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ESG SECURITISATION: ACCELERATING AFTER A SLOW START

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Financing that takes into account environmental, social and governance ("**ESG**") factors has steadily been gaining prominence for several years. Investors across the board are increasingly seeking products which are not only financially robust, but which are also aligned with the broader ESG agenda. The best way to adapt securitisation to address ESG concerns has been a question for some time and has recently been looked into by the European Banking Authority in its report on "Developing a Framework for Sustainable Securitisation" (the "**EBA Report**")[1]. This article will explore the evolution of ESG concerns in securitisation from both a regulatory and a market perspective. It will look at the place of securitisation in the broader range of financing tools seeking to achieve positive ESG outcomes, as well as the challenges and opportunities it is facing.

General background

It is hard not to notice that ESG investment is booming – hardly a day goes by without ESG news in the main financial press. According to research from Bloomberg[2], ESG assets are forecast to represent a third of global assets under management by 2025. ESG financing figures for 2021 published by AFME[3] show the upward trend of new ESG bond and loan issuances. ESG bond and loan issuance volumes for the financial year 2021 were EUR749.8bn, up significantly from EUR396.4bn in 2020. While ESG securitisation issuances also increased in 2021 to EUR8bn (up from EUR2.1bn issued in 2020) with a mix of asset classes comprising consumer asset-backed securities and residential mortgage-backed securities, ESG securitisations still only made up 1.07% of ESG bond and loan issuances.

As these figures demonstrate, ESG securitisation volumes remain relatively modest as a proportion of the overall green and sustainability-linked financing market. One of the reasons for this may be a lack of a single, clear standard used to determine when securitisations meet ESG standards. As the EBA Report points out, there are at least three types of frameworks that are used to determine this, including (i) whether the

1 https://www.eba.europa.eu/eba-recommends-adjustments-proposed-eu-green-bond-standard-regards-securitisation-transactions
2 Bloomberg Intelligence, "ESG assets may hit $53 trillion by 2025, a third of global AUM", available at: https://www.bloomberg.com/professional/blog/esg-assets-may-hit-53-trillion-by-2025-a-third-of-global-aum/
3 AFME, "ESG Finance Q4 and Full Year 2021 - European Sustainable Finance" available at: https://www.afme.eu/Publications/Data-Research/Details/-ESG-Finance-Q4-and-Full-Year-2021---European-Sustainable-Finance.

securitisation is backed by ESG assets; (ii) whether the proceeds of sale of the assets into the securitisation will be used for some ESG purpose by the seller; and (iii) whether the key counterparties to the transaction commit to achieving certain sustainability-related KPIs. There is a further question about what counts as ESG or sustainability-related in the context of a securitisation.

This confusion about what metric to use for determining if a securitisation "counts" as ESG can make it even more difficult to meet those requirements. As alluded to in the EBA report, even a securitisation that qualifies as ESG purely on the basis of green use of proceeds by the originator/seller may – for purely reputational reasons – want to make sure that the assets backing it meet some kind of a minimal ESG standard (something akin to the "do no significant harm" principle from the EU Taxonomy Regulation) so as not to put off investors who may not wish to fund an "ESG" investment backed by e.g. high-emissions diesel cars.

Another reason ESG securitisation may not have got much beyond the starting blocks is that – to the extent the relevant standard is a securitisation backed by ESG-aligned assets – there is a clear lack of supply. Even where there are some clear options for how securitised assets could meet ESG criteria (e.g. excellent EPC ratings for homes financed in an RMBS or low emissions/electric cars for auto ABS), the inventories of these assets aren't sufficient to form the basis of a vibrant, liquid ESG securitisation market now. The EBA Report expresses concerns about this and it would seem from its Opinion on the proposal for an EU Green Bond Standard[4] that the ECB shares these concerns, although it expresses them less explicitly. We explore this issue further below.

