May 17, 2023

Sandra L. Thompson

Director

Federal Housing Finance Agency

400 7th Street, SW

Washington, D.C. 20219

Re: **FHFA Request for Information on**

**Enterprise Single-Family Social Bond Policy**

Dear Ms. Thompson:

PGIM Fixed Income is pleased to respond to FHFA’s request for information (“RFI”) on the Enterprises single-family social bond policy and program design. PGIM Fixed Income is the fixed income business of PGIM, the investment management enterprise of Prudential Financial, Inc. with approximately $1.2 trillion in assets under management as of March 31, 2023.

As an investment manager, PGIM Fixed Income is responsible for fulfilling investment mandates that include certain ESG/impact strategies. As part of our analysis, we need to be confident that there is impact generated from any Enterprise Single-Family Social Bond Program (the “Bond Program”). This assessment is a crucial part of how we meet the objectives of our ESG strategies. To assess social bonds for inclusion in our ESG mandates (and to provide the ESG-related reporting that is increasingly required by our ESG-focused clients), we will need to be able to clearly and easily identify the criteria used to categorize bonds under as “social” – which includes consideration of borrower profiles as well as certain environmental considerations, as discussed more fully herein. We will also need to understand, with specificity, details related to application of specific social index categories.

**Outcomes, Borrower Benefits, and Reporting**

***A-1: What program outcomes and borrower impacts should an Enterprise Single-Family Social Bond program seek to achieve? Which borrower benefit impact measures should be reported?***

FHFA should consider structuring social bonds in such a way that any pay-up is directly allocated towards improving housing affordability, housing sustainability and environmental outcomes for individual borrowers. The Bond Program could improve housing affordability by lowering rates, offering down payment assistance and/or lowering mortgage insurance requirements for target borrowers. This will improve access to homeownership by tackling housing affordability, which has become an increasing challenge in this higher rate environment.

Any improvements in housing affordability should not come at the expense of housing sustainability. While it’s crucial to tackle housing affordability through the established program given that it is the largest impediment to homeownership, it’s also important to do so in a way that promotes financial well-being for borrowers. It would be counterproductive to offer down payment assistance to low-income borrowers, for example, if that ultimately increases the probability of delinquency/default. To improve housing sustainability, one potential option is that pay-ups be used to broaden access to borrower counseling, similar to what is already provided for HomeReady and Home Possible borrowers.

Environmental factors are a crucial component of social lending. Placing borrowers in homes with higher environmental risk factors potentially increases the ongoing maintenance costs of such homes, making these homes less affordable and less sustainable. Any mortgages issued under the Bond Program should be able to demonstrate consideration of environmental factors to ensure that no significant harm results as part of the Bond Program. We recommend that disclosures be added to help investors calibrate environmental risk factors. FHFA might also consider allocating pay-ups towards environmental programs that help homeowners in the Bond Program pool improve the energy efficiency of their homes. This could help mitigate environmental damage from these homes while also making them more affordable for homeowners by lowering carrying costs. To the extent any environmental trade-offs can be minimized, the more useful the social bonds will be to ESG-oriented investors.

The FHFA should use the Bond Program to achieve a broad set of goals, not restricting itself to simply lowering the cost of homeownership, but also improving sustainability and environmental outcomes. To achieve these goals, the GSEs should direct the use of any pay-ups associated with the Bond Program, ideally through the cash window. Using the cash window would not only ensure more control over the pay-ups but could conceivably make impact reporting/disclosure more straightforward. Such impact reporting should also disclose incremental positive outcome achieved versus what would have happened without the Bond Program. For example, metrics on how many target borrowers had lower rates than the cohort, had greater access to borrower counseling, or had improved the energy efficiency of their homes would all help give investors confidence that the Bond Program is achieving its stated goal.

