

# Commentary

## ESG Factors in Global CMBS

### DBRS Morningstar

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### Introduction

This commentary collates and updates previous discussions covering the Environmental, Social, and Governance (ESG) factors that could affect the credit analysis of the DBRS Morningstar global commercial mortgage-backed securities (CMBS) groups. In this commentary, we will provide updated background and discuss current trends on these factors affecting commercial real estate (CRE) investing and lending.

On July 4, 2023, DBRS Morningstar published an update to *DBRS Morningstar Criteria: Approach to Environmental, Social, and Governance Risk Factors in Credit Ratings*, a methodology outlining our approach to evaluating ESG factors and their potential effect on credit ratings assigned across our four credit ratings business lines. In the methodology, a total of 17 ESG factors are identified to be potentially relevant to the DBRS Morningstar credit ratings process; however, not every factor was determined to be relevant to each business unit or methodology.

### Exhibit 1 ESG Factors in DBRS Morningstar’s Rating Analysis

Environmental	Social	Governance
<ul style="list-style-type: none"> <li>Emissions, Effluents, and Waste (G/F/C/S)</li> <li>Carbon and Greenhouse Gas (GHG) Costs (G/F/C/S)*</li> <li>Resource and Energy Management (G/C)</li> <li>Land Impact and Biodiversity (G/C)</li> <li>Climate and Weather Risks (G/F/C/S)</li> </ul>	<ul style="list-style-type: none"> <li>Social Impact of Products and Services (F/C/S)</li> <li>Human Capital and Human Rights (G/F/C/S)</li> <li>Product Governance (F/C/S)</li> <li>Data Privacy and Security (F/C/S)</li> <li>Occupational Health and Safety (C)</li> <li>Community Relations (F/C)</li> <li>Access to Basic Services (G/F/C)</li> </ul>	<ul style="list-style-type: none"> <li>Bribery, Corruption, and Political Risks (G/F/C)</li> <li>Business Ethics (F/C)</li> <li>Corporate/Transaction Governance (F/C/S)</li> <li>Institutional Strength, Governance, and Transparency (G)**</li> <li>Peace and Security (G)**</li> </ul>

\*Denotes applicability to rating groups:

G = Governments, F = Financial Institutions, C = Corporate Finance, S = Structured Finance.

\*\*Exclusively Government risk factors.

Source: DBRS Morningstar.

With regard to the global CMBS groups, a subset of eight ESG risk factors was deemed relevant in evaluating structured CRE securities. These factors are:

#### **Environmental**

- Emissions, Effluents, and Waste
- Carbon and Greenhouse Gas Costs
- Climate and Weather Risks

#### **Social**

- Social Impact of Products and Services
- Human Capital and Human Rights
- Product Governance
- Data Privacy and Security

#### **Governance**

- Corporate/Transaction Governance

As noted in the methodology, DBRS Morningstar does not assess ESG from the viewpoint of how sustainable, ethical, or responsible the issuer's or sponsor's operations or policies are. DBRS Morningstar considers ESG factors in the context of an issuer's or sponsor's credit profile, and underlying real estate collateral, where they may have a material impact on the issuer's or sponsor's, financial aspects, such as its revenues, expenses, cash flows, asset value, refinancing flexibility, etc.

#### **Discussion of Environmental Factors**

##### **Factor #1: Emissions, Effluents, and Waste**

DBRS Morningstar determines whether the costs or risks of environmental contamination or other pollution-related conditions will result in a higher default risk or lower recoveries for securitized assets. Determining the presence and level of environmental contamination at a property as well as the potential for ongoing generation and use of toxic materials is a well-established due-diligence step for originating collateral that will be contributed to CMBS. The process includes the completion of a Phase I environmental report, which determines the presence or absence of Recognized Environmental Conditions, Controlled Recognized Environmental Conditions, and Historical Recognized Environmental Conditions.

