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THE EMERGING AREA OF SUSTAINABLE SECURITISATION

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Introduction

Sustainable securitisation is gathering pace. According to S&P Global Ratings, last year saw over €4 billion in green and social securitisation issuance in Europe. Key players in this market include Dutch mortgage lender Obvion and specialist UK lender Kensington Mortgages. In Europe, regulators are also active in this space, with the European Banking Authority ("**EBA**") publishing its report "Developing a framework for sustainable securitisation" in March of this year ("**EBA Report**")[1], and the European Supervisory Authorities ("**ESAs**") recently publishing a consultation paper on the draft Regulatory Technical Standards ("**RTS**") on sustainability disclosures for Simple, Transparent and Standardised ("**STS**") securitisations.[2] Sustainable securitisation is eventually intended to be part of a broader package of measures launched in 2018 by the European Commission which includes (i) the EU Taxonomy Regulation ("**Taxonomy**")[3], (ii) the SFDR[4] and (iii) the EU Climate Benchmarks Regulation[5]. In this article we look at the current shape of the sustainable securitisation market, how securitisation bonds can qualify as green bonds, and what all of this means for originators and investors.

1. EBA, Developing a framework for sustainable securitisation (2 March 2022): https://www.eba.europa.eu/sites/default/documents/files/document_library/Publications/Reports/2022/1027593/EBA%20report%20on%20sustainable%20securitisation.pdf
2. ESAs, Joint Consultation Paper – STS securitisations-related sustainability disclosures (2 May 2022): https://www.eba.europa.eu/sites/default/documents/files/document_library/Publications/Consultations/2022/Consultation%20on%20STS%20securitisation%20related%20sustainability%20disclosures/ESAs%20Consultation%20on%20sustainability%20disclosures%20for%20STS%20securitisation/1031949/Joint%20ESAs%20consultation%20paper%20on%20sustainability%20disclosures%20for%20STS%20securitisations.pdf
3. Regulation (EU) 2020/852 on the establishment of a framework to facilitate sustainable investment
4. Regulation (EU) 2019/2088 on sustainability-related disclosures in the financial services sector
5. Regulation (EU) 2019/2089 as regards EU Climate Transition Benchmarks, EU Paris-aligned Benchmarks and sustainability-related disclosures for benchmarks

What Does Sustainable Securitisation Currently Look Like In Practice?

On a product level, there is currently no dedicated framework for sustainable securitisation. Therefore, labelling a securitisation as "sustainable", "green" or "social" is to some extent subject to the judgement of those parties structuring and funding the transaction. Despite this, the market seems to have decided that there are three primary factors which could support a conclusion that a securitisation is "sustainable".

First and most obviously, do the assets backing the deal comprise sustainable collateral, for example energy-efficient mortgages, electric auto loans, or consumer loans to underserved borrowers? Readers will be aware that this is currently a challenge for the market given the lack of available sustainable collateral at present. Second, are the proceeds of the securitisation transaction being used by the originator to finance or re-finance assets that have a positive sustainable impact, "greening" its lending going forward? And the third factor is the extent to which parties are able to satisfy certain sustainability-linked key performance indicators, demonstrating positive change to the originator's business.

While there may be a lack of clearly defined criteria or standards for securitisation specifically, a review of sustainable securitisation transactions in Europe since 2016 highlights as a key trend the use of independent second party opinions confirming compliance of the securitisation bonds with the related relevant standards established by the International Capital Market Association ("**ICMA**"): the Green Bond Principles ("**GBP**"), the Social Bond Principles ("**SBP**"), the Sustainability Bond Guidelines ("**SBG**") and the Sustainability-Linked Bond Principles ("**SLBP**").

The GBP adopt a "use of proceeds" lens in determining a bond's green-ness. A good illustration of this standard applied in practice is the Green Storm RMBS deals by Obvion. Since it established Europe's first green securitisation in 2016, Obvion has brought to market various green mortgaged-backed securities, with the most recent being Green Storm 2022. From a collateral perspective, the underlying assets of the deal relate to energy efficient residential mortgages, based on the Energy Performance Certificate ("**EPC**") ratings of the mortgaged properties; Obvion address-matches properties in the bond with externally provided EPC data from real estate data company Calcasa. The proceeds are also being used to finance further green mortgages. The "green" status of Green Storm 2022 was cemented through Obvion's commissioning of an independent research, ratings and analytics firm called Sustainalytics to provide an opinion which confirmed (i) the alignment of the transaction with ICMA's GBP, (ii) the robustness and credibility of the notes qualifying as "Green Bonds" under the GBP, and (iii) compliance of the transaction with the Climate Bond Standard. The 2022 deal also follows on a best efforts basis the Taxonomy and the EU Green Bond Standard ("**EU GBS**"), which we discuss below.