Nonetheless, ESG securitisation as a tool for financing pools of assets, as opposed to financing corporates, is definitely gaining momentum. The first ESG securitisations started to appear in the European market from about 2017-2018 and quickly grabbed the headlines, and it is a testament to potential of this market that the IFLR structured debt deal of the year award for 2021 went to North Westerly VI ESG CLO managed by NIBC Bank.

What has happened so far?

There have been very few ESG asset securitisations in the main consumer asset classes to date. As mentioned above, other types of ESG financing, including corporate bonds and use of proceeds ESG covered bonds and, in the securitisation space, CLOs have led the way. This is partly because those deals are not limited on the supply side by availability of ESG assets the way securitisation would be. The most significant ESG securitisation deals we've seen in Europe so far have been the Green Storm RMBS issuances in The Netherlands, the Gemgarto Social RMBS, and Finsbury Square Green RMBS (both UK deals for Kensington) in the first half of 2021. Others are expected to follow.

While Green Storm is not explicitly linked to a set of ESG principles, the UK RMBS transactions of 2021 (including Yorkshire Building Society with Brass No.10) have chosen to align to the ICMA Green Bond Principles and the ICMA Social Bond

4 https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52021AB0030&from=EN (the "**ECB Opinion**")

Principles. For the Kensington transactions, the arrangers also took on an ESG structuring bank role, providing investors with soft comfort of third-party involvement in the process alongside the second party opinion provider who provides an opinion on the transaction and its economic sponsor (originator, in these cases), including benchmarking the use of proceeds, the asset selection and the originator's internal sustainability framework against external standards such as the ICMA Green Bond Principles.

Because of low levels of ESG asset availability, though, these deals have had to rely in large part on green use of proceeds by the originator, rather than green assets being used to fund the deal. For example, in Finsbury Square Green 2021-1, Kensington securitised £68m of green loans and committed to use the proceeds of the remainder of the class A notes to originate a further £570m of green mortgages over the following 5 years.

On the social side of ESG, market participants are still grappling with what it means to be a social securitisation. Clearly alignment to ICMA Social Bond Principles is workable, as Kensington showed with its Gemgarto 2021-1 issuance where the social project was making home loan finance available to applicants who are underserved by high street lenders using automated scoring processes given the complexity and characteristics of their income. Clearly the near-prime consumer credit market fits this bill squarely, especially with the use of credit builder products designed to improve or rehabilitate people's credit scores providing a ladder to prime products and rates in the future. The question remains whether this part of the market will seek to relabel itself as social. That, in turn, raises the question of whether relabelling of what is already happening as "social lending" will drive increased overall lending in underserved markets and drive greater energy efficiency in housing stock. Only time will tell.

Opportunities and challenges

The relatively modest size of the ESG securitisation market on the one hand and the ever-increasing investor demand for ESG investment opportunities across a broad range of debt products, from loans to securitisations, on the other present a clear opportunity for future growth of ESG securitisations. Indeed, recent research continues to demonstrate that investor demand in this space outstrips supply. Feeding into this trend is, among many other things, recent credit research demonstrating signs of positive correlation between the long-term viability of businesses and assets and its alignment with environmental, social and governance best practices.

While creating unique opportunities for growth of ESG securitisations, increased investor demand – combined with the relative under-development of the ESG securitisation market – creates two sets of challenges.

First, a lack of eligible collateral and verifiable, easily comparable, high quality information in respect of existing portfolios pitched against the heightened investor demand create risks of greenwashing and associated reputational concerns.

Second, the understandable desire on the part of investors for more standardisation, transparency and verification and the associated push for more regulation which would remove, at least to a degree, the risks of investing in something which is an ESG

securitisation in name only, is juxtaposed against the risk of creating an overly regulated landscape with overlapping and conflicting frameworks, and the associated potentially prohibitive compliance costs.

Balancing between factors and considerations which are often pulling in opposite directions is probably the main challenge faced by the ESG securitisation market at the moment. Leaving the area completely unregulated and relying solely on the market initiatives is not an option which realistically remains on the table, given the relative complexity of securitisation as a financing tool and the multiplicity of regulatory frameworks already in place and in the pipeline. On the other hand, creating too much regulation – or putting relatively rigid regulation in at too early a stage – would hamper development of the ESG securitisation market and work against the objective of unlocking its potential in delivering funding to ESG-aligned goals and opportunities in sectors where other funding tools may be unavailable or commercially unattractive.

