ESG Industry Report Card: Residential Mortgage-Backed Securities

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Key Takeaways

- The residential mortgage-backed securities (RMBS) sector has average exposure to environmental credit factors, given that the geographic diversification of collateral pools reduces exposure to physical climate risks.
- Social credit factors are above average for the RMBS sector. Regulators are increasingly focused on ensuring that lenders are considering the borrower's affordability in underwriting, and managing delinquent borrowers given that housing is a basic need. We believe the exposure would be relatively higher for nonprime mortgages due to affordability considerations.
- Governance credit factors are below average for RMBS given that collateral pools are typically static, the roles and responsibilities of each transaction party and the allocation of cash flows are well defined, and transactions are structured to achieve isolation of the assets from the seller. However, governance weaknesses at the originator or servicer levels could still have a negative rating effect.

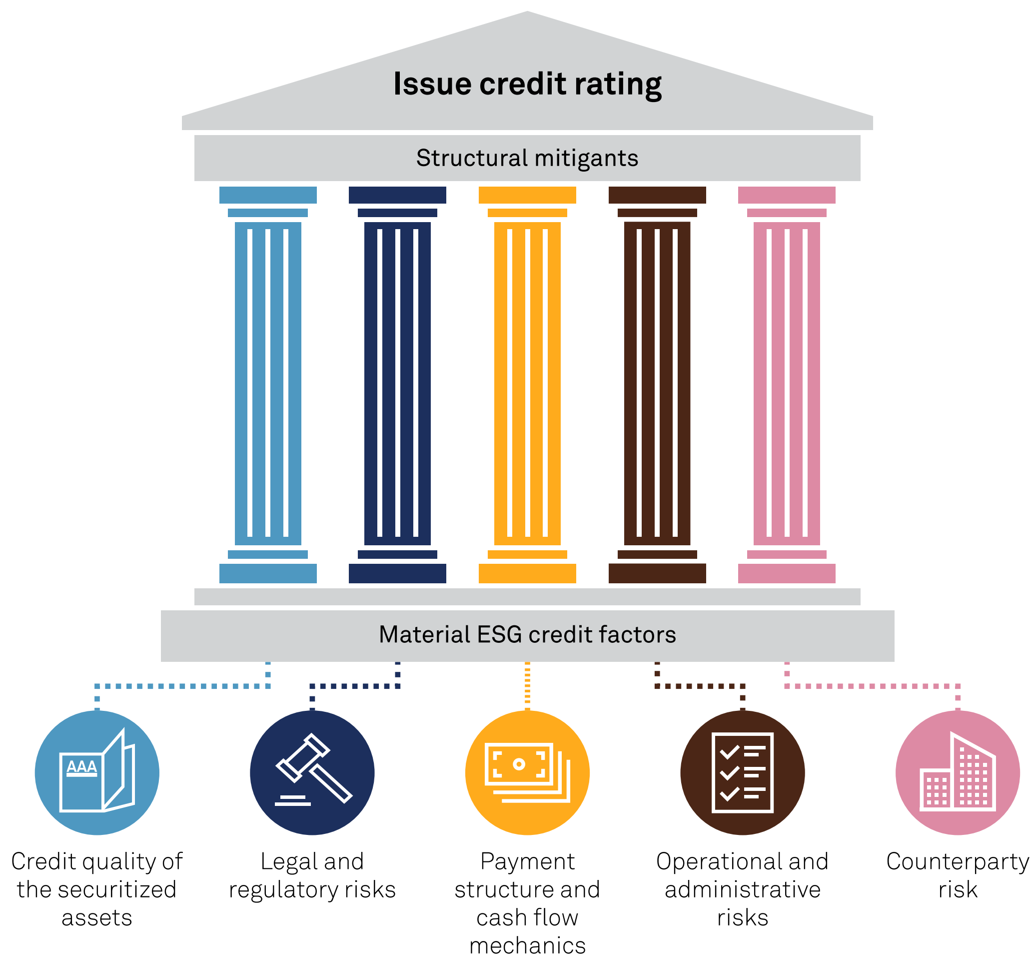
Analytic Approach

Environmental, social, and governance (ESG) risks and opportunities can affect an obligor's capacity to meet its financial commitments in many ways. S&P Global Ratings incorporates these factors into its ratings methodology and analytics, which enables analysts to factor near-, medium-, and long-term effects--both qualitative and quantitative--during multiple steps in the credit analysis. Strong ESG credentials do not necessarily indicate strong creditworthiness (see "The Role Of Environmental, Social, And Governance Credit Factors In Our Ratings Analysis," published on Sept. 12, 2019).