Lastly, Credit Risk Transfer (“CRT”) investors should be considered in the establishment of the Bond Program. There is growing demand for ESG-focused funds across all asset classes and to that end, the Bond Program framework should also be utilized to provide value to CRT investors. We recommend that loans under the Bond Program framework that have higher loan-level social scores be referenced in separate CRT transactions. As there are fewer such loans originated in each quarter than typical mortgage loans, there may need to be a lag between loan origination and CRT delivery. This will create the necessary cohort size for a CRT transaction, but also have the added benefit of building borrower payment history. Such payment history may help offset the higher credit risk of these loans and keep CRT spreads for ESG CRTs in line with non-ESG CRTs.

***A-2: Should pay-ups from social bonds that accrue to the Enterprises or lenders be deployed to maximize borrower benefit? For example, should funds be allocated for specific programs,[1] to provide financial or other benefits to the individual borrowers that comprise a given pool, or some combination of options? Would improved liquidity resulting from the issuance of MBS social bond pools generate a sufficient benefit to borrowers, or should borrowers whose loans are included in a social pool receive specific benefit(s)? What could those specific benefits be?***

Transparency related to pay-ups is critical for investor analysis. Demonstrable evidence that pay-ups, and the GSE programs they are used to fund, directly benefit the borrowers whose loans are included in a Bond Program pool would be a consideration. Critically, there should be specific reporting on not just how much money was allocated to GSE programs targeting housing affordability, sustainability and environmental improvements as a result of social bond pay-ups, but also on how these programmatic investments catalyzed by such pay-ups directly impacted eligible borrower outcomes. This might include, for example, how many eligible borrowers were impacted by these specific programs and the quantifiable impact on borrowers, such as decreased delinquency rates, lower mortgage interest rates, down payment assistance, etc. Ultimately, an established framework, as referenced in our response to A-1, is necessary to demonstrate measurable proof to show the intended borrower impact is being realized.

While improved liquidity resulting from the issuance of MBS social bond pools is certainly a significant benefit from this program (notably for lenders who sell eligible mortgages to the cash window, but also for lenders that originate and pool loans with high loan-level social scores given evidence of higher pay-ups for pools with better SCS and SDS scores), it is not sufficient for investors needing to report on the specific impact/outcomes from their investments. As such, borrowers whose loans are included in a Bond Program pool should receive specific benefits from the GSE programs being funded by any pay-ups.

***A-3: Should the Enterprises monitor ongoing borrower impacts and benefits? If so, how? How often should reporting on impacts be provided?***

Yes – the specific ways in which the pay-ups have been allocated to improve housing affordability, housing sustainability and environmental risks should be reported on an ongoing basis. Monitoring is critical for ESG investors who are increasingly requesting reporting on the impact of their investments. To ensure that the programs would be broadly accepted by ESG investors, we believe that the standard minimum measure should be annual; however, the specific frequency would depend on the specific impacts and benefits targeted through the Bond Program.

The Enterprises should monitor ongoing borrower impacts and benefits. Some impacts and benefits that could be monitored include:

* Mortgage rates for target borrowers relative to the cohort;
* Sustainability of homeownership in the form of delinquency rates and utilization of borrower counseling; and
* Energy efficiency improvements funded via pay-ups.

**Eligible Loans**

***B-1: What attributes should be used to determine whether a loan is eligible for a social bond pool (e.g., income, geography, down payment assistance, reduction in mortgage interest rate, buydown programs)? What are the advantages and disadvantages to identifying eligibility based on mortgage product versus some other methodology (e.g., minimum Social Index scores)?***

A variety of attributes could be used to determine whether a loan is eligible for a social bond pool; however, for ESG investors it is critical that the attributes used for eligibility clearly and directly relate to a socially beneficial goal. In our view, investable social bond programs for ESG mandates should include borrowers with lower homeownership rates relative to other borrowers.

The Enterprises could consider eligible loans to borrowers that are similar to what’s included in the Social Index; however, Social Index Scores alone are not sufficient to form the basis of a Bond Program without transparency related to underlying criteria. The Enterprises’ current Social Index scoring, where an overall score is given without providing detailed information on application of specific social index categories, is currently not sufficient to allow these bonds to fulfill ESG-focused mandates. In addition, property level characteristics currently included in the Social Index include considerations such as low-income areas, do not guarantee that the benefits accrue to certain targeted populations. As such, we recommend the Social Index be disaggregated where possible, with eligibility for the Bond Framework based solely on income and borrower characteristics (and not property characteristics). Furthermore, we recommend that any program explicitly exclude loans where the loan purpose is identified as being for an investment property, second home or vacation property.

