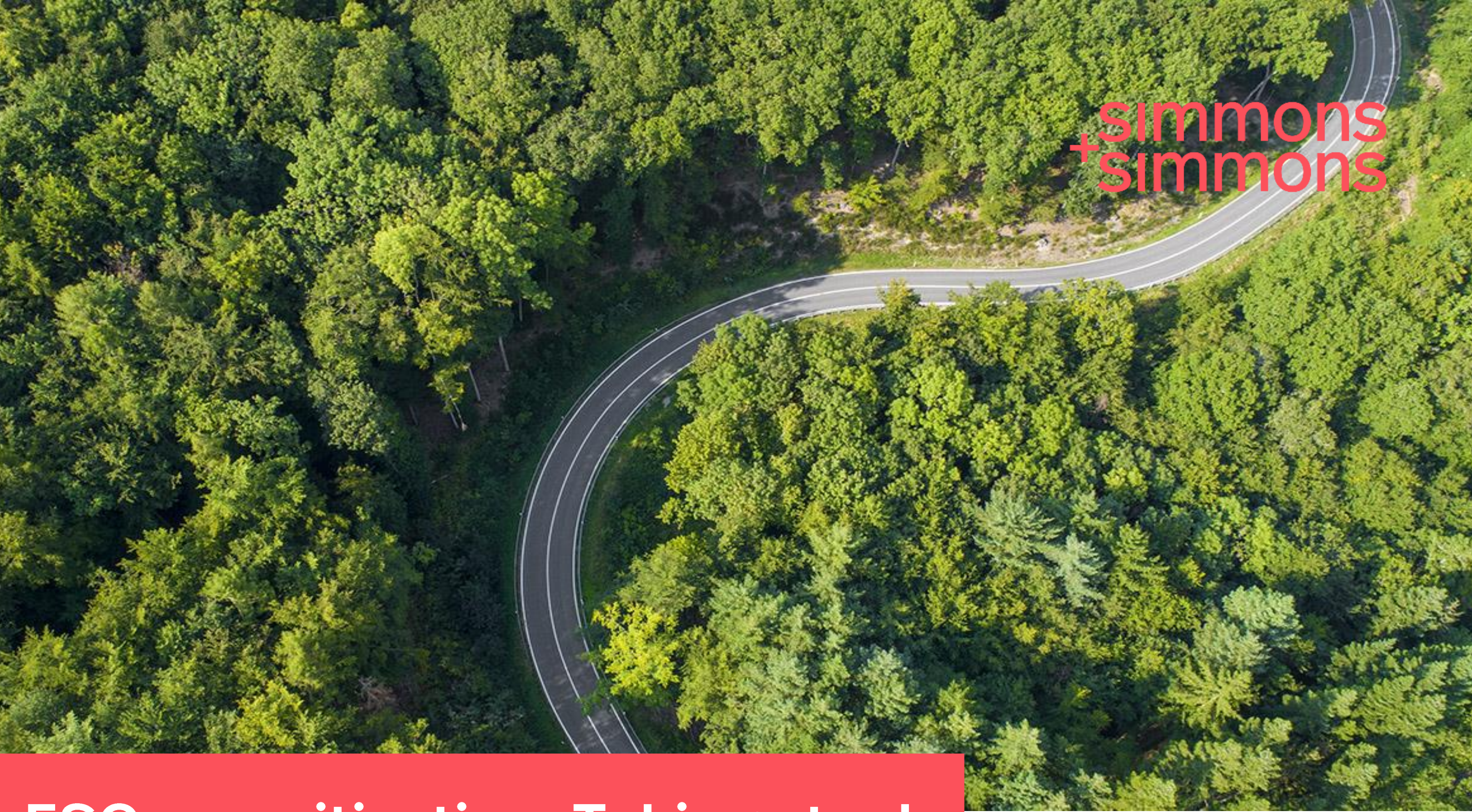

ESG securitisation: Taking stock

1. Introduction

A significant amount of capital is expected to be made available for investment in ESG transactions in the coming years, and growth in this area continues at breakneck pace. New ESG bond and loan issuances in Europe in 2021 amounted to nearly EUR 750bn, far surpassing the totals in 2020 (EUR 389bn) and 2019 (EUR 245bn)[1]. There has been an associated explosion in the amount of legislation aiming to address ESG-related concerns, as regulators seek to create frameworks to help achieve ambitious ESG-related objectives. Sector-specific legislation is still being developed, however, and the array of existing rules are not yet harmonised.

This note outlines the issues that should be considered when originators and sponsors (i.e. sell-side parties) structure an ESG securitisation. While our focus is primarily on the 'here and now', we have also outlined potential future legislative developments, particularly those described in the European Banking Authority's (the "EBA") recent report "Developing a Framework for Sustainable Securitisation" (the "EBA Report")[2].

2. What is an ESG securitisation?

One of the difficulties with structuring an ESG securitisation is the absence of a

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1 Based on data contained in (i) ESG Finance Q4 and Full Year 2021 – European Sustainable Finance, published by AFME on 23 February 2022 and (ii) AFME Securitisation Data Report Q4 2020, published by AFME on 4 March 2021.

2 See "Developing a Framework for Sustainable Securitisation", published by the European Banking Authority on 2 March 2022, available here.

regulatory framework that determines whether a transaction can be labelled an 'ESG securitisation' or not. This is exacerbated by the variation between different securitisations, as regards the parties, structures and assets involved[3]. There is consequently no market consensus on what constitutes an 'ESG securitisation' at present. However, as noted in the EBA Report it is common to consider the following three factors when evaluating the ESG credentials of a securitisation:

- Whether the assets being securitised have a positive impact on ESG metrics;
- Whether the proceeds from or capital relief afforded by[4] a securitisation are deployed to advance defined ESG objectives; and
- Whether the key transaction parties commit to advancing defined ESG objectives.

There has been a longstanding debate as to the relative significance of these factors and in particular whether 'use of proceeds' transactions' (i.e. transactions relying on the second factor above) should merit the ESG label in the same way as 'ESG collateral transactions' (i.e. transactions relying on the first factor above). Proponents argue that use of proceeds transactions can play an important part in transitioning to a sustainable economy, particularly given the relative scarcity of ESG-friendly collateral and the limits that places on ESG collateral transactions. Critics, meanwhile, argue that use of proceeds transactions are inconsistent with ESG principles and even a form of greenwashing. It seems increasingly likely that use of proceeds transactions will be permitted to carry the ESG label for the reasons we examine further below, but this is not yet certain. Similar ambiguity exists as regards the precise meaning of 'ESG' and how ESG metrics or objectives are measured. Regulatory frameworks addressing these issues have been developed[5] but a lack of clarity persists in some areas, particularly in relation to 'social' transactions[6].

In the absence of a specific legislative framework categorising what is an ESG securitisation and what is not, market participants have been producing their own frameworks to support the view that the transaction is consistent with ESG practices. Those frameworks are typically structured to comply with certain voluntary market-led principles, particularly those developed by ICMA for sustainability bonds (though dozens

3 This has not been so much of an issue for the more established ESG loans or bonds markets, where the ESG credentials of a transaction can be evaluated solely by reference to the ESG performance of the issuer or borrower.

4 In the case of synthetic securitisations, where no new funding is provided.

5 See the discussion on the EU Taxonomy Regulation further below. This sets out definitions for 'environmentally sustainable' in relation to certain economic activities. The EBA Report suggests financial institutions are not uniformly relying on the EU Taxonomy Regulation approaches at present, instead preferring their own internal frameworks and standards to define ESG factors.

