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Securitisation innovation in focus

Spring 2020

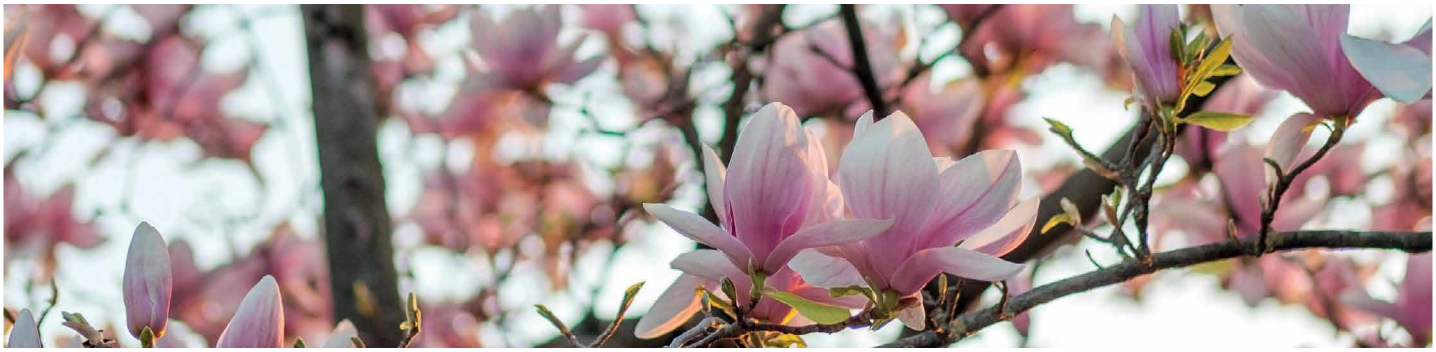
CRT Research Report

Quarterly analysis for the risk transfer community

Impact SRT

Origination and documentation

Defining ESG



London, March 2020

Welcome to the second quarterly SCI Research Report on the capital relief trades market. This series of reports aims to provide in-depth analyses of topical themes and trends being discussed in the sector, and are part of SCI's premium subscription package.

This quarter, we explore the synergies between impact investing and significant risk transfer. Specifically, the premise of the report is that synthetic securitisation and risk transfer technology can help bridge the investment gap between the US$2.5trn per annum needed to avert a climate disaster by catalysing ESG/positive impact finance in bank portfolio management.

There is at present both a positive acceptance among banks of their responsibility for greening the economy and a market opportunity to address climate risk. Market-driven structures, especially SRT transactions, can facilitate dynamic allocation of bank capital towards impact issues.

As of the time of writing, four impact capital relief trades have been issued. Although the primary motivation for executing SRTs remains capital release, a desirable secondary motivation is ESG considerations, and more ESG/positive impact SRTs are believed to be in the pipeline.

One factor that is limiting the growth of the sector for the moment, however, is a lack of standardisation in terms of defining, measuring and reporting ESG factors. Nevertheless, over the next 12 to 36 months, the market is expected to coalesce as large institutional investors require more uniform reporting and banks quantify the positive-impact and negative-impact assets on their books in greater detail. Indeed, ESG risk is already becoming an integral part of broader credit analysis frameworks.

This report explores the processes and infrastructure involved in originating impact SRTs, as well as documentation and transparency issues, how to assess performance and ways of incentivising/facilitating further volume.

Happy reading!

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CHAPTER ONE: INTRODUCTION

An estimated US$2.5trn a year needs to be generated in investment to help avert a climate disaster. At the same time, awareness of environmental, social and governance (ESG) issues is increasing and impact investing is gaining momentum, with more and more players on both the buy- and sell-side entering the space. Significant risk transfer can help bridge this investment gap by catalysing impact finance in bank portfolio management.

"Urgency around addressing climate risk is driving mainstream investment decisions," observes Martin Steindl, manager ESG at FMO. "Investors are pressuring institutions on climate disclosures and also banks will be held more accountable regarding responsible investing in the future. Consequently, banks started signing up to international frameworks, improving internal processes and hiring more ESG specialists, like we do at FMO."

> "INVESTORS ARE PRESSURING INSTITUTIONS ON CLIMATE DISCLOSURES AND ALSO BANKS WILL BE HELD MORE ACCOUNTABLE REGARDING RESPONSIBLE INVESTING IN THE FUTURE"

Weighting factors

Natixis' roll-out in September 2019 of a green weighting factor across its balance sheet, for instance, is seen as a compelling framework for other institutions because it should allow the bank to transform the climate impact of its financing activity. Under the mechanism, analytical RWAs are reduced by up to 50% for green deals, while facilities that have negative climate impact will have their analytical RWAs increased by up to 24%.

The adjustment of the expected rate of return of each financing based on its environmental impact should provide a strong incentive for Natixis' teams to favour green financing when assessing deals with equivalent credit risk. The aim is to set the bank on a trajectory consistent with the objectives of the Paris Agreement on climate change.

Andrew Hohns, md at Mariner Investment Group, believes that SRT can facilitate the push towards greener bank balance sheets – especially in respect of banks that have a preponderance of 'brown' assets, such as the Nordic banks, with relatively high fossil fuel exploration and production exposures. "Right now, there is a positive and organic acceptance among banks of their responsibility for greening the economy," he says. "There is both an urgency and a market opportunity to address climate risk. Market-driven structures can support the roll-out of the European Commission's green supporting factor and brown penalising factor [see Box: European Green Deal] and facilitate dynamic allocation of bank capital towards impact issues."

He continues: "The solutions are costly and financing them will take a concerted effort by banks, which are front-line players in translating bankable projects and developer interest into capital markets product. SRT can play its part by harnessing ESG momentum to become a meaningful tool to generate positive returns and facilitate the shift to a durable theme for a new decade."

Impact CRTs

As of the time of writing (March 2020), four impact capital relief trades have been issued (see Appendix), the first three of which involved Mariner Investment Group. The first of these deals was Crédit Agricole's US$3bn Premium Green 2017-2 from March 2017, which referenced a portfolio of roughly 200 obligors distributed across a range of sectors, including infrastructure, shipping, real estate, oil and gas.


Andrew Hohns, Mariner Investment Group

The second deal was the African Development Bank's US$1bn Room2Run transaction from September 2018, which referenced a pan-African portfolio of loans to infrastructure projects and financial institutions. The deal was the first-ever CRT between a multi-lateral development bank and private sector investors.

The third was Societe Generale's US$3.4bn Jupiter transaction from October 2019, which for the first time incorporated a capital allocation factor that incentivises additional positive impact finance lending. The deal references more than 250 loans in over 40 countries across a variety of sectors, including energy, infrastructure, shipping, aircraft, metals and mining, real estate and TMT.

Under the terms of the transaction, SG committed to dedicate 25% of the risk-weighted asset reduction to spur new positive impact financing over the following three years. The bank defines positive impact finance as per the United Nations Environment Programme Finance Initiative (UNEP FI): Positive Impact Business & Finance guidelines as "that which serves to deliver a positive contribution to one or more of the three pillars of sustainable development (economic, environmental and social), once any potential negative impacts to any of the pillars have been duly identified and mitigated."

