Commentary

ESG Factors in RMBS, Part Three: Governance

DBRS Morningstar
January 25, 2023

Utsav Shah
Senior Analyst
RMBS Mumbai
+91 022 6121 7100
utsav.shah@morningstar.com

Paul Bretzlaff
Senior Vice President
CAN Structured Finance
+1 416 597-7330
paul.bretzlaff@dbrsmorningstar.com

Sagar Kongettira
Managing Director
U.S. RMBS
+1 203 883-5856
sagar.kongettira@dbrsmorningstar.com

Ketan Thaker
Head of European RMBS and Covered Bonds
European Structured Finance
+44 20 3356 1525
ketan.thaker@dbrsmorningstar.com

Introduction

This is the third and final commentary 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 the second commentary, *ESG Factors in RMBS, Part Two: Social Factors*, published on May 19, 2022, DBRS Morningstar discussed the four social credit factors that it considers in its ratings analysis. In this commentary, we will cover the single governance factor and will provide examples of how this important factor is considered in our RMBS credit rating analysis.

DBRS Morningstar Criteria: Approach to Environmental, Social, and Governance Risk Factors in Credit Ratings outlines 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 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 The Governance Factor

Structured finance debt issuers are usually special-purpose vehicles (SPV) or trusts that are established for the sole purpose of owning the assets and issuing the SPV debt. SPVs have stringent rules to ensure bankruptcy remoteness, restrictions on active management, and, typically, counterparty replacement mechanisms. The transaction governance factor relates to the independence of the issuer or trust, alignment of interest between transaction parties, and provisions for future events, all of which can affect a transaction's credit performance, whereas ongoing performance reporting affects the ability to monitor credit risk. The benchmark DBRS Morningstar uses for transaction governance is difficult to exceed, hence governance considerations will likely be credit neutral in most cases but can also be credit negative.

Transaction Governance

With regard to transaction governance, DBRS Morningstar:

- Reviews whether the transaction's structure affects the assessment of the credit risk posed to investors because of a lack of appropriate independence of the issuer from the originator and/or other transaction parties.
- Considers the alignment of interest between the transaction parties and noteholders. Does this affect the assessment of credit risk posed to investors because the alignment of interest is inferior or superior to comparable transactions in the sector?
- Evaluates defined mechanisms in the structure and how they deal with future events and how they may affect the assessment of credit risk posed to investors.
- Considers how the transaction's structure provides for timely and appropriate performance and asset reporting. Does this affect the assessment of credit risk posed to investors because it is inferior or superior to comparable transactions in the sector?

Examples of transaction governance risks that could affect the RMBS credit analysis include:

- Misalignment of interest between transaction parties and noteholders of different seniority may affect the credit risk for noteholders as a whole or noteholders of different seniority within the issuer’s capital structure.
- Servicers that advance principal and interest (P&I) and are also the holders of subordinate notes could result in conflict of interests as P&I may be advanced for longer since it may be beneficial to the subordinate noteholders, but it may also cause higher severities.
- Weak representations and warranties (R&W) provided by transaction parties about the accuracy of data of the mortgage loans, compliance with underwriting guidelines, and compliance with appraisal industry standards combined with insufficient third-party due diligence may affect the assessment of credit risk posed to noteholders.
- Weak R&W enforcement mechanisms that are inferior to comparable transactions in the sector in areas such as procedures to put forth a claim, automatic review of breaches, and the use of arbitration to settle disputes may affect the assessment of credit risk posed to noteholders.
- Transaction structures that contain weak provisions relative to comparable transactions in the sector in areas such as sponsor incentives and profit extraction mechanisms/priority may affect the assessment of credit risk posed to noteholders.

About DBRS Morningstar

DBRS Morningstar is a full-service global credit ratings business with approximately 700 employees around the world. We're a market leader in Canada, and in multiple asset classes across the U.S. and Europe.

We rate more than 3,000 issuers and nearly 60,000 securities worldwide, providing independent credit ratings for financial institutions, corporate and sovereign entities, and structured finance products and instruments. Market innovators choose to work with us because of our agility, transparency, and tech-forward approach.

DBRS Morningstar is empowering investor success as the go-to source for independent credit ratings. And we are bringing transparency, responsiveness, and leading-edge technology to the industry.

That's why DBRS Morningstar is the next generation of credit ratings.

Learn more at dbrsmorningstar.com.