6 There is generally more ambiguity on what constitutes a 'social' securitisation (compared to 'green' transactions), as there might be disagreement on what exactly a transaction would need to do in order to create a societal benefit or positive social impact. There can also be an inherent conflict between the 'E' and 'S' aspects of the ESG agenda, as the goals embedded in these initials do not always align with one another.

of others exist, such as the Climate Bonds Initiative). A common practice is then for a 'second party opinion' to be issued by a specialist provider or rating agency to support the view that the transaction framework is aligned to the relevant principles. Each of these practices (which we consider further in paragraph 6 below) are designed to assure investors that an investment in the securitisation would be consistent with their own ESG requirements.

Box 1: Examples of assets used in ESG securitisations[7]

ABS type	Loan type
RMBS	Mortgage loans to finance newly built energy efficient houses, renovations to improve house insulation, installation of heat pumps, rooftop solar panels and other energy and water efficiency upgrades
Auto ABS	Loans and leases to finance electric or hybrid vehicles or vehicles which meet fuel efficiency and low emission standards
SME	Loans to finance small business sustainable projects such as organic foods, products made from recycled materials, batteries and storage products or innovative technology which improves energy efficiency[8]
Corporate	Loans to finance infrastructure projects such a wind power station, water and waste management projects; low-emission public transport, electric vehicles charging stations, and other energy efficient projects
CMBS	Mortgage loans to finance acquisition or improvement of social or student housing, hospitals, community or educational centres; commercial rooftop solar energy loans
ABCP	(Re)financing trade receivables generated by companies which are transitioning to more sustainable business models such as auto manufacturers, manufacturers of household equipment or non-toxic cleaning products
CLO	CLO managers apply "negative screening criteria" and will not invest in loans backed by companies that derive a portion of their revenue from certain industries such as tobacco, extraction of oil & gas, coal and weapons[9]

7 Source: Reproduced from the discussion paper "ESG Disclosure and Diligence Practises for the European Securitisation Market", published by AFME in March 2021.

8 It is arguable that the private securitisations of assets supported by the UK Government's various COVID-19 support programmes (for instance, the Coronavirus Business Interruption Loan Scheme) are 'social securitisations' given the purpose of the UK Government's participation.

9 See below for a further discussion on the various ESG-related tools developed in the CLO markets.

3. Market overview and recent examples

ESG issuances represent a small but growing segment of the EU's broader securitisation market. According to AFME, ESG securitisation issuance in the EU reached EUR 8bn in 2021[10], across several different asset classes. This is a marked increase from the volumes issued in the preceding years but still accounts for only 3.4 per cent. of overall EU securitisation issuance[11] and just 1 per cent. of the total EU ESG bond and loan issuance[12] over the same period. Overall volumes are also low when compared to other global markets and to other asset classes. For instance, ESG transactions comprised 20.2 per cent. of overall EU bond issuance in 2021, and similar figures arise in the loans market too (where sustainability and green-linked transactions comprised 25.4 per cent. of EU loans origination in 2021)[13]. ESG bond and loan issuance volumes were markedly lower in the first quarter of 2022[14], though it seems likely this was due (at least in part) to more challenging market conditions.

Slower adoption in the securitisation market is largely explained by the reasons referenced further above, i.e. the difficulty in defining what is and what is not an 'ESG securitisation' and the shortage of ESG-friendly collateral. Several other factors were identified in the market survey conducted by the EBA and published in its EBA Report[15], such as the difficulty in identifying sustainable assets or projects and assessing sustainability-related impacts, and the lack of clarity as regards the application of EU sustainable finance regulation to the EU's securitisation framework.

ESG issuances in some securitisation asset classes have grown at a faster pace than others. For instance, there has been much greater level of ESG activity in the green RMBS and green auto ABS segments to date than in other asset classes, due to the greater availability of ESG assets and data and the more suitable nature of those assets from an ESG perspective. Growth in the CLO market is particularly notable, and CLO managers are increasingly using sophisticated tools for ESG purposes. This includes wide-spread use of negative screening in ESG eligibility criteria to preclude investment in sectors considered harmful from an ESG perspective. More recent CLO transactions[16] have gone a step further and use advanced screening methods like positive screening, which requires the CLO manager to conduct due diligence and assign an ESG score to each underlying asset (based on asset and portfolio-level ESG criteria and metrics that it has developed), monitor the ESG score of each asset on an ongoing basis and, in some

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10 Based on data contained in (i) ESG Finance Q4 and Full Year 2021 – European Sustainable Finance, published by AFME on 23 February 2022 and (ii) AFME Securitisation Data Report Q4 2021 and 2021 Full Year, published by AFME on 15 March 2022.

11 Ibid.

12 Ibid.

13 Ibid.

14 See ESG Finance Report Q1 2022 – European Sustainable Finance, published by AFME on 10 May 2022.

15 See EBA Report, pages 24 to 27.

16 For example, NIBC's North Westerly VII ESG CLO DAC and Blackrock European CLO VII managed by Blackrock Investment Management (UK) Limited.

cases, take steps to maintain a weighted average ESG score across the portfolio (for example, by consulting with the obligor or selling the non-ESG compliant asset). Ever more advanced ESG-related tools are being developed in the CLO markets in response to investors' demand, some of which may become standard for ESG CLOs in due course.

Examples of recent sustainable securitisation transactions issued or originated in Europe (excluding CLOs) was included in the EBA Report and is reproduced in the annex to this note.

4. Snapshot of regulations relevant to the sell-side

When structuring an ESG securitisation the sell-side parties must, naturally, comply with any ESG rules that directly apply to the transaction and their activities in relation to it. In addition, however, sell-side parties should be cognisant of any ESG rules that apply to potential investors in the securitisations they are structuring (i.e. buy-side rules). The most prominent rules that sell-side parties should be aware of are outlined below.

4.1 Securitisation Regulations

Securitisations in the EU are regulated by the EU Securitisation Regulation (the "EUSR")[17]. In the UK, similar rules exist in the form of the on-shored UK Securitisation Regulation (the "UKSR"). The EUSR and UKSR both set out detailed due diligence and disclosure standards for securitisation transactions. From an ESG perspective, the most relevant provisions[18] are those that require originators and sponsors of STS securitisations to disclose, where the underlying exposures are residential loans or auto loans or leases, the available information related to the environmental performance of the assets financed by such residential loans, auto loans or leases. This is designed to allow investors to evaluate the ESG performance of the relevant assets and to compare them with assets of other STS securitisations. However, the disclosure obligations are relatively limited. This is for two reasons: firstly because they currently[19] only apply to STS transactions of residential loans or auto loans or leases, and secondly because disclosure is only required if the relevant information is available.

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[17] Regulation (EU) 2017/2402.

[18] See Article 22(4) of the EUSR and UKSR (which each impose disclosure obligations in respect of non-ABCP traditional STS securitisations) and Article 22d(4) of the EUSR (which imposes corresponding disclosure obligations in respect of on-balance-sheet (i.e. synthetic) STS securitisations). By way of background, Article 22(4) of the UKSR mirrors the EUSR as regards the requirements applicable to non-ABCP traditional securitisations. However, the UKSR does not contain provisions equivalent to Article 22d(4) of the EUSR in relation to synthetic securitisations. This is because Article 22d(4) of the EUSR was inserted into the EUSR by Regulation (EU) 2021/557 as part of the Capital Markets Recovery Package – which (amongst other things) extended the STS regime to synthetic securitisations – and equivalent rules have not yet been implemented in relation to the UKSR.

[19] See further below as regards potential changes to the EUSR and UKSR to extend these existing disclosure requirements to a broader range of securitisations.