Our credit ratings on structured finance transactions incorporate ESG credit factors when, in our opinion, they could affect the likelihood of timely payment of interest or ultimate repayment of principal by the legal final maturity date of the securities. However, in most cases, exposure to ESG credit factors in structured finance transactions is indirect or mitigated by legal and structural features already embedded in typical transactions.

Chart 1

How We Consider ESG Factors In Our Structured Finance Analytical Framework



Source: S&P Global Ratings.
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Our ESG industry report cards qualitatively explore the relative exposures (average, below average, above average) of different sectors to ESG credit factors over the short-, medium-, and long-term. This sector comparison is not an input to our credit ratings or a component of our credit rating methodologies; it is based on our current qualitative, forward-looking opinion of potential credit risks across sectors. In addition, the structured finance ESG industry report cards list examples of ESG credit factors for the sector that may have a more positive or negative influence on a transaction's credit quality compared to sector peers or the broader sector.

The qualitative assessment of the relative exposure to ESG credit factors for each sector reflects the potential exposure to ESG risks. It does not consider the presence of structural features that could mitigate these risks (e.g. credit enhancement, short-time horizon of a transaction, insurance, etc.). Therefore, even if there is a material ESG credit factor for a given sector or transaction, there may ultimately be no ratings impact if structural mitigants are present. This is because we assign issue credit ratings to structured finance securities. These credit opinions address the likelihood of repayment of a specific financial obligation, and consider forms of credit

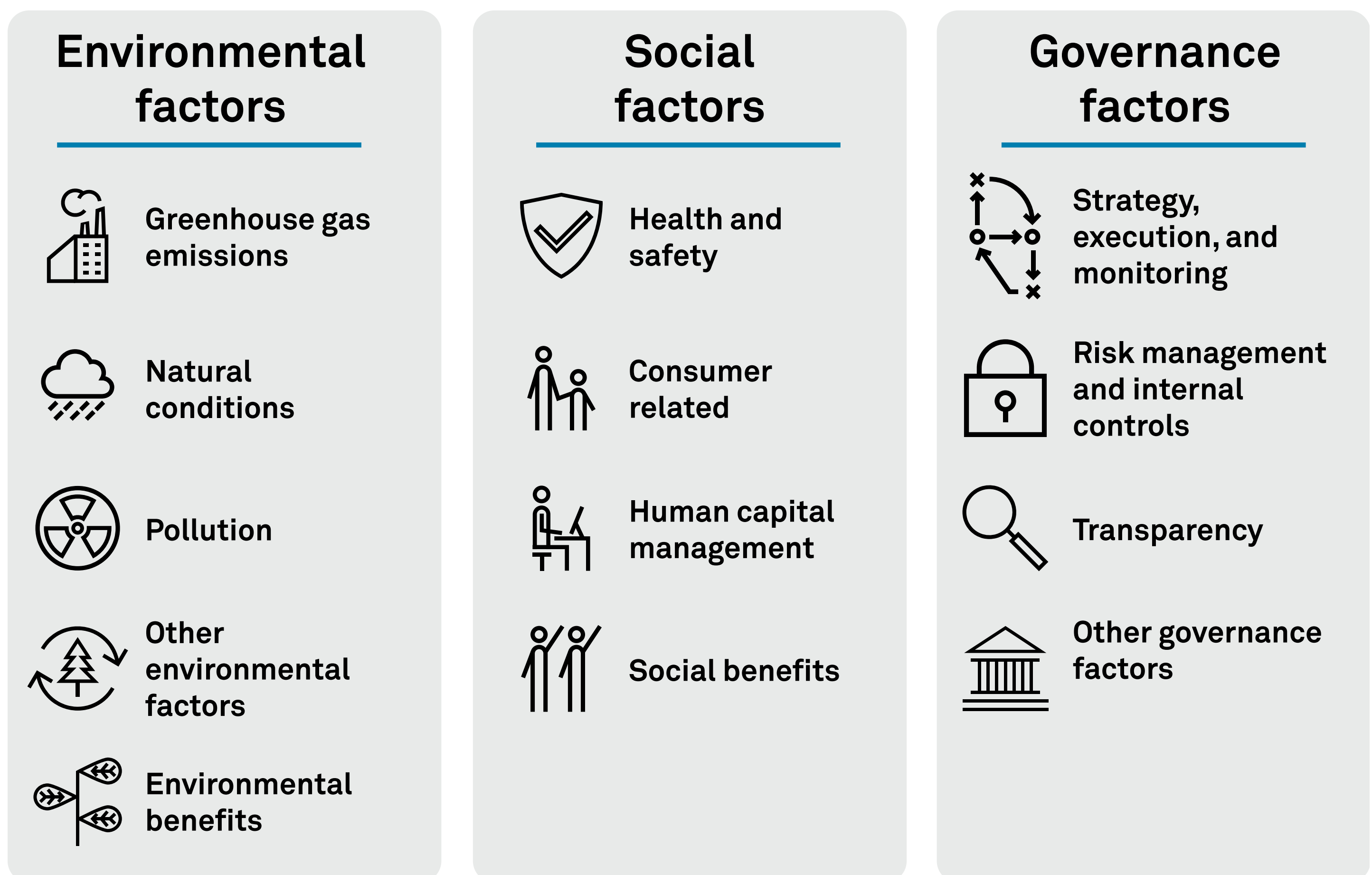
enhancement, such as collateral security and subordination. This differs from issuer credit ratings (ICR) that we assign to corporates and sovereigns, for example. Our ICRs are opinions about an obligor's overall creditworthiness, and do not apply to any specific financial obligation, as they do not take into account the nature and provisions of the obligation, their standing in bankruptcy or liquidation, statutory preferences, or their legality and enforceability. Therefore, ESG credit factors that could affect a corporate issuer's ICR may not be material to a structured finance issue credit rating, and vice versa (see "S&P Global Ratings Definitions," published on Jan. 5, 2021).

