STRUCTURED FINANCE ASSOCIATION

SFA Research Corner

Searching for Standardization: Connecting RMBS to Social Capital

March 4, 2022

Elen Callahan
Head of Research
203.512.0503

Jessica Steele
Research Analyst
202.847.4557

In a 2020 industry survey, SFA reported that only 6% of issuers were providing ESG-related data for their securitization transactions, but more than one-third of respondents indicated that they were evaluating or developing a plan to provide ESG information. In the same survey SFA reported that nearly all institutional investor respondents applied an ESG framework to all or some of their investment decisions. To address the disconnect and meet our members' strong demand, SFA began an initiative to develop an ESG Disclosure Framework for the structured finance market. Guided in part by existing ESG frameworks including those published by industry participants, SFA's framework will address the unique considerations and needs of the structured finance industry and those of each underlying asset class.

In this article we look at how issuers in the private label RMBS space are addressing the clamor for ESG- data specifically in the ESG-Social context. We discuss two widely accepted ESG standards and how the government sponsored enterprises are applying one of these standards for disclosure on the enterprise level. We also compare two ESG models that are emerging on the securitization level – one that seeks to measure the degree of ESG impact on a securitized pool and the other a securitization that uses a Second Party Opinion.

Recently Fannie Mae and Freddie Mac, SFA members and leaders in RMBS issuance, demonstrated their commitment to disclosure on the corporate level. Late in 2021, Fannie Mae released its inaugural Sustainability Accounting Standards Board (SASB) Report and in January 2022, Freddie Mac issued the Report under the Sustainability Accounting Standards Board ("SASB") Standards and Management Criteria. In their reports, the agencies voluntarily disclose their corporate level sustainability information as guided by standards set by SASB.

Fannie Mae and Freddie Mac are in good company. The number of organizations that reference SASB standards in public communications or that report their ESG impacts using the SASB standards and metrics has soared from under 500 in 2019 to over 1200 in 2021. As of September 2021, more than half of the S&P Global 1200 index (608 of 1201 companies, representing 70% of the global market capitalization) were using SASB standards in communications with investors.

Founded in 2011, SASB is an independent non-profit organization known in the ESG world for having developed a complete set of reporting standards for 77 industries in the corporate world. These standards, according to SASB, identify the subset of sustainability issues that are most relevant to each industry's performance and include disclosure topics, accounting metrics, technical protocols, and activity metrics.

SASB standards cover issues that are related to five categories of sustainability – environmental, social capital, human capital, business model and innovation, and leadership and governance. Each industry standard includes an average of six disclosure topics and 13 qualitative and quantitative metrics to use in evaluation. Technical protocols accompany each metric and provide guidance on definitions, scope, accounting, compilation, and presentation. Presenting the subset of ESG impacts most relevant to each industry, these disclosures provide decision-relevant information for investors who wish to see beyond a company's corporate social responsibility (SCR) statement and delve into its risks and opportunities directly related to industry-specific ESG factors. SABS standards focus on financial materiality or the sustainability information that is most likely to impact financial performance and long-term enterprise.

SASB encourages organizations using their standards to adapt them to fit their business model. Looking closer at Fannie Mae and Freddie Mac's disclosure reports, three of SASB's seven Finance-related industries were referenced in their report—Mortgage Finance (FN-MF); Commercial Banks (FN-CB); and Investment Banking and Brokerage (FN-IB). The Agencies adapted these standards to align with their operations, providing within their reports the rationale for which of SASB's standards and metrics they modified or omitted.

In their reports, the Agencies identified three disclosure topics within Mortgage Finance, the industry that they identify as most closely aligned with their business, as relevant and material – Lending Practices, Discriminatory Lending, and Environmental Risk to Mortgaged Properties. Lending Practices and Discriminatory Lending addresses concerns around Selling Practices and falls under ESG-Social in SASB's materiality map. Environmental Risk to Mortgaged Properties addresses capital concerns, a category that falls under ESG-Environmental. The metrics used to measure the impact of these topics may be quantitative, qualitative or both. In Fannie Mae's report, two metrics that address the Lending Practice topic are the number and value of single-family mortgages by type and FICO score (quantitative) and the description of remuneration structure of loan originators (qualitative).