A derogation to the abovementioned provisions was added to the EUSR (but not the UKSR) in April 2021, as part of the EU's Capital Markets Recovery Package. The derogation allows originators of STS securitisations to publish available information related to the principal adverse impacts of the assets financed by the underlying exposures on sustainability factors, in lieu of information on environmental performance. This derogation is intended to align the disclosure requirements under the EUSR with those in the SFDR (as defined and described further below), which also uses the concepts of 'sustainability factors' and 'principal adverse impacts'. Detailed rules setting out what disclosures originators must make in order to rely on this derogation were originally expected to be published by July 2021, in the form of regulatory technical standards ("RTS") that 'mirror or draw upon' those developed under SFDR. A draft of the RTS was published by the joint European Supervisory Authorities in May 2022, as discussed further in paragraph 7.2 below.

In addition to the above, delegated technical standards[20] published in relation to the EUSR and UKSR require originators, sponsors and special purpose securitisation issuers to provide an Energy Performance Certificate ("EPC") and the name of the EPC provider in relation to securitisations where the underlying exposures are residential mortgage loans, auto loans or leases or consumer loans. Such requirements apply to all securitisations with such exposures (and not just STS securitisations), but only to the extent such information is available. It is permissible to specify the relevant items as not applicable.

4.2 Sustainable Finance Disclosures Regulation

The EU's Sustainable Finance Disclosures Regulation[21] ("SFDR") aims to improve the flow of ESG-related information to investors. This is achieved primarily by requiring certain sustainability information to be reported to investors and certain sustainability risks and impacts to be considered in investment decision-making. The key rules apply to financial market participants[22] that make available financial products[23] to investors. Those rules are unlikely to apply directly to the sell-side parties to a securitisation, on the basis that:

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20 See Regulation (EU) 2020/1224, items RREC10/11 of Annex II (residential real estate), AUTL57/58 of Annex V (automobile) and CMRL68/69 of Annex VI (consumer) and the corresponding provisions under the on-shored UK delegated legislation.

21 Regulation (EU) 2019/2088.

22 As defined in Article 2(1) of the SFDR. The definition captures EU-based buy-side firms, including fund managers, firms conducting MiFID investment management activities, pension schemes and insurers. Note that non-EU managers are also brought in scope of SFDR where they actively market non-EU funds in the EU.

23 As defined in Article 2(12) of the SFDR. The definition captures alternative investment funds, insurance-based products, pension products and schemes, UCITS and portfolios managed under MiFID II.

- Securitisation positions are not within the scope of the 'financial products' definition under the SFDR.

- Most sell-side parties (including originators, sponsors and special purpose securitisation issuers) are not within the scope of the 'financial market participants' definition. The notable exception is EU-based investment firms or credit institutions that provide portfolio management services, which will capture EU-based CLO managers.

The SFDR may nevertheless have a significant bearing on securitisations. This is because investors in a securitisation may themselves be financial market participants subject to the SFDR. If so, those investors may request certain ESG-related data from the sell-side parties for regulatory compliance purposes or, in some cases[24], to enable them to market their own financial products as being compliant with the SFDR. Where in-scope, financial market participants must (amongst other things):

- At an entity level, disclose on their website information concerning:

  - Their policies on the integration of sustainability risks in their investment decision-making process (Article 3).

  - Whether they consider the principal adverse impacts of their investment decisions on sustainability factors[25]. If they do, the financial market participant must publish a statement on their due diligence policies in relation to those impacts and certain other information. If they do not, the financial market participant must explain why not, though this opt-out is not open to certain larger financial market participants[26] (Article 4). The statement required under Article 4 of the SFDR is often referred to as a Principal Adverse Sustainability Impact Statement (a "PASI Statement"). Rules prescribing the form and contents of PASI Statements are expected to take effect from 1 January 2023[27].

- At a financial product level, classify their financial products as regards their ESG objectives and include, in their pre-contractual disclosures, information concerning:

24 For instance, it is now not unusual for funds investing in CLOs to market financial products as being compliant with Article 8 of the SFDR.

25 Defined in Article 2(24) of the SFDR as "any environmental, social and employee matters, respect for human rights, anti-corruption and anti-bribery matters".

26 Namely those financial market participants with more than 500 employees on average over a financial year. This may be tested on a consolidated balance sheet basis where the financial market participant is a parent undertaking of a large corporate group. See Articles 4(3) and (4) of SFDR.

27 These rules will form part of the consolidated SFDR RTS described in footnote 46 below.

- The manner in which sustainability risks are integrated into their investment decisions and the likely impacts of sustainability risks on the returns of the financial product (Article 6).
- Whether (and if so, how) the financial product considers principal adverse impacts on sustainability factors (Article 7) (though note this requirement will not apply until 30 December 2022).
- Where the financial product promotes environmental or social characteristics, information on how those characteristics are met (Article 8).
- Where the financial product has sustainable investment as its objective, information on how that objective is to be attained (Article 9).

A significant question for financial market participants generally is therefore the category in which their financial products fall, and the disclosure obligations which flow from those categorisations. In very broad terms, financial products under Article 9 are subject to the highest standards from an ESG perspective, as the financial product must have 'sustainable investment as its objective'[28]. By contrast, financial products under Article 8 must 'promote environmental or social characteristics', which is a less stringent standard that captures a broader range of financial products that claim to take ESG factors into account, amongst other factors. Even financial products that do not make environmental or social commitments at all (and thus cannot be marketed as ESG-friendly) must still consider sustainability risks, or explain why they are not relevant, under Article 6. Additional ongoing disclosure obligations apply to Article 8 and Article 9 financial products, designed to help investors measure the impact of the financial product against its stated ESG objectives. Those obligations include the requirement to publish certain website disclosures (Article 10) and periodic reports (Article 11).

From a securitisation perspective, the most germane issue is the likelihood that sell-side parties will receive information requests stemming from the SFDR. Those requests may be made whether or not the securitisation transaction is being marketed as ESG-friendly, although requests will be more likely where the investors are financial market participants that need 'principal adverse impact' data to determine the extent to which the securitisation would align with their own ESG targets. In other cases (namely, the CLO markets), managers have even sought to manage the underlying portfolio and provide ESG-related disclosures to investors in a manner consistent with Article 8 of the SFDR. This is with a view to attracting investment from funds that are themselves marketing Article 8

[28] The term 'sustainable investment' is defined in Article 2(12) of the SFDR. Broadly, it means the financial product must contribute to an environmental or social objective without doing significant harm to any other environmental or social objective, and be made in companies with good governance practises.

financial products and thus require detailed data for their own reporting purposes.

Another consideration for sell-side parties will be whether they want their securitisations to constitute "sustainable investments" under SFDR. For financial market participants, where they have identified a financial product as falling with Article 8 or Article 9 of the SFDR, they will from 1 January 2023 also be required to disclose the extent to which that financial product makes sustainable investments. In order to qualify as a sustainable investment, the investment must be in an economic activity that contributes to an environmental or social objective, provided that it does not do any significant harm to any other environmental or social objectives and the investee company must follow good governance practices (Article 2(17)). This is often referred to as an 'Article 8+ financial product'. Where the terms of a financial product commits to making sustainable investments, then investments meeting this definition must also be identified.

Note that the SFDR is not applicable in the UK, since most of its operative provisions entered into force after the end of the Brexit transitional period (so did not form part of EU retained law) and those that did have been revoked. However, certain UK firms may be in-scope by virtue of their activities in the EU, and out of scope investors may in fact seek to comply with the SFDR rules on a voluntary basis.