These challenges suggest that – at least for an initial period – a "use of proceeds" paradigm for ESG securitisation may be the best way for the market to prioritise ESG concerns while building up the stock of ESG-aligned assets needed to build a robust ongoing ESG securitisation market that can be backed by ESG-aligned assets.

Indeed, as mentioned above, the EBA Report acknowledges the concern about a lack of ESG-aligned assets as well as the concern about regulating too heavily and too early. Its main conclusion is that it is too early to put in place a specific framework for sustainable securitisation, preferring instead to recommend adjustments to the proposal for an EU Green Bond Standard to make it workable for securitisations – mainly by applying the issuer obligations set out in the proposal at the originator level, at least initially. This would have the effect of applying a "green use of proceeds" standard for ESG securitisation and provide an opportunity to build up a stock of ESG-aligned assets to grow a vibrant ESG securitisation market in Europe.

Regulatory framework and market Initiatives

When looking at the current framework for ESG securitisation, it is worth noting that the more developed segments of the green, sustainability-linked and ESG finance markets have evolved over time from much the same place, as largely "bottom-up" driven, voluntary market initiatives. In the bond world, the main set of initiatives has been the ICMA Principles – including the Green Bond Principles, the Social Bond Principles and, more recently, the Sustainability-Linked Bond Principles.

Some of the challenges facing the ESG securitisation market – like the lack of standardisation, verification and consistency of information and greenwashing concerns – are also not unique to securitisation. The EU Taxonomy Regulation seeks to address some of these concerns by creating an overarching common language for discussing ESG concerns, targets and KPIs, thereby facilitating a shared understanding among corporates, financiers, policymakers and regulators.

The EU Taxonomy Regulation is an important example of the clear shift from industry-led initiatives to regulation in the determination of what counts as ESG, and securitisation is no exception to that trend. This has the potential to be a positive development, but in order for that to be true, policymakers will need to ensure that

they do not move too quickly or make the criteria too difficult to comply with, with the result that they end up choking off a nascent market before it can flourish.

The pieces of regulation and upcoming regulatory initiatives relating to ESG securitisation can be divided into "buy side" and "sell side" regulation. We consider each below.

"Buy side" regulation

In the EU, the main piece of regulation which establishes the framework for both entity- and product-level disclosures applicable to asset managers is the Sustainable Finance Disclosure Regulation (or "**SFDR**")[5]. While its application to securitisations has largely been limited to CLOs to date[6], it is quite clear that this piece of regulation plays an important in setting the ESG agenda for financial investor community as a whole, including investors in securitisations. Unsurprisingly, an increased number of investor ESG deal requests coincided with the roll-out of the SFDR for precisely this reason. It should be noted that while the SFDR represents an important milestone in creating a standardised and predictable playing field for sustainability disclosures, both at the entity and product levels (in the case of the latter, by linking up with the EU Taxonomy), its requirements are sometimes difficult to apply to securitisations. This is because the SFDR often assumes a degree of control over the information flows which is more typical of a private equity relationship than of a fund investing in broadly distributed, traded debt or consumer assets. The recent proposal by the European Commission for a Corporate Sustainability Reporting Directive ("**CSRD**") is looking to significantly expand the scope of entities subject to sustainability reporting obligations to plug this gap in respect of corporate loans by ensuring that companies report the information which is required by investors and other market participants who are subject to the SFDR.

Similarly, although the EU Taxonomy Regulation represents a crucial step towards creation of a single sustainability "vocabulary" in Europe, it is also not always easy to apply to securitisations.

