ESG SECURITISATION: WEATHERING THE STORM?

Environmental, social and governance ("**ESG**") factors have become a permanent fixture of the financial markets in recent years. Investors globally are recognising the benefit in incorporating sustainability and responsible decision-making into their investment frameworks. ESG securitisation was slower off the mark than other forms of ESG finance, but has gained momentum in recent years. This article will explore the key challenges and opportunities for originators, arrangers and investors seeking to incorporate ESG factors in securitisation. It will look at recent regulatory and market trends and consider the future direction of travel for ESG securitisation.

This is an update of an article originally published on 5 June 2023 as part of our publication "Securitisation markets and regulation: choosing different paths?", accessible here.

Key Issues

- ESG securitisation issuance volumes slowed in 2022 after a boom in 2021, in line with broader market trends.
- The ESG securitisation market in Europe is relatively modest compared to that in the US and China. There are clear opportunities for future growth as the availability of ESG eligible collateral increases.
- The regulatory framework in this area continues to develop in response to market feedback. The new European Green Bond Standard contains provisions which facilitate its application to securitisations, which we expect to play an important part in addressing existing labelling concerns.

General Background

ESG investment saw a boom in 2021, with figures published by AFME showing European ESG bond and loan issuance volumes rising from €396.4bn in 2020 to €749.8bn in 2021.[1] These volumes fell to €680bn in 2022[2], reflecting broader macro-economic conditions in the public markets. Similarly, European ESG securitisation issuances jumped from €2.1bn issued in 2020 to €8bn in 2021 before a quieter year in 2022 when volumes fell to €1.2bn (making up less than 0.2% of total ESG issuances in 2022). As these figures demonstrate, ESG securitisation volumes have remained relatively modest as a proportion of the overall green and sustainability-linked financing market, with only a small handful of ESG-labelled deals. In 2022, the public markets have been a challenging environment – has this caused issuers to focus primarily on execution risk at the expense of ESG factors?

One of the reasons for the fairly modest issuance volumes in 2022 was undoubtedly the challenging economic and market environment which persisted for the most part of the year. Against that backdrop, it would hardly come as a surprise that the lack of clear ESG standards for securitisation, and a shortage of eligible collateral, continued to limit the growth of ESG securitisation. Nonetheless, continued focus on ESG factors in the broader

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[1] AFME, "Q4 2021 and 2021 Full Year ESG Finance Report": https://www.afme.eu/Portals/0/DispatchFeaturedImages/AFME%20Sustainable%20Finance%20Report%20-%20Q421%20and%202021FY.pdf

[2] AFME, "Q4 2022 and Full Year 2022 ESG Finance Report": https://www.afme.eu/Portals/0/DispatchFeaturedImages/AFME%20ESG%20Finance%20Report%20Q4%202022%20and%202022FY-1.pdf

finance markets remains the main driving force for growth of ESG securitisations. It gives hope that overall volumes will recover and grow as market conditions stabilise and improve, and the regulatory framework for ESG securitisations is refined and clarified through a number of existing and future initiatives. In particular, the provisions of the new European Green Bond Standard ("**EuGBS**") which facilitate its application to securitisations will undoubtedly play an important part in addressing at least some of the existing labelling concerns and supporting future growth.

What has happened so far?

Labelling of ESG securitisation has remained one of the main areas of focus, but this tends to get bogged down in concerns over which metric(s) to use to determine if a securitisation "counts" as ESG. This remains a matter of debate and feeds into an overall environment where many market participants opt out of seeking an ESG label over greenwashing concerns. As the European Banking Authority notes in its report on "Developing a Framework for Sustainable Securitisation"[3] (the "**EBA Report**"), there are at least three types of frameworks that can be used to classify a securitisation as meeting ESG standards:

(i). securitisations backed by ESG assets;

(ii). securitisations where the proceeds of sale of the assets are used for some ESG purpose by the originator; and

(iii). (securitisations where the key counterparties commit to achieving certain sustainability-related KPIs.[4]

The choice between these three main options is not always easy and the categories are not mutually exclusive. For example, even where a securitisation relies primarily on use of proceeds to claim ESG status, it may also be structured to ensure that the underlying assets comply with a minimal ESG standard (something akin to the "do no significant harm" principle from the EU Taxonomy Regulation[5]) so as not to put off investors who may not wish to fund an "ESG" investment backed by e.g. high-emissions diesel cars. Additionally, there are several existing securitisations which would arguably meet ESG standards despite not having been identified as ESG transactions. A good example in particular is near-prime consumer lending, which may well fall under the "social" limb of ESG. This begs the question as to why these transactions do not seek ESG labelling. One of the contributing factors is likely the lack of clarity over the relevant metric(s).