From the UK perspective, in June 2021 Kensington Mortgages announced the UK's first green mortgage securitisation in the form of Finsbury Square 2021-1, five months after Kensington issued the UK's first social RMBS deal. Finsbury Square 2021-1 offered various tranches of notes including a triple-A senior tranche labelled "A-Green". Similar to Obvion, Kensington commissioned another firm, ISS ESG, to produce an independent second party opinion confirming that the Green Bond Framework developed by Kensington aligned with ICMA's GBP. Importantly, the second party opinion practice is not confined to the green space, with S&P Global Ratings providing an alignment opinion in respect of Yorkshire Building Society's newly developed Social Bond Framework against ICMA's SBP, which was used to label the Brass 10 RMBS as "social" in 2021.

Sustainable securitisation in the EU ABCP market so far focusses on "use of proceeds", for example the recent issue of Crédit Agricole CIB's LMA S.A., its European ABCP securitisation programme, publicised as refinancing trade receivables contributing to the energy and environmental transition, and in particular to the renewable energy, energy efficiency, clean mobility and waste and water management sectors. However, to date no specific framework has been used in the ABCP market to demonstrate "green" credentials.

It is clear that, while the sustainable securitisation market in Europe is less developed than in the US and China, appetite for sustainable securitisation is strong. The ratings agency Fitch expects the markets in Europe, the US, China and Australia to remain concentrated in the three main green asset classes, namely home loans for energy efficiency-improvements, rooftop solar loans, and car loans. However, the EBA Report suggests that *"the focus is shifting from environmental objectives to social objectives, which are becoming increasingly important, especially in the post Covid-19 economic environment"*. All of this must however be read against a backdrop of some key challenges for the market, as highlighted in the EBA Report, namely (i) the lack of available sustainable assets, (ii) the absence of definitions, standards and data to foster transparency and credibility in the market, and (iii) challenges experienced by some investors in participating in securitisation generally, especially from the perspective of insurers, which we discuss below.

How Can Securitisation Bonds Qualify As Green Bonds?

We have seen so far, then, that a large part of determining whether a securitisation is "green" depends on the debt instrument itself satisfying ICMA's GBP. At a high level, "Green Bonds" under ICMA's standards are any type of bond or instrument where the proceeds or an equivalent amount will be exclusively applied to finance or re-finance, in part or in full, new and/or existing eligible "Green Projects" and which are aligned with the four core components of the GBP, namely (i) use of proceeds, (ii) process for project evaluation and selection, (iii) management of proceeds, and (iv) reporting. However, market participants may soon have the choice of a new green label in the form of the EU GBS.

The EU GBS is an EU standard aimed at increasing transparency and accountability, the regulation for which was first published by the European Commission in July 2021 as part of the wider Strategy for Financing the Transition to a Sustainable Economy. The GBS aims to create a voluntary high-quality standard for green bonds with common definitions of environmentally sustainable economic activities based on the Taxonomy, standardised disclosures, and reporting to support the financing of green investments. To obtain the label, the bond must (i) use 100% of its proceeds to finance economic activities which satisfy the Taxonomy criteria, (ii) comply with the EU GBS disclosures framework, and (iii) be checked by an external reviewer which is registered with and supervised by ESMA. (For further information on the EU GBS, please see HSF's most recent article on the topic.)[6]

To what extent does the EU's proposed GBS align with ICMA's criteria, taking into account the EBA's recommendations in relation to the application of the EU GBS to securitisation? Whilst the proposed EU GBS is intended to align to a certain extent with ICMA's GBP, the EU GBS differs from ICMA's GBP in some respects. Notably, the EU GBS requires the proceeds to be directed at Taxonomy-aligned activities, whilst the GBP's concept of "Green Projects" is not specifically defined in relation to the Taxonomy, although the second pillar of the GBP does encourage issuers to provide information on alignment with the Taxonomy. It should be noted that the Taxonomy aims to create a consistent set of definitions and criteria whereby assets may be considered "green"; however it is not yet comprehensive for all asset classes (there is not, for example, a Taxonomy definition for green residential mortgages, or for green securitisation). It is also widely acknowledged that the Taxonomy represents a "gold standard" which at this stage of the development of the market in this area many transactions may not be able to meet. The GBP, by not requiring mandatory adherence to Taxonomy standards, is more flexible and may permit "lighter" shades of green. Another difference is that the EU GBS intends to establish a system for external reviewers to be registered and supervised, which is not present in the GBP.

