KEY POINTS
- Environmental, social and governance (ESG) factors are now a point of focus for all securitisation market participants. Yet, ESG issuances in the securitisation market trail significantly behind other capital market debt products.
- This article considers factors hindering the growth of ESG securitisations, including lack of standardisation and available assets, as well as possible improvements in the pipeline.
- Proceeds Securitisations and amber bonds have a significant role to play in the market's growth and in supporting the transition to the green economy.
- Additional ESG related regulation should be approached cautiously as over-burdening the securitisation market could risk stifling its initial attempts to align to ESG principles.

Feature

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Talking about a revolution: making ESG securitisations mainstream

This article considers the constraints hampering environmental, social and governance (ESG) securitisations and the ESG securitisation market generally including the current regulatory framework, the various forms an ESG securitisation can take and possibly policy solutions to stumbling blocks in the market.

INTRODUCTION

We are witnessing a revolution where environmental, social and governance (ESG) factors are now a point of focus for all securitisation market participants. Securitisation is uniquely placed to help drive forward the green and social agenda and ESG represents a huge opportunity for securitisation, not just in terms of market share, but also as a power for positive change.

The securitisation market is trailing significantly behind other capital market debt products on ESG transactions as a proportion of those markets: AFME[1] found that while European ESG securitisation issuances passed through the €1bn barrier in 2021 (for the second time), European ESG bond issuances have risen above US$100bn.

Originators in the securitisation market are very keen to facilitate ESG securities and a vast majority of securitisation market participants (86%)[2] have reported they have ESG programmes in place at enterprise level. ESG is also now an urgent focus for capital markets investors. So, if there is interest both from originators and investors, what is hampering ESG securitisations? There seem to be two main constraints:

- **uncertainty**: unlike conventional debt and loans, lack of clarity as to what is a green or social investment makes it harder to create a marketable product. In addition, whilst it seems that ESG securitisation structures attract a lot of interest, there is not a sufficiently clear "greenium" (a green pricing premium) at the moment for ESG securitisations to gain traction with all originators and sponsors; and
- **lack of eligible assets**: whilst clearly an issue of scale, the market needs guidance and consistent, comparable criteria to determine what is meaningful when looking at ESG assets. Many firms have positive green and social policies but how can the market differentiate between those entities that have a serious commitment to green and social policies and those that do not?

This article takes a broader look at these issues and the ESG securitisation market generally, including the current regulatory framework, the various forms an ESG securitisation can take, and possible policy solutions to stumbling blocks in the market.

LEGAL FRAMEWORK

European Union

ESG-related matters have been relevant to securitisation transactions since well before the adoption of the European Green Deal[3] and the Action Plan on Financing Sustainable Growth.[4] Notably, the EU Securitisation Regulation (the EUSR)[5] requires the provision of environmental performance metrics (where available) in respect of residential and auto portfolios for simple, transparent and standardised (STS) transactions.

The EBA, in close co-operation with ESMA and EIOPA (together, the ESAs), is required to develop a framework for disclosure of information on environmental performance and sustainability. On 2 May 2022, the ESAs provided draft regulatory technical standards on the content, methodologies and presentation of sustainability indicators relating to adverse impacts on the climate and other ESG-related adverse impacts of residential loan or auto loan or lease securitisations which qualify as STS (together, the Draft Sustainability RTS) as well as a consultation paper seeking input on the Draft Sustainability RTS. The consultation paper does not propose a framework but includes information on principal adverse impact indicators for other types of exposures which are not included in the scope of Draft Sustainability RTS (ie which are not residential or auto exposures), paving the road for originators of other products, also to choose to opt into the disclosure regime.

In addition, on 2 March 2022, the EBA produced its *Report on developing a framework for sustainable securitisation* (Report) which examines how to develop sustainable securitisation. Notably the Report supports Proceeds Securitisation (as defined in the "Use of proceeds" section below), noting that changes will be required to: (i) the EUSR; and (ii) the proposed regulation for the EU Green Bond Standard (EU GBS), in both cases so that the use of proceeds requirements apply to the originator (as opposed to the issuer). Also, interestingly, Proceeds Securitisations may not require the underlying collateral itself to be green.

