissions, DEI advancements, and robust company stewardship, to name a few."

Certain securitized products easily lend themselves to ESG inclusion, addressing measurable outcomes and impacts, according to a new report from Deutsche Bank Research. For example, CMBS pools contain mortgages on commercial properties that implement well-established green building certifications or affordable housing objectives, easily satisfying the "E(nviromental)" or the "S(ocial)" components of ESG CMBS. Fannie Mae and Freddie Mac are the most prolific issuers of ESG CMBS and offer bonds that address both "E" and "S" components and hold an ESG rating from an independent ESG rating company.

Since 2011, Fannie Mae has issued over $85 billion into the global green bonds market through the Multifamily Green MBS platform. The bonds finance existing multifamily properties, including workforce and senior housing. In order to be eligible for the program, property owners must commit to targeted property improvements that reduce energy and water usage. The must also receive a nationally recognized third-party green building certification.

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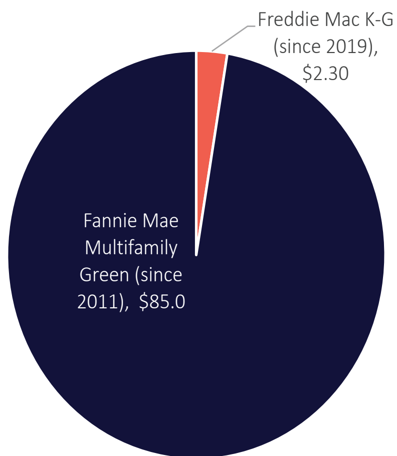
WHAT WE'RE WATCHING (CONTINUED)

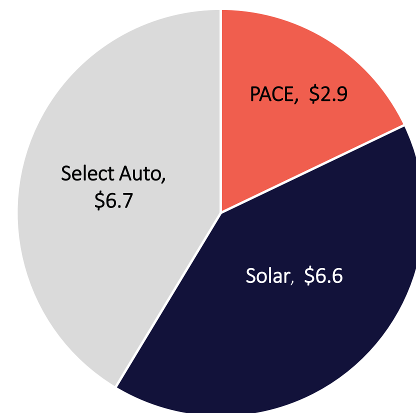
The impact of Fannie Mae's Green Multifamily platform includes, according to the agency, saving 7.8 billion kBTU of energy and 7.7 billion gallons of water, reducing CO2 emissions by more than 525,000 metric tons, and saving each family an average of $178 in annual energy and water costs. Similarly, in 2019, Freddie Mac debuted the K-G CMBS bonds, which are backed by multifamily loans originated through the agency's Green Advantage program. Freddie's Green program seeks to improve and finance workforce rental housing while supporting the environment through reduced water and energy consumption. To date, the agency has issued $2.25 billion of bonds, funding 86 loans.

Agency ESG CMBS to Date ($ billions)



Source: Fannie Mae, Freddie Mac

Green ABS Issuance ($ billion)



Source: Deutsche Bank Research

ABS bonds that address green initiatives are also clear examples of ESG-friendly offerings to date. These include securitizations backed by residential solar financings and auto ABS pools that include financings for the sale or lease of electric vehicles. Property assessed clean energy financings (PACE), which finance green upgrades to residential properties, round out the green ABS offerings. On the CLO front, to date there are 10 U.S. deals, totaling $4.4 billion, with specific negative screening language that prohibits leveraged corporate loans from certain industries in the CLO pool.

MARKET SUMMARY

Nearly $6.5 billion of securitized bonds came to market in the last week of January, bringing the month's total to $31 billion. Coming off a year of strong performance despite unprecedented challenges, demand for securitized bonds remained robust. Bond prices in the secondary market were pushed higher, pushing the bid-ask spreads across products incrementally tighter.

