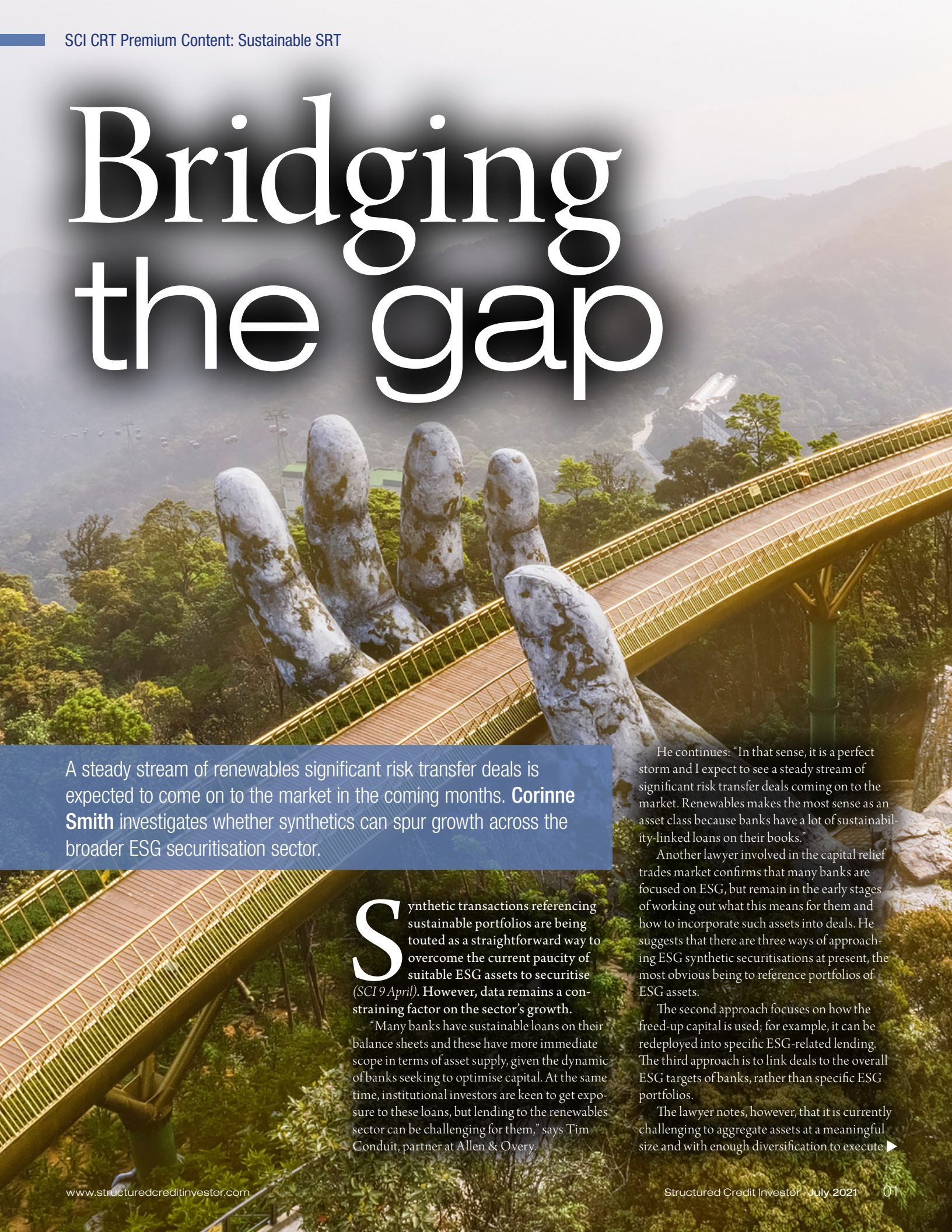
Bridging the gap



A steady stream of renewables significant risk transfer deals is expected to come on to the market in the coming months. **Corinne Smith** investigates whether synthetics can spur growth across the broader ESG securitisation sector.

Synthetic transactions referencing sustainable portfolios are being touted as a straightforward way to overcome the current paucity of suitable ESG assets to securitise *(SCI 9 April)*. **However, data remains a constraining factor on the sector's growth.**

"Many banks have sustainable loans on their balance sheets and these have more immediate scope in terms of asset supply, given the dynamic of banks seeking to optimise capital. At the same time, institutional investors are keen to get exposure to these loans, but lending to the renewables sector can be challenging for them," says Tim Conduit, partner at Allen & Overy.