Finally, RBS completed a CRT referencing a £1.1bn portfolio of UK project finance loans in January 2020. Dubbed Project Grasshopper, the approximately £78m financial guarantee is the first risk transfer transaction to be backed entirely by green assets. Macquarie Infrastructure Debt Investment Solutions, in conjunction with BAE

EUROPEAN GREEN DEAL

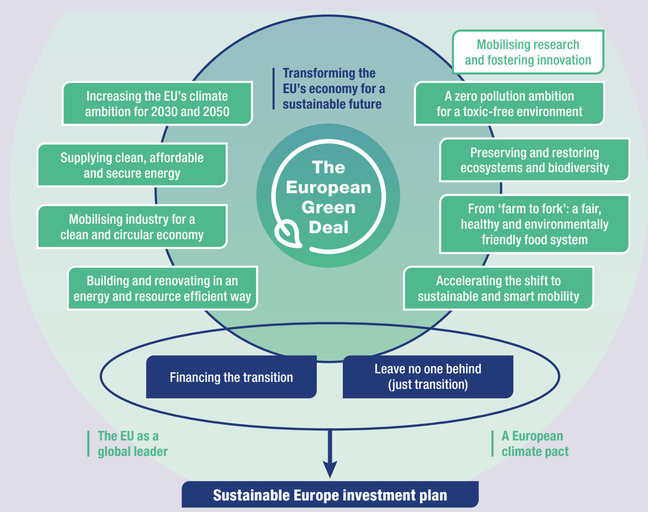
The European Commission outlined in December 2019 the European Green Deal, a growth strategy designed to make Europe the first climate-neutral continent by 2050. Under this strategy, a European Green Deal Investment Plan aims to mobilise at least €1trn of sustainable investments over the next decade. It will also enable a framework to facilitate public and private investments needed for the transition to a climate-neutral, green, competitive and inclusive economy.

The effort progresses the action plan on sustainable finance, which was adopted by the Commission in March 2018. Its key actions include:

- establishing a clear taxonomy for sustainable activities
- establishing EU labels for green financial products
- introducing measures to clarify the duties of asset managers and institutional investors regarding sustainability
- strengthening the transparency of companies on their ESG policies
- and introducing a 'green supporting factor' in the EU prudential rules for banks and insurance companies.

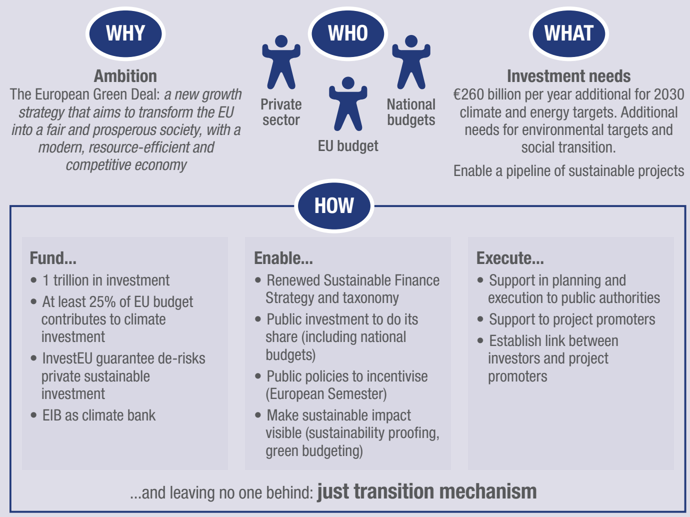
The latter is a multiple applied to capital risk-weights to reduce the relative weighting of sustainable assets, thereby encouraging institutions to incorporate climate risks into their risk management policies. Some stakeholders suggest that the converse of this – a 'brown penalising factor', which would see higher capital requirements applied for carbon-intensive assets – should also be introduced.

European Green Deal



Source: European Commission

Sustainable Europe investment plan



Source: European Commission

Killian Walsh, KBRA

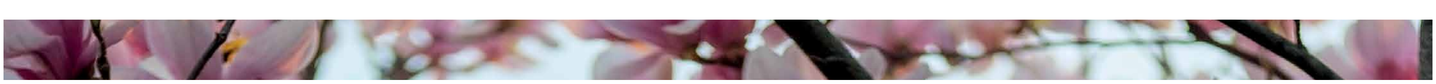
Systems Pension Funds Investment Management, invested in the securitisation.

Pipeline

Killian Walsh, director, ABS at KBRA, suggests that there are more ESG/impact SRTs in the pipeline. "ESG considerations are increasingly on banks' radars and we see a trend beginning for the redeployment of released capital towards ESG causes. This positive momentum is backed up by a desire from both issuers and investors. Bank capital remains scarce, so the primary motivation for executing SRTs will remain capital release, but a desirable secondary motivation can be ESG considerations," he notes.

One factor that is limiting the growth of the sector for the moment, however, is a lack of standardisation in terms of defining, measuring and reporting ESG considerations. "We expect that over the next 12 to 36 months, the market will coalesce as large institutional investors require more uniform reporting and the gaming of standards will decline. And as banks quantify the positive-impact and negative-impact assets on their books in greater detail, there will be increased scrutiny around ratings stability and performance, which should help further demystify the sector. Ultimately, ESG risk will become part of broader credit analysis," Hohns notes.

The remainder of this report will explore the processes and infrastructure involved in originating impact SRTs, as well as documentation and transparency issues, how to assess performance, incentivising/facilitating further volume and the role of ESG considerations in credit risk management.■



CHAPTER TWO: SRT AS A POSITIVE IMPACT CATALYST

Significant risk transfer is primarily associated with achieving favourable capital treatment, but the utility of the instrument as a catalyst for ESG/positive impact financings – by enabling banks to redeploy capital from legacy 'dirty' assets into new 'clean' assets – is gaining traction. A pricing incentive for SRT issuers would nevertheless help synthetic securitisation play a more meaningful role in addressing ESG risk.

"The capital relief trade market has a track record of over 20 years and continues to grow in terms of application, originators and jurisdictions. The stigma that used to be associated with the tool has been overcome and it is recognised as an efficient way of distributing risk and redeploying capital," says Sanjev Warna-kula-suriya, partner at Latham & Watkins.

He adds: "There is now real engagement with regulators, which view it as a useful technology to channel funds into the real economy – and this could potentially be harnessed in the fight against climate disaster. It's a question of educating both issuers and investors as to the availability of SRT for different purposes."

Synthetic securitisation

Synthetic securitisation is potentially a more appropriate tool for impact investments because it allows banks to maintain relationships with their clients and transfer risk to make available more funding for sustainable causes, according to Warna-kula-suriya. "SRT is relatively straightforward and the least disruptive tool compared to the alternatives. True sale securitisation, for example, involves breaking the link between borrower and lender."

Sanjev Warna-kula-suriya, Latham & Watkins

Parya Badie, partner at Allen & Overy, concurs: "Under a synthetic securitisation arrangement, a portfolio can be put together that is tailored to investor requirements. The exposure can be as broad or as specific as necessary, yet the originator can maintain its direct relationship with the borrowers."

Further, ESG financings tend to be small deals, so institutional investors don't typically have the opportunity to invest in them. But SRT represents an innovative way to provide access to ESG projects.