4.3 Taxonomy Regulation and NFRD

The EU's Taxonomy Regulation[29] establishes a classification system (or taxonomy) to determine whether an economic activity is environmentally sustainable or not, and imposes disclosure requirements on banks and certain large corporates. The Taxonomy Regulation does not apply directly to securitisations at a transaction level (for the same reasons as the SFDR[30]) but remains relevant to sell-side parties in two respects:

- Firstly, the taxonomy set out in the Taxonomy Regulation is central to creating a common understanding of the economic activities that qualify as environmentally sustainable (as summarised in Box 2 further below). This in turn enables investors to establish the degree to which an investment can be considered environmentally sustainable. The Taxonomy Regulation underpins many of the EU's ESG legislative initiatives (including the SFDR) and questions

29 Regulation (EU) 2020/852.

30 Principally because many of the obligations in the Taxonomy Regulation apply to 'financial market participants' that make available 'financial products', per Article 1(2)(b) of the Taxonomy Regulation. Those terms cross-refer to the definitions in the SFDR, which (as previously outlined) do not apply to securitisations exposures.

concerning taxonomy eligibility or alignment arise in many different settings[31]. One example is the impact that the Taxonomy Regulation has on determining which assets can be considered 'green' and therefore the volume of green assets available for ESG securitisations. As noted in the EBA Report:

- Mortgage loans are only considered 'green' under the Taxonomy Regulation if the relevant property has an EPC rating of 'A' or ranks in the top 15 per cent. of properties from an energy efficiency perspective[32]. In practice this places a significant constraint on the supply of green assets, as few buildings in Europe have been assigned an EPC rating and the number of 'A' ratings is low.

- Electric vehicles are automatically green under the Taxonomy Regulation and plug-in hybrid vehicles are considered green for a transitional period ending 2025[33]. However, these sorts of vehicles are estimated to represent only 1.2 per cent. of the overall EU passenger car stock[34].

In all, the EBA estimates that the overall pool of EU taxonomy-aligned green assets was no greater than EUR 15.6 billion in 2020[35].

- Secondly, Article 8 of the Taxonomy Regulation requires in-scope entities to publish information on how and to what extent their activities are associated with economic activities that qualify as environmentally sustainable under Articles 3 and 9 the Taxonomy Regulation. For the purposes of Article 8, the 'in-scope entities' are entities that are required to publish non-financial information under Article 19a or Article 29a of the Accounting Directive[36] as amended by the Non-Financial Reporting Directive[37] ("NFRD"). At present, this captures 'large public interest entities' including entities listed on an EU regulated market, EU credit institutions, EU insurance undertakings and any other entities designated by Member States as public interest entities, provided the relevant entity (or, in the case of parent undertakings, its consolidated group) meets two out of three minimum size thresholds: specifically, having a balance sheet in excess of EUR 20 million, a net turnover in excess of EUR 40 million or more than 250 employees on average during

31 For example, issuers seeking to market their bonds as compliant with the EU Green Bond Standard under the Draft Green Bond Regulation must (under the current proposed text) fully allocate the net proceeds of the issuance to taxonomy-aligned economic activities. The EU Green Bond Regulations are outlined further below.

32 See point 7.7(1) of Annex I of the regulatory technical standards establishing the technical screening criteria in respect of climate change mitigation and climate change adaptation, available here

33 Ibid., point 3.3(l)(ii).

34 See "Green Securitisation – Part II: Collateral Concerns" published by Rabobank on 6 September 2021 (available here), as referenced on page 25 of the EBA Report.

35 See page 25 of the EBA Report for details on how this estimate was reached.

36 Directive 2013/34/EU.

37 Directive 2014/95/EU.

the financial year. The NFRD will thus impose ESG-related disclosure requirements on most banks, which are not otherwise within the scope of the SFDR. The proposed Corporate Sustainability Reporting Directive[38] ("CSRD") is expected to significantly extend the scope of Article 8 of the Taxonomy Regulation to all "large" EU entities (irrespective of whether they are public interest entities) and all listed EU entities.

The specific content and presentation of the key performance indicators ("KPI") required from entities subject to Article 8 of the Taxonomy Regulation are set out in a delegated regulation[39]. Different rules apply to financial undertakings and non-financial undertakings. For financial undertakings, the rules also vary depending on the category of the undertaking in question. By way of general summary:

- For credit institutions (i.e. banks), the main KPI is the bank's 'green asset ratio', being the proportion of its balance sheet exposures to taxonomy-aligned clients. Other metrics apply to certain business activities too, e.g. the bank's brokerage activities and asset management activities.

- For asset managers, the main KPI is calculated by taking the weighted average of the value of the asset manager's investments in taxonomy-aligned economic activities and dividing it by its total assets under management.

- For investment firms, different KPIs apply in relation to the investment firm's (i) dealing on own account activities, which focus on the green assets ratio with respect to the investment firm's assets and (ii) investment services and activities other than dealing on own account, which focus on the proportion of revenue generated from the taxonomy-aligned activities of the investment firm's clients.

- For insurers, different KPIs apply in relation to the insurer's (i) investments, calculated as the weighted average of investments that are directed at funding or associated with taxonomy-aligned economic activities and (ii) underwriting activities, calculated as the gross premiums written on or reinsurance revenue in respect of taxonomy-aligned insurance or reinsurance activities.

The requirements for non-financial undertakings are more straightforward. The rules require reporting of the non-financial undertaking's taxonomy

38 The final legislative proposal was published by the European Commission on 21 April 2021 and is available here.

39 Regulation (EU) 2021/2178, available here.

eligibility and alignment as derived from their turnover, capital expenditure or operating expenditure.

From the perspective of the sell-side parties to a securitisation, the disclosure obligations described above are significant as they create a demand amongst investors for ESG-related data (in much the same way as the SFDR).

Note that the Taxonomy Regulation is not directly applicable in the UK (as the rules were not on-shored) but a UK Green Taxonomy is expected to come into force in the UK by the end of 2022[40].

Box 2: When is an economic activity considered environmentally sustainable under the Taxonomy Regulation?

An economic activity will be "environmentally sustainable" under Article 3 of the Taxonomy Regulation if it:

- Contributes substantially to at least one of the six environmental objectives specified in the Taxonomy Regulation. These are (i) climate change mitigation (ii) climate change adaptation (iii) sustainable use and protection of water and marine resources (iv) transition to a circular economy (v) pollution prevention and control and (vi) protection and restoration of biodiversity and ecosystems.
- Does not significantly harm the other specified environmental objectives. This generally means that an economic activity that causes more harm to the environment than the benefits it brings cannot be considered environmentally sustainable. A more specific meaning is set out in Article 17 of the Taxonomy Regulation.
- Is carried out in compliance with minimum social and labour safeguards, as set out in Article 18 of the Taxonomy Regulation. Broadly speaking, this relates to the manner in which an economic activity is conducted rather than the economic activity itself.
- Complies with the applicable technical screening criteria. Technical screening criteria sets out specific requirements and thresholds necessary to determine: (i) the conditions under which an economic activity qualifies as contributing substantially to an environmental objective, per bullet one above and (ii) whether that economic activity does no significant harm to any of the other environmental objectives, per bullet two above. Technical screening criteria will be published for each of the six environmental objectives set out in the Taxonomy Regulation, via delegated regulations.