It’s also crucial that there be an element of “do no significant harm” built into the eligibility requirements. Existing and proposed ESG-related regulations, such as the EU’s Regulation (EU) 2019/2088 (“SFDR”),[[1]](#footnote-2) often specify that, in order for investments to qualify as “sustainable” they must demonstrate that they do no significant harm to certain environmental or social characteristics. Thus, as part of our analysis it becomes critical to understand any potential environmental or social trade-offs involved. For example, the Bond Program should not encourage homebuilding in areas with known environmental risks (e.g., in FEMA-designated flood zones) or with significant environmental hazards to health and well-being (e.g., areas with contaminated groundwater; high levels of ambient pollution; severe noise pollution; in close proximity to potentially hazardous facilities such as refineries, chemical plants, landfills, etc.). Further, in our view, the Bond Program should not encourage homeowners to buy homes they cannot afford. To the extent that trade-offs can be minimized, the more useful the Bond Program will be to ESG-oriented investors. This is why environmental disclosure and programs such as homeowner counseling are so crucial to this framework. While PGIM Fixed Income does not aim to comment on policy-related issues, to classify an investment as “sustainable” under SFDR we are required to address the “do no significant harm” principle.

**Disclosures and Borrower Reidentification**

***D-2: What incremental insights or additional disclosures do ESG investors need to appropriately evaluate social bonds? For each proposed insight or disclosure (e.g., borrower income band), should it be provided at the loan-level, pool- level, cohort-level, or some other level, or should some type of masking be employed? How would that additional disclosure aid investment decisions? To what extent would a specific disclosure increase the risk of borrower reidentification or provide sensitive, personal insight into the borrower?***

In order to assess eligibility, ESG investors will need to understand the basic elements of what makes a bond “social”, including how these pools differ from standard borrower pools outside of the Bond Program. Importantly, one single score will not be sufficient for these purposes, and more disclosure is needed about the borrowers in the pool. While sharing personal identifiable information (PII) is not our objective, disclosing information on the share of borrowers in the pool above/below certain social thresholds would help us assess the ESG benefits of the pool as related to our own internal methodology. For example, disclosing the portion of the pool that is below a specific AMI threshold can help ensure the overall pool is appropriate for a social bond without having to access loan-level data.

The use of the pay-ups is just as important as the composition of the Bond Program pool. There needs to be clear evidence that the pay-ups are used to directly benefit borrowers by improving housing affordability, sustainability and environmental factors.  In our view, new disclosures will be needed around how these pay-ups were used.  For ease of disclosure, we recommend that these pay-ups be controlled by the GSEs, ideally through utilizing the cash window.  Transparency around pay-ups is crucial to understanding and analyzing whether the Bond Program is positively impacting the targeted population.

Furthermore, disclosures should also be added to demonstrate that the “do no significant harm” principle is being followed, and that social benefits aren’t being offset by increasing environmental risks or promoting unsustainable lending. Disclosures that will help illustrate this include showing the share of:

* Homes in the pool located in environmentally sensitive areas, with low energy/water efficiency ratings, located in a flood zone, that have previously suffered hurricane damage, located in an area particularly prone to wildfire risk, or located on a fault line, among other environmental factors; and
* Borrowers in the pool receiving financial counseling, which helps promote sustainable lending.

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We appreciate the opportunity to share our views on the Bond Program and would be pleased to discuss in more detail at your convenience.

Sincerely,

/s/ Armelle De Vienne

Armelle De Vienne

Co-Head of ESG

PGIM Fixed Income

1. Regulation (EU) 2019/2088 on sustainability‐related disclosures in the financial services sector. [↑](#footnote-ref-2)