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Amundi Pioneer

ASSET MANAGEMENT

ESG

ESG in Securitized Assets

A Principled Approach

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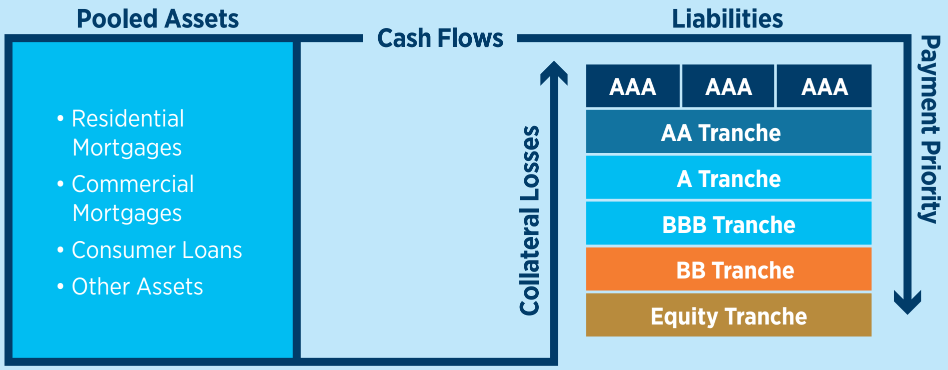
Executive Summary

- Securitized assets do not fit neatly within the ESG framework frequently employed in corporate bond and equity markets, but ESG considerations remain a critical component of sound credit analysis.
- Because of the unique nature of securitized assets, we believe a principled approach to ESG is more appropriate than a quantitative methodology.
- As prudent managers of capital, we integrate ESG principles into our credit analysis of securitized assets.

What Is a Securitization?

A securitization is a transaction in which assets are placed into a legal vehicle that issues bonds whose principal and interest payments are backed by the cash flows from the vehicle's assets. Common asset types include residential mortgages, commercial mortgages and consumer loans. To satisfy investor demand for different levels of risk and potential return, securitizations are "tranched" – or issued at varying levels of credit quality and payment priorities.



Challenges to ESG Analysis within Securitized Assets

Within fixed income, securitized assets present a unique set of challenges to ESG analysis.

The movement towards ESG has gained traction within equities. But, as others have noted, the approaches to ESG established in equities do not always translate to fixed income sectors. For example, debt investors lack the right to participate in proxy votes and shareholder proposals, thereby limiting the role that ESG activism can play within fixed income. Also, while equity investing involves perpetual ownership, finite maturities in fixed income mean the long term costs and benefits of ESG may not come to fruition during the investment horizon. Within fixed income, securitized assets present a unique set of challenges to ESG analysis.

Challenges to Applying ESG to Securitized Assets

1. **Complexity.** Securitizations often involve multiple parties and assets with nuanced history.
2. **Opacity.** Data is often unavailable for the parties involved in securitizations.
3. **Objectivity.** There are no third party providers of ESG scores for securitized assets.

1. Complexity. The most immediate obstacle is the very legal essence of a securitization. Unlike corporate bonds and equities, the actual issuer of a securitization is a legal entity with no employees, no management team and no real business activity. Attempts to extend an ESG framework to the securitization's related parties must differentiate between the issuer and the originator (the entity responsible for having created the assets), the sponsor (the entity responsible for having selected the assets), the trustee (the entity responsible for remitting payments and enforcing rights), and the servicer (the entity responsible for maintaining the assets).

This is not merely an operational mapping challenge. Within this complex web of rights and relationships, the motivations for ESG can break down. For example, should an ESG investment process prohibit investing in a securitization of residential mortgages if the originator had a predatory disregard for consumer wellbeing? What if, subsequent to becoming non-performing, these mortgages were then sold and transferred to a servicer whose remediation efforts include consumer-friendly debt relief? What if the trustee to the securitization is owned by a large bank with social or governance issues in another business line? Such nuances are not unusual. An ESG investment process is likely to fall short of its goals if it is mechanically extended to securitizations where many of the multiple parties involved will be immaterial or unmeasurable.