These recognized environmental conditions are defined as the presence or likely presence of any hazardous substance or petroleum products in, on, or at a property:

1. Due for release to the environment,
2. Under conditions that indicate a release to the environment, or
3. Under conditions that pose a material threat of future release to the environment.

De minimus conditions are not recognized environmental conditions. If the Phase I report does not identify any recognized environmental conditions, the report can advise that no further action or testing is required. If recognized environmental conditions are present, however, a Phase II report will be commissioned. The Phase II report could include additional testing and, if necessary, a remediation plan or other appropriate strategy to handle the contamination. Remediation can take several forms, such as removing and disposing of the contamination or constructing an appropriate barrier to minimize the contaminant risk for future users of the building or site.

Once complete, a local, state, or, in some cases, federal public agency issues a No Further Action Required letter or appropriate document indicating that all work has been satisfactorily completed and regulatory requirements have been met. Asbestos and lead paint can be handled differently and can often remain if they are not expected to be disturbed during a construction or renovation program. However, the Phase II report will often recommend the completion of a detailed management plan that guides removal and disposal if plans change and future construction would disturb these contaminants. Determining the environmental condition of the CRE collateral is critical to assessing risk. Undetected contamination can result in significant project delays, unexpected remediation costs, and, in extreme cases, limitations on the property's use.

Examples of common types of contamination include petrochemicals, often associated with abandoned underground storage tanks (USTs); heavy metals and lead from previous manufacturing activities; and improperly disposed chemicals from dry cleaning operations. Another important factor in analyzing environmental risk involves determining if current or expected operations at the property generate pollution and toxins, and then evaluating if those contaminants are properly addressed. Inappropriate generation and handling of emissions, effluents, and waste could lead to fines and other costs that could affect the tenant's operations and subsequently affect the collateral's cash flow and value.

Some examples of Emissions, Effluents, and Waste risks that could affect credit ratings are:

- An environmental report shows contamination issues (e.g., mold after a previous flooding) that would require significant investment to rectify.
- Former retail fueling facilities with USTs that have residual oil and gas contamination that would typically be identified during the Phase I reconnaissance.
- Early 20th-century industrial arts training facilities with industrial process contamination.

### **Factor #2: Carbon and Greenhouse Gas (GHG) Costs**

With regard to carbon and GHGs, DBRS Morningstar uses available data to determine if costs or risks related to GHGs (gases that absorb and emit radiant energy) result in higher default risk or lower recoveries for securitized assets and if GHG-efficient assets can potentially benefit affordability, ability to finance, or future values. DBRS Morningstar will incorporate information regarding any third-party energy-efficiency certifications discussed below when available. Also, if these certifications are in place, DBRS Morningstar will evaluate their impact on energy costs and incorporate any energy-cost savings into its net cash flow analysis. This environmental factor centers on the underlying CRE collateral's

overall energy efficiency, the potential costs to make the property(ies) more energy efficient, and the potential future value loss for carbon intensive assets (including the risk of asset stranding).

Tenants and investors have turned their focus toward reducing the overall carbon footprint of various types of CRE collateral, and buildings that have not addressed these issues may be less attractive to such investors over the long term. In contrast, highly energy-efficient buildings could, given investors' and lenders' increasing focus on such features, benefit from relatively more stable future values and/or lower financing costs, thereby positively affecting DBRS Morningstar's credit analysis.

One way to frame the energy-efficiency efforts and the collateral's effect on the carbon footprint is to look to the requirements and standards in the leading "green building" certification programs and ESG policy organizations. For example, the leading green certification programs in the United States are

1. Leadership in Energy and Environmental Design (LEED), which is sponsored by the U.S. Green Building Council and is well known in Europe; and
2. Energy Star, which is sponsored by the U.S. Environmental Protection Agency.