All of this, combined with the supply-side constraints, translates into relatively low issuance volumes for ESG securitisations in Europe to date, at least in the main consumer asset classes.[6]

One notable transaction issued in 2022 is the Koromo issuance for Toyota in Italy which was backed by alternative fuel vehicle loans, which were over 98 per cent. straight hybrid vehicles (i.e. vehicles that recharge their electric

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[3] https://www.eba.europa.eu/eba-recommends-adjustments-proposed-eu-green-bond-standard-regards-securitisation-transactions

[4] We note that certain synthetic securitisations have involved undertakings to use the regulatory capital saved to originate eligible ESG financings.

[5] Regulation (EU) 2020/852 of the European Parliament and of the Council of 18 June 2020 on the establishment of a framework to facilitate sustainable investment: https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A32020R0852

[6] We note nevertheless that while the volumes are relatively low, there have been a wide variety of transactions which could be viewed as "ESG themed" securitisations including ABCP, RMBS, CMBS and synthetics with ESG features.

batteries using their petrol-powered engines). Toyota chose to not seek second party verification of the ESG status of this transaction, as it is reported to be waiting to bring a deal to market with "greener" collateral (i.e. a higher percentage of the asset pool relating to plug-in hybrid or electric vehicles, which have less environmental impact) before it seeks such certification. This is an example of a general concern about what constitutes a "truly green" asset pool, which has led deals in large part to rely on green use of proceeds by the originator to obtain external ESG verification, rather than on green assets being funded by the deal. On the social side of ESG, questions around what it means to be a "social" securitisation continue to persist, with new issuance of "social" transactions remaining rather scarce despite the potential of the existing near-prime consumer credit market.

Opportunities and Challenges

Comparisons with the ESG securitisation market in the US and China suggest that ESG securitisation in Europe has great potential for growth, with ESG securitisation constituting only 1.4% of total ESG issuances in Europe between 2019-2022, in comparison to 8.1% in China and 32.3% in the US.[7] Given the relatively modest ESG securitisation market in Europe, together with the ever increasing demand for ESG investment products, there are clear opportunities for future growth of ESG securitisations. However, there remain two key challenges in this space.

First, supplies of eligible collateral are limited, particularly in the RMBS space which remains the main consumer asset class by volume. For certain consumer asset classes there are clear options for how securitised assets could meet ESG criteria (e.g. excellent EPC ratings for homes financed in an RMBS, low emissions/electric cars for auto ABS, near prime credit cards for UK credit card securitisation). However, the inventories of mortgage loans financing appropriately rated homes are insufficient to support large volumes of issuance. To meet reporting criteria, originators/sellers require verifiable, easily comparable, and high quality information on asset portfolios. This can be challenging to obtain for legacy portfolios (e.g. portfolios of older homes for which EPC certificates are less readily available). This challenge is a key reason CLOs have led the way for European ESG securitisation.

However, the quantity of ESG assets and the quality of available information in respect of consumer assets continues to grow at a rapid pace. AFME and S&P Global Ratings predict that potential securitisable green lending to households across 8 major European markets could exceed €300bn annually by 2030.[8] This includes predicted annual gross green mortgage lending of €125bn. In the electric vehicle space, they forecast securitisable financing for new battery electric vehicles of €80bn annually across five major European economies, with a further €30bn in annual financing for used electric vehicles.[9] Another solution to the shortage of ESG assets currently available may be to source collateral from multiple jurisdictions. Although sourcing from a single jurisdiction offers simplicity of analysis for investors, taking a cross-jurisdictional asset pool may provide greater scale and diversification of risk. It might also be possible to source collateral from developing nations or regions

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[7] AFME, "European Green Securitisation Regulatory State of Play": https://www.afme.eu/portals/0/dispatchfeaturedimages/afme_esgsecuritisation_2022_07_final-2.pdf?utm_campaign=esgsecuritisation&utm_source=afme&utm_medium=email&dm_i=3TYX,1II37,2D3JR8,5LFDA,1

[8] AFME, "European Green Securitisation Regulatory State of Play", as above.

[9] AFME, "European Green Securitisation Regulatory State of Play", as above

where there is either a "green" context in terms of conservation of the environment or promoting projects with a significant social impact (e.g. on housing, health or promoting sustainable energy transition or development).