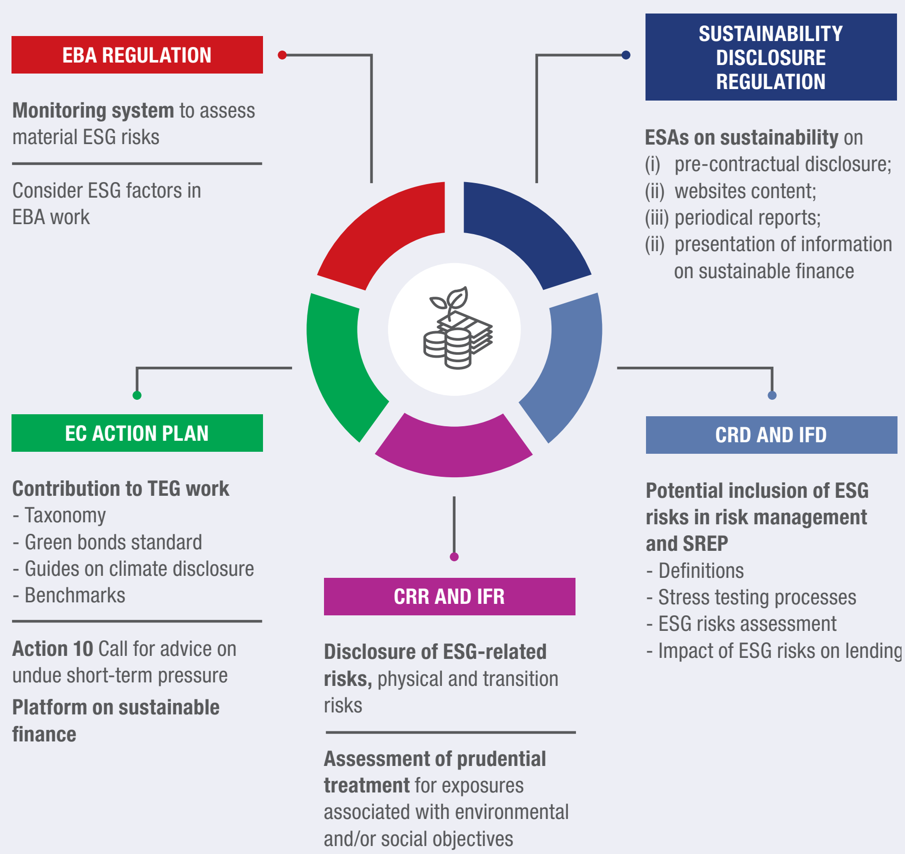
Catalysing impact

Mariner Investment Group md Andrew Hohns, for one, believes that SRT is catalysing impact finance in bank portfolio management. "We're eager to do what we can with our Funds and our mandates and hope that over time bank capital management personnel will recognise the growing investor interest in positive redeployment deals and how this translates into a lower hurdle rate in terms of ROE, which enables banks to be more competitive and to book additional pro-ESG loans."

Hohns suggests that there are a couple of different ways to think about how impact should be defined. One is to actively invest in ESG-oriented portfolios.

"Most impact securitisations so far have featured negatively-screened pools and this is certainly a step in the right direction. It's not complicated to apply certain parameter-based tests for originator banks to comply with under an SRT, including screening and replenishment criteria," he observes.

EBA mandates on sustainable finance



Source: EBA

Indeed, Mariner has participated in some deals where the pool is positively screened; for example, the assets are 100% renewables or affordable housing. But Hohns says the firm is also seeking to drive innovation in conditional redeployment requirements.

Conditionality

"We feel it's important to address non-ESG compliant loans that are already on bank balance sheets. The aim is to liberate the capital held against such loans and procure a commitment to redeploy it into pro-green lending. Conditionality requirements are ultimately a transfer pricing mechanism to reduce financing expense for such projects," he explains.

He continues: "SG and Credit Agricole are at the forefront of this initiative. It creates a dynamic force in terms of influencing overall bank behaviour. If we see more commercial banks, alongside of MDB regional ECAs following their example, it should catalyse significantly lower pricing for new loan generation that is positively impactful. With these kinds of initiatives, we'll be moving in the direction we need to in order to do our part for climate from a capital markets perspective."

While the primary motivation behind executing an SRT remains achieving capital relief, any way that ESG features can be incorporated is an additional benefit, according to Pascale Olivié, director, asset-backed products – advisory at Societe Generale. The aim with the Jupiter transaction, for instance, is to reallocate part of the released capital to new assets with positive impact features.

"Societe Generale has adopted the highest standards in terms of governance and decided to exclude from its operations certain counterparties or transactions that do not meet environmental and social standards," Olivié explains. "We adopted the UN Principles for Responsible Banking in 2019, so it's a combination of the right management of our own operations, the right management and exclusion of certain counterparties or transactions that do not meet ESG standards and pushing on Positive Impact. A positive impact feature adds value to an SRT transaction, but only if it's consistent with the Bank's overall strategy in terms of ESG."

Suitable assets

In terms of identifying a suitable portfolio to reference in an SRT, she says it depends on the nature of the bank's balance sheet and the available amount of assets that are potentially eligible for a trade. "In an SRT deal, the bank aims to select a portfolio representative of its core business. However, restricting eligible assets to positive impact finance assets or allocating the freed capital to positive impact finance assets only could be a stringent constraint," says Olivié.

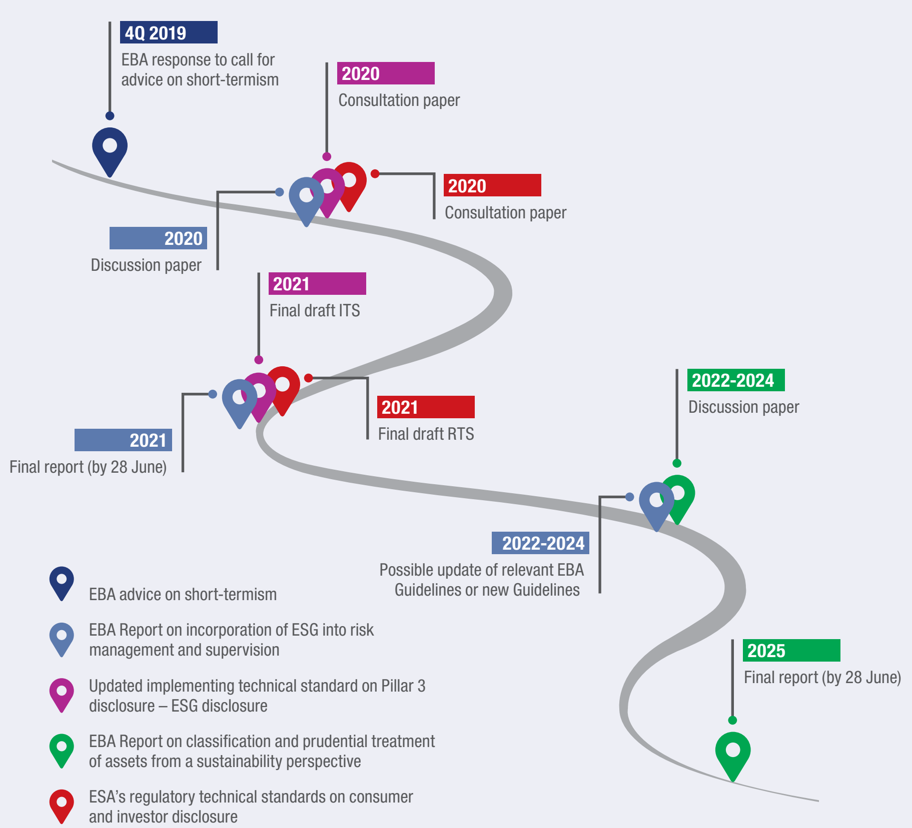
She adds: "While there is a broader trend within banks to originate more green assets or assets with impact, we still hold assets that aren't necessarily green. Typically, banks don't have enough assets to build an entirely positive impact portfolio, so first we can use reallocation of capital to support new origination of ESG/ positive impact assets."

Amitji Odedra, associate director at Qbera Capital, agrees that synthetic securitisation can enable banks to redeploy capital from legacy 'dirty' assets into new 'clean' assets. "We have seen four ESG SRTs issued so far and the market is getting its head around this. However, one potential limiting factor in the near term is whether banks are able to originate enough impact assets to execute a deal."

In terms of increasing impact SRT volumes, Warna-kula-suriya suggests that the next step is to translate this motivation for private sector participants. "The technology is available, but how do we bridge the gap?" he asks.

Whether impact SRTs will attract new investors to the capital relief trades market is debatable, however. "We have significant interest among our limited partners for deals that feature positive impact components. But SRT is bespoke and specialist, so the addition of impact as an asset class is unlikely to generate an influx of new investors to the market. Nevertheless, other managers involved in the sector may begin incorporating ESG aspects into their underwriting, which would create positive reverberations across LPs looking to deploy into impact assets," Hohns observes.

Milestones for EBA regulatory mandates on sustainable finance



Source: EBA

Amitji Odedra, Qbera Capital

IMPACT AND THE UN SDGS

The most assertive approach to integrating ESG factors into investment processes is ‘impact investing’, whereby capital is allocated not only to avoid doing harm but also to bring about positive changes. ‘Impact’ is most commonly measured with reference to the United Nations’ 17 Sustainable Development Goals (SDGs), which are incorporated into its 2030 Agenda for Sustainable Development. A recent NN Investment Partners survey of Nordic institutional investors – conducted in association with consultancy Kirstein – suggests that in terms of specific SDGs, Climate Action (Goal 13) is the most important SDG for those polled, followed by Affordable and Clean Energy (Goal 7) and Clean Water and Sanitation (Goal 6).