Other examples of certification programs include energy performance certificates (EPC) in the European Union and in the UK; the Building Research Establishment's Environmental Assessment Method (BREEAM), which is also used in Europe; and various national programs such as Haute Qualité Environnementale in France or Deutsche Gesellschaft für Nachhaltiges Bauen e.V. or the German Sustainable Building Council in Germany, which both consider environmental factors. The Global Real Estate Sustainability Benchmark (GRESB) is an international organization of institutional CRE owner and investor members that has committed to adhering to ESG principles and providing reports on their members' ESG activity on an ongoing basis.

The U.S. Green Building Council has several LEED certification programs, three of which apply to CRE buildings and are relevant to DBRS Morningstar's evaluation of environmental factors. LEED-certified buildings are assigned Platinum, Gold, and Silver levels of certification in Building Design and Construction (BD+C) for new construction and renovations, Interior Design and Construction (ID+C) for complete interior fit-out programs, and Building Operations and Management (O+M) for existing buildings that are undergoing improvement work or that have operational factors requiring little or no construction. Each of these factors has some relevance to the DBRS Morningstar CMBS group's assessment of ESG risk as we evaluate existing stabilized assets, transitional assets undergoing renovation and repositioning, and the occasional ground-up construction asset. The U.S. Environmental Protection Agency's Energy Star program is an energy-efficiency management program for existing buildings. Energy Star provides tools and strategies to manage energy use and offers a certification program. On average, Energy Star-certified buildings use 35% less energy and generate 35% less GHG emissions than their peers. BREEAM is a globally recognized sustainability assessment method for master planning projects, infrastructure, and buildings. The BREEAM classifications range from

Acceptable (in-use scheme only) to Pass, Good, Very Good, Excellent, and Outstanding, and are reflected in a series of stars on the BREEAM certificate.<sup>1</sup>

Some design, operational, and other building characteristics that the U.S. Green Building Council, U.S. Environmental Protection Agency, BREEAM, and GRESB have identified as relevant also map to DBRS Morningstar's identification of Carbon and GHG Costs risks, including:

- Building components that optimize energy performance and incorporate renewable energy.
- Reduced parking footprints and access to public transportation. Accommodation for electric vehicles and bicycles.
- Reduced indoor water use.
- Improved indoor environmental quality (e.g., low-emitting materials, air quality testing).
- Reduced artificial light and more natural daylight.
- Reduced acoustical pollution.
- Compliance with green cleaning policies.
- Incorporation of new technologies (i.e., electrochromatic glass, building integrated photovoltaics, and green walls).

Examining these requirements is useful in evaluating the collateral's level of energy efficiency and carbon footprint. DBRS Morningstar expects, in addition to certifications, an increasing trend toward borrowers directly reporting properties' current GHGs, as well as outlining a strategy to reduce their carbon footprint in the future. This is because tenants and investors alike are placing increased emphasis on energy efficiency and transparency in reporting on these energy efficiencies at the property and portfolio level. For corporate tenants, considering their net zero targets, the carbon footprint of the properties they occupy becomes more important and carbon intensive assets might lose out in the future. Some examples of Carbon and GHG Costs risks that could affect credit ratings are:

- A mortgage portfolio from a "sustainable lender" that contains only loans backed by properties with top energy ratings may have less-volatile property values and higher recoveries in the event of default.
- Regulatory restrictions for landlords related to meeting minimum energy-efficiency standards could result in higher default risk and lower recoveries in the short to medium term.
- An office building incurs the upfront costs to install solar panels to meet part of the property's energy requirements and benefits from the long-term reduction in energy costs.
- Commercial property-assessed clean energy (C-PACE) financing is incorporated into the capital stack to fund designated energy-efficient components.
- Loans secured by buildings with an extraordinary low EPC assessment, which, if not improved, could negatively affect its future value and refinance ability. Conversely, a strategy to improve the assessment would likely result in higher capex requirements.