The DBRS Morningstar group of companies consists of DBRS, Inc. (Delaware, U.S.)(NRSRO, DRO affiliate); DBRS Limited (Ontario, Canada)(DRO, NRSRO affiliate); DBRS Ratings GmbH (Frankfurt, Germany)(EU CRA, NRSRO affiliate, DRO affiliate); and DBRS Ratings Limited (England and Wales)(UK CRA, NRSRO affiliate, DRO affiliate). DBRS Morningstar does not hold an Australian financial services license. DBRS Morningstar credit ratings, and other types of credit opinions and reports, are not intended for Australian residents or entities. DBRS Morningstar does not authorize their distribution to Australian resident individuals or entities, and accepts no responsibility or liability whatsoever for the actions of third parties in this respect. For more information on regulatory registrations, recognitions and approvals of the DBRS Morningstar group of companies, please see: https://www.dbrsmorningstar.com/research/225752/highlights.pdf.

The DBRS Morningstar group of companies are wholly-owned subsidiaries of Morningstar, Inc.

© 2023 DBRS Morningstar. All Rights Reserved. The information upon which DBRS Morningstar credit ratings and other types of credit opinions and reports are based is obtained by DBRS Morningstar from sources DBRS Morningstar believes to be reliable. DBRS Morningstar does not audit the information it receives in connection with the analytical process, and it does not and cannot independently verify that information in every instance. The extent of any factual investigation or independent verification depends on facts and circumstances. DBRS Morningstar credit ratings, other types of credit opinions, reports and any other information provided by DBRS Morningstar are provided "as is" and without representation or warranty of any kind and DBRS Morningstar assumes no obligation to update any such ratings, opinions, reports or other information. DBRS Morningstar hereby disclaims any representation or warranty, express or implied, as to the accuracy, timeliness, completeness, merchantability, fitness for any particular purpose or non-infringement of any of such information. In no event shall DBRS Morningstar or its directors, officers, employees, independent contractors, agents, affiliates and representatives (collectively, DBRS Morningstar Representatives) be liable (1) for any inaccuracy, delay, loss of data, interruption in service, error or omission or for any damages resulting therefrom, or (2) for any direct, indirect, incidental, special, compensatory or consequential damages arising from any use of credit ratings, other types of credit opinions and reports or arising from any error (negligent or otherwise) or other circumstance or contingency within or outside the control of DBRS Morningstar or any DBRS Morningstar Representative, in connection with or related to obtaining, collecting, compiling, analyzing, interpreting, communicating, publishing or delivering any such information. IN ANY EVENT, TO THE EXTENT PERMITTED BY LAW, THE AGGREGATE LIABILITY OF DBRS MORNINGSTAR AND THE DBRS MORNINGSTAR REPRESENTATIVES FOR ANY REASON WHATSOEVER SHALL NOT EXCEED THE GREATER OF (A) THE TOTAL AMOUNT PAID BY THE USER FOR SERVICES PROVIDED BY DBRS MORNINGSTAR DURING THE TWELVE (12) MONTHS IMMEDIATELY PRECEDING THE EVENT GIVING RISE TO LIABILITY, AND (B) U.S. $100. DBRS Morningstar does not act as a fiduciary or an investment advisor. DBRS Morningstar does not provide investment, financial or other advice. Credit ratings, other types of credit opinions and other analysis and research issued by DBRS Morningstar (a) are, and must be construed solely as, statements of opinion and not statements of fact as to credit worthiness, investment, financial or other advice or recommendations to purchase, sell or hold any securities; (b) do not take into account your personal objectives, financial situations or needs; (c) should be weighed, if at all, solely as one factor in any investment or credit decision; (d) are not intended for use by retail investors; and (e) address only credit risk and do not address other investment risks, such as liquidity risk or market volatility risk. Accordingly, credit ratings, other types of credit opinions and other analysis and research issued by DBRS Morningstar are not a substitute for due care and the study and evaluation of each investment decision, security or credit that one may consider making, purchasing, holding, selling, or providing, as applicable. A report with respect to a DBRS Morningstar credit rating or other credit opinion is neither a prospectus nor a substitute for the information assembled, verified and presented to investors by the issuer and its agents in connection with the sale of the securities. DBRS Morningstar may receive compensation for its credit ratings and other credit opinions from, among others, issuers, insurers, guarantors and/or underwriters of debt securities. This publication may not be reproduced, retransmitted or distributed in any form without the prior written consent of DBRS Morningstar. ALL DBRS MORNINGSTAR CREDIT RATINGS AND OTHER TYPES OF CREDIT OPINIONS ARE SUBJECT TO DEFINITIONS, LIMITATIONS, POLICIES AND METHODOLOGIES THAT ARE AVAILABLE ON https://www.dbrsmorningstar.com. Users may, through hypertext or other computer links, gain access to or from websites operated by persons other than DBRS Morningstar. Such hyperlinks or other computer links are provided for convenience only. DBRS Morningstar does not endorse the content, the operator or operations of third party websites. DBRS Morningstar is not responsible for the content or operation of such third party websites and DBRS Morningstar shall have no liability to you or any other person or entity for the use of third party websites.