The social struggle

Concerns around 'socialwashing' remain, despite recent advances in defining social securitisations. **Claudia Lewis** investigates why the 'social' side of ESG securitisation is more complex than its 'green' cousin.

The European social securitisation sector is lagging behind the green securitisation sector, in terms of both standardisation and the availability of qualitative data. Despite advancements in defining 'social', following the introduction of ICMA's social securitisation framework last year *(SCI 29 June 2022)*, **some concerns around 'socialwashing' remain.**

"There is still a very blurred line between what is social and what might not be beneficial, or may actually be taking advantage of vulnerable customers," suggests Elena Rinaldi, portfolio manager at TwentyFour Asset Management. "There are some guidelines, but what we have seen so far with the more popular social deals is that they are looking at or targeting financial inclusion, reducing inequality and giving access to finance to underserved borrowers."

The social side of ESG securitisation remains more complex, as it lacks the same standardisation in both concept and language as green transactions. "Green is easier than doing social as there is a standard definition of what is considered green – like properties with EPC ratings above B and therefore a lender has to issue mortgages backed by a certain amount of energy efficient properties or use the proceeds to lend towards achieving those ratings – you can't really get around that," Rinaldi observes.

She continues: "I think that's why social deals haven't been that popular, because investors struggle to rely on the label and it is too questionable on certain deals."

With no clear 'standard' for what is social and what is not, social securitisations could be vulnerable to social-greenwashing, or 'socialwashing'.

Last year, European ESG securitisation issuance fell to €1.2bn from a recorded total of €8bn in 2021, according to AFME's ESG Finance Report for 2022. More broadly, the report highlights the disparity between the green and social segments – noting that while green bond issuance grew by 6%, social bond issuance declined by 40%.

As well as being harder to define, social issuance may continue to take second place to environmental, as green deals are advantaged by being mandated by governments as they work to meet net zero targets and are incentivised by a green premium, or 'greenium' *(SCI 9 February)*. "In the social market, we have the opposite problem – there is no offering discounted rates. ▶

Elena Rinaldi, TwentyFour Asset Management

You have to charge higher, if you want to target these borrowers with complex credit histories or adverse backgrounds," states Rinaldi.

Trailblazing social bond issuances from the likes of Kensington Mortgages have not only been compliant with ICMA's guidelines, but are also widely considered as a strong example of socially-linked securitisation *(SCI 27 January 2021)*. Kensington targets borrowers not served by traditional banks, such as the self-employed, people with incomes from multiple sources, contractors, first-time buyers and borrowers with limited credit histories.

"When we issued our first social bond in 2021, the eligible social project of the bond was the purchase of a portfolio of owner-occupied loans originated by Kensington Mortgages. Given Kensington's business model, this meant that we were able to use all owner-occupied loans originated by Kensington, as these meet the social objective of the bond," says Alex Maddox, capital markets and digital director at Kensington Mortgages.

"Generally, when investors think social in the residential housing market, they think of projects aiming to provide housing at affordable rates to low-income individuals or loans targeting social housing. But this is not the market that Kensington operates in – our eligible social project relates to improving access to home loan finance and facilitating home ownership to a target population that could not access mortgage loans from UK mainstream banks," explains Camille Boileau, svp, capital markets at Kensington Mortgages. "Our eligible social project is aligned to the Social Bond Principles from ICMA and contributes to the achievement of the United Nations Sustainable Development Goals."

Kensington focuses on viable customers that do not fit the 'one size fits all' approach taken by high street banks, whose highly automated and efficiency-driven approaches to underwriting facilitates their ability to offer the most competitive rates. Providing mortgage products to borrowers with complex financial circumstances requires a more tailored and granular approach – which Kensington is able to do by using its manual underwriting capabilities.

"Deploying a human underwriter for each case means we incur a higher origination cost versus an automated underwriting platform. This higher cost means that the interest rate is generally 1%-2% higher than the interest rates charged by high street banks; it is not because the population we lend to is more adverse and therefore riskier," explains Boileau.

Underserved borrowers – including lower-income borrowers, the self-employed and those with lower credit scores – account for 50% of the portfolio securing German digital-lending platform auxmoney's second social bond issuance, Fortuna Consumer Loan ABS 2022-1.
In the unsecured credit sector, interest rates on auxmoney loans can be as high as 17% – although rates for borrowers with the best credit score start at 5%, with a range of six credit scores resulting in average interest rates of approximately 10% and a portfolio that is well diversified across the various risk segments.

Alex Maddox, Kensington Mortgages

"DEPLOYING A HUMAN UNDERWRITER FOR EACH CASE MEANS WE INCUR A HIGHER ORIGINATION COST VERSUS AN AUTOMATED UNDERWRITING PLATFORM"

"They are barbelling their portfolio and adding customers with very low rates on one side, at around 5%. And to balance that on the other side and the high default rate, they are offering rates at 17% to the other end of the spectrum," Rinaldi points out.

auxmoney received a strong ESG second-party opinion from ISS in 2021. As the ISS report explains: "A study conducted by Deutsche Bundesbank (2016) stated that the interest rates (based on risk adjustments) are in line with overall market practice. Given that these borrowers cannot get loans for lower interest rates elsewhere, they do not perceive auxmoney's interest rates as too high. Importantly, interest rates remain below ranges that apply for credit card or overdraft segments."

With the rising interest rate environment and a recession predicted for Germany, interest in accessing credit is expected to increase from consumers having a harder time gaining access. Already, this is being seen in the expanding German buy now, pay later industry – which is expected to see growth in payments by 19.4% annually to become a US$98bn industry by 2028.

