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ESG FI CMBS Panel -- Friday, April 23, 2021

Moderator: Keith Kockenmeister, Senior Managing Director, Kroll Bond Rating Agency, Inc.
Panelists:
- Peter Beer, Vice President & Securitized Credit Analyst, Payden & Rygel
- Leland Bunch, Managing Director, Head of CMBS Capital Markets, Bank of America
- Thomas A. Fink, CRE, Senior Vice President and Managing Director of Trepp, LLC
- Edward Reardon, Managing Director, Deutsche Bank

Current state of ESG for CMBS relative to other asset types
- CMBS presents a large opportunity for ESG integration; the building and construction sector accounted for 36% of final energy use and 39% of energy and process-related CO2 emissions in 2018.
- Agencies such as Fannie are leading the charge in projecting more granular metrics down to the CUSIP level, though we are still in nascent stages on the standardization front for inputs.
- The data flow process needs to be harmonized before stakeholders can fully apply the models to determine which factors should carry the most weight in terms of risk and impact.
- CMBS is slightly differentiated in terms of level look-through and reporting, whereas CLOs have a heavier emphasis on governance and process.

The role of regulators
- Europe has been the predominant leader in establishing ESG as best practice, though governments did not play as much of a role in comparison to the large pension funds, who were pushing ESG aggressively as part of their core investment agenda.
- US capital markets are significantly larger by a factor of 2-3x. The US tends to have a more interactive approach with regulators to ensure policies are sustainable and work towards the interest of the industry.
- The industry domestically has shifted and forged ahead over the last several years, agnostic to the political tilt of the administration in power. This was primarily driven by the 'coalition of the willing', comprised largely of private sector lenders.
- There needs to be alignment of interests between asset owners and other stakeholders to ensure long term viability, which is attuned to the bottom line to develop a proper ESG framework.
- Challenges remain in motivating the borrower without sufficient governmental support. The acceleration towards ESG is likely both a function of a greater regulatory push and the efforts of quasi-governmental agencies.
- What boundaries should be drawn in the federal right to regulate a market that is characterized mostly by institutional activity and is largely private in nature?
    - There needs to be a private market solution in place and a pathway to translate value into tangible metrics that investors would find appealing. The time horizon is also key as investors are less incentivized to become early adopters of energy efficient technology given its rapid evolution and growing scalability within a few years' time. Solar energy has since become extremely cost effective and is now considered to be the 'cheapest

electricity in history'. The extent to which people are willing to change their behavior is a function of social pressure pushing to switch to more energy efficient options.

How do you quantify climate change and natural disaster risk as part of the ESG strategy?

- Geographic mapping is one approach – tying out regional risk exposure directly linked to a portfolio of investments. FEMA's National Risk Index (NRI) is an effective tool at providing a more holistic view of community risk.
- LEED certification can be helpful for ongoing performance monitoring, though standardizing reporting remains challenging.
- Doc scraping, including sentiment extraction or key word analysis may be a pathway to develop a more holistic sense of insurance coverage that is in line with a materiality approach.

What are the parameters or industry designations for green investments?

- Formal labels, preferably from a third-party provider are clearly defined, though there is scope to make responsible arguments based on the asset profile.
- Value-add CRE investments may be a less obvious choice but if the sponsor is deploying CapEx and has intent to make a meaningful impact, the case should be made especially if the reporting gets better and is attractive from a credit standpoint.
- On occasion more needs to be done on the credit side to understand the borrower profile fully, but should be not precluded from the green designation category given that it may have a good profile from an impact standpoint (e.g. Sage Housing's social housing bond), despite not having a formal label.
- Information barriers remains a key challenge, and leveraging natural language processing on servicer commentary may be a good avenue to determine if there is intent to modify behavior, or if this is a case of an opportunistic sponsor etc. Developing relationships with syndicate desks and issuers to get the disclosures and conduct surveillance may not be a scalable solution in the long term, but it does lead to good conversations and improved disclosure.
- PACE bonds are a popular source of sustainable assets but is not without its own set of challenges, including the priming of the mortgage and origination practices that may be considered dubious at best in terms of good social impact. It may be palatable if one is willing to take on construction risk, and if the borrower and lender are on the same page from day one. The CPACE industry is evolving and may see some of the problematic behavior phase out over time.

What is the state of play for ESG scores in the CRE industry?

- The 'E' portion is easier to quantify by some standards given the physicality of buildings, but the 'S' is trickier as different social impact factors are valued differently depending on the asset class and investor. There is no binary scoring mechanism that exists, and under which circumstances should the materiality approach prevail versus more quantitative metrics?

- Once a standard is determined, this consensus on the right data to be included needs to be written in loan docs and should be cost-efficient for it to be scalable across asset classes.
- There is considerable public information available beyond third party providers, which can be costly for smaller investors, and the use of physical and transition risk models can be leveraged on the CMBS side.
- It is not practical for investors to wait for the full standardization of all inputs to determine an ESG classification on an investment. Make use of LEED and other sustainable design certification systems to determine what is material and what is not. CMBS is slightly behind other structured asset classes but may be well integrated within several years.

Additional resources

- Bank of America has increased its commitment to deploy $1 trillion for sustainable finance by 2030
- Green Buildings in CMBS: Effects of LEED and Energy Star Certification on Default Risk & Loan Terms
- Does LEED Certification Save Energy? Evidence from Federal Buildings