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Implications of sustainability and ESG for the securitisation market

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Tim Conduit and Isabel Tinsley assess the key ESG-related milestones in the securitisation market and more widely. They highlight some key features of ESG-compliant securitisations and share their views on significant future developments.

ESG-focused securitisations have recently moved from being a niche product towards occupying an increasingly mainstream position in the securitisation market. Although ESG-related securitisations were traditionally limited to the green covered bonds market, over the past year several landmark securitisations have brought sustainability to the forefront of the market.

This movement within the securitisation context is aligned with the wider global and political commitment towards greater focus on the sustainability of investments and an increased investor interest in human rights considerations.

Policymakers and regulators in the EU, the US and the UK are prioritising sustainability and wider ESG issues and introducing a detailed and complex set of standards and reporting requirements that affect what can be classified as a sustainable finance product.

The landscape is continuing to evolve at pace and at scale. The implications for the securitisation market are significant. Sustainability and ESG are becoming increasingly important issues for securitisation market participants to understand in order to avoid missing out in the transition to sustainable finance.

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Emergence of ESG-compliant CMBS

2020 saw the creation of two ESG-compliant commercial mortgage-backed securities (CMBS), each a first for this market. In February 2020, River Green Finance DAC issued €186.4m of commercial mortgage-backed notes due 2032, which were secured on two loans which financed the acquisition of an energy-efficient property located to the west of Paris.

The underlying property had received various certifications for its energy efficiency. In addition, the building encouraged wider environmental improvements, for example by providing electric charge points in its carpark to encourage employees to move away from using petrol cars.

In October 2020, Sage AR Funding No. 1 Plc issued £220m of social housing rental secured notes due 2030, which were secured on a senior loan. The proceeds of this loan were to be on-lent in order to fund the acquisition or refinancing of UK affordable housing properties. Sage's portfolio is focused on affordable and social rental and shared ownership properties which are let to persons who have been identified as being in housing need, such as the homeless, and are listed on local authority housing registers.

While River Green Finance met the "E" in ESG and Sage the "S", they both contained some important common characteristics. In each case, the issuer or the underlying sponsor created a framework (green and social, respectively) for the assets' compliance with certain sustainability criteria.

In both cases a third party, Sustainalytics, a company that rates the ESG performance of companies and financial products, issued a publicly available opinion on the framework's alignment with the ICMA Green Bond Principles and ICMA Social Bond Principles, respectively. On both CMBS, Sustainalytics also opined that the relevant framework was aligned with Sustainable Development Goal 11 (Sustainable Cities and Communities).

Each offering circular contained a "Sustainability" section analysing this compliance for investors, and examining the use and management of proceeds, proposed allocation and impact reporting, and project evaluation and selection processes. The River Green Finance notes were listed in the green segment of Euronext Dublin, one of the many green sections of stock exchanges that have been created in recent years to help investors identify environmentally friendly financings.

Developments in the RMBS market

There have been equally significant developments in the residential mortgage-backed securities (RMBS) space. In March 2021, Brass No. 10 Plc issued £1,932,000,000 of notes due 2069, the proceeds of which were used to buy a portfolio of residential mortgage loans from Yorkshire Building Society (YBS). YBS is then to use the consideration it receives from the issuer for that sale in accordance with an eligible social project.

The eligible social project will have a positive social impact because it will make available higher rate savings products and/or competitively priced mortgage products to all YBS customers, including customers who may be underserved by other lenders in the market because of the complexity of their characteristics (for example, self-employed borrowers, contractors, first-time buyers and retired borrowers), thereby meeting the "S" in "ESG".

YBS put in place a social bond framework to govern its eligible social project and Standard & Poor's (S&P) then issued an opinion on that framework's compliance with the ICMA Social Bond Principles, as well as UN Sustainable Development Goals 10 (Reduced Inequalities) and 11 (Sustainable cities and communities), on the basis that it improves access to banking services and socioeconomic advancement.

Prior to this, in February 2021 Gemgarto 2021-1 Plc issued £116,348,000 of notes due 2067, a social RMBS also backed by loans lent to 'excluded' individuals which followed a similar structure. Meanwhile in the Netherlands, Obvion issued its fifth green securitisation of energy efficient Dutch mortgages under its Green STORM programme in March 2021.

Developments in the synthetic securitisation market

Meanwhile, large ESG offerings have also recently taken place in the synthetic securitisation market. In January 2020, NatWest Bank and NatWest Markets arranged a £1.1bn synthetic securitisation which referenced a pool of loans relating to offshore wind, solar, smart-meters, energy-from-waste and biomass power.

The loans were verified by a third-party provider as being green, this time by reference to the Loan Market Association Green Loan Principles. This transaction allowed NatWest's capital to be recycled and invested in further ESG-friendly products.