ESG Credit Factors

We define ESG credit factors as ESG risks, or opportunities, that influence an obligor's capacity and willingness to meet its financial commitments. This influence could be reflected, for example, through reduced ability of the underlying borrowers to repay the securitized receivables, the value of any collateral, disruptions in servicing or transaction cash flows, financial exposures to transaction counterparties, or increased legal and regulatory risks.

Chart 2

Examples Of ESG Credit Factors



This report explores how ESG credit factors could influence the credit quality of RMBS and provides a benchmark for typical ESG considerations in the sector. Specific transactions may be

exposed to ESG credit factors that could have a more positive or negative influence on the credit rating than the sector benchmark. These comparative views of ESG risks across transactions are typically qualitative at present, because there are currently limited ESG data points that are widely available to quantify the relative risks. Over time, we expect that a common taxonomy for ESG credit factors across structured finance sectors will emerge, at which point more data will become available to strengthen our analysis of ESG credit factors.

In our published rating rationales, we expect to provide more insight and transparency of any ESG credit factors that are material to our credit ratings in a dedicated ESG paragraph. Our goal is to highlight how a transaction compares to our ESG sector benchmark (where applicable), identify the relative ESG risks and opportunities, and discuss any structural mitigants to these risks. However, if in our view ESG credit factors are not material to the credit risk profile of a transaction, we generally would not make any specific disclosures beyond a reference to our ESG sector benchmarks, where applicable. Through this initiative we aim to highlight how our rating analysis has accounted for specific ESG credit factors and add transparency around which ESG credit factors could drive future rating changes, if any.

RMBS ESG Benchmark

Our ESG sector benchmark for RMBS consists of a static pool of prime quality, fully amortizing mortgages, originated by a regulated financial institution to individuals with no adverse credit history for the purchase of owner-occupied properties. The pools are highly diversified by obligor and geography, and the mortgage loans are not delinquent when sold to the issuer.

Exposure to environmental credit factors for the benchmark is considered average. Physical climate risks such as floods, storms, or wildfires, could severely damage properties and reduce their value, impacting recoveries if borrowers default. In our view, well-diversified portfolios reduce exposure to extreme weather events.

Social credit factors are considered above average because housing is viewed as one of the most basic human needs. Conduct risk presents a direct social exposure for lenders and servicers, particularly as regulators are increasingly focused on ensuring fair treatment of borrowers, predominately retail ones. Aggressive collection practices or failure to underwrite in accordance with applicable regulations would increase legal and regulatory risks. In our view, social risks would be relatively higher for nonprime borrowers given affordability considerations.

Exposure to governance credit factors is below average. Given the nature of structured finance transactions, most have relatively strong governance frameworks through, for example, the generally very tight restrictions on what activities the special-purpose entity can undertake compared to other entities. Given that our ESG benchmark is a static pool with no reinvestment, the originator's role becomes less active over the transaction's life, mitigating the risk of loosening underwriting standards or potential adverse selection. Large mortgage lenders generally have strong internal control frameworks with external audits and oversight in place. In our view, the RMBS transactions that would have relatively higher exposure to governance credit factors would be those that are revolving, or have a prefunding mechanism, or that include loans from originators with a short track record or weak internal controls.

