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# Securitisation

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# Securitisation: Financing the Green Transition

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## Introduction

Climate change has become a focal point for the United Nations, the World Health Organisation and world leaders.<sup>1,2</sup> Climate change is primarily caused by greenhouse gas emissions.<sup>3</sup> “Net zero” describes a state where greenhouse gas emissions due to human activities are equal to the removal of emissions over a given period.<sup>4</sup> Under the Paris Agreement, global leaders pledged to achieve net-zero emissions by 2050,<sup>5</sup> which will require a green transition away from fossil fuels.<sup>6</sup>

Financing the green transition is a key priority and will be the focus of the next United Nations climate conference (COP 29).<sup>7</sup> It is estimated that the green transition will require \$5–7 trillion of annual investment before 2030.<sup>8</sup> Governments have begun to finance the green transition. For example, in the U.S., the 2022 Inflation Reduction Act pledged \$369 billion to energy security and climate change programmes.<sup>9</sup> In the EU, a €1 trillion fiscal package accompanied the European Green Deal, which aims to fund the transition away from fossil fuels, develop green infrastructure and encourage green industrial sectors.<sup>10,11</sup> However, private finance will be crucial to fund the green transition and achieve net zero.<sup>12</sup> The green finance sector has experienced rapid growth over the past decade, with the utilisation of green loans, bonds and derivatives on the rise.<sup>13</sup> More recently, green securitisations have been acknowledged by international organisations, including the World Bank and the Glasgow Financial Alliance for Net Zero, as having the potential to unlock additional private finance to fund the green transition.<sup>14,15</sup>

## The Increasing Role of Green Securitisation

In the U.S., government-sponsored enterprises are purchasing mortgage pools targeting low-carbon buildings and refinancing these assets in the mortgage-backed securities market to finance energy and water efficiency programmes.<sup>16</sup> An example is Fannie Mae, which has issued \$47 billion in green residential mortgage-backed securities (RMBS).<sup>17</sup> Additionally, Property Assessed Clean Energy (PACE) securitised loans are being used in the U.S. to finance energy efficiency and renewable energy improvements on commercial and residential properties, with the loans repaid by property owners through a property tax. The sponsoring state collects this tax and redistributes the payments to the lending agencies.<sup>18</sup> PACE-inspired financing models have

subsequently been developed in Spain under EuroPACE and there is scope for more expansive implementation.<sup>19</sup> Similar to PACE, solar asset-backed securities (ABS) are securitisations of leases and loans funding solar energy projects. The first solar ABS in Germany was launched by Enpal in 2023, with a €356 million commitment used to finance over 12,500 new solar systems.<sup>20</sup>

Green securitisation is more established in the U.S. and China, representing 32% and 8% of bond issuances respectively.<sup>21</sup> The market is smaller in Europe, with green securitisation representing 1.4% of total bond issuances.<sup>22</sup> However, the European market is growing, with green securitisation issuances increasing significantly from 2020 to 2021, from €2.1 billion to €8 billion.<sup>23</sup> In 2023, European green securitisation doubled from 2022 to €2.4 billion.<sup>24</sup> There is potential for further growth, with the Association for Financial Markets in Europe (AFME) estimating that securitisable green lending to households in European markets could increase to over €300 billion by 2030.<sup>25</sup> The green home renovation lending and electric vehicle financing markets, valued respectively at €75 billion and €80 billion<sup>26</sup> annually, are also yet to reach their potential as securitisable asset classes.

## Potential Benefits

### Benefits for investors

Green securitisation presents new investment opportunities for investors. Securitisations, as a general matter, can aggregate smaller projects into investment grade instruments that are appropriate for large and institutional investors. Conversely, smaller investors can gain exposure to larger projects that would have otherwise been unaffordable. In a green securitisation context, this allows new classes of investors access to green finance opportunities, which helps to fund projects that are often at the cutting-edge of technological advancements in areas such as renewable energy and sustainable infrastructure.