He continues: "In that sense, it is a perfect storm and I expect to see a steady stream of significant risk transfer deals coming on to the market. Renewables makes the most sense as an asset class because banks have a lot of sustainability-linked loans on their books."

Another lawyer involved in the capital relief trades market confirms that many banks are focused on ESG, but remain in the early stages of working out what this means for them and how to incorporate such assets into deals. He suggests that there are three ways of approaching ESG synthetic securitisations at present, the most obvious being to reference portfolios of ESG assets.

The second approach focuses on how the freed-up capital is used; for example, it can be redeployed into specific ESG-related lending. The third approach is to link deals to the overall ESG targets of banks, rather than specific ESG portfolios.

The lawyer notes, however, that it is currently challenging to aggregate assets at a meaningful size and with enough diversification to execute ▶

Tim Conduit, Allen & Overy

Alien Pauw, PGGM

a pure ESG SRT deal. "The ability to capture the requisite data is an issue. The assets historically referenced by capital relief trades weren't originated with ESG considerations in mind," he explains.

Alien Pauw, investment manager at PGGM, agrees that it's challenging to source 100% ESG SRTs of a sufficient size at present. "The supply of positive impact assets remains limited, so we consider 50% of the underlying having a positive impact and the remainder having a neutral impact as acceptable for the moment."

Nevertheless, banks are increasingly implementing ESG frameworks to target lending in these areas. The more these frameworks are reflected in bank origination policies, the more data will be captured that can be used to facilitate CRTs.

In the meantime, as one structurer notes, it is important to provide for a transition process – whereby lenders are incentivised to promote sustainable finance. In its Sustainable Finance Strategy, adopted earlier this month *(SCI 7 July)*, the European Commission notes that the current framework could be developed to "better recognise investments for intermediary steps on the pathway towards sustainability". As a first step, it says it will consider proposing legislation to support the financing of certain economic activities – primarily in the energy sector – that contribute to reducing greenhouse gas emissions in a way that "supports the transition towards climate neutrality" throughout the current decade.

"If the industry adopts a strict approach to what constitutes an ESG securitisation, only a small portion of the market will be covered. Unless transitional assets are included in the criteria, the industry's efforts will lose impetus," Conduit suggests.

He points out that there has been some criticism of the green supporting factor and brown penalising factor concepts currently being considered by European policymakers. In theory, the former would discount the risk weights that apply to green lending, while the latter would increase risk weights for polluting assets held on a bank's books.

"The EU must tread carefully in this area, since it is important to avoid creating stranded assets," Conduit explains. "We should be moving away from our reliance on fossil fuels, for example, but there is still a lot of generation capacity and you can't simply make everything run on renewables from day one."

A recent BofA Global Research report calls for a sliding sustainability scale to be introduced, whereby the use of proceeds or the application of released capital generated by a securitisation is directed to the origination of sustainable assets, or where a portion of sustainable assets in a pool can be combined with sustainable proceeds use. Subsequent securitisations from a given originator or programme could be required – over a defined period of time – to increase the share of sustainable assets in the underlying pools until 100% of ESG assets is reached.

> "IF THE INDUSTRY ADOPTS A STRICT APPROACH TO WHAT CONSTITUTES AN ESG SECURITISATION, ONLY A SMALL PORTION OF THE MARKET WILL BE COVERED"

Alternatively, sustainable securitisation assets could reflect, say, 10%-15% of the best-in-class assets in a given country. This echoes the European Commission's adoption in April of a sustainable finance taxonomy *(SCI 22 April)*, the scope of which includes financing secured by pre-2021 buildings that fall within the top 15% of energy efficient buildings in a country or region, and buildings constructed after January 2021 with energy efficiency levels that are 10% better than the nearly zero-energy building (NZEB) standard. The aim of these criteria is to support energy transition by capturing a country's improvements in energy efficiency standards over time.

"In this way, securitisation can facilitate the transition to a sustainable economy and sustainable bank balance sheets in a compressed period of time, and can reflect the state of sustainable asset creation and availability at present and over time," the BofA report states.