2. Opacity. The businesses that finance their activities via securitizations are often privately held entities that lack the transparency that has enabled the ESG scoring approaches established in equities and corporate bonds. Assuming one can decide upon which entity to score, the problem of assigning an ESG score shifts to the opacity around that entity's business practices. Large corporations that finance themselves with traditional debt or equity may be willing to divulge this information in exchange for access to public capital markets, but for the smaller private parties often encountered in securitization markets, this information is often considered a proprietary trade secret.

3. Objectivity. For these reasons, there are currently no third party providers of ESG scores for securitized assets. Utilizing an objective measure is simply not an option. Without a third party score, investor attempts at developing a proprietary ESG score cannot be readily measured for their objectivity or their materiality to investment results.

Why Does ESG Matter to Securitized Assets?

Perhaps the most convincing argument for the relevance of ESG to securitized assets is the subprime mortgage crisis.

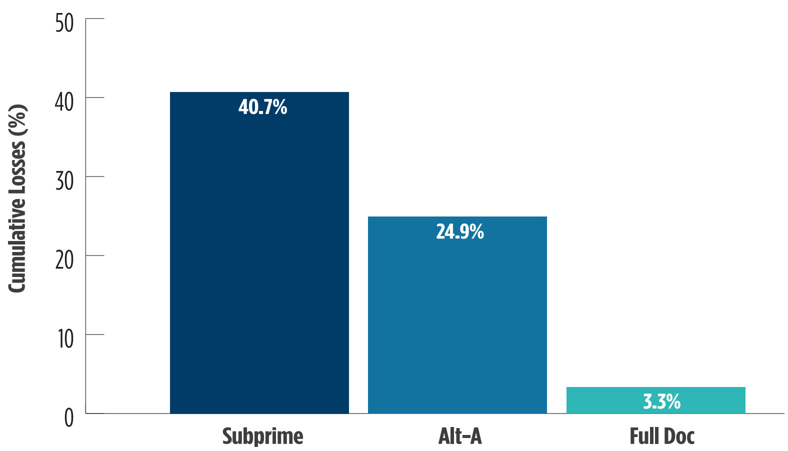
Despite these obstacles, we believe ESG is an important component of a responsible investment strategy in securitized assets. In fact, in many ways, ESG is especially important in securitized assets. Many ESG risks can be thought of as tail risks or event risks. Climate change could impair an asset's value, a business's social impact could invite a catastrophic regulatory intervention, and lax governance could allow for fraudulent representations of asset quality. Securitized investors are painfully familiar with such scenarios.

Perhaps the most convincing argument for the relevance of ESG to securitized assets is the subprime mortgage crisis. During this era, many consumers were steered into unaffordable products without regard for the consumer's wellbeing or the externalities of the industry's eventual outcome. Lax governance enabled fraud at multiple levels, providing additional fuel for the fire. Incorporating ESG into the credit process could possibly have prevented this era's tragic and costly conclusion for investors and society alike.

The Subprime Mortgage Crisis

In 2007, lending practices that ignored consumer wellbeing and inadequate governance experienced massive losses compared to properly underwritten full-documentation (full doc) mortgages from the same period.

In 2007, Subprime Lenders Suffered the Greatest Losses



Source: Consumer Finance Protection Bureau. Fannie Mae, Amherst Securities, Amundi Pioneer Analytics.

Alt-A is a classification of mortgages with a risk profile falling between prime and subprime. **Full Documentation Loan** refers to a loan where all income and assets are documented. It is typically referred to as a "full doc" loan in the mortgage industry and is a common type of loan used for financing a home purchase.

Our Approach to ESG within Securitized Assets

Our highest priority is seeking to maximize long-term, risk-adjusted returns for our clients.

The uniqueness of securitized assets requires its own approach. Fundamentally, we believe that businesses that disregard ESG do not amount to financially sustainable businesses. Our approach to ESG focuses on this intuition.

Enabling lending practices that disregard consumer wellbeing is imprudent. We believe businesses with weak governance and weak transparency will eventually make weak securitizations and therefore should be avoided. Though less apparent than social and governance issues, investments with environmental impact should also be considered for their sustainability. Importantly, as ESG criteria become more widely adopted, securitization investors must remain vigilant of the risks posed by borrowers whose ESG-unfriendly practices may have priced them out of other debt markets.

