RESEARCH:

THE EVOLUTION AND CHALLENGES OF THE ESG SECURITISATION MARKET IN THE UK AND EU

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KEY CONSIDERATIONS

In the context of securitisation, the most important considerations in assessing ESG securitisation transactions are how well the nature of the collateral, the use of proceeds and the relevant policies of the parties are underpinned by ESG principles.

To date, the European securitisation market has only had a handful of ESG transactions, predominantly RMBS deals and most of these transactions combined both sustainable collateral and sustainable use of proceeds.

- ✓ While overall financial markets have seen increasing scrutiny and regulations with ESG-related objectives, the securitisation market is yet to find its footing on regulatory arrangements in relation to ESG financing in both the United Kingdom and the European Union, where market participants rely solely on industry-led initiatives.

- ✓ In the near future, the European and UK regulators do not intend to introduce a substantive regulatory framework for ESG financing in the securitisation market.

- ✓ Against the backdrop of increasing concern for current ESG practices and standards in the wider market globally, this article highlights the evolution of ESG concerns in securitisation from a regulatory perspective.

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I. DEFINITION OF ESG

At present, there is no commonly agreed or standard definition/understanding of what ESG is, but generally, as considered by the EBA in its report on sustainable securitisation, ESG factors include:

– A positive impact on environmental factors, such as reducing greenhouse gas emissions, improving waste management and water use, reducing pollution and enhancing biodiversity;

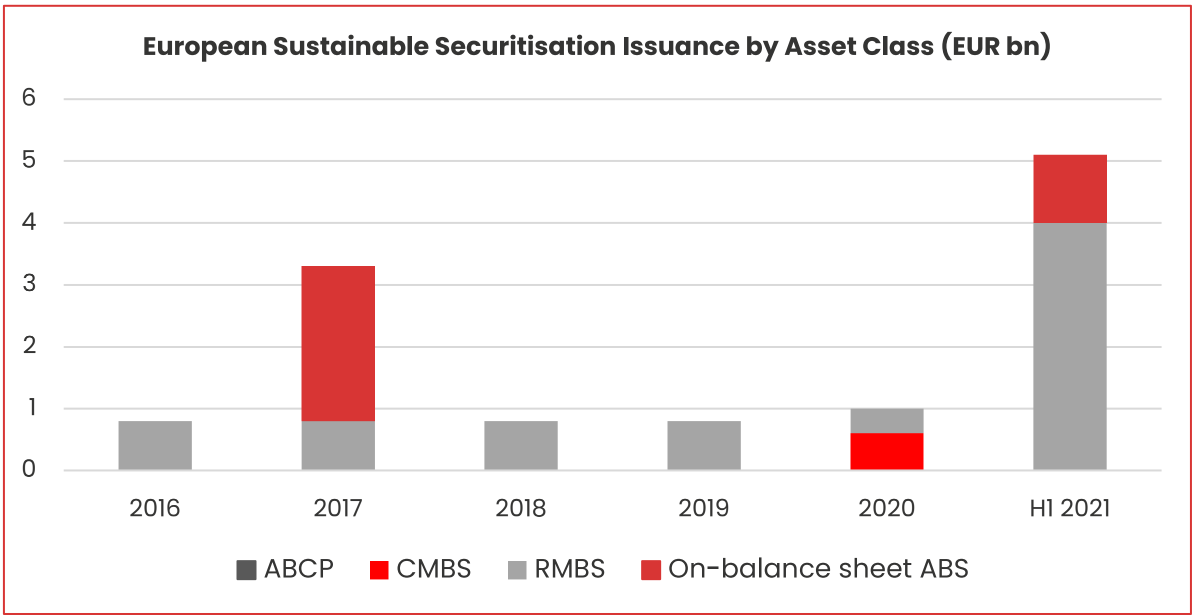
– A positive impact on social factors such as reducing credit and financial exclusion and improving diversity, gender equality, labour treatment and human rights;

– A positive impact on governance factors such as fostering integrity in corporate conduct through, for example, accountability, transparency, stakeholder engagement and renumeration policy.[1]

