MARCH 2021

MORTGAGE AND PROPERTY REPORT

Welcome to the first 2021 edition of the Mortgage and Property Report. In this issue, we look at the growing importance of Environmental, Social and Governance (ESG) factors in the mortgage market. We look at what this means for lenders, customers and investors in RMBS. We examine the emergence of "green" mortgages, as well as the shift towards ESG investment funds and ESG compliant RMBS issuances.

Key Highlights

- ESG considerations are emerging in all parts of the mortgage finance chain, from ESG products to ESG-backed bond issuances
- The market for ESG investment is growing at pace every year, with more investors placing this at the core of their strategies and dedicating funds to ESG assets
- As ESG plays an ever more important role in investment decisions, the need for standardised frameworks to compare practices amongst different companies, regions, and industries is key

Introduction

ESG considerations are playing an increasingly important role in all aspects of life, and the mortgage and securitisation markets are no exception. There is no one definition for "ESG", but the label brings together under one umbrella three separate measures on which products, practices, and companies can be assessed. Awareness and interest in each has come at a different time and with different levels of priority, but a tipping point of sorts has now been reached where their combined importance cannot be ignored. Of the three, "governance" was the first to become an important factor on which to assess businesses, and investors have long expected companies to operate within robust corporate governance and risk management frameworks. This is particularly true in the heavily regulated mortgage industry, where concepts like "Treating Customers Fairly" (TCF) are expected to be at the heart of firms' practices. Environmental concerns were the second portion of ESG to gain extensive attention, with issues such as the use of renewable and efficient energy sources and battling climate change gaining widespread support. Social practices have come under scrutiny more recently, and though they are no less important, they have historically been less well-defined, and thus more difficult to measure. The Covid-19 crisis has brought concerns like employee well-being to the forefront, and in recent years we have also seen an increased focus on issues such as diversity and inclusiveness, equal opportunities and investment in communities. In the mortgage market, access to affordable housing is also an important social consideration. Ultimately the area of focus for each of the components varies by industry, but it is becoming clear that as employees, consumers and investors increasingly judge businesses and products by their ESG credentials, there is a growing need for these to be transparent, clear and standardised.

ESG and Mortgage Products

On the mortgage product side, the focus thus far has been largely on the environmental aspect of ESG, with the emergence of "green" mortgages, which seek to reward customers who buy energy-efficient properties by offering them a lower interest rate than they might otherwise pay. These were first introduced in the mainstream market by Barclays in 2018, and in the same year, the Bank of England published some research (later extended into a White Paper)[2] suggesting customers who purchase energy efficient homes may be less likely to fall into arrears because the lower cost of energy bills results in higher disposable incomes. The conclusion was that the energy efficiency of a property is a predictor of mortgage risk – an attractive reason for lenders to offer these if proven to be true. Questions have been raised however about whether the relationship is causal, or simply a reflection of other factors, such as time of purchase and borrower preferences.

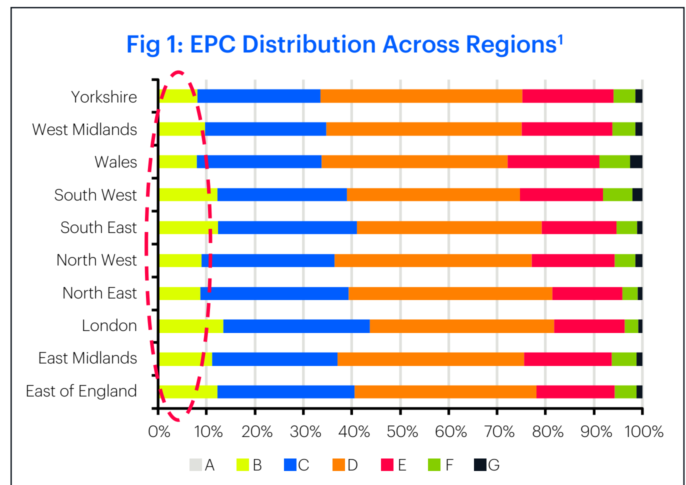

Fig 1: EPC Distribution Across Regions[1]

Whether they are less risky or not aside, green mortgages are gaining ground and are being offered by an increasing number of lenders. Typically, a property needs an Energy Performance Certificate (EPC) score in bands A or B (which equate to 91+ and 81-91 points respectively) in order to be eligible to be financed via a green mortgage. As seen in figure 1, these scores are exceedingly rare, making up less than 11% of all properties in England as of 2019. The percentage of band A properties is so low that it does not appear in the chart, with 0.25% in the East of England being the highest proportion nationwide.

