JUNE 2023

GREEN SECURITISATIONS IN EUROPE: FIFTY SHADES OF GREEN

INTRODUCTION

Recent years have seen ESG ascend to the top of corporates' and market participants' agendas. ESG is now a mainstream consideration across many financial products, most notably in the loans and bonds sectors. Yet in the EU and the UK, despite the emphasis placed on sustainable finance as a means of reallocating financial flows towards ESG-compatible activities and achieving the EU and the UK's goals of being climate neutral by 2050, the securitisation market has lagged behind other markets in engaging with the ESG trend. The comparatively rapid uptake for ESG securitisation issuances in other jurisdictions, most notably China and the US, demonstrates that the slower rate of adoption in Europe is not due to intrinsic features of a securitisation, but rather stems from a range of other factors which we will explore further in this article. As the term 'ESG' suggests, an ESG securitisation could take the form of several characteristics, be it a 'green', 'social' or 'sustainable' securitisation. Thus far, ESG securitisations have predominantly come in the form of 'green' securitisations, with the number of social and sustainability-linked transactions trailing some ways behind, and it is through this lens that we look at the challenges facing a sustained growth in ESG securitisations in Europe.

As is the case for loans and bonds, green securitisations may take different forms, including:

- **Green Collateral Transactions**, where some or all of the underlying portfolio comprises green assets (e.g. renewable energy projects, energy-efficient mortgages or electric vehicles), as disclosed in the offering document; and

- **Green Use of Proceeds (UoP) Transactions**, where proceeds of the securitisation are deployed towards projects or initiatives with green characteristics, often in accordance with a sustainable finance framework.

Investors may also consider whether key transaction parties are committed to promoting and achieving specified green objectives, though this has not been a principal feature of green securitisations in the EU and UK to date. AFME's comprehensive report on historic green securitisations in the EU and the UK between 2016 and 2022[1] illustrates that most EU and UK transactions to date have, to the extent known to AFME, combined the features of Green Collateral Transactions and Green UoP Transactions, with only one transaction falling solely within the Green UoP Transaction category. While Green Collateral Transactions face certain challenges (as compared to Green UoP Transactions), most notably with the limited pools of green assets in the EU and UK and the absence of harmonised ESG criteria across the wide range of asset classes that may constitute a securitisation portfolio, this trend is perhaps reflective of investors' preference for Green Collateral Transactions in offering the most certainty on green characteristics (and lesser risk of greenwashing).

That said, the tide may yet turn towards Green UoP Transactions in view of the above challenges, at least in the near to medium term until the available pools of green assets in the EU and UK deepens. This is reflected in the European Banking Authority's (**EBA**) comments on the proposed EU Green Bond Standard (**EuGB Standard**) and how it may be applied to securitisations.[2] In particular, the EBA notes that applying the use of proceeds requirement at the issuer or securitisation SPV level could restrict the generation of new green assets (as it would require the issuer or securitisation SPV to invest in green assets in the first place (i.e. a Green Collateral Transaction), in circumstances where existing green assets are limited). Instead, by applying the use of proceeds requirement to

[1] 'European Green Securitisation Regulatory State of Play – Obstacles to growth and opportunities for leadership', December 2022, Association for Financial Markets in Europe (pages 6-7).
[2] 'Developing a Framework for Sustainable Securitisation', EBA/REP/2022/06.

583292435

the originator, Green UoP Transactions can be a means to generate new green assets, potentially as a stepping stone to wider adoption of Green Collateral Transactions once existing green asset pools expand. In the following section, we consider other issues relevant to green securitisations, with a focus on Green UoP Transactions.

CHALLENGES TO GROWTH

Definitional issues

As highlighted above, a green securitisation can take several forms. This poses a challenge in its own right – if the market is not able to agree on how a green securitisation is to be defined, how can investors be comfortable that the transaction is truly a green securitisation?

We have seen regulatory convergence in recent years on the definition of what makes up a green securitisation. In June 2022, the International Capital Markets Association (**ICMA**) released new and updated publications, including new definitions for green securitisations.[3] In essence, ICMA folded green securitisations into its wider Green Bond Principles, meaning that only Green UoP Transactions may benefit from ICMA's Green Bond designation.

In February 2023, the EU Commission announced that they had reached a provisional agreement on the EuGB Standard. This incorporated the recommendation from the EBA to include green securitisations under the umbrella of the EuGB Standard – meaning, as with ICMA, that this designation would only apply to Green UoP Transactions.

