ESG for fixed income's structured product sector

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INTELLIGENT GOVERNANCE PROTOCOLS ASSURE SUSTAINABLE FIXED INCOME AND EQUITY MARKETS.

Many of the governance protocols imbedded in recent financing trusts (a special purpose vehicle or "SPV") fall far short of best-in-class governance. Thirty-five plus years after its creation, the US RMBS market still suffers from:

1 A complex mosaic of federal, state and local laws that require loan originators and servicers to interpret the nuances of law. As such, each operator designs bespoke operating practices. Virtually every operator has their own style built into their guides.

2 On the loan financing side, each individual loan has a unique story and each SPV has unique operating practices. As such, when each loan is deposited into an SPV, there is:
   - a need to customise each SPVs legal documents to reflect the unique representations and warranties ("R&W") related to that deal's unique originator/servicer guides. Guides change on a monthly basis;
   - a lack of easily enforceable SPV operating standards;
   - a lack of *life-of-trust* independent supervision to test for compliance to those origination, securitisation, and SPV standards;
   - a lack of ongoing *independent* supervision to enforce compliance;
   - a lack of *financial alignment of interest* with the supervisory party to assure they are financially motivated to perform conflict-free risk management services for 30+ years; and
   - limited and sometimes ineffective governance protocols to act as a backstop when the SPV experiences unexpected issues.

Governance flaws within SPVs are a global structured products issue (ABS, RMBS, CMBS, CLO, etc.). For this paper, we use US RMBS to highlight some notable points related to governance.

Based on PentAlpha's direct interviews, numerous institutional investors have not purchased recent RMBS deals due to a lack of confidence. As a result of this belief, and other important technicals, the US private label RMBS market continues to shrink. In fact, the investable supply of the fixed income structured products sector, far below the

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pre-crisis high, continues to struggle. It appears this reduction in tradable supply can be partially attributed to the lack of confidence in the governance function.

Within RMBS, the rating agencies continue to rate new securitisations with “weak” governance provisions. By providing ratings, with modest adjustments for the weak governance, the agencies effectively empower sponsors to issue rated deals with weak governance. Importantly, during a new deal offering period, some investors cite that they have limited to no access to many critical transaction documents which would allow them to adjust price for the various governance approaches.

Over the past 24 months, the RMBS 2.0 sector has become a collection of bespoke operators, inconsistent financing-trust structures, lower credit quality loans, reduced upfront diligence, and ‘handcuffed’ governance supervision, if any. A decade-long effort to create a common securitisation approach has failed to be implemented in scale, partly due to the need to navigate the mound of ever-changing banking and financing laws and apply them to a 30-year “brain dead” trust. As a reminder, this same challenge applies across RMBS, CMBS, ABS, CLO and some corporate products.

Virtually each securitiser navigates these law and regulations modestly differently and builds internal guidelines consistent with their interpretation. While most individual loan level interpretations are not problematic, it is the aggregation of those nuanced guides and contracts, coupled with highly complex operating practices within the SPV, that begins to create critical governance challenges in securitisations. Alongside the evolution of local, state and federal laws and regulation, we have observed many securitisation contracts move from ‘will and shall’ to ‘could and may’. Rarely are these dilutive changes highlighted in the offering documents. After tens of billions of dollars in reported fines, it is understandable that securitisation issuers are focused on tightening or ‘ring fencing’ their post issuance financial exposures.

PentAlpha strongly believes in reduced government regulations for many parts of the securitisation segment, but we also believe each trust should incorporate a modern self-governing function that is consistent in approach across all asset sectors. Post-crisis, a select few industry leaders have incorporated elevated SPV governance protocols in their financing trusts. Market participants have stated that those issuers deserve accolades for their leadership and favourable consideration by the investment management community. Unfortunately, other issuing sponsors have not followed their lead and do not incorporate such protocols into their deals because they can still finance their loans by selling rated bonds at attractive spreads in this low-bond-supply environment. The sustainability of the private label RMBS sector is not assured due to a lack of consistency related to modern governance protocols.

While asset managers often praise the control and governance provisions found in whole loan transaction documents and investment practices, those rights and protections are diluted notably when the same loans are deposited into an SPV. Due to the enhanced controls in private whole loan transactions, a growing number of asset owners and asset managers prefer to invest in loan pools over bond CUSIPs. In some instances, their loan investment activities are growing briskly. In fact, some investment managers are said to be negotiating multi-billion-dollar flow programs to acquire loans or provide private financing for the owners. These bespoke transactions benefit from custom control, governance, and enforcement provisions. Bond supply and bond trading price transparency falls as a result.

In response to lower demand for bonds, smaller and costlier securitisations are issued. Long term, this can make the structured products sector a higher cost funding source. The smaller bond supply could also make securitisations a less attractive investment product as the major fixed income indices downsize their allocation to structured products.