Environmental Credit Factors

ESG Benchmark: Average Exposure

Environmental Factors

Greenhouse gas emissions	Natural conditions	Pollution	Other environmental factors	Environmental benefits
Generally not a potential material exposure for this asset class.	Concentrations by obligor, industry, or geography may increase exposure to potential natural disasters or other physical climate-related risks, such as hurricanes, wildfires, earthquakes, and flooding.	Generally not a potential material exposure for this asset class.	Generally not a potential material exposure for this asset class.	Mortgage contracts may contain a reduction in the contractual rate of interest payable by borrowers as the energy performance certificate rating on their property improves. This could result in lower yield to the issuer as properties become more energy efficient.
	The servicer's operations may be exposed to physical climate risks, potentially resulting in a disruption in collections.			
	The rating on the sovereign where the securitized assets are domiciled can cap structured finance transaction ratings. The sovereign rating may be impacted by natural disasters or other climate change-related risks.			

Social Credit Factors

ESG Benchmark: Above Average Exposure

Social Factors

Health and safety	Consumer related	Human capital management	Social benefits
In concentrated pools, such as multifamily, properties found to have not been constructed in accordance with building codes could experience market value declines or potentially be condemned.	Changing urbanization trends could affect property values. This risk may be higher for concentrated portfolios by geography or property type.	High turnover of collections staff, labor disputes, or industrial action at the servicer could lead to a disruption in collections, increasing liquidity risk and extending recovery timing.	Programs that help provide access to affordable housing finance, such as government guarantees or incentives, may reduce loss severities. However, lower interest rates for these borrowers may also reduce excess spread in transactions.
In transactions with geographic concentrations, concerns regarding the safety of the communities where the properties are located, such as the availability of potable water, could affect property valuations.	Credit scoring methods applied to lend to underserved communities may be untested in stressed economic environments. This could lead to higher defaults than expected.		
A pandemic could result in cash flow declines that affect required credit enhancement levels and increase liquidity risks. For example, foreclosure timelines may be extended, or mandatory payment holidays may be offered to consumers who are affected by the pandemic.	Interest rates deemed usurious could result in reduced yield or could challenge the validity of the loans in securitized pools.		
	Consumer credit legislation and regulation, including affordability considerations or aggressive collection practices, could increase legal and regulatory risk for some products.		
	Restrictions that prevent lenders from realizing on the security, such as a moratorium on foreclosures or extended use of payment plans, may reduce recoveries, increase liquidity risk, or result in longer recovery timing.		

Governance Credit Factors

ESG Benchmark: Below Average Exposure

Governance Factors

Strategy, execution, and monitoring	Risk management and internal controls	Transparency	Other governance factors
For management teams with a limited track record in the sector, there may be higher defaults or increased operational risk.	Revolving collateral pools, or transactions with a prefunding mechanism, may be subject to deterioration in underwriting or adverse selection.	Concerns on data quantity, quality, and timeliness may affect our ability to rate a transaction, or potentially cap the rating.	Compensation structure and incentives of different transaction parties can result in conflicting interests, which may not have a strong alignment of interest with noteholders.
Increasing risk appetite of the originator, aggressive growth, or expansion into new products may result in higher defaults than the historical performance data reflects.	Bankruptcy risk could be heightened for key transaction parties that exhibit weak governance and internal controls.	The lack of a third-party audit, limited scope, or material due diligence findings may increase uncertainty of the credit quality of the collateral.	
Key man risk and a lack of succession planning at the originator or servicer may increase operational risk.	Several governance-related factors could increase the likelihood of a special-purpose entity entering insolvency proceedings. This might include weak documentation regarding restrictions on an issuer's objects and powers, debt limitations, and independent directors; restrictions on a merger or reorganization; and limitations on amendments to organizational documents, separateness, and security interests over the issuer's assets.	Lack of transparency in loan documentation and any related finance or insurance products, such as payment protection insurance, could increase legal and regulatory risk or result in potential set-off.	
	A successful cyberattack on the servicer could disrupt collections or result in a loss of borrower data that exposes the issuer to legal or regulatory risks.		
	The lack of a transition plan for a backup servicer, or inability to replace a key transaction party, may increase operational risk in a transaction.		
	A weak compliance culture of the originator and servicer could increase legal and regulatory risk.		
	Failure of a transaction counterparty to comply with documented remedies if its credit quality deteriorates could increase counterparty risk.		

Governance Factors (cont.)

Strategy, execution, and monitoring	Risk management and internal controls	Transparency	Other governance factors
	Failure of an originator and servicer to comply with applicable regulation could increase legal and regulatory risk, including the enforceability of the loans.		
	The lack of replacement provisions for interest rate benchmarks could lead to basis risk, reductions in cash flows, and increased legal and regulatory risk.		
	Weak representations and warranties provided by transaction parties may increase uncertainty of the credit quality of the collateral.		
	Extensive use of manual overrides or exceptions to automated underwriting scorecards may increase uncertainty of the credit quality of the collateral.		
	Flexibility of key transaction counterparties with respect to definitions, covenants, and performance triggers in the governing documents could lead to release of credit enhancement. For example, the ability of the servicer to amend the time period that defines when loans are considered defaulted.		

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