
Commentary

ESG Factors in RMBS, Part Two: Social Factors

DBRS Morningstar

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Introduction

This is the second in a series of commentaries that discusses environmental, social, and governance (ESG) factors affecting credit analysis that the DBRS Morningstar residential mortgage-backed security (RMBS) group conducts. In the first commentary, *ESG Factors in RMBS, Part One: Environmental Factors*, published on November 19, 2021, DBRS Morningstar discussed two environmental credit factors that it considers in its ratings analysis. In this commentary, DBRS Morningstar will cover four social credit factors and provide examples of how these important factors are considered in its RMBS credit rating analysis. A subsequent commentary will cover governance factors.

On March 10, 2020, DBRS Morningstar published *DBRS Morningstar's Approach to Environmental, Social, and Governance Risk Factors in Credit Ratings*, and on May 17, 2022, DBRS Morningstar published its *DBRS Morningstar Criteria: Approach to Environmental, Social, and Governance Risk Factors in Credit Ratings*, both of which outline our approach to evaluating ESG risk factors and their potential effect on credit ratings across four business lines: Governments, Financial Institutions, Structured Finance, and Corporate Finance. In the commentary, DBRS Morningstar identified 17 risk factors that DBRS Morningstar currently considers in its ratings process; however, it was determined that not every risk factor applies to each business unit or methodology. With regard to North American and European RMBS, DBRS Morningstar considers seven ESG risk factors in evaluating residential mortgage loans and RMBS transactions:

Environmental

- Carbon and Greenhouse Gas (GHG) Costs
- Climate and Weather Risks

Social

- Social Impact of Products and Services
- Human Capital and Human Rights
- Product Governance
- Data Privacy and Security

Governance

- Corporate/Transaction Governance

Discussion of Social Factors

DBRS Morningstar assesses social risk factors that could affect collateral defaults and recovery rates through quantitative analysis when estimating pool losses. When social factors emerge and are not yet reflected in performance data, DBRS Morningstar could evaluate their impact on portfolio credit performance through qualitative analysis.

Factor #1: Social Impact of Products and Services

With regard to the social impact of products and services, DBRS Morningstar determines

- If the securitized assets (loans secured by residential properties) have an extraordinarily positive or negative social impact on the borrowers and/or society and if the characteristics of these assets result in different default rates and/or recovery expectations.
- If a business model (typically that of the lender and/or servicer) has an extraordinarily positive or negative social effect on stakeholders and/or society and when this results in different default rates and/or recovery expectations.
- If changes in consumer behaviour or secular social trends affect the default and loss risk of the securitized assets.

Our analysis focuses on risks or benefits to the operations and the performance of the underlying securitized assets, particularly in the case of an extraordinary social impact that could affect collateral performance.

Examples of risks related to the social impact of products and services that could affect credit analysis include the following:

- Government or private programs that promote homeownership can have a positive effect on low-income communities. However, these programs could affect the credit analysis in several ways, including potentially lower credit standards and the need for additional training and effective procedures on early default resolution, which are often needed to mitigate the potential for higher delinquencies.
- The Nationale Hypotheek Garantie (NHG) in the Netherlands supports sustainable homeownership. In this scheme, an established government-guaranteed fund provides guarantees on mortgage loans that meet NHG's qualifying criteria. This results in a lower cost of borrowing and lower risks for lenders in case of borrower default. DBRS Morningstar published a commentary titled [*NHG: A Dutch Loan Guarantee Program That Is Both Socially Supportive and Credit Positive*](#) on September 2, 2020, highlighting NHG's potential credit-positive impact in its credit analysis.
- The UK's Help to Buy and Right to Buy schemes have a social impact by helping first-time buyers and renters purchase properties. The Right to Buy scheme allows most council tenants to buy their council homes at a discount. We consider the higher default risk (because of the type of borrowers/leverage) and loss severity (because of Right To Buy's lower property value) as having a negative impact on credit analysis.
- Predatory loans are generally characterized by very high interest rates that may include excessive fees and undisclosed terms, which may have a negative impact on communities. Predatory lenders typically target vulnerable borrowers and trap them in cycles of debt that can lead to foreclosure and even

bankruptcy. Loans with such characteristics may have higher default rates, negatively affecting credit analysis.

- Servicers facing regulatory actions, labour disputes, or higher turnover of loan-servicing staff may face collections disruptions. This unmitigated risk could increase liquidity risk and extend recovery timing, thus causing higher default rates.

Factor #2: Human Capital and Human Rights

With regard to human capital and human rights, DBRS Morningstar determines if the originator, servicer, and/or sponsor(s) are exposed to staffing risks, which could have a financial or operational effect on the structured finance transaction.