According to the Organisation for Economic Co-operation and Development (OECD), investors that consider environmental, social and governmental (ESG) issues are more likely to avoid controversies, have stronger reputations, better retain customers and employees and maintain the trust of shareholders during periods of uncertainty.<sup>27</sup> Large organisations are increasingly expected to set ESG related goals, which can include investment in

green initiatives.<sup>28</sup> In 2023, the UK Pensions Regulator launched a regulatory initiative to diligence pension funds' statement of investment principles, including ESG targets, and has the ability to issue fines for non-compliance.<sup>29</sup> Investments through green securitisation can help organisations achieve their ESG goals. Green securitisation can also help investors to achieve green objectives more sustainably, by diversifying portfolios.<sup>30</sup>

#### Benefits for originators

Originators can use securitisation to reduce credit exposure to green assets. This could allow an originator (e.g., with credit exposure to loans for green vehicles or renewable energy projects) to share a proportion of its risk with investors. Originators can also use servicers who specialise in green assets to help manage payments and lifecycle events of the underlying assets, which can help to maximise returns.<sup>31</sup> Securitisation can be used to decrease interest costs by uncoupling the rating of the securitised products from an originator's own rating, allowing for a diversification of funding sources.<sup>32</sup> Lenders who currently focus on green lending could particularly benefit from green securitisation.

#### Improvements to green infrastructure

Green securitisation creates funding capacity for green infrastructure projects, which is vital for the global economy to reach net zero. This is particularly important in emerging markets and developing economies in the Global South and parts of Africa, which require more infrastructural development under the green transition and are disproportionately affected by climate change.<sup>33</sup> An example of how securitisation can be used to fund these projects is "Room2Run", a \$1 billion synthetic securitisation of African Development Bank (AfDB) loans. This was the first synthetic securitisation between a multilateral development bank and private investors, allowing the AfDB to generate \$650 million of capital for renewable energy projects.<sup>34</sup> The UK Government provided a guarantee to the AfDB through the "Room2Run Sovereign" transaction, unlocking a further \$400 million in climate financing for Africa. The AfDB recently used this capital to invest in stormwater drainage infrastructure and reforestation projects in Benin, by way of a \$129 million loan to the Republic of Benin's Secondary Town Stormwater Drainage Project.<sup>35</sup>

## Challenges

#### Greenwashing

Greenwashing has been recognised as a risk in the financial sector by policymakers globally. In the EU, greenwashing has been described by the European Supervisory Authorities (ESAs) as a practice where sustainability-related statements do not clearly and fairly reflect the underlying sustainability profile of an entity or financial product.<sup>36</sup> The European Securities and Market Authority (ESMA) published a Progress Report on greenwashing in 2023 that highlighted that misleading claims may relate to all key aspects of the sustainability profile of a product and the emergence of new financial products, such as securitisations, may create additional complexity for investors in verifying sustainability-related claims.<sup>37</sup> The Commodity Futures Trading Commission (CFTC)<sup>38</sup> considers certain forms of greenwashing to be fraud. In the UK, the Financial Conduct Authority (FCA) has recently introduced a general "anti-greenwashing rule", applicable to all FCA-authorised firms

from 31 May 2024, requiring firms to ensure any references to the sustainability characteristics of products and services are fair, clear and not misleading.<sup>39</sup> Additionally, greenwashing related litigation is increasing, with the number of climate change-related cases doubling from 2015 to 2022.<sup>40</sup> In addition to legal penalties, organisations can suffer serious reputational harm if implicated in greenwashing scandals.<sup>41</sup>