The UK did not on-shore the SFDR as part of its post-Brexit process. However, a framework mandating certain ESG disclosures for financial investors is also being introduced in the UK as part of the Green Finance Strategy adopted by the UK Government in 2019. In June 2021, FCA published two consultation papers on climate-related disclosures. One proposed climate-related disclosure requirements for asset managers, life insurers and FCA-regulated pension providers with the aim of introducing mandatory climate-related disclosures across the UK economy and of integrating the recommendations of the Task Force on Climate-related Financial Disclosures. Another consultation focused on disclosures by listed companies, but also included a broader fact-finding request seeking views on ESG prospectus disclosure for debt securities and possible regulatory oversight of third party ESG verifiers and ESG rating agencies[7]. The policy statement on climate-related disclosures by regulated

5 Regulation (EU) 2019/2088 of the European Parliament and of the Council of 27 November 2019 on sustainability – related disclosures in the financial services sector.
6 Securitisation products in general are not "financial products" for the purposes of SFDR and are therefore not regulated under it.
7 See further ESG publications at https://www.cliffordchance.com/expertise/services/esg/esg-insights.html.

entities, as well as a final version of the ESG Sourcebook, was published in December 2021. The first disclosures under the new rules will be required by June 2023.

Additionally, onshoring of the EU technical screening criteria, as well as to the international alignment issues, are also under consideration as it is viewed as important that any UK taxonomy recognises international standards due to the global nature of the issue of sustainability.

"Sell side" regulation

On the sell-side, the main regulatory initiative is the proposal for an EU Green Bond Standard ("**EUGBS**"). This proposal was largely inspired by the ICMA Green Bond Principles but was designed to give it formal regulatory status. The EU Green Bond Standard proposal picks up many of the Green Bond Principles, including taking a "use of proceeds" approach, requiring extra reporting on the "green" aspects of the transaction, and requiring external verification. It is also explicitly meant to include securitisation bonds. That said, the original Commission proposal for an EUGBS is not especially well-adapted to securitisations, imposing most of the relevant obligations at the level of the bond issuer in a way that would be inappropriate for many SPV securitisation issuers and failing to clarify how the proposal's use of proceeds approach should apply to securitisations. These have been the securitisation industry's chief criticisms of the EUGBS proposal, and they have also been raised in the ECB Opinion and the EBA Report. With any luck, then, the proposals will be amended by the Council, the Parliament or both before the end of the legislative process on the EUGBS so that the final legislative outcome is better adapted to the needs of the securitisation markets.

In addition to the EUGBS there are a number of initiatives both in the EU and the UK which are looking at securitisation as a financial product and, more specifically, at the framework for enhanced ESG disclosure for securitisations. Both the EU and the UK consultations on reviews of their respective Securitisation Regulations at the end of last year included ESG questions intended to solicit market feedback on the best approach to such disclosure. While the market views these initiatives as generally positive, the feedback received as part of the consultation processes, both in the EU and in the UK, uniformly encouraged a cautious and carefully balanced approach to requiring further ESG disclosure for securitisations. The resulting UK report suggested that HM Treasury has limited appetite for a specific sustainability framework just for securitisations. Given that we understand the equivalent Commission review report has been delayed in order to allow the EBA Report to be published, we currently expect that the EU will go in the same direction and focus its energies on the EUGBS and on the existing mandate for sustainability information to be published as part of the general Securitisation Regulation disclosure obligations (albeit this may be expanded to all securitisations rather than being restricted to STS securitisations as originally envisaged).

Lastly, given the increased focus on ESG, it is likely that the upcoming regular review of the EU Prospectus Regulation will consider green and sustainable bonds as part of the Strategy for Financing the Transition to a Sustainable Economy EU.

Conclusion

ESG finance in general and ESG securitisation in particular without doubt represent a significant, and ever growing, segment of the financial markets. Opportunities presented by ESG securitisation are important not only from the perspective of unlocking financing to those segments of the financial infrastructure which cannot tap into the traditional bond or loan markets but which nonetheless require investment aligned with the ESG objectives, but also – ultimately – from the perspective of achieving the climate change goals. Careful balancing of the competing demands and objectives in this space will be key to unlocking the full potential of ESG securitisations.

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