UN Sustainable Development Goals

Source: United Nations

Capital benefit

Another helpful development would be the introduction of an explicit capital benefit for portfolios that address climate risk, according to Badie. “Banks want to undertake more pro-ESG activities and have made commitments under different international charters. The SRT market continues to grow in terms of new jurisdictions, issuers and asset classes. To the extent the tool is used more widely, more and more issuers will adopt it for ESG portfolios.”

Olivié agrees that a pricing incentive for SRT issuers would be helpful in terms of synthetic securitisation playing a meaningful role in addressing ESG risk. “Aligning positive impact with financial interest may boost new origination for SRT transactions with positive impact features. Positive Impact Finance does not address climate-related matters only: it’s a holistic approach that incorporates social and environmental issues. Targeted SRT and incentive frameworks could therefore push on one specific SDG or risk, but that would necessarily be linked to one specific transaction and documentation,” she observes.

She suggests that a first step towards more favourable treatment for assets with positive impact is the provision in CRR 2 for essential public service assets to benefit from a regulatory haircut, to be introduced in mid-2021. Further, defining ESG standards for impact SRT may contribute to increased liquidity of SRT notes.

Anna Bak, associate director in the securitisation division at AFME, says the introduction of preferential regulatory capital treatment for green securitisation would likely make a material difference to the growth of the market – although, of course, to meet prudential requirements, such treatment would need to be based on evidence of better credit or liquidity performance.

The introduction of a capital benefit for green issuance has been proven to work, with China implementing such a scheme in its green bond market. But Odedra notes that regulators have to play a role in ensuring it is well thought out and introduced in a timely manner, otherwise participants could be incentivised to enter the market for potentially the wrong reasons.

Warna-kula-suriya warns that as a policy matter, reducing the brown charge via risk transfer may not be palatable to regulators, as it could be seen as a way to circumvent the need for lenders to change their behaviour.

Meaningful role

For synthetic securitisation to play a more meaningful role in addressing the climate crisis, Ingrid York, partner at White & Case, says that there needs to be greater awareness of the adaptability of SRT trades and the fact that they can be used for innovative purposes. “The pro-ESG movement is likely to keep growing in importance, bolstered by the EU Green Deal and ECB support. Ultimately, we’ll get to the stage where investors are asking issuers why their trade doesn’t have a climate feature. Then the market will move to a second phase, where the underlying is all ESG assets.”

Paul Petkov, coo and head of securitisation advisory at Qbera Capital, concurs: “It’s clear that the future lies in ESG origination and capital (re)deployment, and synthetic securitisation is an efficient tool for balance sheet optimisation, especially with Basel 4 coming down the line. We’ll see a market adjustment where more players enter the synthetic space and banks will have to adapt accordingly their asset origination to become greener.”

He concludes: “It takes one participant to push the envelope and the rest of the market will eventually follow. I expect to see further innovation in terms of ways to incentivise green SRT.” ■

“ALIGNING POSITIVE IMPACT WITH FINANCIAL INTEREST MAY BOOST NEW ORIGINATION FOR SRT TRANSACTIONS WITH POSITIVE IMPACT FEATURES”

CHAPTER THREE: ORIGINATING AND STRUCTURING IMPACT SRTS

When structuring an impact SRT transaction, the documentation should evidence the intentions of the parties. The originator bank signs up on day one to certain eligibility criteria and its progress is monitored and measured over time. If a bank doesn't comply with these criteria, it is in breach of the contract.

Given the risk-sharing nature of CRTs, investors in the space need to form a close relationship with the originating bank and be comfortable with its governance, risk management and flow of assets – and whether they are green or not – by establishing closing and replenishment eligibility criteria, according to Paul Petkov, coo and head of securitisation advisory at Qbera Capital. "To really share the underlying assets' and bank's risks, investors need to sit down with the origination team, and it needs to have skin in the game. For instance, some investors require originating banks to retain 20% of each loan, so the bank continues to be invested in the assets," he notes.

> "TO REALLY SHARE THE UNDERLYING ASSETS' AND BANK'S RISKS, INVESTORS NEED TO SIT DOWN WITH THE ORIGINATION TEAM, AND IT NEEDS TO HAVE SKIN IN THE GAME"

Open dialogue

Ingrid York, partner at White & Case, says that one important lesson learnt from her involvement with impact trades such as Societe Generale's Jupiter SRT was to have an open, constructive dialogue with the investor. "During the documentation negotiations, we discussed what the investor's goals were and what the issuer would like to achieve to identify where the common ground is. This then allowed us to put these aims in writing, so that the issuer's commitment is clear and defined. Given that these trades are risk-sharing transactions, their execution should be a collaborative process," she observes.

Ingrid York, White & Case

In Societe Generale's case, under the Jupiter transaction, the reallocation of capital to positive impact assets is discretionary. The bank's ESG team identifies at the origination phase which specific social and development impacts it would like to support.

To determine suitable partners for impact SRT deals, Mariner, for one, keeps an eye on bank policy, provides feedback where appropriate and determines whether there is a suitable opportunity to explore. "There is usually a positive feedback loop: for many banks, impact SRT adds value from a regulatory and public relations perspective. Our partners tend to have robust ESG divisions," notes Andrew Hohns, md at Mariner Investment Group.

He continues: "It's not just a verbal commitment. Our counterparties take their responsibilities seriously and have brought groups on board with mandates for reporting."

Reporting

For Mariner, focusing on the quarterly reports of its risk-sharing partners is crucial. "If banks are forced to quantify impact, they tend to manage it better," Hohns explains.

Affirming whether issuers are fulfilling their ESG mandates is the rationale for reporting, to be agreed with the investors, according to Pascale Olivié, director, asset-backed products – advisory at Societe Generale. To date, impact is measured on an ex-ante basis. Some initiatives exist to set up measurement on an ex-post basis, but given the number and variability of positive impacts, she suggests that this requires research and testing prior to implementation.

Investors should request a formal reporting process that defines violations and how they will be identified, reported and handled, according to Pedro Fernandez, head of ESG at responsAbility. "The need to establish such a reporting system should be included in the legal documentation between the investor, the asset manager and the final investee company," he says.

Typically, impact SRT documentation contains eligibility criteria and day one representations regarding the jurisdiction of borrowers, the nature of the financing and acceptable uses of proceeds. If a loan doesn't ultimately conform with these representations, it is no longer protected under the transaction. However, Allen & Overy partner Parya Badie says that in practise, she is not aware of that ever happening.

Remediation

Depending on the underlying loan and how it was structured, embedded within the documentation is usually a period of remediation/flex to allow an originator to get back on track before a default occurs. A scale can also be incorporated to gauge how much a portfolio can absorb without impacting the eligibility of the assets.

"A client can be behind on its action plan for reasons that are out of its control, such as a conflict in the country, and we can be flexible in these circumstances," says Naomi Campbell, environmental and social officer at FMO. "It's about working closely with the institution to ensure their actions are reasonable and can be fulfilled. Most clients are willing to try to meet our expectations, and it may just take a bit longer."

Martin Steindl, manager ESG at FMO, adds: "If a client doesn't fulfil its action plan, technically they're in default. But we work with them to try to find a solution – although we may not consider them for renewal, if their overall commitment isn't strong enough."

FMO clients are required to report any ESG claims within 3-5 working days as a contractual obligation. The bank assesses the overall performance of its clients in two ways – via client visits and progress on their action plan. Action plans are embedded in the contractual agreement and should be fulfilled over a two- to three-year period.

Risk analysis

When creating an action plan, FMO begins by categorising the client, based on the level of environmental and social impact risk in its portfolio. The aim is to develop a contextual risk analysis, according to Campbell.