1 EBA Report on Developing a Framework for Sustainable Securitisation EBA/REP/2022/06.

II ESG SECURITISATION IN EUROPE AND THE UK

The European securitisation market has seen only a handful of reported ESG transactions. By the end of 2021, the securitisation market had seven green RMBS, one green CMBS, one green ABCP, two green synthetic securitisations and two social RMBS transactions.[2] RMBS by far is the most common asset class for ESG securitisation, but the market is developing into other segments. There is also a growing focus on social objectives alongside environmental objectives. In terms of structure, most transactions have combined both sustainable collateral and sustainable use of proceeds rather than opting for sustainable use of proceeds only. Despite the demand for ESG products, to date the securitisation market in the region has only seen a limited number of ESG transactions, which only make up 2% of the EU ESG bond issuance[3] and 6% of the EU securitisation issuance.[4] Globally, the European securitisation market has lagged behind the US and China in terms of total issuance.



[2] EBA Report on Developing a Framework for Sustainable Securitisation EBA/REP/2022/06.

[3] AFME Q2 2021 ESG Finance Report.

[4] AFME Q2 2021 Securitisation Data Report.

III MARKET INITIATIVES - ICMA GUIDELINES AND CLIMATE BOND INITIATIVES

The current securitisation market operates on existing industry-led initiatives rather than a standardised regulatory framework. The Green Bond and Social Bond Principles developed by the International Capital Market Association (ICMA) are globally utilised as a leading framework for issuance of ESG bonds generally, including securitisation transactions. Another widely accepted trade body guideline is that of the Climate Bonds Initiative, which also provides certification mechanisms for green bond issuance. The two market initiatives have been the main driver in the more active categories of ESG financing, such as green bonds and sustainability-linked bonds. In the context of securitisation transactions, there is no asset-class-specific guideline which captures the complexity of securitisation products and the specific considerations thereof.

More generally, the lack of clarity on the critical aspects of ESG transactions threatens the utility and reliability of the guidelines. The ICMA principles do not prescribe the requirements for use of proceeds to be considered green or social in terms of practice and quality. There is also no consensus on the minimum amount of sustainable collateral or use of proceeds; the analysis is largely left to the discretion of the issuer and third-party verifiers. The risk of reliance on such open-ended standards was delineated in the Mexican City Airport case in 2018. Green bonds were sold to finance the construction of an energy efficient airport in Mexico, and were marketed with industry-certified green credentials in compliance with the ICMA's Green Bond Principles. However, when the Mexican government cancelled the construction plan, no default was triggered on the debt. While S&P withdrew its green evaluation report stating that the residual bonds are different to what was offered initially, the bonds continued to be on the market as 'green' for technically the proceeds are still used for sustainability improvements. This calls into question the robustness of the market-led ESG reporting protocol and the existing regulatory gap.

IV ROAD AHEAD - DEVELOPMENT OF REGULATORY FRAMEWORK

EUROPE

In the context of a securitisation transaction, there is no sector-specific regulation on ESG financing despite the regulator's broader activism in ESG governance in Europe. Two key EU regulations on sustainability disclosure – the EU Taxonomy and the Sustainable Finance Disclosure Regulation (SFDR) – mark a step towards establishing a standardised ESG language by setting out the conditions for environmentally sustainable economic activities and sustainability-related disclosure. However, the regulations do not directly apply to securitisation transactions. Securitisation is not a taxonomy eligible activity, and securitised products in general are not 'financial products' for the purpose of the SFDR, except in limited instances of certain CLO transactions.

In the absence of an applicable regulatory framework, the European Banking Authority considered the issue in its Report on Sustainable Securitisation published in June 2022. The EBA's conclusion was that at this point in time it is not appropriate to establish a sector-specific framework for green securitisation. Rather, the EBA preferred nuanced application of the EU Green Bond Standard (EU GBS) and the Securitisation Regulation to facilitate the development of the sustainable securitisation market. The GBS requirements will apply at the originator level, instead of at the issuer/securitisation special purpose entity level. This will allow transactions that are not backed by green assets to meet the GBS requirements and ensure that originators use the proceeds to fund green assets.