As a high-level principle, organisations can mitigate greenwashing risks by establishing robust processes to ensure communications relating to the sustainability characteristics of their business or of their products are fair, clear and not misleading. Mitigating the risk of greenwashing in the financial sector also forms one of the core underlying drivers of the UK/EU regulatory framework for sustainable finance, and hence the systems and controls firms develop to comply with this framework, where it applies, may help mitigate the risks associated with greenwashing more broadly. An example would be the FCA's anti-greenwashing rule, as this will result in the marketing and distribution of securitisations by FCA-authorised firms to investors being underpinned by a specific regulatory obligation to ensure sustainability claims are not misleading.<sup>42</sup>

Aside from the regulatory framework, the private sector is moving towards applying rigorous industry-led standards to green financing in order to minimise the risk of greenwashing. For example, the International Capital Markets Association (ICMA) recently established the "Green Enabling Activities Taskforce" with BNP Paribas and Natixis to develop market guidance and clarify what constitutes green-enabling activities.<sup>43</sup>

#### Regulatory considerations

The current regulatory framework for sustainable finance in Europe comprises a patchwork of legislation adopted over recent years. Central to this framework are the Sustainable Finance Disclosure Regulation<sup>44</sup> (SFDR) and the Taxonomy Regulation<sup>45</sup> (TR). The SFDR requires "financial market participants" (which includes fund and investment managers) and financial advisers to comply with disclosure requirements regarding their ESG approaches, including the integration of ESG risks and the consideration of adverse ESG impacts, with a view to mitigating the risk of greenwashing in the financial sector. In turn, the TR establishes a classification system for determining if an economic activity qualifies as environmentally sustainable under the EU regulatory framework, including the SFDR. The classification of a product under the SFDR, as well as its TR credentials, factor into the obligations of EU intermediaries, such as investment firms regulated under the Markets in Financial Instruments Directive or insurance brokers regulated under the Insurance Distribution Directive, who are required to take their clients' sustainability preferences into account, for example, when assessing the suitability of a product. Finally, the disclosure framework for buy-side firms and intermediaries described above is intended to be underpinned by sustainability reporting made in the financial statements of companies in scope of the Corporate Sustainability Reporting Directive, which started phasing in from 1 January 2024.

Securitisation generally sits outside the sustainable finance ecosystem described above. Financial instruments, such as bonds, issued pursuant to a securitisation are not a "financial product" in scope of the SFDR, nor would they be directly in scope of the other regimes discussed above. However, given the marketing benefit of the *de facto* labels created by the SFDR framework, the market has seen the emergence of "SFDR-aligned" securitisations (e.g., "Article 8 CLOs"); that is, securitisations marketed as being managed in alignment with SFDR standards, despite falling



outside the scope of the SFDR as a regulatory matter. Moreover, securitisation transactions may be affected by these regimes indirectly where parties to the transaction, such as EU asset managers subject to the SFDR that invest in securitisations, require information from sponsors on the sustainability characteristics of the securitisation to comply with their own regulatory reporting obligations.

As to the framework directly applicable to securitisations in the EU, the core legislation is the Securitisation Regulation<sup>46</sup> (SECR). The SECR established due diligence, risk-retention and transparency requirements for parties involved in securitisations (including originators, sponsors and institutional investors), and established a framework for simple, transparent and standardised (STS) securitisations. The sustainability-related requirements of SECR are, however, limited at present. Notably, the SECR provides that the originator or sponsor of an STS securitisation of certain asset classes (RMBS and auto loans) must disclose available information on the environmental performance of the financed assets through the reporting templates prescribed under the SECR. This was amended with effect from June 2021<sup>47</sup> to provide sponsors and originators with the option to disclose the “principal adverse impacts” (PAI), an SFDR concept referring to negative impacts on sustainability factors, of the financed assets. Technical standards prescribing the format of PAI reporting for such purposes were adopted in March 2024.<sup>48</sup>