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1. Based on performance standards and benchmarks, the method measures sustainable value in a series of categories, ranging from energy to ecology. Each category addresses the most influential factors, including carbon emissions reduction, adaptation to climate change, as well as ecological value and biodiversity protection. A group of large pension funds established the GRESB in 2009 to gain access to comparable and reliable data on their investments' ESG performance. GRESB ESG data covers \$5.3 trillion in real estate and infrastructure value and more than 100 institutional and financial investors use the data to make decisions that lead to a more sustainable real asset industry. The GRESB assesses and benchmarks real assets' ESG performance, providing standardized and validated data to the capital markets.

In support of efforts to reduce the effects of climate change, the Urban Land Institute (ULI) initiated the Greenprint program. Part of the ULI's research arm, the ULI Greenprint Center for Building Performance (ULI Greenprint) focuses on climate mitigation—making the business case for green buildings by tying reductions in carbon emissions to increases in asset value. ULI Greenprint includes a global community of practice of leading real estate owners committed to improving the entire industry's environmental performance. In October 2020, ULI Greenprint announced another goal to reduce the operational carbon emissions of its members' collective buildings to net zero by 2050. This new net zero carbon goal is designed to meaningfully reduce the built environment's impact on climate change beyond existing efforts. The goal encourages portfolio wide carbon reductions via deep energy-efficient improvements, on-site renewable energy, green utility power and building electrification, off-site renewables, as well as renewable energy credits and offsets. The goal is in line with the Paris Agreement and the findings from the Intergovernmental Panel on Climate Change's report to limit global warming to 1.5°C. Limiting global warming is one important component of reducing the severity of climate change.

### **Factor #3: Climate and Weather Risks**

DBRS Morningstar takes into consideration the location of the underlying collateral to assess the potential impact of climate change and weather events on the successful operation and use of the property. Climate change and global warming have garnered significant attention, particularly considering recent extreme weather events and international policy initiatives, such as the Paris Agreement.

Climate change issues, such as wildfires and other catastrophic events, have increased the CRE investment community's attention on the following issues:

1. Vulnerable CRE assets in coastal areas that are subject to rising water levels.
2. CRE assets in areas prone to strong winds, wildfires, flooding (including from rivers), and landslides.
3. Resilient infrastructure design as an effective way to protect these assets (climate change adaptation).

Securitized CRE assets typically benefit from insurance coverage in case of damage, but increasingly the focus is shifting toward certain areas not being privately insurable against certain weather events and/or insurance premiums rising substantially.

Some specific examples of Climate and Weather risks that could affect credit ratings are:

- Potentially higher losses on mortgage portfolios secured by commercial or residential properties in regions that will likely be affected by adverse climate or weather.
- Potentially higher building construction and renovation costs because of more rigorous building codes designed to protect buildings from catastrophic events.
- Higher property taxes and special assessments necessary to fund resilient infrastructure programs to protect real estate in coastal and other vulnerable areas.
- Higher energy costs related to increased need for air conditioning in rapidly warming areas.
- Possible outmigration leading to reduced demand in coastal and other vulnerable areas.

### **Additional Climate Change Considerations**

The July 2023 update to the ESG methodology included an expanded discussion of climate change considerations, which is a particularly widely discussed topic in the CRE industry. In the CRE industry, climate considerations affect both building performance and resiliency, as well as the transition costs required to accomplish building decarbonization.

There has been an increase in climate-driven weather events (acute climate and climate change risk), which can cause additional damage to CRE assets. In North America, for example, historically the focus has been on hurricanes in coastal areas and wildfires in California and the Southwestern United States. However, in recent years, we have seen these events occur more often in other geographic areas as well as increased occurrences of other events. Wildfires have expanded to other parts of the North America and have caused severe property damage in Hawaii, Québec, and eastern areas of the United States. Hurricanes have become more common and intense and have travelled further north on the Eastern Seaboard and have recently affected California. Rising sea levels, in itself a chronic climate change risk, has increased the intensity of storm surges and sunny day/nuisance flooding has been on the rise. Finally, the central part of the U.S. has been subjected to more intense windstorms. In Europe, climate and climate change adverse events that increasingly affect commercial (and residential) real estate include coastal inundation, extreme rain and related river floods, wildfires, and strong winds, in addition to extreme heat and droughts. These increases in weather-related events and potential damage to CRE buildings are occurring while the insurance and re-insurance industry is facing its own set of challenges, increasing the costs and limiting the availability of property and casualty coverage.