40 As set out in the UK Government's Greening Finance: A Roadmap to Sustainable Investing.

4.4 Capital Requirements Regulation ("CRR")

From 28 June 2022, Article 449a of the CRR[41] will require large institutions (effectively, banks) which have securities admitted to trading on an EU regulated market to disclose information on ESG risks, including physical risks and transition risks[42]. Such disclosure is required on an annual basis for the first year and biannually thereafter. The specific disclosure requirements and templates are set out in implementing technical standards[43] developed by the EBA. This requires a series of extensive disclosures to be made, including a range of qualitative and quantitative information on ESG risks and the institution's green assets ratios. From a securitisation perspective, this will again increase the demand for ESG-related information and is designed to incentivise banks to invest in green assets.

Note that, over a slightly longer timeframe, the EBA is required to assess whether a dedicated prudential treatment of assets or activities associated substantially with environmental and/or social objectives would be justified. The relevant report is required under Article 501c before June 2025. The EBA's 2019 Action Plan suggests a discussion paper on this is scheduled for this year. Again, the CRR changes described above are not applicable in the UK.

5. Industry-led principles and second party opinions

When structuring an ESG securitisation, the sell-side parties will often seek to comply with certain industry-led principles and then obtain a second party opinion ("SPO") from a specialist third party that endorses that purported compliance. Together, these practices are intended to reassure investors that the issuance can be legitimately labelled as 'ESG' and form part of an ESG investment strategy. The principles most often relied upon for bond issuances were developed by ICMA (the "ICMA Principles") and many securitisations have applied these principles in the recent past. Separate ICMA Principles have been published for green bonds, social bonds and sustainability-linked bonds, though each set of principles follows a similar structure. Notably, it is possible for a securitisation to comply with ICMA Principles without being entirely collateralised by ESG-friendly assets given the principles adopt a 'use of proceeds' approach as standard. For further details on the ICMA Principles applicable to green bonds, see Box 3.

The other component to the approach described above is the procurement of an SPO. SPOs are a key part of an issuer's pitch to investors, offering assurance that the transaction has been conducted in a manner consistent with the ICMA Principles (or another set of market principles). To produce an SPO, the specialist third party verifier

41 Regulation (EU) No 575/2013.

42 As defined in the report referred to in Article 98(8) of Directive 2013/36/EU.

43 See the EBA's final draft implementing technical standards on prudential disclosures on ESG risks in accordance with Article 449a CRR, available here.

will assess the sustainability strategy and policies of the originator against the requirements of the relevant principles. In connection with this process, the originator may set out its sustainability strategy and policies (such as how it will use the transaction proceeds) in a separate framework document. The framework document may then be made publicly available[44] alongside the SPO itself, intended primarily for review by potential investors.

Box 3: ICMA's Green Bond Principles

The ICMA Green Bond Principles ("GBP") are a set of voluntary guidelines designed to promote robust transparency and disclosure standards for green bonds and to support the development of the green bond market. The four core requirements for alignment with the GBP are summarised below:

- Use of proceeds. This requires the issuance proceeds to be used for eligible 'green projects' that contribute to certain environmental objectives. The GBP provide a non-exhaustive list of certain categories of eligible green projects. The relevant green projects must be described in the legal documentation of the bond (e.g. the 'use of proceeds' section of a prospectus).
- Proceeds for project evaluation and selection. This requires the issuer to communicate to investors (i) the environmental sustainability objectives of the eligible green projects (ii) the process for determining how the projects fit within the eligible green project categories and (iii) information on the processes by which the issuer identifies and manages perceived social and environmental risks associated with the relevant projects.
- Management of proceeds. This requires the net issuance proceeds to be tracked by the issuer and managed in a transparent manner.
- Reporting. This requires issuers to regularly provide information on how the issuance proceeds are used, including a list of the green projects to which the proceeds have been invested, the amount invested and the expected environmentally sustainable impact.

When seeking to comply with the GBP, the issuer or originator may publish a separate 'framework' document that sets out information relating to the above matters (e.g. guidelines relating to how the transaction proceeds may be used). The framework document will be closely examined by any third-party verifier appointed to produce an SPO.

The practice of obtaining SPOs is not without controversy, however. Indeed, a range of concerns have been identified in relation to SPOs and other ESG verifiers and ratings

44 For example, the framework document and SPO for Kensington's Finsbury Square 2021-1 Green PLC RMBS is available here.

providers. For example, IOSCO has previously expressed concerns[45] that there is a lack of clarity and consistency as regards what ESG ratings or data products are intended to measure and their underlying methodologies, and regarding the management of conflicts of interest where ESG ratings and data products providers were closely associated with the companies subject to review. In response to these concerns (and in light of the recommendations made by IOSCO) regulators in both the EU and UK are now focusing on the use of ESG ratings and data products and may develop specific rules that have a bearing on the provision of SPOs for securitisation transactions.

6. Due diligence and disclosure in relation to ESG securitisations

In paragraph 4 we saw that ESG securitisations are currently regulated in a somewhat 'patchwork' manner, primarily through the EUSR and UKSR (on the sell-side) and the SFDR and Taxonomy Regulation (on the buy-side). One of the consequences is that transaction-level disclosure of ESG-related information is not yet standardised. Instead, sell-side parties may find themselves responding to separate (and sometimes conflicting) requests from individual investors, each designed to satisfy their own specific due diligence requirements. Those requests are often made ad hoc during the marketing phase and can vary greatly in terms of detail – some investors expect granular information across several areas, whereas others may raise only high-level questions (if at all). In general terms it is common for investors' due diligence to focus on the following factors:

- The nature of the underlying assets, particularly performance data and how it compares against other assets of the same or similar type.
- How the transaction proceeds will be used, including what post-issuance performance data will be provided in relation to the assets funded by the transaction proceeds. This is particularly important for securitisations that are aligned with the ICMA Principles (or other industry principles) and for the purposes of any associated SPO.
- The key transaction parties (e.g. the originator and sponsor), including details of their ESG policies, standards and reporting.

Originators and sponsors receiving ESG-related questions may additionally be unsure of the appropriate medium in which to disclose ESG information. For instance, some issuers may wish for ESG disclosures to be included within the transaction prospectus whereas others may prefer to respond to investors on a bilateral basis (even if this leads to an unequal distribution of information). This is mitigated in some respects by standardised information being available in respect of certain asset classes: for instance, EPC ratings for RMBS transactions, which may be disclosed through the

45 See IOSCO's "Environmental, Social and Governance (ESG) Ratings and Data Products Providers – Final Report" (November 2021) available here.

standard EUSR (or UKSR) disclosure templates. However, such information alone may not satisfy investors' ESG due diligence requirements, given investors' ESG due diligence requirements will themselves be shaped by the prescriptive regulatory frameworks that we have described elsewhere. One example is where investors are financial market participants within the scope of Article 4 of the SFDR and thus required to produce a PASI Statement outlining whether they consider their investment decisions to have principal adverse impacts on sustainability factors (see paragraph 4.2 above). In those circumstances, investors' ESG data requests may be designed to mirror the detailed content requirements set out in the draft RTS developed under the SFDR (the "SFDR RTS")[46].

These sorts of concerns are well-known amongst market participants and some work has been done to address them in the past. In particular, AFME published a discussion paper[47] last year that set out a series of recommendations for ESG disclosures (on an 'if available' basis) – including a suggested due diligence questionnaire – with a view to bringing about greater consistency across the market. However, concerns remain despite these initiatives. In fact, the market survey conducted by the EBA (and published in its EBA Report) identified the 'lack of data and/or insufficient transparency to identify sustainable assets/projects and to assess sustainability-related impact' as the third biggest challenge to the development of the sustainable securitisation market.

Going forward, it is increasingly likely that ESG disclosures of all types will become more standardised and (in the EU) folded-in to the reporting templates mandated under Article 7 of the EUSR. This seems to be the approach favoured by the joint European Supervisory Authorities, as discussed further in paragraph 7.2(C) below.