There are three sets of ESG targets, in ascending order depending on a client's risk level. The first level is a prohibition from investing in activities on FMO's exclusion list. The second is to adhere to national laws, while the third is to adhere to international best practise and ILO Conventions.

If a client is deemed as high risk, an FMO environmental and social officer will be integrated into the due diligence team. The progress of clients is monitored closely and FMO's annual engagement with them can be stepped up if there are concerns over performance.

"The targets are ambitious, especially in some contexts – therefore, technical assistance can be provided to support clients and encourage them to cascade ESG principles down to their own clients. The ambitiousness of targets is increased for repeat deals," Campbell notes.

Technical assistance

The NASIRA facility, which FMO signed with Jordanian microfinance institution Tamweelcom in June 2019 (see Appendix), is an example of the bank's technical assistance activities. "The NASIRA programme in general enables banks to provide funding to underserved markets, such as refugee entrepreneurs, and its technical assistance component can either support the bank in so doing by – for example – improving their controls and processes to manage such a portfolio or, alternatively, train the recipients of the loans or create accelerator programmes around them. The aim of the programme is to create entry points on both the demand and supply side," Steindl notes.

Two-thirds of FMO volumes on the debt side has longer tenors of 5-7 years. "This gives us a different starting point in the relationship with clients and is a better entry point for issues around governance," Steindl explains.

He concludes that from an ESG perspective, FMO takes into consideration the activities of a financial institution (FI) as a whole, not just the asset class for which the financial instrument has been provided. "We need to focus on more than E&S risks of FMO's financing only, if an FI client is engaging in (other) high-risk sectors across other portfolios that aren't subject to FMO's financing. To have a meaningful impact, ESG improvements need to be made across a wider portfolio of the FI client." ■

"A CLIENT CAN BE BEHIND ON ITS ACTION PLAN FOR REASONS THAT ARE OUT OF ITS CONTROL, SUCH AS A CONFLICT IN THE COUNTRY, AND WE CAN BE FLEXIBLE IN THESE CIRCUMSTANCES"

DOUBLE BOTTOM-LINE BENEFITS

Impact investments have historically been understood to mean compromising on yield. However, multiple studies have proven that this assumption is incorrect.

From an impact investment perspective, Mariner's experience is that it is able to measure success based on double bottom-line benefits. Based on its observation, there appears to be a compelling correlation between companies that use adverse governance language and their experience of negative corporate events, while companies that use positive governance language tend to perform better.

Maurits Fliehe Boeschoten, FMO

Anna Bak, associate director in the securitisation division at AFME, agrees that green assets tend to perform better. She cites green mortgages as an example: recent research shows that mortgages on energy efficient houses perform better, as the borrowers have more income available to repay the loan and so there is less scope for performance to deteriorate.

Further, Amitji Odedra, associate director at Qbera Capital, suggests that any lending activity that is conducted responsibly and evaluated properly should see no yield erosion. "Undertaking ESG analysis as part of the credit process translates into a better credit risk. If companies have strong credentials in that space, they're mitigating risks," he explains.

ESG considerations are changing investment dynamics, according to Maurits Fliehe Boeschoten, senior advisor, structured finance at FMO. "It's prudent not to invest in a reg cap trade without properly understanding the risks, and ESG risks should be included in an investor's risk management framework. If an ESG concern is flagged in relation to an issuer and you bought exposure to them, your stakeholders may have recourse. Scrutiny is certainly increasing in this respect," he observes.

Indeed, whether impact SRT is really pro-ESG or simply a matter of prudent risk management is not clear-cut. As Andy Kaufman, cio at Community Capital Management, notes: "In terms of the 'governance' aspect of ESG, impact is a responsible way for banks to manage their exposures, which can be a governance and risk management tool."

CHAPTER FOUR: DEFINING AND QUANTIFYING IMPACT SRT

Quantifying impact-related returns in the context of SRT is complicated by the fact that there are hundreds of different accepted approaches to measuring success. The terms 'ethical', 'ESG', 'impact' and 'responsible' mean different things to different market participants.

Amitji Odedra, associate director at Qbera Capital, says that ESG/impact considerations are personal and therein lies part of the challenge in terms of standardisation. "Because as individuals we each have our own ESG drivers, it's almost too broad a universe to standardise effectively."

Community Capital Management cio Andy Kaufman agrees that impact and ESG are based on values, and what is valuable to one person may not be valuable to another. "Impact is still being defined in the capital markets from a conceptual level and general product development. In our view, positive impact finance is judged on the use of proceeds for fixed income. Can I understand dollar for dollar how my capital is being deployed?"

As such, it's important not to take a puritan view of impact, according to Odedra. "Certain compromises about what constitutes impact will have to be made as the sector evolves," he suggests. "But investors are generally comfortable, as long as the end result is positive net/net across the board and there are no red flags. The overriding goal is to start moving the market in the right direction."

> "INVESTORS ARE GENERALLY COMFORTABLE, AS LONG AS THE END RESULT IS POSITIVE NET/NET ACROSS THE BOARD AND THERE ARE NO RED FLAGS"

Interpretation

Indeed, in terms of defining what constitutes ESG assets, Allen & Overy partner Parya Badie notes that often it depends on the investor's own interpretation. "For some deals, investors have their own ability to assess the portfolio or their own rationale for investing in certain assets. It depends on the nature of the pool, but they will ask questions to determine whether the assets are 'green enough'," she says.

She continues: "It also depends on who the investors are accountable to. If they're accountable to their management, they may be in a position to diligence and to take a view on the underlying. If it's a high-profile transaction intended to establish their green credentials in the market, they may want to obtain third-party verification to demonstrate an independent evaluation."

Nevertheless, it is important for investors to have clearly defined requirements on ESG and impact for their investments. Pedro Fernandez, head of ESG at responsAbility, notes that it is fundamental that they communicate these requirements effectively – in the due diligence process, legal documentation and so on – and they need to regularly monitor the correct implementation of these requirements by the asset manager during the selection of investments.

In terms of defining ESG in the context of synthetic securitisation, he says the approach should be consistent with the current application of ESG criteria. In other words, all assets should be screened on ESG.

"Careful ESG assessment and monitoring must guarantee that no unforeseen risks arise in the areas of environment, social and governance, irrespective of the financial practice considered," Fernandez explains. "However, for responsAbility, the application of our ESG criteria is only one of the key selection criteria within the investment process. The same applies to our impact criteria: for our portfolio, we select high-impact companies using a set of measurable impact themes and metrics."

Parya Badie, Allen & Overy

Verification

Odedra points out that 'greenwashing' – whereby loans are classified as impactful to create volume, when in reality they're borderline – is quite a widespread risk. "There is a paucity of ESG experts at originators. As a structurer, the aim is to tap liquidity and so parameters can be adjusted to make a scenario more favourable. Independent third-party verification can help in terms of measuring and affirming an originator's ESG performance."

Badie believes that as ESG transactions become more prevalent, demand for independent verification agents will increase. Nevertheless, she suggests that it would be helpful if there was a more common understanding about how to verify a pool as being 'green'.

For NatWest's Project Grasshopper SRT, the issue of whether the assets were green or not was addressed via a Sustainalytics opinion, which confirmed that the portfolio is in line with the LMA's green loan principles.

Disclosure

Standardisation of ESG disclosures would also help in terms of the evolution of the market. "The current fragmentation of KPIs, reporting frameworks, surveys, ratings and benchmarks makes it impossible to effectively compare ESG information. Fewer indicators that are materiality-based and aim to create comparability would contribute to enhancing the capital market inclusion," Fernandez observes.

Paul Petkov, coo and head of securitisation advisory at Qbera Capital, suggests that the push to create the STS label implies that the market will also gradually move towards ESG standardisation as well. "For example, there may be a place to add ESG criteria in the PCS reports. The rating agencies also have a role to play," he observes.