As such, auxmoney is perceived as fulfilling an important function in the country's financial sector. According to ISS, the lender's scoring model meets €30bn-€35bn of the total €90-€100bn demand for consumer lending (as of 2020).

"The German market is different, so lenders may have to take more drastic measures. But I think there is always going to be something you can do on the social side," notes Rinaldi.

She adds: "You can always make it viable at a decent rate that isn't massively higher than the average, if that is your objective. We've always seen that in the UK."

Although meeting the demand of 4-4.5 million individuals in Germany classified with 'manageable' risks, default rates across auxmoney's Fortuna deals have turned some heads.

Rinaldi questions whether such default assumptions are, in fact, 'social'. "To me, having those kinds of default rates on performance means borrowers are struggling to pay their monthly instalment," she states.

"It is essential to consider the context and the specific borrower demographics served by auxmoney," explains Boudewijn Dierick, md of auxmoney's investment entity. "Banks often do not provide loans to clients below certain credit Schufa scores, as in many cases, their dated risk models do

Boudewijn Dierick, auxmoney

TALKING TRANSPARENCY

The issue of socialwashing is a major discussion topic in the US at present, as the SEC debates how involved it should be in deciding the metrics that would need to be met in order to label something as a social bond.

"This is the first issue since Gary Gensler took over as chair of the SEC, where he has needed more time to examine things. I expect they will settle to do more than investors want, but less than the SEC have dreamed of," states Michael Bright, ceo of SFA.

He believes much of it can be solved with transparency. "I think the asset managers need to provide the granular data to the retail clients, who are investing in the funds. The data sets and fields that investors want to know about will probably evolve over time, but to me, the only way something can last is if there is an agreement on what data information will be provided – just like a normal ABS. Take credit scores; that is just one piece of the puzzle, but investors will have their own credit analysis anyway, so you can't just give someone a score or put a stamp on it without providing the data."

Bright points to the approaches of the three GSEs, each of which have taken a different stance towards social bond issuance. "Fannie Mae is releasing an index, which a lot of investors consider to be unhelpful," he explains. "Ginnie Mae is going the other way, by releasing only pool level data for investors to use as they please – which investors have been loving. Then, Freddie Mac's approach has been right in the middle."

Bright concludes: "Our hope is that the world moves towards where the Ginnie model is – agencies provide data that can be used by investors to make decisions."

not allow for an appropriate assessment of those types of borrowers. Only through auxmoney's proprietary advanced risk models, we can provide access to credit while reducing the risk and cost of lending for certain borrower segments."

He continues: "Dedicated to promoting social and financial inclusion in the market, auxmoney also focuses on customers in the traditionally underserved category such as the self-employed, freelancers, entrepreneurs, employees in probationary periods and students. At the same time, auxmoney adheres to responsible lending principles by tailoring loans to borrowers' ability to repay. If there are doubts about the ability to repay, we do not make a credit offer and as a matter of fact, the majority of all loan applicants still get rejected."

As of March 2023, auxmoney has originated in excess of €4bn in loans. Since 2021, funding via the Fortuna deals has played a vital role in this process.

> "IN THE CURRENT WORLD, IT IS KEY FOR ISSUERS TO SUPPLEMENT THE RELEVANT ESG DATA TO INVESTORS"

"As a platform that connects lenders with borrowers over the past 15 years, we are aware of our special responsibility towards both groups and it proves that our business model is sustainable. Part of obtaining the ESG label from ISS was a thorough review of our internal lending practises across all areas, from advertising and sales to customer service," Dierick notes.

Nevertheless, with sound structures and investor protections in place, interest in the Fortuna transactions are unlikely to be solely due to their ESG labelling. "Investors could be getting 20bp, 25bp or even 30bp of premium versus prime on a consumer deal, as well as having more protection," notes Rinaldi. "And with massive credit support at the top, the deal almost cannot be broken. So, if you are comfortable from a credit point of view, investors may not consider carefully the ESG side as well like we do."

Despite question marks around future ESG RMBS issuance from Kensington following its recent acquisition by Barclays, the lender remains positive regarding the future of the social securitisation market. "We issued the first ABS social transaction in the UK, and also the first from a specialist lender. Quickly after, Yorkshire Building Society issued its debut social bond using a similar eligible social project," notes Yolanda Bushell, senior associate, capital markets at Kensington Mortgages.

She continues: "Specialist lending is about 10%-15% of the total UK mortgage market, which means that we can expect further social issuances from other specialist lenders. ABS should be a good market for ESG issuances, given the pool can be defined and proceeds allocated on day one, as opposed to sovereign or corporate issuers."

Maddox adds: "Lending to this targeted population is very important, given they are viable customers from a credit and affordability perspective – and we see this segment growing, especially since Covid-19."

Generally, investors appear to favour undertaking their own due diligence on social criteria as they are required to demonstrate that they have considered ESG factors for all investments. Nevertheless, Boileau suggests that more needs to be done in terms of disclosure of frameworks and standardisation, so investors can compare ESG bonds.

"In the current world, it is key for issuers to supplement the relevant ESG data to investors, in order for them to be able to monitor ESG attributes of deals. Standardisation and transparency are the path forward to develop a social bond market. It is therefore key to see some involvement from the regulator to provide greater consistency in this market," she explains.

Maddox adds: "While socialwashing is an issue, and people should be very thoughtful about it, it is at least helpful to have some rules and guidelines. Although, ultimately, investors and the rest of the market should form their own opinion."

auxmoney agrees with this notion. "We provide our investors with a very granular set of information on the underlying loans and borrower characteristics. This allows our investors to also draw their own conclusions. In fact, this is why many investors have chosen to invest in our assets," Dierick concludes.

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