In its report on sustainable securitisation, the EBA was keen to have the EU GBS apply to securitisation, but suggested, among other things, shifting the requirements from the issuer (which for a securitisation is quite limiting since the only use of proceeds by the SPV is acquisition of the asset pool) to the originator. However, this approach can only take the analysis so far. A "use of proceeds" standard at the level of the originator may not be sufficient for some investors who may instead require a more comprehensive label which requires the securitisation to consist of green collateral. This would be the gap that a dedicated securitisation framework would fill. Despite this, in its report the EBA said that it is currently too early to establish such a framework. Substantially more green assets need to exist before we can go to this next stage, and so the market in Europe will need to satisfy itself with the EU GBS (with the GBP as an alternative) for now. Assuming that a dedicated green securitisation framework is eventually implemented, the EBA also mentions concrete issues that are well known to securitisation practitioners. For example, one key issue would be to make data available for investors to compare the green credentials of the underlying portfolio with the green credentials of the originator's overall balance sheet (to limit the risk of "adverse green selection of assets" by originators).

The current position then is that whilst the EU GBS would provide a label for securitisation bonds which comply with the relevant requirements, it would not introduce an actual definition of green securitisation and would not prevent non-compliant EU GBS securitisations from being marketed as green securitisations provided that parties can point to compliance with the ICMA GBP or to another relevant set of standards.

6. HSF, The EU Green Bond Standard: Will Compulsion Fragment the Market (3 February 2022): https://www.herbertsmithfreehills.com/insight/the-eu-green-bond-standard-will-compulsion-fragment-the-market

Sustainable Finance Regulation More Widely

The broader sustainable finance regulatory landscape in the EU focusses on disclosure and reporting, and is made up of various pieces, two of the most prominent being the Taxonomy and the SFDR. Securitisation transactions, as defined in Article 2(1) of both the EU and UK Securitisation Regulations, are not captured by the SFDR, including the additional SFDR disclosures relating to Taxonomy, on the basis that they do not fall within the definition of "financial product". So, whilst certain parties to securitisations are of course subject to considerable transparency obligations under Article 7 of the EU and UK Securitisation Regulations, there is currently a lack of sustainability-specific requirements.

Hence the EU took some steps through its Capital Markets Recovery Package ("**CMRP**") to amend the EU Securitisation Regulation by introducing, among other things, optional disclosure provisions for STS securitisations relating to the principal adverse impacts ("**PAI**") of the assets financed by the underlying exposures on sustainability factors. In relation to this, the ESAs recently published a joint consultation paper on a draft RTS setting out the content, methodologies, and presentation of such disclosures. The aim of the draft RTS is to assist investors in measuring and comparing the negative impacts on sustainability factors caused by the assets financed by the underlying exposures and to assist financial market participants by providing a framework for measuring negative impacts. Whilst this moves the market forward somewhat, it remains to be seen how much further the European regulators will go. Next steps could be to implement the recommendation by the EBA to extend such disclosures to non-STS securitisation for the same asset classes covered by the RTS, and to consider the EBA's recommendation to introduce mandatory PAI disclosures for all securitisations once the market has further matured. It is to be hoped that disclosure of sustainability factors even for securitisations which are not marketed as green could encourage cross-pollination of ideas and over time encourage issuers to raise standards/reduce adverse impacts. In future, should securitisation be captured by the SFDR, information on PAI in relation to underlying assets and the transaction generally would be required in a number of situations to permit asset managers and other institutional investors to comply with their own transparency obligations.

What does all of this mean for our clients?

The immediate question for investors is what is the benefit, if any, of holding ICMA GBP- or EU GBS-aligned securitisation bonds? There are at least three parts to answering this. First, investing in such bonds could contribute towards voluntary and regulatory sustainability mandates. Second, sustainability risk is increasingly understood as an important investment factor, again in part due to regulatory requirements in this respect (investment banks for example are required to undertake a sustainability risk assessment on all of their assets). Viewed through that lens, investing in green bonds could help from a growth, diversification and risk management perspective. Third, with increasing scrutiny of asset managers' ESG credentials, maintaining a sufficiently sustainable brand and reputation is more vital than ever.

An interesting concept to explore here is the way in which disclosure obligations create demand for green assets. One example relates to the requirement under Article 8 of the Taxonomy for banks caught by the Non-Financial Reporting Directive ("**NFRD**") to disclose their Green Asset Ratio, which is essentially the total assets invested in Taxonomy-aligned economic activities as a share of total covered assets. Banks are therefore incentivised to invest in green assets, which would include EU GBS-aligned securitisation bonds, in order to be able to publish a ratio which satisfies market expectation. The sustainability preferences amendments to MiFID II and the Insurance Distribution Directive ("**IDD**") are another example, which will give retail and professional clients the opportunity to indicate their preferences on the extent to which their products (including underlying investments) must be comprised of sustainable assets or consider PAI. These amendments will begin on 2 August 2022 and the knock-on effect will likely be for sustainable products and assets to be even more in demand. Similar dynamics are also at play in the context of the growing market demand for Article 8 and Article 9 SFDR financial products. Broadly, an Article 8 SFDR product is a product which promotes environmental or social characteristics, whilst an Article 9 SFDR product is a product which has sustainable investment as its objective. All of these factors add up to a persuasive case that in future there will be greater liquidity available for sustainable securitisation bonds than for transactions which are not able to be marketed on that basis.