Aside from the environmental performance reporting of the aforementioned asset classes and optional PAI disclosures for STS securitisations, the SECR does not set out a framework for green securitisations. However, the ESAs have expressed an intention to enhance the disclosure of climate-related risks in relation to securitisations. For example, in March 2023, the ESAs and European Central Bank issued a joint statement encouraging originators and sponsors to complete voluntary climate-related fields in SECR reporting templates.<sup>49</sup> Furthermore, in the first phase of its consultation on SECR reporting templates, ESMA considered whether climate-related metrics could be incorporated into the existing reporting framework, but it is not yet clear whether this proposal will be carried forward.<sup>50</sup>

There has, however, been progress in recent years towards a unified framework for green securitisation in the EU. The recently adopted European Green Bond Standard (EuGBS) Regulation,<sup>51</sup> which introduced the “EuGBS” as a voluntary designation for use by bond issuers, is available for true-sale securitisations. Among the conditions to qualify for the designation are that the bond’s proceeds must be fully invested in environmentally sustainable activities in accordance with the TR. While the designation is not currently available for synthetic securitisations, the EBA is mandated to report by December 2028 on the feasibility of extending the regime to synthetic securitisations. Hence the potential is there for an uptake of the EuGBS designation in the securitisation market in the years to come.

In the UK, there is similarly no framework for green securitisations (and no imminent plans to establish one).<sup>52</sup> Currently, UK originators and sponsors of STS securitisations of RMBS and auto loans are required to disclose available information on the environmental performance of financed assets, but the PAI framework does not exist in the UK. However, proposals for ESG reporting are expected to feature in the Financial Conduct Authority’s upcoming consultation on the disclosure framework for securitisations in the UK.<sup>53</sup>

## Politics

The role of ESG in investment decisions has received pushback politically, most notably in the U.S. In 2023, more than a

dozen states adopted laws discouraging ESG considerations in investment decisions or banning ties to financial companies that include such considerations.<sup>54</sup> Whilst this state legislation is generally limited to public pension investments, it impacts the wider perception of ESG. The main concern by critics of ESG focused investment is that ESG considerations may infringe upon a state’s, or director’s fiduciary duty to maximise returns. Under the Department of Labor’s “ESG Rule”, retirement plans are able to consider ESG factors alongside traditional financial factors.<sup>55</sup> The ESG Rule was challenged by 26 State Attorneys General in a Texas federal court as being inconsistent with federal law, which requires retirement plans to act solely and exclusively for the financial benefit of participants.<sup>56</sup> The Attorneys General filed an appeal to this decision in a U.S. Appeals Court and the parties have filed briefs in support of their arguments.<sup>57</sup> The uncertain position of ESG factors in investment decisions represents a challenge for investors who wish to make ESG driven investments, including in green securitisations, particularly those who have ties to U.S. institutional investors. The possible negative perception of ESG in certain jurisdictions may also pose a challenge to green securitisation uptake more broadly. However, according to a recent Bloomberg survey, the perception globally of ESG amongst investors remains positive.<sup>58</sup>

## Conclusion

Significant levels of private finance are required to achieve net zero greenhouse gas emissions by 2050, in line with the Paris Agreement. Green securitisation can allow new classes of investors to access green finance and release capital for additional green infrastructure improvements. Investments through green securitisation can contribute to ESG mandates and improve the sustainability of long-term financial returns. For originators, green securitisation offers a way to mitigate credit risk and diversify funding sources. However, market participants must navigate a number of challenges, including greenwashing risk, the fragmented regulatory landscape and political backlash against ESG. If these can be overcome, green securitisation has the potential to unlock reserves of capital that can be used to fund the green transition to net zero and combat climate change.

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Sidley has been at the forefront of the Securitisation and Structured Finance markets for over 40 years and during that time has been involved in a number of ground-breaking securitisation products and structures in numerous jurisdictions across the UK and Europe, including establishing domestic and multi-jurisdictional commercial mortgage-backed securities platforms, asset-backed commercial paper and securities conduits, residential mortgage-backed securities related products, whole business securitisations and covered bonds, as well as developing a deep experience in advising arrangers, managers and investors on collateralised loan obligations, collateralised debt obligations and other structured credit transactions.

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