7. Potential future developments

We have seen that there is a wide range of legislative initiatives that may shape the development of the nascent ESG securitisation market. The deluge of legislation – both new initiatives and technical standards relating to existing frameworks – is set to continue in 2022 and beyond. In the EU, the EBA Report suggests regulators' efforts will focus in the short term on adapting the Draft Green Bond Regulation to better accommodate securitisation concerns, as opposed to establishing a dedicated securitisation-specific framework (at least for now). Amendments to the EUSR may also be implemented to extend the existing ESG disclosure obligations to a broader range of transactions. The anticipated changes in these areas are outlined below. Readers should be aware that this is not intended to be exhaustive and may wish to refer to broader

46 The latest iteration of the SFDR RTS was adopted by the European Commission on 6 April 2022 (available here) and is scheduled to apply from 1 January 2023, subject to scrutiny by the European Parliament and Council.

47 See 'Discussion Paper: ESG Disclosure and Diligence Practices for the European Securitisation Market' published by AFME in March 2021, available here.

summaries available elsewhere[48].

7.1 Draft Green Bond Regulation

Legislative proposals for the Draft Green Bond Regulation[49] were first published by the European Commission in July 2021. The Draft Green Bond Regulation sets out rules that issuers must comply with if they wish to market their bonds as having met the so-called 'green bond standard', thus allowing them to use the label 'European green bond' or 'EuGB'. This labelling system is intended to help investors identify high-quality green bonds and to promote common standards across both the debt and equity bond markets in the EU.

If a bond is to be marketed as a EuGB under the Draft Green Bond Regulation, the issuer must:

- Fully allocate the net proceeds of the issuance before maturity to economic activities that meet the criteria for environmentally sustainable economic activities (as set out in Article 3 of the Taxonomy Regulation) or will meet such criteria in a defined period of time as set out in a taxonomy-aligned plan. In this sense, the Draft Green Bond Regulation will apply only to 'use of proceeds' transactions and does not consider the ESG credentials of the issuer or any collateral securing the bond.

- Pre-issuance: Prepare a European green bond factsheet in the prescribed form, that has been approved by an ESMA-registered external reviewer and published on the issuer's website (along with the reviewer's pre-issuance review). Any prospectus published in relation to the issuance must describe that the proceeds are being used in accordance with the Draft Green Bond Regulation.

- Post-issuance: Prepare detailed annual allocation reports regarding the use of the net proceeds. The final allocation report must be reviewed by the external reviewer, who must then publish its own post-issuance review. In addition, a green bond impact report in the prescribed form must be prepared when the net proceeds are fully allocated.

48 For example, see "State of Play: Status of European Regulatory developments on Sustainable Finance" published by AFME in November 2021, available here.

49 The European Commission's initial legislative proposal for the Draft Green Bond Regulation is available here. It should be noted however that the Draft Green Bond Regulation is subject to ongoing legislative review and that significant amendments were proposed in the rapporteur's draft report published in November 2021. The proposed amendments include expanding the scope of the Draft Green Bond Regulation and making the EuGB designation mandatory for all green bonds between 2023 and 2028. It is unclear whether these amendments will be included in the final text.

The framework set out in the Draft Green Bond Regulation is intended to be usable for true sale[50] securitisation transactions. However, several issues have been identified with the framework from a securitisation perspective. In particular (and as noted in the EBA Report and elsewhere[51]) the rules envisage that the use of proceeds requirements are applied at the issuer level. This is unlikely to be appropriate for special purpose securitisation issuers because they are in practice only able to use issuance proceeds to purchase the pool of underlying assets from the originator. In turn, this means that:

- A securitisation could only qualify as an EuGB if the underlying portfolio is made-up entirely of taxonomy-aligned assets. This would effectively impose a collateral-based approach for securitisations issued by special purpose securitisation issuers, which is inconsistent with the use of proceeds approach applicable to all other types of bonds.

- The originator in respect of a securitisation marketed as an EuGB would be free to use the transaction proceeds to (re)finance assets that are not taxonomy-aligned.

Similar concerns arise in the context of the disclosure rules under the Draft Green Bond Regulation. At present, the requirements are again designed to apply at an issuer level, which does not account for the nature of special purpose securitisation issuers and the fact that it is originators and sponsors that control information concerning the nature and characteristics of the underlying assets. In other words, the disclosure rules in the Draft Green Bond Regulation are cast too narrowly given special purpose securitisation issuers rely on the originators and sponsors for the provision of data relating to the underlying assets.

To address these concerns (amongst others), the EBA Report proposes a series of amendments to the Draft Green Bond Regulation. The headline proposal is for the use of proceeds requirements to apply at the originator level rather than the issuer level. Significantly, this would allow securitisations that are not backed by a portfolio of green assets to be marketed using the EuGB label, provided the originator (not the issuer) uses the transaction proceeds to (re)finance taxonomy-aligned activities. The danger with this approach is that it permits securitisations carrying the EuGB label to be secured by underlying assets that are not ESG-friendly. However, the EBA suggest that this can be mitigated through additional disclosure rules. Those rules would ensure investors are provided with:

- Information concerning the environmental performance of the underlying

50 Synthetic securitisations are unlikely to be within the scope of the Draft Green Bond Regulation for the reasons described in paragraph 62 of the EBA Report.

51 See AFME's position paper on the Draft Green Bond Regulation, published in December 2021 and available here.

assets, so they can conduct due diligence in relation to the underlying assets to assure themselves that (notwithstanding the EuGB label) the assets are compliant with their own ESG requirements.

- Data enabling ESG comparisons between the underlying assets to the securitisation and the originator's other assets, to guard against originators investing in new assets which are harmful from an ESG perspective with a view to securitising them through an EuGB-compliant securitisation and the risk of adverse green selection of assets[52].

The EBA Report suggests that these additional disclosures could be implemented by mandating that the green asset ratio and the banking book taxonomy-alignment ratio[53] of the originators and of the underlying assets must be disclosed in the pre-issuance factsheet prepared in connection with the securitisation (or similar KPIs, in the case of non-banking financial institutions). Elsewhere, the EBA Report suggests adjusting the disclosure framework and reporting requirements in the Draft Green Bond Regulation, so that they are compatible with Article 7 of the SFDR.

7.2 The EUSR and UKSR

(A) A recap

In paragraph 4.1 we saw that the existing EUSR and UKSR contain a few specific ESG-related disclosure requirements. For instance, the EUSR:

- Requires originators and sponsors of STS securitisations to disclose, where the underlying exposures are residential loans or auto loans or leases, the available information related to the environmental performance of the assets financed by such residential loans, auto loans or leases.

- Gives originators of STS securitisations the option to publish available information related to the principal adverse impacts of the assets financed by the underlying exposures on sustainability factors, in lieu of information on environmental performance (i.e. by way of derogation to the disclosure obligations described in the previous bullet).

These provisions have been revisited recently, both by the EBA Report and the report published by the joint European Supervisory Authorities

52 The term 'adverse green selection of assets' refers to originators selling off legacy 'brown' collateral through the issuance of EuGB securitisation notes whilst retaining high-quality green collateral on its balance sheet.

53 This concept is specified in the EBA's implementing technical standards on Pillar-3 disclosures on ESG risks in accordance with Article 434a of the Capital Requirements Regulation, available here.

(the "ESAs") in May 2022 (the "Joint ESAs Report")[54]. The latter contains a draft RTS prescribing how information concerning the principal adverse impacts on sustainability factors of the assets financed by the underlying exposures of securitisations should be presented (the "Draft STS Disclosure RTS").