SASB's Sustainability Disclosure Topics and Accounting Metrics

TOPIC	ACCOUNTING METRIC	CATEGORY	UNIT OF MEASURE	CODE
Lending Practices	(1) Number and (2) value of residential mortgages of the following types: (a) Hybrid or Option Adjustable-rate Mortgages (ARM), (b) Prepayment Penalty, (c) Higher Rate, (d) Total, by FICO scores above or below 660	Quantitative	Number, Reporting currency	FN-MF-270a.1
	(1) Number and (2) value of (a) residential mortgage modifications, (b) foreclosures, and (c) short sales or deeds in lieu of foreclosure, by FICO scores above and below 660	Quantitative	Number, Reporting currency	FN-MF-270a.2
	Total amount of monetary losses as a result of legal proceedings associated with communications to customers or remuneration of loan originators [2]	Quantitative	Reporting currency	FN-MF-270a.3
	Description of remuneration structure of loan originators	Discussion and Analysis	n/a	FN-MF-270a.4
Discriminatory Lending	(1) Number, (2) value, and (3) weighted average Loan-to-Value (LTV) ratio of mortgages issued to (a) minority and (b) all other borrowers, by FICO scores above and below 660	Quantitative	Number, Reporting currency, Percentage (%)	FN-MF-270b.1
	Total amount of monetary losses as a result of legal proceedings associated with discriminatory mortgage lending[3]	Quantitative	Reporting currency	FN-MF-270b.2
	Description of policies and procedures for ensuring nondiscriminatory mortgage origination	Discussion and Analysis	n/a	FN-MF-270b.3
Environmental Risk to Mortgaged Properties	(1) Number and (2) value of mortgage loans in 100-year flood zones	Quantitative	Number, Reporting currency	FN-MF-450a.1
	(1) Total expected loss and (2) Loss Given Default (LGD) attributable to mortgage loan default and delinquency due to weather-related natural catastrophes, by geographic region	Quantitative	Reporting currency, Percentage (%)	FN-MF-450a.2
	Description of how climate change and other environmental risks are incorporated into mortgage origination and underwriting	Discussion and Analysis	n/a	FN-MF-450a.3

Source: SASB Standards Downloads, Financials Industries, Mortgage Finance

On the securitization level, leading private label RMBS issuers have also begun making voluntary disclosures, some also referencing SASB standards. Redwood Trust Inc., an SFA member and one of the largest issuers of jumbo private label RMBS, responded to growing investors' desire for ESG information by disclosing certain ESG-related attributes that are identified in the SASB standards in the offering memorandum documents for their Sequoia securitizations. In Sequoia Mortgage Trust 2022-1, for example, Redwood Trust disclosed two Lending Practice metrics from the Mortgage Finance sub-industry — SASB's FN-MF-270a.1, which measures the number and value of residential mortgages with Hybrid or Option Adjustable-Rate Mortgages, Prepayment Penalty, or Higher Rate by FICO score, and FN-MF-270a.2, which measures the number and value of residential mortgage modifications, foreclosures and short sales or deeds in lieu of foreclosure, also by FICO score. Both of these metrics may be categorized as ESG-Social.

"As markets and the needs of our investors have evolved, so to have our disclosures," said Fred Matera, Managing Director and Head of Redwood Residential at Redwood Trust. "In this spirit, beginning with our December 2021 Sequoia securitization, Redwood proactively introduced disclosure of certain ESG attributes related to loans backing these securities. Redwood holds itself to a high standard when it comes to providing investors with consumable and relevant data for evaluating our products. We know from our investors that they are eager for greater visibility into ESG attributes of collateral and rely on this information for their evaluation process. We will continue this dialogue to ensure our ESG disclosures deliver relevant data points in the manner most useful to our investors."

While these disclosures provide investors with valuable information to evaluate ESG attributes of the pool, they are not intended to label the Sequoia RMBS offering as "green," "social," or "sustainable." However, as the market reaches consensus around these and other standards, these metrics can prove to be the starting point by which an investor can evaluate green, social, or sustainable aspects of a securitization investment.

SASB standards have met with wide acceptance, but they are not the only standards being referenced in voluntary disclosures. In early April 2021, Angel Oak Capital Advisors, part of Angel Oak Companies, a non-QM lender and SFA member, developed their Social Bond framework. The framework followed the Social Bond Principles of International Capital Market Association (ICMA) and was given a second party opinion (SPO) in March 2021 by Institutional Shareholder Services (ISS ESG), an external reviewer that references ICMA. SPOs, which were also received by Fannie Mae and Freddie Mac from Sustainalytics on their respective Social Bonds Frameworks, measure the financing objectives of a social bond program against the UN's Sustainable Development Goals (SDG). In 2021, Angel Oak issued eight private label RMBS, two of which were formally designated as Social Bonds issued under this framework.