The following year, in February 2021, Glennmont Partners completed a €1.3bn synthetic risk transaction backed by a portfolio of project finance loans for solar, wind and bio energy plants owned by Intesa SanPaolo. Within the first two years of closing of the transaction, Intesa will be permitted to add new green finance products to the reference portfolio, with the aim of liberating capital for Intesa, thereby allowing it to finance other clean energy investments.

Both of these transactions enabled investment in future sustainable products as well as financing a current renewable energy portfolio.

The bigger picture

Large, landmark sustainable transactions have therefore taken place across the public securitisation markets over the past year. This forms part of a wider move towards sustainability across the financial markets generally and a systemic global shift towards increased focus on ESG.

Looking back, the key milestone which originally started this trend was the creation of the UN Global Compact in 1999 and the UN Principles for Responsible Investing in 2006, then followed by the UN Sustainable Development Goals and the UNFCCC Paris Agreement in 2015.

Changing investor sentiment, greater regulation and increased litigation and shareholder activism in the human rights and environmental space worldwide over the past decade have combined with these global initiatives to create a snowball effect. The pandemic has further focused the minds of governments, regulators and investors on sustainability and has pushed the "S" in ESG more to the forefront.

Sustainable finance products are becoming increasingly varied and innovative. Although in the past investors tended to focus on green investments, we have now seen, for example, the issuance of blue bonds and diversity bonds (proceeds being applied towards marine conservation and companies with gender balanced boards, respectively).

Challenges

The sustainable finance market has historically faced some challenges. One debate in the market has been how to define "green" or "social" when structuring an ESG compliant product. The lack of a clearly accepted definition creates uncertainty and some sustainable financial products do not require reporting on an ongoing basis as to the underlying assets' continued compliance with ESG criteria, and/or do not penalise the issuer for any such non-compliance.

The sustainable loan market has seen margin ratchets based on failure to meet certain key performance indicators but this concept has not been widely adopted in the bonds market (although it has been seen; for example, ENEL, an Italian energy company, issued an SDG-linked bond under which the annual coupon would automatically increase by 25 basis points if ENEL did not achieve its stated aim of increasing renewables from 48% to 55% of its installed capacity by the end of 2021.

It can also be difficult to measure the positive impact of a particular project or financing, particularly in the case of an asset pool that is intended to have a socially positive effect. The lack of defined and shared methods for measuring an asset's impact on society and a proliferation of different rating methodologies which attempt to address this has created confusion.

A debate has also taken place, within the securitisation market and more widely, as to how strict the criteria should be to determine whether an asset should be treated as "sustainable". The market has to date not reached a consensus on the central question of whether a securitisation labelled as (for example) green should be restricted to purely green assets, or if it should be permissible for any "transition" deal, which is promoting a move towards more environmental sustainability, to be marketed as ESG compliant.

The road ahead

Governments across the world have been looking at these issues and the EU in particular has created a wide ranging and detailed classification system which is currently due to become applicable in 2022. The Taxonomy Regulation 2020/852 aims to regulate standards and labels for sustainable finance and create a common language to classify certain economic activities as sustainable. Meanwhile, the EU Green Bonds Standard, which will be complied with on a voluntary basis, builds upon the Taxonomy Regulation and aims to create a common standard for the green bonds market.

The EU has also proposed the integration of sustainability factors into investment mandates, thereby creating a legal obligation to factor sustainability risks into capital allocation decisions asset managers and institutional investors.

Perhaps most notably of all, the EU has endorsed the creation of a "green supporting factor", whereby capital requirements for certain sustainable products (such as energy efficient mortgages or electric cars) would be lowered. In tandem, the EU has announced its "Green Deal Investment Plan" in January 2020, aiming to mobilise at least €1trn of sustainable investment over the next decade.

In the UK, the government has created a green finance strategy aimed at mobilising finance towards sustainability.

In the US, the new Biden administration has publicly committed to fighting climate change and to the US rejoining the Paris Agreement.

A raft of legislation and investment is therefore on its way worldwide and we expect these major developments, in particular the "green supporting factor", to create a further seismic shift towards sustainability in the securitisation markets.

Our expectation is that the uptick in ESG securitisation related activity will continue to accelerate. The greater regulation on the horizon will likely foster certainty in the markets and encourage a further exponential rise in sustainable finance products. We welcome AFME's suggestion in their recent position paper of a "transitioning securitisation" label, opening the sustainable securitisation market up to a much wider pool of assets.

Against this background, we expect that, in the coming years, asset managers, institutional investors and financial institutions will increasingly be required, and expected, to be on top of these issues.

We are on the cusp of a sea change, and ESG awareness and compliance is becoming simply a matter of good governance and risk management.