It goes on to note that analysing sustainable securitisations involves not only asset-level aspects, but also deal-related parties. Asset-level assessment can encompass the assets included in the securitisation or can integrate the supply chain that leads to the assets forming part of the securitisation pool – albeit the latter can create

GREEN SECURITISATION CATEGORIES

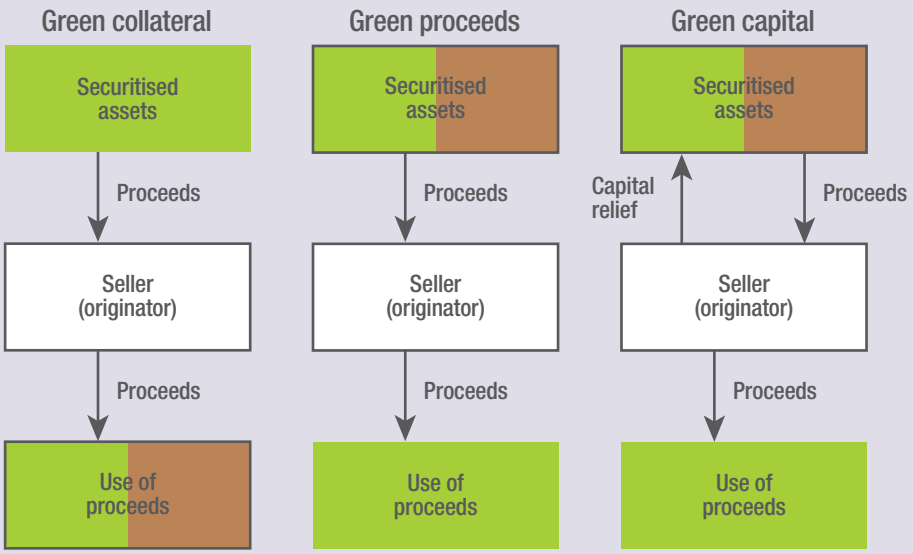
There remains no clear definition or agreement on what constitutes a green securitisation *(SCI 12 March 2020)*. Nevertheless, Rabobank credit strategists state that, in their view, ICMA's Green Bond Principles (GBP) are the market standard for a green bond and are also relevant for the securitisation market.

Importantly, alignment with the GBP doesn't require green collateral, providing the proceeds are allocated towards green projects. The European Green Bond Standard (EUGBS) – proposed by the European Commission in early July – also takes a broad 'use of proceeds' approach, meaning that providing the proceeds are put towards green projects (according to the EU taxonomy), a securitisation can be aligned with the EUGBS.

The Rabobank strategists broadly divide green securitisations into three categories. The first category is Green Collateral Securitisation, which is backed by a pool of green assets, whereby investors are exposed to the green collateral and its performance.

Second is Green Proceeds Securitisation, where the proceeds of the transaction are used to (re)finance (new) green assets. The assets backing the securitisation can be green or brown assets, as long as the proceeds are put towards green projects.

Figure 1: Different types of green securitisations



Source: Rabobank

Third is Green Capital Securitisation, where a capital relief trade or synthetic transaction is executed and the freed-up capital is used to fund (new) green lending. "Hence, it is similar to the proceeds type but differs in terms of purpose/treatment of the transaction, in that the former is merely for funding purposes and the latter sees the assets and/or the risk taken off the balance sheet of the originator/seller," the strategists explain.

They point out these three types of securitisation are not mutually exclusive. For example, a transaction can feature green collateral, with the proceeds also allocated to green projects.

both qualitative and quantitative difficulties in sustainability assessment.

As for deal-related parties, while the ESG assessment may be simpler, it presents a challenge it terms of the ranking of their contribution to the sustainability label of the securitisation. Consequently, one approach may be to limit the ESG assessment to the originator, retainer or servicer of a securitisation.

Rabobank credit strategists suggest that green proceeds securitisations make sense as a first step and as a way to generate more green collateral, which can then be used for green collateral securitisations. They note that this is particularly important for smaller non-bank players, which may simply have insufficient collateral at present, with Kensington Mortgages being a prime example.

The lender's Finsbury Square 2021-1 Green RMBS is an example of a green proceeds securitisation (see 'Green securitisation categories' box), according to the Rabobank strategists, which they view as a viable alternative to 100% green collateral securitisations as long as a lack of collateral remains a constraining factor for more green securitisations overall. Only the senior tranche of the transaction is labelled green and proceeds will be used to purchase a specific pool of loans originated by Kensington designated as eligible green projects under the lender's Green Bond Framework *(SCI 7 June)*.