In terms of social bonds, the market has generally lagged behind the green bond segment, and the securitisation market has played a minor role in comparison to the sovereign and corporate segments. The EU is in the process of developing its social taxonomy, but it is unlikely to be available in the near future as the project has been put on hold indefinitely due to discord in the parliament. At issuance level, the EBA stated that the European Supervisory Authorities may be mandated to develop a standard for social loans and bonds.

In relation to simple, transparent and standardised (STS) transactions, the Draft Sustainability Regulatory Technical Standards (RTS) provide directions on disclosure requirements on non-ABCP (asset-backed commercial paper) STS securitisations of residential loans and auto loans and leases. The aim of the Draft RTS is to standardise the form in which the principal adverse impact (PAI) disclosures are made. Although the Draft RS is not purported to facilitate ESG financing, it marks a step towards formalisation and standardisation of regulations on ESG transactions in the securitisation market.

UK

The UK regulator has taken a similar approach to the EU. The Treasury's Review of the Securitisation Regulation in 2021 indicates that at this stage the regulator is not planning to introduce a substantive regulatory framework. The Treasury also importantly stated that green securitisations do not warrant beneficial capital treatment. In terms of applicability of existing regulations, the regulator will be considering whether it is appropriate to extend the environmental information disclosure requirements under the Securitisation Regulation. However, there is little clarity on the direction of the future framework at present.

Additionally, the regulator identified a number of related initiatives that may be relevant to regulatory development such as the UK Taxonomy Regulation and Sustainability Disclosure Requirements (SDR). The UK Taxonomy Regulation will act as a framework for SDR by establishing the criteria for 'green' economic activities. Based on the proposal, the UK government appears to be drafting the Taxonomy based on the EU version of the regulation, which does not apply directly to securitisation transactions. There will be more clarity on its interaction with securitisation transactions by the end of 2022 when the legislation is expected to come in to force.

Further, the FCA's recent announcement in November also suggests a momentum towards regulating the market players involved in the ESG space. The UK has been considering whether to bring ESG data and rating providers within the FCA's regulatory perimeter. Although the issue does not directly pertain to regulating ESG securitisation, expanding the scope of regulation to ESG data and rating providers is a step towards a more robust control of the ESG market in general.

V OPPORTUNITIES AND CHALLENGES

ESG finance represents a significant and ever-growing opportunity. Increasingly, investors are seeking ESG investment opportunities in fixed income having experienced the benefits of integrating ESG factors into their investment strategies and responding to client demands. Investors in securitised products potentially have a wide-reaching impact in areas that are not available to equity investors, such as social housing.

The growth of this segment in the securitisation market will require a legitimate framework amidst increasing concerns for greenwashing risks, which was highlighted by the recent US regulator's enforcement actions against investment funds. The current patchwork of industry-led arrangements has not resolved the issue of credibility and undermined confidence in issuing and investing in ESG products. The lack of standardisation and systemisation is not a problem unique to the securitisation market in Europe. This factor in isolation does not adequately explain why Europe is yet to achieve a flourishing securitisation market for ESG financing. Introducing definitions and rules alone will not fix other issues, such as the lack of ESG-aligned assets and limited attractiveness of ESG securitised products, due to the lack of capital benefits and extra costs involved in the verification process. This is why it is also necessary to consider the desirability of a rapid expansion of the ESG market, which precipitated scepticism of products with ESG labels in the US.

A well-conceived regulatory framework for the securitisation market will be useful in helping market participants to overcome concerns for regulatory uncertainty and greenwashing risks, as well as shaping the market so that it is able to efficiently fund the green transition in the wider economy. Future regulatory developments will be an exercise to strike the correct balance between creating rules for certainty and avoiding overly burdensome requirements, which will hinder the market. A careful balancing of objectives will be key to realising a valuable opportunity for this market.

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