While one might expect this harmonisation of definitions to simplify matters, it is questionable whether the market would have an appetite for green securitisations completely backed by non-green assets, or whether some level of green assets in the pool would nonetheless be expected. ICMA expressly acknowledges that investors may have concerns over the ESG criteria relating to the collateral and that individual investors should form their own views as to whether the collateral in any specific green securitisation is in line with their investment mandate. In fact, AFME's report indicates that all green securitisations in the EU to 2022 included some elements of green collateral.

Structural challenges

For certain originators, using a Green UoP Transaction definition may have structural challenges. It is not market practice for originators to 'earmark' funds from a securitisation for a specific purpose in the way that they might for a tranche of a loan or a bond issuance.

Furthermore, while a large bank originator with a well-diversified balance sheet might have an easier time allocating proceeds towards green assets, since (in theory at least) the proceeds could be allocated anywhere across the institution, small or specialist originators are unlikely to enjoy the same level of flexibility since their securitisation proceeds are typically used to fund origination of further assets similar to those just securitised. For originators with smaller balance sheets, committing the full amount of capital from an individual securitisation entirely to green assets may be inefficient.

Limited market for use of proceeds

Given the regulatory convergence towards a Green UoP Transaction definition, this also leads to the question of the level of demand for underlying green assets that the proceeds from a green securitisation can be channelled into. The EBA, in coming to the conclusion that a Green UoP Transaction definition should be adopted, reasoned among other things that there were not sufficient green assets to support a framework based on Green Collateral Transactions. However, for the reasons above, for some originators the issue of limited demand for green assets may arise even for Green UoP Transactions.

AFME predicts that the market for green mortgage lending and electric auto financing could reach €125bn and €80bn respectively by 2030. Such an uptick in demand for the underlying green assets would provide significant support for the market for green securitisations of both the UoP and Collateral varieties. Data from Fitch suggests we may be reaching that tipping point for electric vehicle loans with the proportion of electric vehicle registrations rising from just over 10% of all car registrations in 2019 to just under 50% by 2022.[4]

However, as with the evolving definition of what makes a 'green' securitisation, what assets count as 'green' may continue to change over time. The credentials of an asset will always be judged against other assets that are funded

[3] 'Green Bond Principles – Voluntary Process Guidelines for Issuing Green Bonds', June 2021 (with June 2022 Appendix 1), International Capital Markets Association

[4] 'https://www.fitchratings.com/research/structured-finance/more-collateral-standardisation-would-boost-green-auto-abs-in-europe-27-02-2023', February 2023, Fitch Ratings

at the same point in time and it is hard to say with any certainty that green assets will grow in market share if the criteria become ever more rigorous.

Limited consensus on underlying data

Underpinning every ESG securitisation is the data. From information about the collateral to the originators themselves, there are plenty of metrics that allow investors and analysts to measure an ESG securitisation. However, as with most cases of non-financial data, there is no clear universal standard as to how this data should be presented or the level of detail that needs to be disclosed, resulting in varying approaches and assessment criteria being adopted across investors. Because of how suddenly ESG concerns have shot to the forefront of investors' minds, some types of data may simply not be available to originators yet. More often than not, the data disclosed and the level of such disclosure is the result of conversations between the originator and its investors on a deal-by-deal basis.

The EU Taxonomy Regulation, the Sustainable Finance Disclosure Regulation and the UK Green Taxonomy have provided some welcome clarity in terms of definitions and disclosures but are not perfect either. The EU Taxonomy Regulation for example, has faced criticisms from industry bodies such as the European Round Table for Industry, for having unclear definitions and divergent interpretations. Until such time as the market settles on a unified standard, individual investors will need to develop their own models for measuring the 'green-ness' of a transaction and reducing reputational risks of greenwashing.

LOOKING FORWARD

Given the limited pools of green assets available at present, we expect market participants and regulators alike to increase their focus on Green UoP Transactions in the near to medium term. However, Green Collateral Transactions, with naturally more straightforward and easily evidenced ESG credentials, seem likely to continue to dominate the market over that timeframe.

While the expansion of green securitisations will also depend on the availability of regulatory framework and harmonised criteria which has not been forthcoming to date, given widespread recognition of the securitisation market's potential to fuel further development of ESG finance, we are hopeful that there will be sufficient market and regulatory impetus to address these factors. We can only expect investors to have ever more stringent and specific requirements as to deals in which they are able to invest, as the ESG finance sphere develops and market participants become increasingly cognisant of the risks of greenwashing, all of which point towards the need for a harmonised framework that can be applied across asset classes.

RICHARD JONES
PARTNER
T: +44 (0)20 7090 4733
E: richard.jones@slaughterandmay.com

OLIVER WICKER
PARTNER
T: +44 (0)20 7090 3995
E: oliver.wicker@slaughterandmay.com