These weather- and insurance-related conditions have increased the focus that DBRS Morningstar places on individual building characteristics that could serve to mitigate resulting damages. Property-level examples include moving mechanical equipment from lower levels to upper floors, installing additional floors of penetration proof glass, and removing combustible material from areas near the exterior of the building. Community/municipal-based programs include building flood-resistant infrastructure such as sea walls and natural vegetation barriers. These and other efforts are necessary to increase resiliency and limit damage going forward.

CRE collateral will need to respond to general decarbonization trends to remain competitive. Transition costs related to decarbonization and transition risk, the risk that comes from not adequately addressing the need to transition to a low carbon economy, are an important consideration. Reducing GHGs, particularly decreasing carbon emissions, has been identified as a critical component of reducing global warming, which will, in turn, slow climate change and weather-related climate events. The number of companies and prospective tenants making net zero carbon pledges, essentially committing to reduce and then eliminate their carbon emissions, is increasing. Those making pledges recognize that the characteristics of the real estate they use will have a significant impact on their ability to meet those net zero carbon pledges. Buildings that do not burn fossil fuels and incorporate other carbon-reduction strategies will be more competitive. Buildings that do not respond to these trends run the risk of becoming “stranded,” a term describing buildings that do not meet market desires and cannot attract tenants or buyers.

DBRS Morningstar studies the property owner's strategy for a property to determine if consideration has been given to funding improvements that will reduce transition risk. This is a particularly important consideration for properties located in jurisdictions that have enacted legislation requiring designated progress in reducing carbon initiatives and increasing energy efficiencies. For example, in the case with Local Law 97 in New York City, fines and penalties for noncompliance are significant.

### **Discussion of Social Factors**

DBRS Morningstar can assess social factors that affect historical collateral default and recovery rates through quantitative analysis when estimating pool losses. When social factors are emergent and not yet reflected in historical performance data, our qualitative analysis will estimate the effect of these factors on portfolio credit performance.

#### **Factor #1: Social Impact of Products and Services**

With regard to the social impact of products and services, DBRS Morningstar determines:

- If the securitized assets, typically CRE properties, have an extraordinarily positive or negative social impact on the parties in the transaction and/or society as a whole and whether the characteristics of these assets contribute to default rates and/or recovery expectations.
- If a company's business model, typically determined by the landlord and/or the sponsor, has an extraordinarily positive or negative social impact on its stakeholders and/or society and whether this results in different default rates and/or recovery expectations.
- If changes in consumer behavior or secular social trends affect the default and loss risk of the securitized assets. Our analysis focuses on risks to the operations and performance of the property, particularly in the case of an extraordinary social impact that could have an impact on the collateral.

Examples of social impact of products and services risks that could affect credit ratings include:

- The trend toward e-commerce and online shopping may affect CRE values negatively (retail) or positively (industrial warehouses).
- The trend toward ESG considerations in CRE lending may affect lending terms (affecting affordability) and CRE values positively or negatively depending on the "ESG credentials" of an asset or loan.
- A CRE sponsor's strategy to modernize and convert public or subsidized housing into free-market units negatively affects tenants' affordability but could have a positive effect on the value of the collateral amid higher rental cash flow. If successful, it can increase the rental cash flow and value of its housing stock, reducing default risk and increasing recoveries.
- Alternatively, continued use as subsidized/social housing is beneficial for tenants' affordability, and typically also reduces cash flow volatility, which could justify lower capitalization rates and more attractive debt service coverage ratios.