The second challenge is that the market remains focussed on finding the right balance between – on the one hand – standardisation, transparency and verification across different types of ESG securitisations and – on the other hand – the risks of creating an overly regulated landscape with overlapping and conflicting frameworks and potentially prohibitive compliance costs. Achieving the right balance between these conflicting demands has remained the major challenge faced by the ESG securitisation market. It seems that creation of a specific regulatory framework for ESG securitisations remains off the table at present, with the main solution in focus being the “use of proceeds” paradigm adopted for securitisations in the context of the EuGBS. This may be the best way for the market to fund the ESG transition (i.e. the creation of a large stock of ESG assets) while the desired ESG "end state" remains a more long-term goal. The question of how best to verify the ESG status of securitisations also remains open. ESMA published a letter in June 2022[10] summarising concerns raised in response to a call for evidence about ESG ratings providers. Concerns surrounded:

(i) lack of coverage of specific industries;

(ii) insufficient granularity of data;

(iii) complexity; and

(iv) lack of transparency around methodology.

Investors in any case conduct their own detailed due diligence on securitised portfolios using available data, but availability of consistent and accurate ratings would assist these important investment decisions and provide a means of external validation for investor's processes.

Regulatory Framework and Market Initiatives

As described in our April 2022 briefing "*ESG Securitisation: accelerating after a slow start*"[11], there are a number of regulations and regulatory initiatives which apply on the buy- and sell-side.

We consider the key developments for each below.

“Buy side” regulation

In the EU, the main framework remains the Sustainable Finance Disclosure Regulation (“**SFDR**”)[12] which established the framework for both entity- and product-level disclosures applicable to asset managers. Its application to securitisations has largely been indirect (with only CLOs managed by EU managers being caught directly) and has resulted in "in-scope" investors seeking additional disclosures on deals they are buying to enable them, in turn, provide the required disclosures to their own stakeholders. The SFDR remains a significant piece of legislation which establishes an ESG reporting standard across financial markets.

10 https://www.esma.europa.eu/sites/default/files/library/esma80-416-347_letter_on_esg_ratings_call_for_evidence_june_2022.pdf

11 https://www.cliffordchance.com/briefings/2022/04/esg-securitisation--accelerating-after-a-slow-start.html

12 Regulation (EU) 2019/2088 of the European Parliament and of the Council of 27 November 2019 on sustainability-related disclosures in the financial services sector https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=celex%3A32019R2088

The Corporate Sustainability Reporting Directive ("**CSRD**")[13] significantly expands the scope of entities which are subject to sustainability reporting obligations. All large public-interest companies with more than 500 employees, including banks, incorporated in the EU will be required to report according to European Sustainability Reporting Standards. The CSRD is intended to ensure that investors have greater access to information required to assess investment risk arising from climate change and other sustainability issues. It will play an important role in setting the ESG agenda for the financial investor community as a whole, including in the ESG securitisation market.

In the UK, discussions around the UK equivalent of the SFDR, the Sustainable Disclosure Regulation ("**SDR**") are still ongoing, with the final rules expected at some point in mid-2023 and the key elements of the SDR regime proposed to apply from mid-2024. Industry's main outstanding questions are around the mapping of the SFDR labels onto the SDR labels and the scope of the future regulatory divergence between the EU and the UK regimes. The UK Green Taxonomy consultation is expected in autumn 2023. Finally, in March 2023, the UK Government expanded on its Green Finance Strategy which forms part of the broader framework for mandating ESG disclosures for financial investors[14].

"Sell side" regulation

On the sell-side, political agreement was reached in relation to a European Green Bond Standard in November 2022.[15] The original Commission proposal for this regulation was largely inspired by the ICMA Green Bond Principles. The EuGBS Regulation departs from those principles in a number of substantive ways but will give the framework a formal regulatory status as a voluntary standard.

At the time of publication, the EuGBS Regulation is going through the final steps of the legislative process. It is likely to begin to apply some time in H2 2024. The EuGBS follows a "use of proceeds" approach for the designation of European green bonds. It requires that proceeds of such bonds are allocated in a way that fulfils requirements set out in the EU taxonomy regulation and satisfies specific conditions set out in the EuGBS, although there is some flexibility for up to 15% of the proceeds in certain circumstances.

Issuers located in "non-cooperative" jurisdiction for tax purposes or "highrisk" countries for anti-money laundering purposes are effectively barred from seeking the "European green bond" label.

The EuGBS includes provisions addressing transparency and external review requirements that apply throughout the cycle of each European green bond issue. In particular, there is a detailed factsheet that has to be produced before issuance, a periodic allocation report to account for the use of proceeds by the issuer and a report on the environmental impact of the use of the bond's proceeds. Each of these reports is required to be externally reviewed and published such that it remains in the public domain for at least 12 months after the maturity of the bonds concerned.