(B) Amendments outlined in the EBA Report

In its EBA Report, the EBA was required to examine the EUSR's disclosure and due diligence rules and how the EUSR could better integrate sustainability-related disclosures. When doing so the EBA highlighted that there is a tension in the existing rules between, on the one hand, investors that are required to conduct due diligence in respect of the transactions in which they invest and, on the other, the difficulty in obtaining ESG data in relation to securitisations. These issues generally stem from securitisations falling outside the scope of the SFDR, as explained further above.

The EBA conclude that the EUSR should be amended to improve the availability of standardised data on the principal adverse impact of securitisation investments on ESG factors. The EBA thus propose to:

- Extend disclosures regarding the principal adverse impact of securitisation investments to non-STS securitisations for the same asset classes covered by the Draft STS Disclosure RTS.

- Adjust the ESMA disclosure templates to ensure that loan level data contained in those templates is relevant to determine principal adverse effects at a transaction level, for those transactions within the scope of the Draft STS Disclosure RTS.

- Over the medium term, introduce mandatory principal adverse impact disclosures for all securitisations once the sustainable securitisation market has further matured.

In other words, as an initial step the EBA are proposing to extend the disclosure rules that currently apply to STS securitisations where the underlying exposures are residential loans or auto loans or leases to non-STS transactions in the same asset classes. Further disclosure obligations would then be introduced over the longer term to a wider range of securitisations.

54 See "Joint Regulatory Technical Standards on STS securitisations-related sustainability disclosures", published by the joint European Supervisory Authorities on 2 May 2022, available here.

(C) The Joint ESAs Report and the Draft STS Disclosure RTS

These sorts of issues were examined again in the Joint ESAs Report published in May 2022. The headline objective of the report is to consult on proposed reporting templates (set out in the Draft STS Disclosure RTS) for completion by originators and sponsors when disclosing information about the principal adverse effects on sustainability factors of the assets financed by a securitisation's underlying exposures. At this stage, those templates are stated to pertain only to STS securitisations (both non-ABCP traditional and synthetic) where the underlying exposures are residential loans or auto loans or leases. This is because originators and sponsors are assumed to be submitting information in connection with the derogations to the EUSR disclosure obligations described further above, which only apply to STS securitisations. However, the Joint ESAs Report and the Draft STS Disclosure RTS are of potentially broader significance, as:

- In its report, the ESAs suggest it might be appropriate to allow originators of securitisations backed by other types of underlying exposures to provide information on principal adverse impacts on sustainability factors, if they wish. The ESAs are thus seeking feedback on whether the disclosure requirements should be extended (and the Draft STS Disclosure RTS adjusted) to cover, for instance, commercial real estate, SME loans, corporate debt and trade receivables. It is unclear at this juncture whether the extension being mooted is intended to apply to STS securitisations only or to all securitisations (i.e. including non-STS), though the latter approach would dovetail with the comments in the EBA Report referenced above. EU regulators' approach to these sorts of questions may become clearer when the European Commission publish its Article 46 report in the coming months[55].

- It is possible (though too early to say) that the approach outlined by the ESAs – and the specific disclosures required in the proposed templates – will shape the approach taken by market participants when responding to bilateral ESG information requests going forward.

55 The European Commission is required to produce a report under Article 46 of the EUSR. This was originally due by 1 January 2022 and now expected in the summer of 2022. One of the issues that must be covered by the report is the implementation of the requirements set out in Articles 22(4) and 26d(4) and whether they may be extended to securitisation where the underlying exposures are not residential loans or auto loans or leases.

The disclosure templates themselves are designed to closely align with the templates developed under SFDR. For this reason, the ESAs based the templates set out in the Draft STS Disclosure RTS on Annex 1 of the SFDR RTS, diverging only to take account of the specific characteristics of securitisations and the relevant legal framework. Certain other concepts (e.g. the green assets ratio) are drawn from the delegated regulation produced in relation to Article 8 of the Taxonomy Regulation, as described further in paragraph 4.3 above.

The completed templates are intended to be made available as part of the disclosures mandated under Article 7 of the EUSR (albeit as a standalone document) and, for public securitisations, submitted to a securitisation registered with ESMA.

(D) Position under the UKSR

Under the UKSR regime, regulators are not currently required to report on the development of a sustainable securitisation framework in the same way as the EBA has done[56]. That said, HM Treasury has consulted on various ESG-related issues as part of the review conducted pursuant to Article 46 of the UKSR. As part of that process, HM Treasury indicated[57] that it will consult further on extending the existing Article 22(4) disclosure requirements, but only subject to the availability of the relevant information. It also indicated that it does not expect to set up a standalone securitisation framework in the immediate future, preferring instead to wait until the UK's Sustainability Disclosure Requirements regime is established. No guidance has been given as regards how securitisation will fit within that Sustainability Disclosure Requirements framework.

7.3 The EU and UK prospectus regimes

Both the EU and UK are expected to amend their prospectus regimes in the near future. In the EU, the European Commission's Renewed Sustainable Finance Strategy proposed to adjust the EU Prospectus Regulation[58] to introduce targeted prospectus disclosure requirements, in order to "create minimum requirements for the comparability, transparency and harmonisation of information available for all ESG securities". This is likely to be addressed as part of the European Commission's next review of the EU Prospectus Regulation (as mandated under Article 48), due before 21 July 2022. It is not yet known whether changes will be

[56] This is because Article 45a, which mandates the EBA Report, was inserted into the EUSR after the Brexit implementation period, and no equivalent review has been mandated since.

[57] See HM Treasury's "Review of the Securitisation Regulation: Report and call for evidence response" published 13 December 2021.

[58] Regulation (EU) 2017/1129.

made nor how those changes would interact with the Draft Green Bond Regulation, EUSR or UKSR (as described above).

7.4 Towards dedicated frameworks for green and social securitisation

Another key area is the potential development of dedicated legislative frameworks for green and social securitisations. In the EU, the EBA Report concluded that it is too early to establish a dedicated green framework at this juncture. This is on the basis that securitisations will already be accommodated by the Draft Green Bond Regulation (as amended per the EBA's proposals) and, at present, the priority is to finance new green assets rather than re-financing existing green assets, which lends itself more readily to the EuGB's use of proceeds approach. In this context, a separate and additional securitisation-specific framework – which would likely be collateral-based – may not be appropriate, particularly given the shortage of green collateral at present. A framework for social securitisations is a more remote possibility for the time being, given EU regulatory frameworks have not yet been implemented.

The EBA nevertheless set out some design considerations for future dedicated green and social securitisation regimes. For green securitisation, three alternative approaches were outlined for a framework and labelling system intended to complement the Draft Green Bond Regulation. The three options are as follows:

- Green collateral approach ('light green'). Under this approach, a securitisation could be labelled as a 'green securitisation' if the underlying assets predominantly consist of green assets (for instance, by a two-thirds majority). There would be no restrictions on how the issuer uses the transaction proceeds, as will be the case for bonds using the EuGB label.

- Combined approach ('medium green'). Under this approach, a securitisation could be labelled as a 'green securitisation' if the proceeds of the transaction and the underlying collateral both comply with certain minimum thresholds. By way of example, if both thresholds were set at 50 per cent. then a bond could qualify if at least 50 per cent. of the proceeds are applied for green purposes and at least 50 per cent. of the underlying assets are green. The EBA Report suggests this is pragmatic and reflective of current practises, but may be complex to implement.