Though we do not advocate for a quantitative approach, we believe ESG considerations should be maintained as a critical component of a prudent investment process. Instead of a quantitative approach, investors in securitized assets may be better served by utilizing ESG as a framework from which to consider investment risks whose very nature makes them difficult to quantify.

An ESG framework would prove anemic if it were merely applied to the issuer of a securitization, which, as discussed, is typically a legal entity that lacks any employees, management and business activity. Instead, as creditors, it is critical to understand which parties are generating the material economic benefits of a securitization. Creditors should "follow the money" in order to apply the ESG considerations to the pertinent parties.

Our ESG Framework for Securitized Assets

1. **Avoid securitizations where inadequate governance creates unmeasurable risk**
2. **Avoid securitizations whose assets are originated and serviced without regard to consumer wellbeing**
3. **Avoid securitizations whose environmental exposure is unsustainable**
4. **Apply these principles to the parties that are critical to the economics of the securitization**

Our highest priority is seeking to maximize long-term, risk-adjusted returns for our clients. We do not believe investors are well served with inflexible inclusion or exclusion rules. However, we seek to avoid ESG risks that pose material and unmeasurable downside for debt investors.

By integrating ESG into our investment process, we price ESG risks. By pricing ESG risks, our process discourages poor ESG practices.

Examples of Our ESG Approach in Action

Automobile Asset Backed Securities (ABS): The car is nearly a necessity for many households in the United States, but millions are unable to buy a car with cash or bank financing. Many of these buyers often end up with high interest loans that are often packaged into securitizations. Though charging an interest rate commensurate with risk is not innately problematic, lending and servicing practices vary widely. As part of our credit process, we consider the sponsor's corporate culture, their history of regulatory compliance, and their use of incentives to encourage sound practices.

Residential Mortgage Backed Securities (MBS): In the years leading up to the subprime mortgage crisis, many consumers were steered into products with ultimately unaffordable payments without regard for the consumer's wellbeing or the externalities of the industry's eventual outcome. Perhaps this crisis could have been avoided had lenders simply considered the borrower's ability to repay their mortgage. Subsequent to the enactment of the Dodd-Frank Act[1], this is now required by law. When analyzing residential MBS, we complement our quantitative credit analysis with an assessment of the originator's incentives and the robustness of their income and appraisal documentation.

Esoteric ABS: Securitizations can also be utilized to finance dozens of other assets such as cell phone towers, railcars, shipping containers, commercial airplanes and restaurant franchises. The diversity of these assets requires a flexible but principled ESG approach. In a recent securitization of diamond inventories, we considered it critical that all diamonds were certified by a 3rd party as conflict-free.

Commercial MBS: Commercial real estate is essential for economic activity, and consequently, it is also responsible for contributing to climate change. Our ESG principles consider a commercial loan's exposure to climate change and the efforts in place to reduce the property's impact on the climate. Though we do not consider it necessary that a commercial property adhere to specific policies or 3rd party certifications, we view many "green" practices to be both environmentally and financially sound. In a recent securitization of a loan backed by a beachfront hotel, we considered the hotel's efforts to conserve water and energy consumption along with its potential exposure to rising sea levels.

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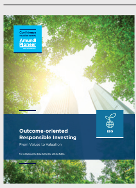
1. The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), enacted in July 2010, allows the US government to place restrictions on the US financial industry. The restrictions, which include programs to stop mortgage companies and lenders from taking advantage of consumers, are intended to limit risk by enforcing transparency and accountability.

Learn More about Amundi Pioneer's Approach to ESG Investing

Additional Publications Available:



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Case Study: Prestige Financial

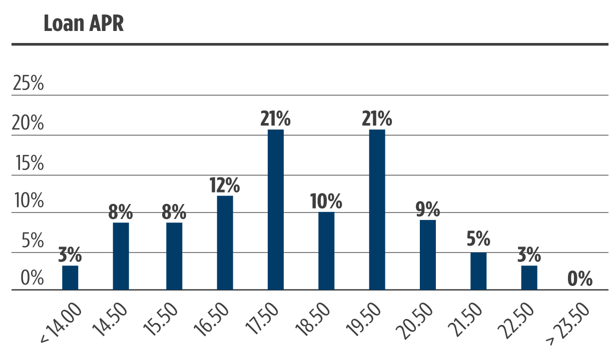
PART 2017-1A is a securitization of auto loans sponsored by Prestige Financial, a privately held company that invests in auto loans made by car dealers to borrowers with subprime credit. Origination and servicing practices vary widely across the industry. Because of their inability to access traditional financing, these borrowers are vulnerable to unscrupulous practices such as discriminatory pricing, late fees that sidestep usury laws, and harassment from servicers.