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[13] Directive (EU) 2022/2464 of the European Parliament and of the Council of 14 December 2022 amending Regulation (EU) No 537/2014, Directive 2004/109/EC, Directive 2006/43/EC and Directive 2013/34/EU, as regards corporate sustainability reporting.

[14] HM Government, "Mobilising Green Investment – 2023 Green Finance Strategy": https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1147377/mobilising-green-investment-2023-green-finance-strategy.pdf

[15] https://finance.ec.europa.eu/sustainable-finance/tools-and-standards/european-green-bond-standard_en

In addition to mandatory reporting, the EuGBS establishes a framework for voluntary disclosure in relation to environmentally sustainable and sustainability-linked bonds. No form of voluntary reporting has been prescribed – rather, the Commission has been given a mandate to develop reporting templates suitable for both pre- and post-issuance reporting.

In order to adapt these requirements to securitisation, the EuGBS Regulation includes conditions specific to securitisation. The main such condition is that the entity responsible for the satisfaction of the relevant requirements is the originator and not the SSPE (i.e. issuer) for securitisation transactions. There are also provisions addressing the situation where there are multiple originators. The EuGBS makes bonds issued for the purposes of synthetic securitisation explicitly ineligible for the designation as "European green bonds".

Another securitisation-specific requirement is that, in order for securitisation bonds to be eligible for the designation, the securitised exposures cannot include exposures financing the exploration, mining, extraction, production, processing, storage, refining or distribution, including transportation, and trade of fossil fuels. This is to avoid the reputation of the EuGBS being undermined if bonds with the label were used to finance existing fossil fuel assets. Originators are required to include a description of how the requirement as to the composition of the securitised exposures has been met in the pre-issuance fact sheet. In addition, competent authorities have been granted powers to request that originators demonstrate that this requirement has been fulfilled.

Finally, the EuGBS introduces securitisation-specific disclosure requirements. The securitisation prospectus must make it clear that the transaction is a securitisation and that the responsibility for fulfilling the EuGBS use of proceeds commitments falls on the originator. In addition, the prospectus must include disclosure about the assets' taxonomy alignment, taxonomy eligibility and compliance with "do no significant harm" principles, in each case on a "best efforts" basis and to the best of the relevant originator's ability, based on available data. These qualifiers are especially important because the historic nature of a number of securitised assets creates significant challenges to the collection of the relevant data. This asset level disclosure is required before issuance and also on a periodic basis after issuance.

Supranationals and development banks as catalysts

Many of the supra-national development banks and international financial institutions ("**IFIs**") have clearly embraced the ESG agenda. They can be valuable catalysts to the development of the ESG securitisation market (both cash and synthetic). They mainly assist by giving technical support, by acting as anchor investors for certain tranches or by providing full or partial transaction guarantees to promote interest and investment in this developing market, thereby supporting the move to a sustainable economy, growth and human welfare.

Conclusion

ESG securitisation offers valuable benefits – not only by unlocking financing for those segments of the real economy which are aligned with ESG factors but cannot tap into the traditional bond or loan markets – but also ultimately by directing wholesale capital markets investments to achieve sustainability goals and long-term benefits for humanity. Opening up a European ESG securitisation market would also source new investment products for investors who have a keen appetite to invest in ESG assets. Although the challenging market conditions which persisted throughout 2022 have not made the task of putting ESG securitisations together easier, there remains hope that more recent initiatives, such as the EuGBS, will help resolve at least some of the concerns around labelling, standardisation and transparency and encourage market recovery and future growth of the ESG securitisation market.

The combination of regulatory innovation and the use of IFIs and development banks to act as a catalyst for wholesale investment may well permit the European ESG securitisation market to close the gap on its US and Asian counterparts in the years ahead.

CONTACTS

Andrew Bryan
Knowledge Director

T +44 20 7006 2829
E andrew.bryan
@cliffordchance.com

Maddie Burrell
Lawyer

T +44 20 7006 1920
E maddie.burrell
@cliffordchance.com

Adam Craig
Partner

T +44 20 7006 8862
E adam.craig
@cliffordchance.com

Mikhail Kleptsov
Senior Associate

T +44 20 7006 1959
E mikhail.kleptsov
@cliffordchance.com

Jonathan Lewis
Partner

T +33 1 4405 5281
E jonathan.lewis
@cliffordchance.com

Julia Tsybina
Partner

T +44 20 7006 4368
E julia.tsybina
@cliffordchance.com

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www.cliffordchance.com

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