- Combined collateral ('dark green'). Under this approach a securitisation could be labelled as a 'green securitisation' if the bond complies with the EuGB use of proceeds requirements (so, 100 per cent. of the proceeds are applied towards taxonomy-aligned activities) and, in addition, a minimum amount of the underlying assets being green. As such, the 'dark green' approach is conceived as a 'bolt-on' to the EuGB framework.

Several associated issues will need to be considered if and when the framework is developed, including whether changes to the Taxonomy Regulation are needed to better accommodate securitisation-related factors[59] and whether transitional assets ought to be eligible for inclusion in the pool of underlying assets.

7.5 The UK's ESG framework

So far this note has concentrated on ESG regulation in the EU as it pertains to securitisation. This is simply because the EU's various ESG initiatives are further advanced than the UK's. For instance, the EU's SFDR and Taxonomy Regulation both originated from the EU's 2018 Action Plan on Sustainable Growth (and entered into force in 2019 and 2020 respectively), whereas UK legislation sharing the same aims is still being developed. The UK Government set out its intended approach in its 'roadmap' published in October 2021[60]. In very broad terms:

- The UK 'equivalent' to the SFDR is the Sustainability Disclosure Requirements. A discussion paper[61] relating to the proposed rules was published by the FCA in November 2021 and closed for comments in January 2022. The regime is expected to set out product classification, labelling and disclosure rules with similar objectives to the SFDR, but the manner in which those objectives will be achieved is expected to differ.

- The UK is seeking to define what counts as environmentally sustainable and address other taxonomy-related issues by adapting the EU's Taxonomy Regulation. A Green Technical Advisory Group was established in June 2021 for the purposes of advising the UK Government on how best to do this. The overall approach is expected to follow the EU's Taxonomy Regulation, but some differences are becoming apparent. As with the EU regime, the UK will develop technical screening criteria for determining whether an economic activity is taxonomy-aligned. The initial focus is the technical screening criteria for climate change mitigation and climate change adaptation, the rules for which are scheduled to come into force at the end of 2022.

There are a number of associated regulatory initiatives in the UK which may prove relevant in a securitisation context in due course (such as consultations

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59 The EBA Report outlines several challenges in this respect, including that the Taxonomy Regulation is currently imprecise for some asset classes and restrictive on what can be classified as green (which reduces the pool of underlying assets that could be securitised under the framework).

60 See the UK Government's paper "Greening Finance: A Roadmap to Sustainable Investing" published in October 2021, available here.

61 See the FCA's discussion paper "Sustainability Disclosure Requirements (SDR) and investment labels" published November 2021, available here.

concerning the regulation of green bonds[62]), but these are either at an early stage of development or not specifically relevant to securitisation. We have not sought to summarise those initiatives here for those reasons.

Finally, the UK Government's 2019 Green Finance Strategy paved the way for listed companies, asset managers, large asset owners and occupational pension schemes to make climate-related disclosures in line with the recommendations of the Taskforce on Climate-related Financial Disclosure ("TCFD"). The requirement to make TCFD-aligned reports are being introduced in a phased roll-out, starting from January 2021 for premium listed companies and the largest pension scheme trustees. This regime is focused on entity-level and product-level reporting, rather than any form of pre-contractual commitment or disclosure. Individual products will need to report on a minimum of four key climate metrics including scope 1 and 2 greenhouse gas emissions, total carbon emissions, total carbon footprint and weighted average carbon intensity. Products which invest in securitisations will therefore need to obtain information on these metrics as they apply to the securitisation.

8. Conclusion

The ESG securitisation market presents a significant opportunity for sell-side parties. Investor demand seems set to continue, and the comparatively small size of the ESG securitisation market at present (when compared to the ESG bonds and loans markets) suggests that there is room for substantial growth. There are a number of challenges that need to be resolved along the way, though. The dearth of ESG-friendly collateral and the absence of standardised disclosure frameworks are at the top of the list, but both may be addressed to some extent by regulators' proposals for reform. Indeed, if those reforms manage to introduce consistent and transparent frameworks centred around a use of proceeds model (perhaps moving towards an ESG collateral approach in due course, when more ESG-friendly becomes available) then the conditions may become ripe for the ESG securitisation market to grow markedly. The danger is that regulators go too far and create an overly burdensome regulatory environment involving myriad complex rules that are too difficult or costly to manage in practice.

If you would like to discuss any of the issues raised in this note, please contact one of the lawyers listed further below or any of your regular Simmons & Simmons contacts.

This note should not be construed as legal advice. Readers are advised to speak to their legal counsel before taking action in relation to any of the matters described above.

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62 See the FCA's consultation paper published June 2021 (available here), which implies, through the feedback requested from stakeholders, that the FCA are considering regulatory intervention in the green bonds market – for example, whether rules concerning use of proceeds approaches should be introduced.

Annex

Examples of sustainable securitisation transactions issued and/or originated in Europe, excluding CLOs

Year	Name	Country	Amount	ABS type	Description
2016	Green Storm 2016	Netherlands	EUR 526.2m	Green RMBS	**Green collateral/green proceeds:** Backed by portfolios entirely made up of energy-efficient mortgages and water use improvements, and the proceeds are used to (re)finance these loans.
2017	Green Storm 2017	Netherlands	EUR 594m		
2018	Green Storm 2018	Netherlands	EUR 582m		
2019	Green Storm 2019	Netherlands	EUR 641m		
2021	Green Storm 2021	Netherlands	EUR 526m		
2017	Premium Green 2017-2	France	USD 3bn	Green synthetic	**Green collateral/green proceeds:** Backed by a variety of loans, including project finance on renewable energy; freed up capital for green lending in diverse sectors.
2020	River Green Finance	France	EUR 189m	Green CMBS	**Green collateral/green proceeds:** Backed by a single loan secured on an energy-efficient office building.
2020	Green Belém No.1	Portugal	EUR 385m (Class A)	Green RMBS	**Green collateral/green proceeds:** Backed by a pool of prime mortgage loans, and the proceeds are used to finance green building and sustainable finance projects. STS-compliant.
2020	La Fayette Asset Securitisation LLC	France	USD 25m	Green auto ABCP	**Green collateral/green proceeds:** Backed by designated green assets, either because the seller is active in green sectors or, as indicated by seller pool data, reports assets and proceeds are used to finance electric vehicles. Subsequent issues include financing for solar energy equipment loans and trade receivables.
2021	Project Boquerón	Spain	EUR 1.6bn	Green synthetic	**Green collateral/green proceeds/green sustainability-linked bond:** Backed by a portfolio of renewable energy efficiency financing; includes a step-down coupon upon meeting specified ESG/impact lending targets and capital relief redeployed to an area which directly cuts carbon emissions.
2021	Kensington's Finsbury	UK	GBP 750m	Green RMBS	**Green proceeds:** The proceeds from the class A are used to finance part of the green

	Square 2021-1				collateral, and the remaining unallocated proceeds will be put towards new green mortgage lending over the next five years. STS compliant.
2021	Gemgarto 2021-1 PLC	UK	GBP 470m	Social RMBS	**Social collateral and social proceeds:** Backed by a pool of prime, performing, first-ranking mortgages and monies used to (re)finance owner-occupied mortgages to underserved borrowers with complex incomes (self-employed, first-time buyers with limited credit history, contractors, retired and/or younger borrowers).
2021	Brass No. 10	UK	GBP 1,932m	Social RMBS	**Social collateral and social proceeds:** Backed by a pool of mortgages targeted towards first time buyers, retired and self-employed borrowers; part of the proceeds used towards social projects including higher-rate savings products and/or competitively priced mortgage products to 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).

Source: Reproduced from the EBA Report, pages 20 and 21

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