The primary focus of this factor is the availability of sufficient human capital to staff entities with material roles in the origination and servicing of loans. If an entity demonstrates poor employment conditions such as a lack of training; low pay; lack of promotion opportunities; or no diversity, equity, and inclusion commitments, it could lead to difficulty retaining and attracting talented staff. Such a situation could potentially affect the ability to originate and service loans. We consider human rights issues in the context of the potential for fines or other regulatory actions. For instance, a servicer fined by the Financial Conduct Authority for cross-selling inappropriate insurance products is an example of unmitigated compliance risk that could hurt its operations. Therefore, DBRS Morningstar is concerned about originators' and servicers' exposure to staffing risks that could result in negative financial and operational conditions. DBRS Morningstar's criteria focuses primarily on the impact on servicer staffing, rather than the broader effects of housing affordability, community development, values alignment, and other human rights issues.

In addition, DBRS Morningstar incorporates operational risk review results in its collateral analysis. Operational risk in structured finance can generally be defined as the risk of financial loss or a decline in value (or rating) resulting from inadequate or failed people, processes, or systems of a party to a transaction or from external events. These risk factors can potentially have direct and/or indirect ramifications on businesses, investors, clients, employees, and/or other transaction parties. DBRS Morningstar assesses social factors that affect the operational risk performance. When social factors are emergent and not yet reflected in performance, our methodology allows us to assess how well prepared the business being assessed is to deal with these factors.

Examples of human capital and human rights risks considered during operational risk reviews that may have negative implications include the following:

- Employment of staff that do not have the appropriate legal paperwork to work in the country.
- Violation of human rights by redlining (i.e., denying credit because of race, health, or neighbourhood).
- Abusive collections practices that involve threatening and/or intimidating borrowers or tenants.
- If a servicer's office is in a remote location, it may have difficulty attracting and retaining qualified employees, affecting its servicing ability.
- Servicers or originators that engage in unethical workout procedures by offering borrowers repayment plans that they know the borrower cannot afford, causing them to lose the home, will likely experience increased default risk or potentially face legal fines/settlements and higher levels of regulatory oversight.
- A sponsor could have a history of unfair labour and compensation practices that limit the advancement of women or minorities and result in unequal pay, which may make it difficult to attract and retain staff.

Factor #3: Product Governance

With regard to product governance, DBRS Morningstar determines if the originator's, sponsor's and/or servicer's failure to deliver quality products and services adversely affects the quality of the operations; this may result in a higher default risk and/or lower recovery expectations for the securitized assets.

DBRS Morningstar's primary focus related to product governance is the ability of the sponsors and servicers to provide an appropriate high level of service to protect the quality of the underlying collateral. Inadequate loss-mitigation strategies, unfair lending practices, and/or mis-selling or poor foreclosure practices leading to extended foreclosures may affect recoveries negatively. DBRS Morningstar focuses on the potential risks arising from failure of the originator, sponsor, or servicer to deliver quality products and services that may result in higher default risk and/or lower recovery expectations for the securitized assets.

Examples of product governance risks that could affect credit analysis include the following:

- Unmitigated risk of redress for mis-selling and/or regulatory findings that can lead to fines.
- Lending practices that impose unfair or deceptive loan terms on a borrower may negatively affect recoveries.
- Mismanagement of the securitized asset may negatively affect cash flow and recoveries. Examples include hiring underqualified servicing staff and failure to comply with local laws and ordinances.
- Inaccurate reporting of a borrower's payment history to the credit bureaus can negatively affect operations and violate regulatory compliance.

Factor #4: Data Privacy and Security

With regard to data privacy and security, DBRS Morningstar will use information provided by the company and publicly available information to determine if the originator's, servicer's, or sponsor's misuse or negligence in maintaining private client or stakeholder data results in financial penalties or losses for the collateral. Data breaches could lead to financial loss, disruption of operations, damage to the company's reputation, and legal issues. A civil or other type of lawsuit could negatively affect the

parties. DBRS Morningstar will also consider the potential impact of regulation and fines. For example, the General Data Protection Regulation allows Europe's Data Protection Authorities to impose fines of up to EUR 20 million or 4% of annual global turnover (whichever is higher).

Examples of data privacy and security risks that could affect credit analysis include the following:

- The issuer's or its agents' unmitigated misuse or negligence in establishing and maintaining processes protecting sensitive financial information may result in operational disruptions and/or negatively affect recoveries.
- Lapses in data privacy and security could severely hamper a counterparty's ability to conduct business, especially because several financial institutions may have multiple roles in transactions, including as issuers, servicers, custodians, and sponsors of some transactions.
- A sponsor could fail to establish operating standards and procedures for handling data, which may make it more susceptible to data breaches and theft of private data. These lapses in data privacy and security could also hamper its ability to conduct business and/or result in fines.

DBRS Morningstar considers social factors, as applicable, when conducting operational risk reviews for structured finance transactions. DBRS Morningstar believes it is important for its rated transactions to be in compliance with the regulatory requirements established within their respective jurisdictions and to be in good standing with regulators. DBRS Morningstar views favourably companies that are not subject to any regulatory investigation(s) and have fewer borrower complaints filed.

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