The EBA ultimately does not currently recommend a specific framework for sustainable securitisation but has not ruled out that the EU Commission may nevertheless wish to legislate for this. The Report concludes that more time is needed to consider green synthetic securitisation (credit protection instruments not being within the scope of any green standards) and the social securitisation market needs to mature further before contemplating a framework. This is a step in the right direction for securitisation though.

Since the EUSR came into force, there have been a number of further ESG-related rules and regulations, indirectly relevant to the securitisation market. Investors increasingly require ESG disclosure to facilitate compliance with their reporting obligations; in this regard, we note that the Draft Sustainability RTS seek to align, where possible, with some of the existing requirements impacting market participants. The most prominent examples are:

- The **Sustainable Finance Disclosure Regulation**[6] (in force since 10 March 2021), imposes disclosure requirements on financial market participants (other than banks, which are governed by the Non-Financial Disclosure Regulation (see below)).
- The combined provisions of the **EU Taxonomy Regulation**[7] and the **EU Non-Financial Reporting Directive**[8] impose disclosures as to what extent economic activities of large corporates (including banks) are linked to environmentally sustainable activities.
- The proposed **Corporate Sustainability Reporting Directive**[9] would significantly extend the existing reporting requirements of the EU Non-Financial Reporting Directive including by way of introducing audit and more detailed reporting requirements, according to mandatory EU sustainability reporting standards.
- The combined provisions of the **Taxonomy Climate Delegated Act**[10] and the proposed **EU GBS**,[11] require that all "EU Green Bond"-labelled bonds be aligned with the EU Taxonomy Regulation.
- The provisions set forth in the proposal of **Art 449a of the CRR**,[12] would require that listed banks provide quantitative and qualitative ESG risk disclosures, quantitative disclosures of physical climate risk and ESG policies, KPIs and a green asset ratio (**GAR**) which are expected to incentivise banks' investment decisions toward green assets. Different jurisdictions have, or are developing, their own requirements. Initiatives like the International Sustainability Standards Board's proposed standards for sustainability-related and climate related disclosure aim to create norms that would facilitate consistency for corporate disclosure on a global basis.

UK

The UK on-shored the EUSR with effect from 1 January 2021 with minimum changes (the UKSR). The requirements relating to residential and automotive securitisations seeking STS treatment under the EUSR noted above apply through the UKSR. Any subsequent amendments or technical standards do not however form part of this onboarding hence the UKSR does not currently provide for any sustainability technical standards. It is unclear to what extent the UK would seek to draw from the European Draft Sustainability RTS once published and also what approach will be taken on social and governance aspects.

On 13 December 2021, HM Treasury published its *Review of the Securitisation Regulation: Report* and call for evidence response,[13] concluding that no green securitisation framework is expected to be established in the immediate future.

That said, certain UK institutions have provided guidance in respect of matters relating to green securitisations, in particular:

- the FCA's discussion paper, issued in November 2021, on proposed Sustainability Disclosure Requirements and investment labels; and
- the *HM Treasury's Greening Finance: A Roadmap to Sustainable Investing* publication of 18 October 2021, which identifies a number of sustainable objectives.

More recently, on 17 January 2022, the UK has become the first G20 country to mandate climate-related financial disclosures, impacting over 1,300 of the UK's largest companies and financial institutions. These changes impose increased disclosure and due diligence requirements on investors and incentivise investing in ESG products.

It is expected that the UK taxonomy regulation will be modelled on the EU Taxonomy Regulation and will apply to both financial and non-financial firms (UK Taxonomy Regulation, together with the EU Taxonomy Regulation, the Taxonomy Regulations). Separately, the UK government established the Green Technical Advisory Group (GTAG), set up to oversee the Government's delivery of the UK's green taxonomy framework and determine whether investments can be defined as environmentally sustainable or not.