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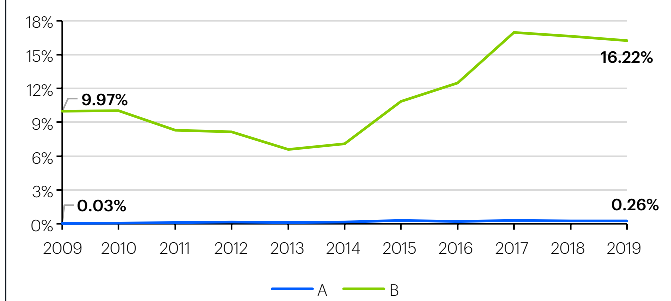
Please contact Alex Maddox +44 (0)20 7532 9845 alex.maddox@kensingtonmortgages.co.uk
Jasmine Heinen +44 (0)20 7532 9005 jasmine.heinen@kensingtonmortgages.co.uk
www.kensingtonmortgages.co.uk

Fig 2: Median EPC Rating by Property Type in England (2019)			
Existing flats	Existing houses	New flats	New houses
70	64	83	84

As would be expected, most band A or B properties are New Builds, as homes are increasingly built to higher standards with better insulation and more energy efficient heating and appliances. As seen in Figure 2, The median existing flat falls into Band C (69-80), the median existing house falls into band D (55-68), while the median new built property of any type falls into Band B. The share of properties in higher bands is increasing through time (fig 3), with c. 10% of registered EPC ratings in 2009 in Band B vs. over 16% in 2019, but Band A still only accounted for 0.26% of registered EPC ratings in 2019. This means the number of green mortgages will likely stay similarly small in the near to medium term.

Fig 3: Percent of Registered EPC Ratings in Period in Bands A and B



To counter the limitations this presents, some lenders, including Kensington, have launched products that reward customers for improving their EPC rating through home improvements rather than for starting out with a high one. Kensington's eKo mortgage offers customers £1K cashback if they improve their property's energy efficiency within 12 months of taking out their mortgage. Of course, this comes with other challenges as the cost of the required improvements and re-assessment of the property will in almost all cases exceed the £1K cashback, meaning customers need to take a longer-term view of their investment rather than look for a one-off reward.

The "social" part of ESG is by far the most subjective and least well-defined, and this also rings true when it comes to mortgage products. There have been some recent initiatives focused on expanding home ownership to customers who are under-served despite having good affordability. While they may not specifically be defined or marketed as such, we would consider most products that facilitate lending to groups or individuals who might otherwise struggle to access home financing (provided the difficulty is not credit-related) to be supporting social lending. This includes lending to customers with complex incomes or in under-served age groups (who would otherwise meet high street criteria), such as the niches Kensington operates in, as well as initiatives such as Right to Buy, or part-ownership products which help customers step onto the housing ladder. Several fintech companies have tried to address the latter in recent years, and we welcome these developments. It may be easy to confuse "social" borrowers with those on low income, but we do not believe this is the right segment to increase lending to without very careful affordability assessments.

ESG and Mortgage Funding

As the number and type of ESG mortgage products has increased, so too has the financing side, and the label has become increasingly important for capital markets investors in recent years, with some setting up dedicated ESG funds. Global ESG Bond Funds are estimated at $6.15bn as of Q1 2021, up from $5.58bn in the previous quarter. Demand has encouraged increased supply, with the European ESG bond market, which includes green, social, and sustainable bonds, growing from c.€140bn in 2019 to c.€253bn in 2020, and accounting for more than 8% of all issuances in 2020 vs. only 5% in 2019. Social bonds saw the largest increase, from c. €12bn in 2019 to over €94bn the following year [3].

RMBS is still a very small segment of this market - while there have been 21 ESG CLOs in Europe, there are just 7 RMBS which fall within the ESG category (5 Dutch deals, 1 Portuguese deal, and Kensington's own GMG 21-1). Of these, 6 relate to Green bonds, including 5 from one originator, Obvion in the Netherlands. The deals are backed by energy efficient properties - those with an EPC rating of A in the Netherlands, or B/C but having realised a 30% improvement vs. an average property built in the same period. UCI issued the first Portuguese green bond last April, which was privately placed, and committed to using an amount equal to the deal's senior tranche to fund new green mortgages over 5 years, in addition to being backed by energy efficient properties (EPC of A or B, or having achieved 30% improvement).

While there is no legal or regulatory definition as to what constitutes a "green" bond (as well as jurisdictional differences) it is generally expected that mortgages would be secured on band A or B properties. The low proportion of these in the UK means the issuance of a green securitisation for smaller non-bank lenders, who tend to be more active in the RMBS market, could be challenging due to the difficulty of originating a large enough portfolio of loans that qualify. Most eligible loans are also likely to be new built flats, a property type which investors typically prefer to see in lower concentrations in a transaction, and which could result in other rating hits.