Paul Petkov, Qbera Capital

He continues: "For instance, KBRA has recently introduced criteria that link ESG to credit risk analysis. As long as the criteria are agreed and uniform, it's possible for investors to compare originating institutions and how the freed-up capital is redeployed."

From 31 March 2020, ESMA requires rating agencies to disclose in reports and press releases where ESG factors were a key driver behind a change to a credit rating or rating outlook, as part of its disclosure requirements under the CRA Regulation. KBRA, for one, will include a break-out of relevant ESG factors as part of its analysis of credit risk and doesn't distinguish between whether a securitisation is cash or synthetic in this analysis.

Credit impact

The rating agency states that its ratings incorporate expectations for the credit impact of ESG factors, which include an evaluation of risk management and mitigation efforts. While it has no precise definition of ESG, factors that it may consider include: greenhouse gas emissions, energy efficiency and waste management under the environmental umbrella; human rights, labour standards and demographic changes under the social umbrella; and transparency/accountability, ownership structure and board composition and independence under the governance umbrella.

KBRA says that it looks to governance factors to analyse the way assets are originated or securitised. For instance, a transaction sponsor's business practices with respect to underwriting, servicing and adherence to the governing regulatory framework for the asset or project under consideration may affect cashflows and therefore credit risk.

GREEN SECURITISATION PRINCIPLES

AFME believes that the term 'Green Securitisation' should be reserved exclusively for transactions collateralised by green assets. The association does not agree that if the underlying collateral is not green, the securitisation should be classified as a green securitisation simply because the proceeds of the securitisation were applied towards, or regulatory capital or liquidity relief achieved allocated to green projects. It notes that a securitisation with non-green underlying collateral where the proceeds are invested in, or regulatory or liquidity capital relief allocated to green projects could still qualify as a green bond, just not as green securitisation.

AFME's September 2019 Position Paper, entitled 'Principles for developing a green securitisation market in Europe', highlights key voluntary principles that the association believes policymakers and market participants should support to help promote green securitisation. These include:

- The importance of defining green securitisation simply and clearly
- The need for political support and financial or regulatory incentives to promote the development of the green securitisation market
- Consideration of the key contractual provisions that will need to be contained in a green securitisation transaction
- The need to consider and address the impact of the evolution of green technologies and standards over time on long-term programmes and the secondary market
- The development of a consistent and simple definition of green securitisation is crucial to the expansion of the green securitisation market
- The New Securitisation Framework should provide the starting point and overall context.

AFME considers the Green Bond Principles requirements relating to the 'process of project selection' and 'specifying the use of proceeds' to be satisfied upfront on a Green Securitisation by virtue of the proceeds being applied to acquire collateral that complies with eligibility criteria meeting the requirements of the applicable green principles or taxonomy.

The association notes that the introduction of preferential regulatory capital treatment for Green Securitisation could help promote green transactions to all securitisation investors, not only those with a green mandate. Other potential incentives could include: reduced haircuts for central bank eligibility schemes; bespoke LCR limits; ongoing governmental and regulatory support by way of guarantees and the related regulatory benefit; and subsidies for establishing new green projects.

"AS LONG AS THE CRITERIA ARE AGREED AND UNIFORM, IT'S POSSIBLE FOR INVESTORS TO COMPARE ORIGINATING INSTITUTIONS AND HOW THE FREED-UP CAPITAL IS REDEPLOYED"

Anna Bak, AFME

Spectrum of Capital

	Financial-only	Responsible	Sustainable	Impact			Impact-only
	Delivering competitive financial returns						
		Mitigating Environmental, Social and Governance (ESG) risks					
			Pursuing Environmental, Social and Governance opportunities				
				Focusing on measurable high-impact solutions			
Focus:	Limited or no regard for environmental, social or governance (ESG) practices	Mitigate risky ESG practices in order to protect value	Adopt progressive ESG practices that may enhance value	Address societal challenges that generate competitive financial returns for investors	Address societal challenges where returns are as yet unproven	Address societal challenges that require a below-market financial return for investors	Address societal challenges that cannot generate a financial return for investors
Examples:		• PE firm integrating ESG risks into investment analysis • Ethically-screened investment fund	•"Best-in-class" SRI fund • Long-only public equity fund using deep integration of ESG to create additional value	• Publicly-listed fund dedicated to renewable energy projects (e.g. a wind farm) • Microfinance structured debt fund (e.g. loans to microfinance banks)	• Social Impact Bonds / Development Impact Bonds	• Fund providing quasi equity or unsecured debt to social enterprises or charities	

Source: Bridges Fund Management

In terms of social factors, demographics, employment, income levels and labour market dynamics can influence consumer behaviour and therefore the performance of an asset. Equally, environmental contamination, implementation of an environmental action plan, compliance with environmental regulations and geographic climate risk can impair the value of collateral.

The agency suggests that ESG investment can generally be mapped along a spectrum based on the relative balance of positive social and/or environmental impact and expected return. If a transaction has a targeted ESG thesis with an acceptable projected financial return – for example, bonds issued to provide funding for projects that have long-term and sustainable social or environmental goals – it is traditionally referred to as 'impact' or 'thematic' investing, where the goal is to create positive social or environmental change in the context of a profitable investment.

Green securitisation

For its part, AFME believes that the new securitisation framework and the existing Green Bond Principles set the context to develop principles and practices for green securitisation. However, in terms of defining what constitutes a green securitisation, the association takes a stricter approach than ICMA, for example *(see Box: Green Securitisation principles)*.

"From our perspective, a green securitisation needs to be a securitisation, sensu stricto, the underlying assets should be green and the proceeds used for green projects. The definition holds true for both cash and synthetic deals," explains Anna Bak, associate director in the securitisation division at AFME.

Bak says that at present, there is much discussion around transitioning – in other words, the process whereby an issuer is becoming greener. For such cases, she says it is necessary to encourage the issuers to transition from brown to green issuance.

She concludes: "The industry should also be aware that 'green' is connected with technological developments and is therefore changing quickly. As standards evolve over time, a transaction originally considered to be green could cease to meet the requirements of the relevant green principles. The need to potentially grandfather this should also be taken into account." ■

> "FROM OUR PERSPECTIVE, A GREEN SECURITISATION NEEDS TO BE A SECURITISATION, SENSU STRICTO, THE UNDERLYING ASSETS SHOULD BE GREEN AND THE PROCEEDS USED FOR GREEN PROJECTS"

APPENDIX: SCI COVERAGE OF IMPACT CRTS

Landmark green SRT introduced

13 March 2017

Mariner Investment Group and Crédit Agricole have collaborated to create the first green capital relief trade, the French lender's largest synthetic issuance to date. Dubbed Premium Green 2017-2, the innovative US$3bn risk transfer transaction combines capital management best practices with the objectives of socially responsible investing.

According to Pascale Olivie, head of structuring, research and asset allocation in Crédit Agricole's credit portfolio management group in Paris, the securitisation allows the lender to "release capital, which can in turn be used to finance green assets for the real economy." These green assets can include renewable energy projects, energy efficiency loans for commercial real estate renovation, and sustainable waste and water treatment facilities.

Molly Whitehouse, director at Mariner Investment Group, notes that the main innovative features of the transaction are 'additionality' and 'conditionality'. These are principles that have been pioneered by multilateral development banks to incorporate concepts like ESG and impact investing into their mission-driven lending *(SCI 11 January)*.

Additionality refers to the principle whereby development banks do not undercut the private market and add funds that are not currently available. Conditionality, on the other hand, implies that the newly released capital can only be used for green investments.

For Premium Green 2017-2, around US$2bn will be used for new green lending, a first for the synthetic format. In this regard, Whitehouse notes that "the transaction's implicit leverage that is involved in putting up the junior exposure allows the release of more capital for green investments than would otherwise be possible."

The deal references a portfolio consisting of roughly 200 obligors and is distributed across a range of assets, including power and infrastructure, shipping, real estate, oil and gas. Power represents 33% of the portfolio, while infrastructure accounts for 21%. These credits are spread across over 35 countries, with the largest concentrations in the US (at 37%) and the UK (11%).