**Factor #2: Human Capital and Human Rights**

With regard to human capital and human rights, DBRS Morningstar determines:

- If the originator, servicer, and/or underlying borrower(s)/sponsor(s) are exposed to staffing risks, which could have a financial or operational effect on the structured finance transaction.

The primary focus of this factor is on the availability of sufficient human capital to staff the various organizations with material roles in the initial transaction and the ongoing operation of the properties and servicing of the transaction. If one of these organizations exhibits inappropriate labor practices or other human rights violations, it could lead to an unwillingness of talented staff to join the organization and could potentially affect operations of the collateral or management of the transaction. We consider human rights issues in the context of this need to fully staff material organizations and in the potential for fines or other regulatory actions. Therefore, DBRS Morningstar is concerned with the exposure of originators, servicers, and underlying borrower(s)/sponsor(s) to staffing risks that could result in negative financial and operational conditions. DBRS Morningstar criteria focus primarily on the impact on servicer staffing, rather than the broader effects of housing affordability, community development, values alignment, and other human rights issues. However, these factors could affect the transaction or operation of the properties in extraordinary circumstances.

Examples of human rights and human capital risks that could affect credit ratings include:

- A servicer may have difficulty attracting and retaining qualified employees, affecting its servicing ability.
- A borrower/sponsor/landlord/property manager may have difficulty attracting and retaining qualified employees, affecting its ability to manage the assets.
- Servicers or originators that engage in bad work-out procedures could experience increased default risk.
- A sponsor could have a history of unfair labor and compensation practices that limit the advancement of women or minorities and results in unequal pay.
- A borrower/sponsor/landlord/property manager may disregard human rights of tenants, which could lead to withheld rent and/or fines and negatively affect cash flow.

**Factor #3: Product Governance**

With regard to product governance, DBRS Morningstar determines if the originator's, servicer's, or underlying borrower(s)' failure to deliver quality products and services causes damage that may result in higher default risk and/or lower recovery expectations for the securitized assets. This is essentially analysis of these parties' ability to operate the asset effectively and maximize cash flow. Our primary focus related to product governance is on the ability of the sponsors and servicers to provide appropriate, high levels of service to protect the quality of the underlying collateral. This is not a new concept in analyzing CRE collateral in structured finance transactions. Property quality and the property's ability to compete in the market are key concerns, especially because borrowers in structured finance transactions are typically special-purpose vehicles (SPVs) without other assets to support the secured real estate assets. We focus on the potential risks if the originator, servicer, or underlying borrower(s) fail to deliver quality products and services and cause damage that may result in higher default risk and/or lower recovery expectations for the securitized assets.

Examples of product governance risks that could affect credit ratings include:

- Unmitigated risk of redress for mis-selling and/or regulatory changes can lead to fines and may negatively affect recoveries.
- Lending practices that impose unfair or deceptive loan terms on a borrower may negatively affect recoveries.
- Mismanagement of the securitized asset may negatively affect cash flow and recoveries. Examples include hiring underqualified leasing and management vendors and failure to comply with local laws and ordinances.

#### **Factor #4: Data Privacy and Security**

With regard to data privacy and security, DBRS Morningstar will use available information to determine if the originator's, servicer's, sponsor's, or underlying borrower(s)' misuse or negligence in maintaining private client or stakeholder data results in financial penalties or losses for the collateral. This could result in an increase in the likelihood of a property level loss. A civil or other type of lawsuit could negatively affect the parties. DBRS Morningstar will also consider the potential impact of regulation and fines. For example, General Data Protection Regulation (GDPR) rules allow Europe to impose fines up to 4% of global revenues for data-related regulatory violations.