We will undoubtedly see a green RMBS in the UK in due course, but in the meantime, Kensington issued the first Social-label RMBS in January 2021. The transaction is backed by a pool of owner-occupied mortgages provided to customers who are typically underserved, thereby improving access to home loan finance and facilitating home ownership for this population. A second party opinion (SPO) provider was appointed to provide an external review of Kensington's Social Bond Framework and confirmed its alignment with the International Capital Market Association (ICMA) Social Bond Principles and the contribution it makes to the United Nations Sustainable Development Goals (UNSDGs). As the first of its kind, the transaction drew considerable investor interest, and we expect more issuers in the UK to strive for a "Social" label on their own deals. These will not necessarily all be based on the same ICMA criteria, and there is a risk that the flexibility of the "Social" label is exploited by some non-conforming lenders to mis-categorise customers with bad credit as "underserved".

Lack of Standardisation

While there are some common shared standards for issuing ESG compliant instruments– for example, most SPO verifiers align their evaluations to the UNSDGs which were established in 2015, and/or ICMA Green Bond or Social Bond Principles, a set of voluntary process guidelines, the real gap is at firm level disclosures. Our own experience issuing an ESG RMBS has brought to light the difficulties

Please contact Alex Maddox +44 (0)20 7532 9845 alex.maddox@kensingtonmortgages.co.uk
Jasmine Heinen +44 (0)20 7532 9005 jasmine.heinen@kensingtonmortgages.co.uk
www.kensingtonmortgages.co.uk

that the lack of standardisation in this still nascent (but growing) niche presents. While it is helpful that more firms are reporting on their ESG targets and achievements, objective comparisons and due diligence are difficult without standardisation of frameworks. With a growing requirement for investors to take ESG compliance into consideration for investment decisions, there is a need for these to be easily comparable and a standard checklist for evaluation to be agreed, which can be adequately assessed in the short period between a transaction being announced and priced. Currently, that "checklist" is often determined by individual investors, who inevitably will have different disclosure requirements, which make it difficult for issuers to effectively respond to these while marketing their transactions. This problem has been recognised, and the Association for Financial Markets in Europe (AFME) is actively working on pushing forward standardised ESG disclosures, both for ESG-labelled investments and the broader market.

Beyond this, there are also discrepancies in the underlying criteria on which ESG compliance will be assessed. This includes core measures like EPC certificates, which vary country by country, even within the European Union. Expected standards for EPC assessors differ (with some countries requiring no professional certification) as does the use and availability of EPC data – for example Germany has no central public database for EPC ratings, while other countries like Spain and France have limited access or regional databases - the UK, Netherlands, and Portugal are amongst those countries that stand out for having fully public access. The possibilities this offers is sadly not fully utilized as the majority of lenders, including High Street banks, do not gather EPC data at the point of origination, and as a result do not share it. These types of issue are important to address as investors cannot be expected to familiarise themselves with the intricacies of rating systems in different geographies or seek out this data themselves. Helpfully, European Securities and Markets Authority (ESMA) reporting requirements now make the inclusion of EPC ratings mandatory, which means we'll likely see this change as more lenders embed the collection of this data is their standard underwriting processes, making it easier to include EPC ratings in loan data tapes, which we support.

Conclusion

Investors' focus on ESG factors is forcing companies to evaluate their performance on these issues. For many, focusing on ESG does not mean drastically changing their behaviour, but rather genuinely assessing the way they currently conduct business - whether it's the suppliers they use, the products they offer, the customers they target, or something as basic as their recycling programme (or lack thereof) - and establishing which practices are good, and merit being called out, and which ones need to be improved. From there, the task for most is likely not a sweeping overhaul, but rather the setting of realistic but meaningful - and measurable - goals. In some instances, it will be a matter of formally recognising practices that are already ESG compliant and receiving due credit for these. The key to driving the movement forward is the setting of standardised frameworks for assessments, so that different issuers can be compared on a like for like basis, and ESG certification becomes a smooth process rather than a burdensome one. Currently, development of the ESG finance market is held back by both limited supply of ESG compliant collateral and lack of standardised frameworks – we believe development of the latter will play an important role in driving forward the former.

Sources:

1. Ministry of Housing, Communities & Local Government Energy Performance Building Certificates for England and Wales 2008-2020
2. Insulated from risk? The relationship between the energy efficiency of properties and mortgage defaults – Bank Underground
   Republished in more detail in 2020 as Bank of England Staff Working Paper No. 852
3. AFME Q4 2020 and FY 2020 ESG Finance Report European Sustainable Finance

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