> "IF THE EU LEGISLATES IN THE AREA OF GREEN CAPITAL REQUIREMENTS, IT WILL BE A GAME-CHANGER FOR ESG SECURITISATION"

Conduit notes that the most effective incentive for banks to transition towards sustainable finance is likely to be significant regulatory intervention. "If the EU legislates in the area of green capital requirements, it will be a game-changer for ESG securitisation. Once there is an active incentive to tap the market, it will become inescapable."

The EBA is set to publish a report by 1 November 2021 – as part of the changes to securitisation legislation to create synthetic STS – on the development of a specific sustainable securitisation framework. The report will assess the introduction of sustainability factors, the implementation of proportionate disclosure/due diligence requirements and the methodologies and presentation of such information.

More importantly, the report will also assess the possible effects of a sustainable securitisation framework on financial stability, the scaling up of the EU securitisation market and of bank lending capacity. Following the EBA's report, the European Commission will submit a report to the European Parliament and Council on the creation of a sustainable securitisation framework, including a possible legislative proposal.

A couple of European studies published in 2Q21 demonstrate that green mortgages tend

THE EU TAXONOMY

The EU Taxonomy is a classification system for sustainable economic activities which contribute to the EU's climate objectives. A total of six environmental objectives have been defined in the Taxonomy, but only two have so far been transposed in delegated acts – namely those on climate change mitigation and adaptation.

Climate change mitigation is concerned with mitigating the impact on the environment of economic activities, while adaptation is concerned with solutions aimed at reducing physical climate risks. "In our view, climate change mitigation is the most relevant one for the securitisation market, as it will encompass the vast majority of building/mortgage stock and car financing, for instance – i.e. the largest segments of the securitisation market," Rabobank credit analysts observe.

In order for an activity to be considered environmentally sustainable under the EU Taxonomy, a number of conditions must be met, including that it: makes a substantial contribution to at least one of the six environmental objectives; does no significant harm (DNSH) to any of the other environmental objectives; complies with the technical screening criteria; and meets minimum social safeguards. The Taxonomy regulation also imposes reporting requirements regarding Taxonomy alignment on a number of financial market participants. As such, a gradual but material increase in focus by investors on reporting in terms of Taxonomy alignment for ABS transactions is anticipated.

> "RESULTS SHOWING THAT GREEN MORTGAGES CARRY LOWER CREDIT RISK MAY BE USED TO LOBBY FOR LOWER CAPITAL CHARGES"

to exhibit lower borrower probability of default than their traditional counterparts. For example, Nationwide estimated that the default probability was 1.1% for a vanilla mortgage borrower versus 0.9% for a green mortgage borrower, based on a sample of 657,000 of its loans. Another study conducted by the University of Venice on the Dutch mortgage market established a negative correlation between credit risk and the energy efficiency of a building.

S&P notes that while borrowers who acquire green properties tend to have higher disposable incomes, these studies also determined that for lower income households, the higher the energy efficiency of the property, the lower their default rates. "In our view, banks may use these results showing that green mortgages carry lower credit risk than traditional mortgage loans to lobby for lower capital charges," the rating agency suggests.

Meanwhile, investors are also trying to encourage banks to adopt ESG practices. For instance, while ESG has been a focus for PGGM for many years, Pauw notes that the next step for her firm is to begin measuring and increasing its share of investments with positive impact.

Last year, the firm established the Sustainable Development Investment Asset Owner Platform (SDI-AOP) with APG, AustralianSuper and British Columbia Investment Management to promulgate standardisation across the industry. This involved creating an SDI taxonomy, based on the UN Sustainable Development Goals, as a way to measure positive impact.

Isabel Tinsley, Allen & Overy

PGGM is currently in discussions with banks on how the taxonomy could help them in their lending business. The aim is to stimulate banks to start measuring positive impact for their corporate lending portfolios and discriminate between banks based on the KPIs.

Measuring ESG in the securitisation context remains confusing, according to Allen & Overy senior associate Isabel Tinsley. She says that the definition of what constitutes ESG needs greater standardisation and fewer market participants providing ratings on it.

"Reducing the number of third-party opinion providers to two or three players and creating a universal ESG benchmark would be helpful," she adds.

Looking ahead, Tinsley suggests that an array of interesting ESG products are likely to emerge going forward. She cites as examples blue bonds linked to marine conservation or bonds linked to gender balance.

One area, in particular, that appears primed to benefit from CRT technology is microfinance lending – especially given that many microfinance lenders use digital technology to originate loans, so the requisite data is available. Microfinance CRTs have the potential to both facilitate a direct positive impact on communities and leverage the limited capital provided by development aid. ■