Once the *Future Regulatory Framework Review: Proposals for Reform* is concluded later this year, there should be more clarity on proposed legislative measures.

TYPES OF ESG SECURITISATIONS

Collateral securitisations

Based on industry-led initiatives, various forms of ESG securitisations have been taken to market in recent years. Of these forms, the most transparent transactions are those involving the securitisation of assets which are themselves seen as being "ESG" and therefore qualify as ESG collateral (Collateral Securitisations). These transactions require a clearly identifiable portfolio of homogenous ESG assets. In recent years, asset classes such as green residential mortgages and, in the US, auto loans for electric vehicles have largely been used for these purposes.

A model in the market, Green Storm 2021, involved the issuance of green RMBS consisting of properties with a high EPC rating where proceeds are allocated to the origination of further "green" mortgages. Also noteworthy as a first in the Continental European market, is auxmoney's social ABS, Fortuna 2022, with assets consisting of loans to consumers who are typically excluded

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from the traditional consumer banking space. These issuances aligned to the ICMA Green Bond Principles and ICMA Social Bond Principles respectively.

For investors, the advantages of Collateral Securitisations are clear: there is less reputational risk of "ESG-washing" (ie the characterisation of a product as ESG compliant being overstated or unreliable) as the link to ESG is intuitive, and repayments under the bonds directly come from "ESG" cash.

Whilst Collateral Securitisations provide the most transparent and clear-cut link to ESG for a securitisation, the strict view regarding the nature of the underlying assets coupled with the limited availability of such assets seems to be a real obstacle to the proliferation of ESG securitisations. In fact, there is a distinct shortage of sufficient ESG assets in the real estate and automotive sector, and the market has limited experience with other asset classes such as social loans or domestic solar energy products. Looking, for example, at RMBS, the share of buildings across Europe with an EPC rating is still small, and EPC class A properties are rare.

Use of proceeds

Another form of ESG securitisation is where the underlying assets may not be ESG but the financing raised by the transaction is used for ESG objectives (Proceeds Securitisations). Proceeds Securitisations have distinct advantages, including being less prescriptive than Collateral Securitisations and not being restricted to a pool of homogeneous ESG assets. On public transactions, Proceeds Securitisations can attract larger financing volumes and facilitate the origination of further ESG assets, providing a solution to the lack of ESG eligible assets and supporting the transition to a greener economy.

A key risk to investors remains the potential for ESG-washing within a Proceeds Securitisation: if originators use "brown" (or non-ESG) collateral, investors will want sufficient comfort that proceeds are properly applied, particularly as limited post-closing control is available to investors once the funds have been passed on from the issuer to the originator. Well-crafted regulations may help in this regard but any regulation should be proportionate and targeted to ensure that the growth of ESG securitisation is not stifled, where securitisation generally is already subject to a heavy regulatory, transparency and compliance burden. Until then, the market should continue to develop with industry-led principles and guidance.

That said, Proceeds Securitisations could be key in jumpstarting the ESG securitisation market, potentially enabling it to reach the same deal volumes as ESG loans and straight debt bonds, a view shared by the ECB[14] and the EBA.[15] Originators with balance sheets which are simply not yet big enough to accommodate an adequate amount of green collateral are offered the possibility to raise finance for the origination of future ESG assets.

The EBA remarked that there is an inconsistency in expecting a double standard (ie collateral and use of proceeds) for securitisations, while green bonds are by their very nature use of proceeds based only. As such, there is no reason for a greater fear of ESG-washing than with bonds.

POLICY RECOMMENDATIONS

ESG-washing is at the forefront of every ESG investor's concerns. Consistency in instrument labelling and reliable, meaningful disclosure might allay investors' worries. Clear industry-led standardised principles which may be supplemented by the following policy recommendations can help to ensure the transparency needed for the market to thrive, as follows.