While R&W are commonly discussed in the context of loan origination and loan trading matters, a specialised governance party is sometimes needed to determine compliance (or aid other parties as they determine compliance) with the R&W provisions offered in RMBS bond offering documents. The SPV bond testing scope is often much broader than what occurred at the individual loan closing table or ongoing servicing. Relative to loan level matters, bond R&W tend to cover a much broader spectrum of items in the bond offering documents.

The governance party is sometimes written into certain securitisation documents upfront to investigate *and take a leadership role in the enforcement process*. In many assignments, the governance party receives well-articulated operating and decision-making guidelines that govern the compliance analysis process. Investors rarely have sufficient rights or time to read the underlying guidelines before buying certificates. As such, they look to the governance party to do so.

On other RMBS 2.0 transactions, a designated party, oftentimes selected after the fact, gets to establish the R&W testing approach as they see fit over each day of the 10 to 30 years of a securitisation's life. In many instances, that party may have conflicting financial or reputational interests. Certain vehicles delay testing until liquidation has already occurred and credit losses are passed through. This could be five years later. Such an opaque and delayed approach jeopardises the RMBS industry's credibility and could damage the growth of emerging securitisation sectors. We at PentAlpha do not believe this approach conforms to principles imbedded in ESG (Environmental, Social and *Governance*).

Life-of-trust independence for this governance party is crucial. Similar to the corporate audit industry which has requirements to separate audit functions from consulting assignments, the same approach should be considered for securitisations. Service providers that enjoy multimillion dollar consulting contracts may not be the best party to determine if that same client is in breach of contractual terms with the SPV. Further, the integrity of the governance process may be jeopardised if the consultant is expected to be a leader in managing the operational and financial remedies on behalf of the SPV. Trustees, master servicers and diligence auditors have not been successful in building a suite of services that collectively serves the complete governance function. As operators themselves, some believe they deserve supervision too.

A review of recent rating agency research and presale reports detail some of their observed R&W governance shortfalls. *We applaud the rating agencies for bright-lining these issues*.

Some notable excerpts from rating agency reports include:

- Very concerned [related to the rep and warranty framework].
- R&W framework is diluted by the testing construct.
- R&W framework is diluted by the presence of materiality factors.
- Value of the R&W framework is lessened by the presence of qualifying and conditional language in conjunction with sunset provisions, which reduces lender breach liability.
- R&W framework is weaker compared with post-crisis prime jumbo …. which limits the breach reviewer's ability to identify or respond to issues.

Comments related to counterparty risks:

- R&W provider is an unrated entity and has limited performance history in non-QM...it may have financial difficulty in meeting repurchase claims for R&W breach.

Comments related to knowledge and process:

- The sponsor does not have any staff underwriters.

Post-crisis, some issuing sponsors have significantly expanded the risk disclosure section of their securitisation documents to better contain their life-of-trust exposure. Below is a partial listing of excerpts from some post crisis securitisations. Collectively, these statements could raise the question of the breadth of any independent governance.

- Investors have no direct right to enforce remedies.
- Noteholders generally do not have the right to institute any suit, action, or proceeding in quality or at law under the [] Agreement ……
- In no event will the Noteholders have the right to direct [us] to investigate or review whether or not a defect or deficiency exists with respect to any [obligation].
- …there is no independent third party engaged with respect to the Notes to monitor and supervise [our] activities as Issuer of the Notes.

- …in connection with our role as Issuer of the Notes, [we] will be acting solely for [our own benefit] and not as agent or fiduciary on behalf of investors in the Notes.
- [We], in any of our capacities with respect to the notes, are not obligated to consider the interests of the Noteholders in taking or refraining from taking any action ….
- [Our] changes in business practices may negatively impact Noteholder.
- Interests of [us] may not be aligned with the interests of the Noteholders.

After tens of trillion of dollars of issuance, PentAlpha believes there should be one agreed-upon modern governance protocol for SPVs that can be applied broadly across all collateral sectors and jurisdictions. Developing a normalised or baseline SPV governance construction is achievable. The equity market's success in developing governance standards in public operating companies is a road map on how to execute the same in the fixed income structured product sector.

ESG principles suggests these governance provisions should be strongly encouraged, if not mandated, by the international investment community as well as ESG oriented bank and finance companies that issue, underwrite and trade in SPV notes. The global regulatory community would be well suited to give credit for this private market solution as well.

Private market financing volume should increase greatly if life-of-trust stewardship improves. PentAlpha believes the inclusion of responsible governance protocols alongside truly independent supervisors would result in consistent operational performance and greater cash flow consistency across all CUSIPS. Long term, the expected result would be lower cost loans for borrowers, lower financing costs for the lending community and improved investment performance to investors in volatile times. Governance is the foundation of sustainable markets.

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