SASB standards and ICMA principles differ in their approach. Issuers that align their programs to ICMA's Social Bond Principles (SBP) incorporate four core components – Use of Proceeds, Process for Project Evaluation and Selection, Management of Proceeds, and Reporting. These components aim to directly address or mitigate a specific social issue and to see positive social outcomes for a targeted population. The SBP promote integrity in the development of the social bond market by clarifying the approach for issuance of a social bond through voluntary process guidelines.

The cornerstone of a social bond is the Use of Proceeds component. To this end, social bonds issued by Angel Oak Mortgage Trust will "finance residential loans granted to an underserved population made up of borrowers with non-standard sources of income, borrowers that are self-employed/sole proprietors, first-time homebuyers, borrowers receiving down payment assistance, borrowers seeking to improve (cure) their credit status, borrowers and renters seeking affordable and workforce housing, and borrowers living in low- to moderate-income (LMI) census tracts and Opportunity Zones."

STRUCTURED FINANCE ASSOCIATION

To address the second SBP core component Angel Oak defined formal concepts around their processes for project evaluation. This ensures that the proceeds of the social bonds issued under the framework will ultimately be used to fund residential mortgage origination to expand access to housing finance for the target populations. Angel Oak addresses the last two SBP concepts – selection and management of proceeds, and reporting – by defining the criteria for loan purchases, the expected allocation period of the proceeds, the role of the servicer and the disclosure of performance information.

"While Fannie Mae and Freddie Mac have done an admirable job addressing affordable housing issues for many low- to moderate-income individuals, our Social Bond Framework serves a different cohort of underserved borrowers," said Rob McDonough, Director of ESG and Regulatory Initiatives at Angel Oak. "Our vertically integrated lending and securitization platform allows us to provide financing to borrowers who can't get access to credit from traditional lenders because they have non-standard sources of income. These include self-employed individuals who own small businesses or work in the gig economy who were especially hard-hit by COVID. Our Social Bond RMBS bring more diverse investors into the mix and create better access to credit for our borrowers."

How UN Sustainable Development Goals Are Relevant to ICMA's Social Bond Principles

UN SDG Goal	Maps to Social Bond Principles
No Poverty	Access to Essential Services, Affordable Housing, Socioeconomic Advancement and Empowerment
Zero Hunger	Access to Essential Services, Affordable Basic Infrastructure, Food Security, Socioeconomic Advancement and Empowerment
Good Health and Well Being	Access to Essential Services, Affordable Basic Infrastructure
Quality Education	Access to Essential Services, Socioeconomic Advancement and Empowerment
Gender Equality	Socioeconomic Advancement and Empowerment
Clean Water and Sanitization	Affordable Basic Infrastructure
Affordable and Clean Energy	Affordable Basic Infrastructure
Decent Work and Economic Growth	Access to Essential Services, Employment Generation, Socioeconomic Advancement and Empowerment
Industry Innovation and Infrastructure	Access to Essential Services, Affordable Basic Infrastructure, Employment Generation
Reduced Inequalities	Access to Essential Services, Socioeconomic Advancement and Empowerment
Sustainable Cities and Communities	Affordable Basic Infrastructure, Affordable Housing, Socioeconomic Advancement and Empowerment
Responsible Consumption and Production	Food Security
Climate Action	Not Relevant
Life Below Water	Socioeconomic Advancement and Empowerment
Life on Land	Socioeconomic Advancement and Empowerment

Source: ICMA Group

SFA members have strongly expressed that the absence of a standard framework in securitization has meant that ESG investing has been a challenge. To reap the benefits that standardization would bring to the securitization market, SFA has established an ESG Initiative to develop an ESG Disclosure Framework specifically for the structured finance market to address its unique considerations and needs including disclosure standards for each underlying asset class. As with all our best practice and standard setting initiatives, the SFA ESG framework will be built via our industry-wide consensus building forums to ensure it receives the full market's input. We invite the industry to discuss and reach consensus around a disclosure framework and identify common categories and topics that will build the ESG lexicon for securitization. Add your voice by joining the SFA ESG task force.