Neither the pricing nor the specific tranche thickness was disclosed. However, Mariner generally invests in tranches with an initial thickness of between 5% and 8%, and the deal is said to be at the tighter end of this range due to the high credit quality of the underlying assets.

The assets remain on the bank's balance sheet in line with the transaction's synthetic format. Olivie says this required "confidence on behalf of the investor that CACIB's risk monitoring and servicing of the assets was credible, which is why we held several due diligence meetings with Mariner".

Gauging the impact of the deal on the market for capital relief trades is difficult, since it is the first transaction of its kind. Yet both Olivie and Whitehouse believe that it could encourage more banks to divert resources towards environmental and social lending and facilitate impact investing.

"We are already seeing a lot of interest out there from both issuers and peers on the buy-side," states Whitehouse. "Moreover, with funds available from third parties such as Mariner to support these approaches, such green transactions can have a catalytic effect to lower the cost of capital that can be a spur for further issuance."

Inaugural infrastructure CRT launched

20 September 2018

The African Development Bank (AfDB), alongside Mariner Investment Group, the European Commission, Mizuho and Africa50, has issued a debut US$1bn capital relief trade (CRT) backed by a pan-African portfolio of loans to infrastructure projects and financial institutions. The transaction, dubbed Room2Run, is not just a first for the AfDB, but also marks the first ever transaction of its kind between a multi-lateral development bank (MDB) and private sector investors.

The transaction was structured as a synthetic securitisation by Mizuho and transfers the mezzanine credit risk on a portfolio of around 50 loans from across the AfDB's non-sovereign lending book. This includes power, transportation, finance sector and manufacturing assets spanning the African continent.

Mariner was lead investor on the deal through its International Infrastructure Finance Company (IIFC) II fund, taking 80% of the senior tranche, while Africa50 invested alongside, taking 20% of the private senior tranche. Additionally, credit protection is being provided by the European Commission's European Fund for Sustainable Development in the form of a senior mezzanine guarantee.

Molly Whitehouse, director at Mariner, explains that Room2Run is aimed at facilitating lending for the AfDB, which this deal achieves by freeing up more than US$650m in lending headroom. This can now be deployed in a range of projects across the continent, while matching Mariner IIFC's strategy as an impact investor.

In terms of the motivation for the deal, Whitehouse explains: "The G20, and in particular through the leadership of Canada, Sweden, and Denmark, has for some time urged development banks to better manage their capital and to do more with the existing capital that shareholders contribute. In particular, they have highlighted using synthetic securitisations as a way to do this." She adds that this transaction proves the usefulness of risk transfer for development banks and the role that private investors can play in funding lending for a supranational organisation.

In terms of hurdles presented by the transaction, Whitehouse says one was the time taken working with the rating agencies as, for one reason, Moody's and Fitch took a more qualitative approach, while S&P took a more quantitative approach.

While a rating wasn't assigned, the objective was that the rating agencies would reflect the value of the transaction into their overall rating on the bank. This impacts where the bank can fund its wholesale debt and, in turn, how it can lend to its policy borrowers, so it was important for all parties, Whitehouse says, that the rating agencies and the bank's shareholders viewed the transaction as accretive to capital.

Furthermore, the 2% first loss position was taken by the bank, while a 15.25% thick investor tranche followed, with Mariner taking 80% of this and the Africa50 taking 20%. A further 10% thick unfunded guarantee was also provided by the European Commission, above the investor tranche.

While, structurally, the deal resembles other CRTs, Whitehouse explains that the investor/guarantee tranche was much thicker than usual due to the conservative views taken by the rating agencies, as it was a first for an MDB. Whitehouse suggests that with further transactions and, as the portfolio performs over time, the tranches of transferred risk may evolve toward the commercial bank market.

In terms of general challenges in the deal, a large degree of time and patience was required with discussions with the AfDB having started over four years ago. However, the payoff has been huge, says Whitehouse, especially as it created a framework that can be used by other development banks across the globe for similar transactions.

On this note, Whitehouse comments: "There has been significant interest from other development banks in following the progress of Room2Run. We have workshopped the deal at various MDB community events, so the other institutions have been reasonably well informed as we have developed the technology. The hope is that now that the viability of this market has been proven, other development banks will integrate these capacities into their capital markets tool kit, extending their reach and resources across the MDB community."

Furthermore, the deal was well received by Mariner's investor base with "quite positive feedback from our LPs," says Whitehouse. She adds: "As with our other CRT investments, we intend to be a buy-and-hold investor, really benefitting from the servicing approach of AfDB in the long-term management of the reference portfolio."

Room2Run also comes at a time of increasing interest in infrastructure CRTs with a number of banks now looking at managing their capital around infrastructure portfolios. Additionally, Whitehouse says that the infrastructure CRT market is broadly "pretty strong and active and there is a heavy pipeline of deals coming through" adding that Mariner has done over "US$10bn in infrastructure deals", with further planned transactions bringing this up to US$12bn.

Most infrastructure transactions are done by banks domiciled in Europe and the UK, although assets backing the deals can be global. Whitehouse comments that geographical diversity in the deals doesn't pose further risks, because infrastructure is found to perform well across jurisdictions – only really the US has seen a higher loss rate on infrastructure CRTs, mainly because they were tied to energy sector properties which were subject to market volatility.

Furthermore, while banks are increasingly looking to manage capital around their infrastructure portfolios, the market is typically bilateral with transactions not publicised, which is in line with Mariner's approach.

"We prefer bilateral trades" explains Whitehouse, "as we are comfortable analysing the portfolio and structuring the deals ourselves. It also costs the same for us to effectively deploy US$200m in equity as it would to take part of a tranche for US$20m – so we prefer bilateral trades."

She says also that while many investors might want to participate in project finance or infrastructure portfolios, they are a specialised asset class that requires a certain degree of expertise. Likewise, Whitehouse says that portfolios are often "lumpier" than the granular portfolios seen in an SME CRT, for example, and that this lumpiness, along with the complexity, limits investor participation and this feeds into seeing bilateral structures more often.

Structurally, infrastructure CRTs are much like other CRTs, says Whitehouse, although they do not feature automatic replenishment of the pool as in more granular transactions. She explains: "In an infrastructure CRT, we work with our bank counterparties to select new assets for replenishment."

"We are generally able" continues Whitehouse, "to get assets approved quite quickly – within about two weeks. We can also speed up this process by pre-approving asset classes that can be added to the pool, should existing assets amortise more quickly than expected."

In terms of the investor landscape there is also strong appetite for the transactions, with most investors being large, buy-and-hold institutional investors from the US, UK and Europe that now see the value in infrastructure CRTs, alongside other vanilla CRTs.

Looking ahead, more harmonised documentation and structuring practices has fuelled greater interest in risk transfer technology and Whitehouse concludes that banks are starting to see that "utilising risk transfer technology on their infrastructure portfolio can be a virtuous cycle, as it can enable them to be more competitive on the primary market as well."

Helping hand

4 July 2019

Dutch development bank FMO has signed a pilot bilateral risk-sharing facility under its NASIRA programme, which guarantees portfolios of loans to vulnerable, underserved entrepreneurs in sub-Saharan Africa and countries neighbouring Europe. The agreement is with Jordanian microfinance institution (MFI) Tamweelcom and will support access to finance for Syrian refugee entrepreneurs.

Jordanian banks have historically refrained from providing financing to Syrians living in Jordan, largely due to perceived high risks. Similarly, with a political solution to the Syrian crisis still pending, most MFIs have also remained on the sidelines.

Underserved entrepreneur segments targeted by NASIRA are women, young people and migrants. NASIRA's approach to blended finance – where public capital is used to facilitate private sector investment in sustainable development projects – is based on synthetic securitisation. The programme can guarantee up to €500m of loans and new exposures can be added for a four-year period.