Examples of data privacy and security risks that could affect credit ratings include:

- The issuer's or its agents' unmitigated misuse or negligence in maintaining sensitive financial information may result in operational disruptions and/or negatively affect recoveries.
- Lapses in data privacy and security could severely hamper a counterparty's ability to conduct business, especially as several financial institutions have multiple roles in these transactions, including as issuers, servicers, custodians, and as institutional sponsors of some transactions.
- A sponsor could fail to establish operating standards and procedures for handling tenant and vendor data, which could make it more susceptible to data breaches and theft of private data. These lapses in data privacy and security could also hamper a landlord's ability to conduct business and/or result in fines, increasing the securitized loan's default risk

#### **Additional Social Considerations**

While the social factors identified the July 2023 methodology update remain unchanged, DBRS Morningstar would like to discuss three areas particularly important in today's CRE market.

First, the shortage of affordable housing in the U.S. and other markets is an important social issue that can be examined through the lens of CRE investments and CMBS transactions. The discussion of the lack of affordable housing is no longer limited to CRE finance and development professionals. It has become a social, political, and economic issue with a wide range of proposed solutions. Solutions can incorporate elements of zoning reform, creative design, and financing sources and incentives. Many of these are emerging.

The North American CMBS' ratings work has generally focused on rating pools of mortgages originated by government-supported agencies such as Freddie Mac. These pools frequently include mortgages on properties with restrictions on rent levels calculated as a percentage of average median income (AMI). Once built and stabilized, affordable/social housing is beneficial for tenants' affordability and typically reduces cash flow volatility, which could justify lower capitalization rates and higher valuations. We anticipate the growth of several types of social bonds that address the need for various types of affordable housing including low income and workforce housing alternatives.

Second, healthy buildings can be considered an important social factor when evaluating ESG considerations and were discussed in a May 21, 2020, DBRS Morningstar commentary titled, "Demand for Healthy Buildings Could Drive ESG Investment in Commercial Real Estate." Healthy building considerations, increasingly verified by one of the healthy building related certification programs like Fitwell or WELL, are particularly important to the health and well-being of building occupants. Maintaining standards in air quality and building operations can increase employees' productivity and long-term quality of life. In the office space area, tenants are particularly attuned to this issue because it is relevant to employees, making it an important recruiting consideration.

Finally, the development of what are now frequently referred to as "15-minute walkable communities" addresses a number of social factors including building community and mental health. These are in addition to traditional environmental considerations including reduction in GHGs because of increased focus on mass transit and the close proximity of residential and retail uses. One social factor frequently referenced in these communities is mental health. These walkable communities foster more social interaction because residents have access to goods and services within walking distance. Rather than spending time driving in isolation, individuals are able to engage in social interaction with neighbors decreasing isolation, increasing a sense of community, and improving mental health. Although this mental health metric is an emerging credit issue, study of this factor does illustrate how real estate related factors can have social impact.

## **Discussion of Governance Factors**

### **Factor #1: Transaction Governance**

Structured finance debt issuers are usually special-purpose vehicles (SPV) or trusts that are established for the sole purpose of owning the assets and issuing the SPV debt. SPVs have stringent rules to ensure bankruptcy remoteness, restrictions on active management, and, typically, counterparty replacement mechanisms. The transaction governance factor relates to the independence of the issuer or trust, alignment of interest between transaction parties, and provisions for future events, all of which can affect a transaction's credit performance, whereas ongoing performance reporting affects the ability to monitor credit risk. Unlike the environmental and social factors discussed in previous commentaries, governance considerations, if any, are usually only negative (i.e., typically cannot be credit positive for CMBS transactions).