Regarding regulatory benefits – for example in terms of preferential capital and liquidity treatment – the benefits for investors are less obvious. As the EBA pointed out, *"the primary objective of green securitisations is to generate funding to (re)finance green assets, and it is not different from any other type of securitisation in terms of its structure"*. The assessment of the relevance of a dedicated prudential treatment for sustainable securitisations should be delivered by 28 June 2025. Some readers may remember the proposed concept of a Green Supporting Factor in the context of the Capital Requirements Regulation, which would have introduced more favourable capital treatment for certain green investments. However, this was heavily criticised and never materialised. On the liquidity front, the European Central Bank's ("**ECB**") greening of its collateral framework provides a welcome starting point.[7] The ECB is now taking into account relevant climate change risks when reviewing the valuation and risk control frameworks for assets mobilised as collateral by counterparties for Eurosystem credit operations, and is now accepting sustainability-linked bonds as collateral.[8] It is unclear whether further development can be expected in this area.

It is worth sparing a thought for the challenges faced by insurers on the buy side of securitisation transactions, given the onerous capital charges faced by insurers, in relation to non-STS securitisation. One way to promote greater uptake of sustainable securitisation products could be to adjust the related capital treatment on insurers' balance sheets, which would likely be welcomed by insurers and originators alike. However, it is doubtful whether such development will take off any time soon, if at all. After all, the UK HM Treasury's recent consultation on the Solvency II review made no mention of securitisation, despite the consultation stressing the need to free up capital for investment in green assets.[9] That said, if HM Treasury's review is successful in encouraging insurers to invest in green assets, that would help to address the shortage of green assets mentioned above. Were that to occur, HM Treasury's review may indirectly help to grow the market of available sustainable securitisation products. Also, the final rules have not yet been issued and so there may still be some residual opportunity for industry to lobby for the inclusion of sustainable securitisation within the review's scope.

The wide-ranging impact of ESG developments on disclosure is also visible in the fact that on some recent transactions, even where there was otherwise no specifically intended ESG alignment, there has been discussion on including certain ESG disclosure in the related prospectus. In particular, this has recently taken the form of including a summary of the material information that has been disclosed to investors through completing some or all of AFME's ESG questionnaire (published in March 2021) as part of the investor materials in the prospectus disclosure.[6] Despite the fact that such information may, in fact, not be directly correlated with the terms of and the issuer's ability to repay the securities being offered (e.g. information about an originator's or sponsor's ESG strategy and policies is not directly relevant to the credit quality of the portfolio), it is reflective of the current trend of development that investors are increasingly requesting such information as part of their investment decisions (and in the standardised format that industry bodies, such as AFME, are producing) and seek to include coverage of this in the representations given in the related subscription agreement. This gives rise to many interesting questions on the development of a widened standard of disclosure, if the direction of travel suggests that even securitisations not specifically marketed as ESG-related must provide some level of disclosure on their ESG credentials. This might be expected to further incentivise originators to burnish their sustainable credentials, although it remains to be seen whether this kind of disclosure can be included for non-traditional transaction structures (for example secondary acquisitions).[10]

Sustainable securitisation presents an exciting development in our industry, and we look forward to guiding clients through the opportunities and challenges that it brings. Eventually, innovation in consumer and business lending will need to drive an increase in this product, by creating sufficient volume of green collateral to support a consistent volume of issuance.

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7. ECB, ECB presents action plan to include climate change considerations in its monetary policy strategy (8 July 2021): https://www.ecb.europa.eu/press/pr/date/2021/html/ecb.pr210708_1~f104919225.en.html#:~:text=Collateral%20framework.,those%20arising%20from%20climate%20change

8. ECB, ECB to accept sustainability-linked bonds as collateral (22 September 2020): https://www.ecb.europa.eu/press/pr/date/2020/html/ecb.pr200922~482e4a5a90.en.html

9. HM Treasury, Review of Solvency II – Consultation (April 2022): https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1071899/20220328_Review_of_Solvency_II_Consultation.pdf

10. AFME, Discussion Paper: ESG Disclosure and Diligence Practices for the European Securitisation Market (March 2021): https://www.afme.eu/Portals/0/DispatchFeaturedImages/ESG%20Disclosure%20and%20Diligence%20Practices%20for%20the%20European%20Securitisation%20Market%20FINAL.pdf

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