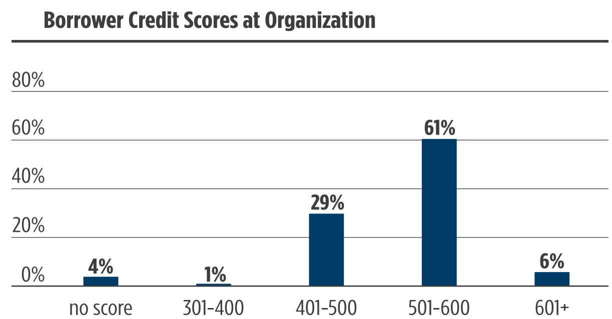
As part of our credit process, we interviewed the Prestige management team to understand their business practices. Prestige states that they "help consumers improve their lives through competitive financing agreements and a vigorously educational servicing process." They do this "because it rewards our customers with dignity and self-sufficiency, our employees with growth and opportunity, and our business partners with prosperity." We asked management to substantiate this corporate culture with facts. After a thorough discussion of their business, the following practices emerged as relevant to our ESG framework.

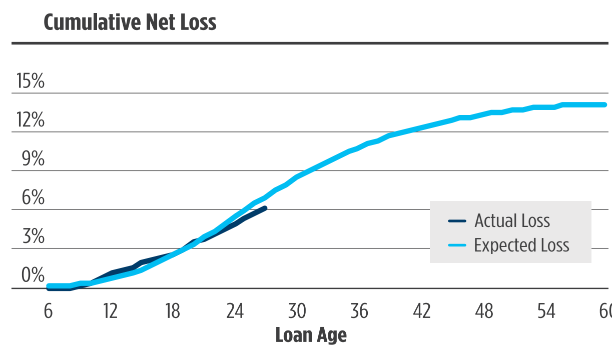
1. Prestige avoids disparately impacting minority borrowers by pricing all loans objectively via an algorithm, limiting dealer rate markup levels, training dealers on Fair Lending practices, and having regular 3rd party audits performed on its portfolio and remunerating potentially affected customers.
2. Through its credit policy, Prestige encourages borrowers to purchase vehicles with lower expected maintenance costs and higher retention values. This is designed to lead to better outcomes for lender and borrower alike.
3. Prestige offers a "Rate Reduction Reward" incentive that allows borrowers to decrease their APR by up to 2% per year by making payments punctually, maintaining car insurance, opting in to receive electronic communications, and signing up for automatic payments.
4. Prestige's servicing center records and monitors employee interactions with customers. Each agent's hourly pay and bonus is materially influenced by their compliance with internal rules and regulatory requirements.
5. As a result of Prestige's origination and servicing practices, the company's borrowers have historically experienced an average increase in their credit score of roughly 85 points over the course of three years, which, according to Equifax, is 1.6x the industry average increase for this credit profile.[2]

Though subprime auto finance is a sector ostensibly at risk of failing ESG criteria, Prestige's practices demonstrated that ESG principles can align the interests of borrowers, lenders, and investors. As part of our investment process, we integrate these ESG considerations alongside our quantitative and qualitative analysis of the transaction's collateral and structure.

PART 2017-1A[3]







Discussion should not be considered a recommendation to buy or sell any security. Not meant to be representative of a holding in any portfolio. Holdings will vary.

2. As of June 30, 2017. **3.** Source: Amundi Pioneer Analytics, July 31, 2017; Actual Loss Curve data in bottom chart is as of May 31, 2019.

Securitized assets may increase or decrease more than other fixed-income securities during times of fluctuating interest rates. Mortgage-backed securities are also subject to pre-payments.

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