With regard to transaction governance, DBRS Morningstar:

- Reviews whether the transaction's structure affects the assessment of the credit risk posed to investors because of a lack of appropriate independence of the issuer from the originator and/or other transaction parties.
- Considers the alignment of interest between the transaction parties and noteholders. Does this affect the assessment of credit risk posed to investors because the alignment of interest is inferior or superior to comparable transactions in the sector?
- Evaluates defined mechanisms in the structure and how they deal with future events and how they may affect the assessment of credit risk posed to investors.
- Considers how the transaction's structure provides for timely and appropriate performance and asset reporting. Does this affect the assessment of credit risk posed to investors because it is inferior or superior to comparable transactions in the sector?
- Identifies unusual deal structures or shortcomings in documentation. There is a general focus on transparency, and incentive alignment to determine if the transaction's structure allows the issuer to be independent from the originator and/or other transaction parties.

Examples of general transaction governance risks that could affect credit ratings include:

- Misalignment of interest between transaction parties and noteholders of different seniority may affect the credit risk for noteholders as a whole or noteholders of different seniority within the issuer's capital structure.
- A lack of structure may negatively affect performance and asset reporting.
- A lack of structure could fail to identify mechanisms on how to deal with future events. One specific example of transaction governance risks that could affect credit ratings would be the potential conflict between CMBS B-piece buyers and special servicers.

With regard to North American governance factors, there are structural elements that may lead to conflicts between the B-piece buyer/controlling class and the special servicers assigned to a pool or single asset. Actions taken by the special servicers are required to maximize the recovery on the mortgage loan on a net present value (NPV) basis to the trust. Special servicers are bound by the servicing standard and are required to act in a manner that benefits and is in the best interests of all certificate holders. However, although their actions may benefit all certificate holders, these actions may not be the preferred resolution favored by the B-piece buyer, which structurally bears the first loss. The servicing standards are designed to mitigate this conflict. The B-piece buyer, however, may have extraordinary influence over the special servicer because the controlling class has the right to terminate the special servicer without cause and appoint a new servicer or even assign the role to an affiliate of the B-piece buyer (although any successor special servicer must typically be an approved special servicer). The B-piece buyer also can require the special servicer to share fees with the B-piece buyer (principally because they are not prohibited from fee sharing in the pooling and servicing agreement). These two abilities have the potential to (1) influence the actions of the special servicer and (2) reduce the revenue of special servicers and thereby negatively affect their ability to retain quality and experienced personnel. The industry would be wise to consider addressing these structural weaknesses.

With regard to European CMBS transactions (that typically consist of one to a handful of loans), there are some specific structures seen in transactions issued before the global financial crisis (GFC) that we consider credit negative governance factors, for example:

1. Control/special servicer replacement/consent rights not switching to higher ranking noteholders from junior noteholders when the collateral's value declines.
2. Continuous senior-ranking payments to excess spread notes (Class X), potentially with support from third-party liquidity provisions, despite the securitized loans being in payment default.
3. Ambiguous loan and transaction principal allocation rules and associated triggers.
4. Ambiguous servicing standards and either insufficient or too wide reaching (that could give rise to conflict of interest considerations) workout options for the special servicer.
5. Special servicing or workout fees of fully recovered loans borne by noteholders even in cases where the sponsor fully repaid the loan.
6. Lack of transparency provision in the transaction's documents related to specially serviced loans.

Positively and as a good standard, special servicers for post-GFC European CMBS typically outline the NPV of various workout options. In addition, at a certain time before the CMBS bond matures, the relevant transaction parties have to outline a note maturity plan while more control shifts to senior noteholders.

### **Summary**

The updated ESG methodology confirms DBRS Morningstar's commitment to incorporate important ESG considerations in our credit ratings process. The CMBS group continues to identify and analyze ESG considerations that are particularly important and impactful in CRE markets. Of all the potentially relevant ESG factors, climate-related considerations appear to have gained importance in sectors like global CMBS because of their underlying assets' exposure to adverse weather events and insurers' increasing caution, turning the focus toward costly climate change adaptation. In terms of transitional climate change considerations, all CRE markets are affected, considering the sector's contribution to carbon emissions and an increased drive toward reduction of carbon footprints, which requires investment into a real estate asset lest it faces asset stranding.

### About DBRS Morningstar

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