Standardisation

Third party verifiers and credit rating agencies are increasingly relevant to investors; they provide investors with reports and certifications and offer tools to compare different types of ESG transactions in the market. Whilst helping to alleviate investor concerns about ESG-washing, there can be concerns as to the integrity of information provided and inconsistent methodologies. The FCA is considering the level of oversight required for certification providers and the European Commission is consulting on shortcomings in the functioning of the ESG ratings market and whether there is a need for EU intervention.[16] No doubt further developments in harmonisation of industry-led principles and methodologies will steer the market towards more standardisation. In time, these principles will most likely be supplemented with regulation.

ESG securitisation label

The creation of an ESG label similar to the STS label could provide the market with much needed clarity and a sound voluntary regulatory framework for ESG securitisations. This label could include Collateral Securitisations and Proceeds Securitisations (or a combination of the two) and would be one way to address transparency concerns. It would also support further standardisation, potentially strengthening investor demand and further alleviating ESG-washing risks. The EBA[17] has considered a possible green securitisation label which would apply to Collateral Securitisations, separate from STS but offering synergies between both frameworks – a position which is also supported by AFME[18] – but concluded that such a dedicated framework might be untimely given the early stage of development of the market. The ESAs have clarified that it is also not the aim of the Draft Sustainability RTS to implement such a framework. If such a framework is introduced in the future however, it would be important that (as with STS) the label remains voluntary and the requirements under it are proportionate.

REPORTING AND DISCLOSURE

Standardised disclosure requirements are burdensome for originators but have the benefit of providing investors with reliable information and foster confidence in products, particularly within the realm of public transactions where the ultimate beneficiaries of asset-backed notes are unlikely to have a direct commercial relationship with the originators in question. This is particularly true in Proceeds Securitisations where investors must be reassured of ongoing compliance

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with pledges or obligations made by originators. Issuers and investors appear to acknowledge that improved availability of more standardised data would help to move the market forward. Indeed, the lack of regulation has resulted in investors creating their own frameworks for due diligence. It is important however that securitisation, in trying to meet its ESG potential, is not over-burdened by new rules, on top of heavy existing reporting requirements. Regulation on this front could ensure periodic reporting is accurate, relevant and consistent with current reporting requirements. Too much regulation, or treating securitisation differently from other capital markets products, risks creating an un-level playing field and could stifle a growing market in its infancy.

Amber bonds

The Platform on Sustainable Finance (PSF) (the EU Commission's independent board of sustainable finance advisers) recently published its report[19] on the EU Taxonomy Regulation and proposes an "Extended Taxonomy" which would include not only labels and recognition for "green" activities, but introduce a traffic light system dividing activities as doing significant harm (red), not doing significant harm nor making a significant contribution (amber), and making a significant contribution (green). Crucially, the PSF suggests gradually amending the criteria leading to an amber classification, incentivising amber activities to transition to green over time or risk losing their amber status and becoming red. Such an approach could be applied to securitisations, and the debt capital markets more generally, as well by offering an "amber bonds" label. In our view, there is potential for such a label to apply to Proceeds Securitisations as they inherently assist with a transition. As with Proceeds Securitisations however, if amber transition financings are to gain the confidence of investors, the underlying transition criteria will have to be convincing.

Regulatory capital treatment

Both a green supporting factor and a "brown" supporting factor have been contemplated in terms of incorporating ESG risks into capital, liquidity and funding calculations. Beneficial capital treatment could have a significant impact in aligning lending and investment decisions of financial institutions to ESG criteria. There is substantial scope for regulators to introduce certain forms of capital relief for originators in relation to ESG securitisations, as is currently the case with STS, on the basis that ESG-linked assets should be more resilient to environmental and social risks. This would enable banks to securitise ESG assets and free up additional capital for new ESG securitisations. Such capital relief would be tied to stringent requirements, alleviating potential risks of ESG-washing.

CONCLUSION

The securitisation market has a long history of innovation and has unique potential to drive forward ESG developments. Substantial capital will be required for the transition to a fairer and more sustainable world and the securitisation market is well placed to be one of the pillars of this transition. ■

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