NASIRA was the first transaction to be signed under European Fund for Sustainable Development (EFSD) programme, which contributed €75m to the fund (representing the first-loss tranche), with the Dutch government's MASSIF Fund – which FMO manages – also contributing €7.5m to the tranche. The remainder of the funds will be provided by FMO and potentially other global investors. The EFSD has also provided up to €8m for technical support, to be divided equally between projects in sub-Saharan Africa and the countries neighbouring Europe.

Under the pilot facility, FMO will provide US$1.5m unfunded credit protection to Tamweelcom through the MASSIF Fund. Syrian refugees in possession of UNHCR identification and a Jordanian Ministry of Interior Card can apply for loans of JOD1,000-JOD7,000 (equivalent to approximately US$1,400-US$9,900). The loans will be used for income-generating businesses, rather than for consumption purposes.

Maurits Fliehe Boeschoten, senior advisor, structured finance at FMO, says that the deal is similar in concept to the African Development Bank's Room2Run risk transfer transaction *(SCI 20 September 2018)* – albeit the guarantee is employed in a slightly different way. The risk-sharing facility is accompanied by a capacity development project.

With the support of consultant Making Cents International, Tamweelcom will onboard new borrowers to a blockchain database – thereby creating a digital ID, including the borrower's credit history. This information becomes verifiable, immutable and portable across borders, providing an incentive for refugees to settle the loan before returning home – as they will bring their credit record – and potentially facilitating access to loans in Syria.

In addition, FMO will support Tamweelcom by improving the reporting capabilities on the guaranteed portfolio and help it gain risk management knowledge, in collaboration with Hypoport's investor reporting tool Prommise. "African banks tend to be very conservative and haven't gone through the cycles that resulted in credit availability in developed countries, yet the quality of their data is often better because they don't have legacy IT systems," explains Fliehe Boeschoten. "As arranger and investor in the Tamweelcom facility, the data is uploaded for us in a rough format and then we undertake the reporting and quality checks. FMO portfolio analysts have the same screens as the partner bank and the hope is that after a while, they'll understand their own risk profile better and ultimately won't need a guarantee in order to lend to vulnerable borrowers."

FMO has a number of other NASIRA agreements in the pipeline, including portfolios sized at around €10m and €20m. The programme can accommodate even larger portfolios, according to Fliehe Boeschoten.

"African banks typically have large loan books. But refugees represent a small group of borrowers, so in the case of Tamweelcom, a facility of less than €3m makes sense," he observes.

In terms of sourcing loans for NASIRA, FMO approaches banks with SME portfolios to see if they're interested in participating in the programme. "FMO has been in the development sector for over 50 years and has a large client/partner network. Africa has a young population and banks need to begin tailoring their banking services accordingly. Consequently, our aim is to work with partner banks to help make them inclusive, build businesses and become part of the economic fabric of a country," says Fliehe Boeschoten.

The NASIRA facility for European neighbouring countries is expected to be signed in November. FMO is also exploring additional EFSD projects and will expand risk-sharing agreements into venture capital.

"We believe strongly that alignment of interest is necessary to enter such markets. Securitisation has driven improvements in data quality and reporting, which support alignment of interest. We embrace the new securitisation regulations, as we feel they reduce concerns among partner banks and the fact we're complying with the rules provides them with more comfort," Fliehe Boeschoten concludes.

Positive impact

16 October 2019

Societe Generale has completed an innovative risk transfer transaction that, for the first time, incorporates a capital allocation factor that incentivises additional positive impact finance lending. Mariner Investment Group has purchased the junior tranche of notes through its IIFC platform.

Dubbed Jupiter, the US$3.4bn transaction references more than 250 loans in over 40 countries across a variety of sectors, including energy, infrastructure, shipping, aircraft, metals and mining, real estate and TMT. Under the terms of the transaction, SG has committed to dedicate 25% of the risk-weighted asset reduction to spur new positive impact financing over the next three years.

By reallocating the released capital from the legacy loan book and dedicating it to enhance the capacity to finance new positive impact projects, the parties aim to strongly advance the UN Sustainable Development Goals. Additionally, if the bank is able to redeploy 50% of the RWA towards the positive impact capital allocation factor by the fourth anniversary of the transaction, Mariner has agreed to a reduction in the coupon – thereby creating a positive pricing incentive for additional positive impact finance investment.

Molly Whitehouse, lead structurer for the Mariner Investment Group investment team, comments: "This deal again illustrates the extent to which credit risk transfer transactions have become an efficient tool for lending institutions. Now, the power of credit risk transfers is also being harnessed for critically important socially responsible investments."

With the addition of its investment in Jupiter, Mariner Investment Group holds a total of over US$7bn in impact-related initial deal notional, including the landmark US$1bn Room2Run synthetic securitisation in cooperation with the African Development Bank.

Grasshopper up

31 January 2020

RBS has completed a landmark capital relief trade referencing a £1.1bn portfolio of UK project finance loans. Dubbed Project Grasshopper, the approximately £78m financial guarantee is the first risk transfer transaction to be backed entirely by green assets and was carried out for both capital relief and credit risk management purposes. Macquarie Infrastructure Debt Investment Solutions, in conjunction with BAE Systems Pension Funds Investment Management, invested in the securitisation.

Banks have previously originated green SRTs, although the deals referenced mixed portfolios. One of the most notable transactions in this respect was Credit Agricole's Premium Green securitisation *(see SCI's capital relief trades database)*.

The latest deal features a portfolio that includes onshore and offshore wind, solar, smart meters, energy from waste and biomass power. Sustainalytics has verified the projects as green and in alignment with industry standards, including the LMA's green loan principles.

RBS has committed to provide £10bn of funding and financing to the sustainable energy sector by the end of 2020, in order to accelerate the transition to a low carbon economy. The UK lender became a founding signatory to the UN's principle for responsible banking in 2019, which commits the bank to further align its business with the Paris agreement on climate change and the UN sustainable development goals.

The tranches amortise sequentially and the portfolio features a three-year replenishment period and a ten-year weighted average life. The cash collateral is protected through various mechanisms that are common in other transactions, such as a rating trigger that shifts the collateral to a third-party account if the issuer's rating is downgraded, as well as self-liquidating CLNs.

NatWest's project finance and portfolio risk mitigation teams executed the trade. It was originated under the Nightingale programme, which has been utilised over the last four years for SME, commercial and residential real estate issuance.

The bank's last transaction under the programme was called Nightingale Securities CRE 2018-1. The £190m financial guarantee referenced a £2.3bn commercial real estate portfolio.

Ratings have not been assigned to the deal, given that the UK PRA no longer requires ratings for UK synthetic securitisations. The latter development provides banks with more flexibility, since they don't need to comply with strict eligibility requirements and can use the more beneficial IRB approach rather than the ERBA approach.

Nevertheless, for idiosyncratic exposures such as commercial real estate and project finance, UK issuers have to use the slotting approach. Under the slotting approach, idiosyncratic exposures are assigned to a number of categories – or slots – depending on how risky they are perceived to be. This information is then used to calculate how much capital a bank must hold against the assets.

According to PRA guidance, banks should assume up to 50% LGD for slotted assets – which means less RWA relief and thicker first-loss tranches or the same thickness, but less RWA relief for the same CDS premium costs *(SCI 30 November 2018)*.

Looking ahead, Bruce Riley, md project finance at NatWest notes: "This transaction enables a significant release of capital, which will be recycled for further lending to the sustainable energy sector and support the growth in renewable generation that is essential for the UK to meet its carbon emission targets and climate change goals. A particular focus for 2020 will be a number of large offshore wind generation assets being developed by some of our key customers. But we also see opportunities in onshore projects across wind, hydro and solar, as well as UK waste."

Benedetto Fiorillo, head of portfolio risk mitigation at Natwest, concludes: "We are in the midst of a solid growth trend in UK project finance lending and this deal was carried out, among other factors, to support the bank's overall strategy to increase lending in the UK sustainable or renewable energy sectors. It delivers an innovative long-term capital management solution for a strategic asset class."