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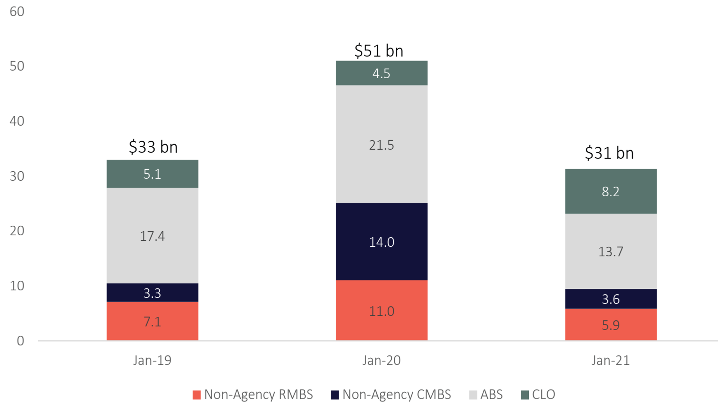
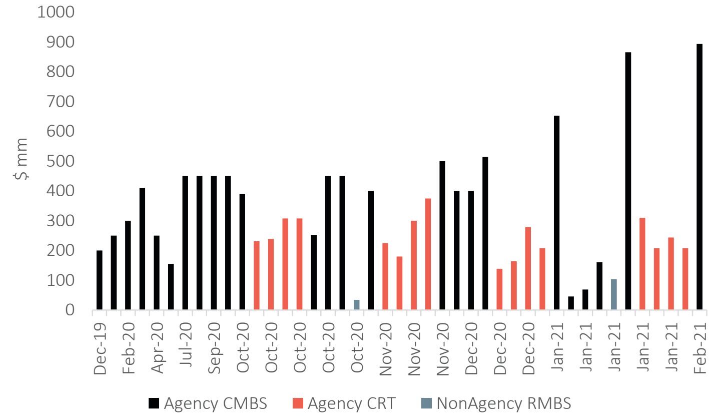
MARKET SUMMARY

Jan 2021 New Issue ($bn) Non-Agency RMBS, CMBS, ABS and CLO



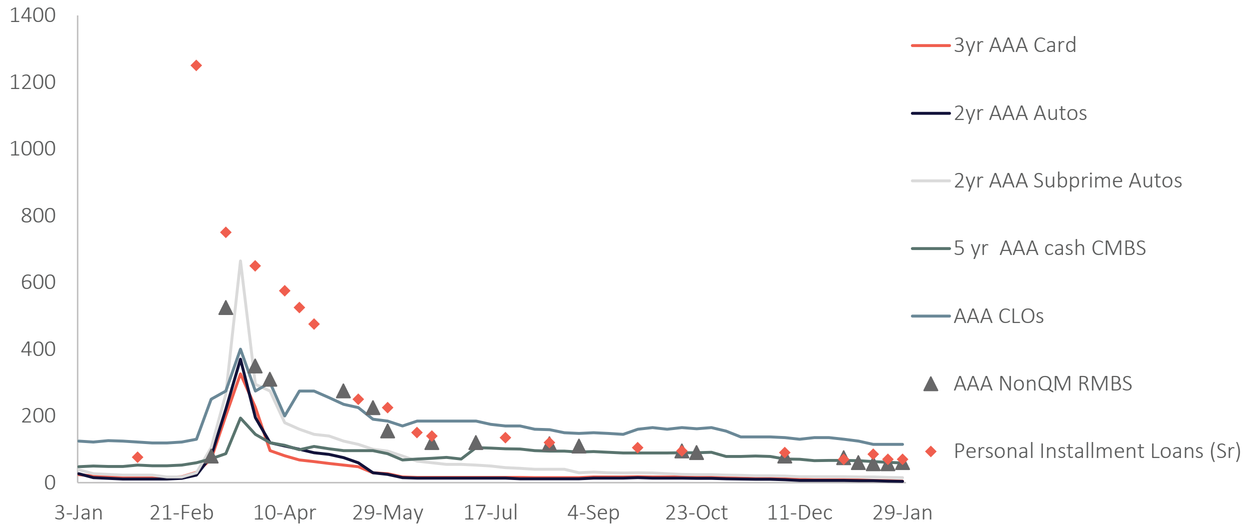
Source: Market Compilation

SOFR-based issuance ($mm)



Source: [FinSight]

Secondary Market Bid-Ask Spreads (bp)



Source: Market Compilation

Secondary Market Bid-Ask Spreads		
(bps)	29-Jan	22-Jan
3yr AAA Card	5	6
2yr AAA Prime Autos	4	5
2yr AAA Subprime Autos	15	16
5yr AAA Cash CMBS	59	61
AAA CLOs	115	115