# Green ABS: a new opportunity

Building a climate-neutral, green, fair and social Europe is one of the four main priorities set out by the European Council in its strategic agenda for 2019-2024 (the **EC Agenda**). According to the EC Agenda, the success of the green transition *"will depend on significant mobilisation of private and public investments, on having an effective circular economy, and an integrated, interconnected and properly functioning European energy market"*.

## The main green initiatives in Europe

Both stakeholder associations and the European Union have introduced various initiatives to facilitate the green transition in the financial markets.

**The main initiatives include:**

a) the market conventions adopted over time aimed at enabling access to debt capital markets in order to fund projects with a positive environmental impact (**Green Projects**). The main market convention is the Green Bond Principles adopted by the International Capital Markets Association (**ICMA**) and built on best market practices (**GBP**);

b) the nomination by the European Commission of a technical expert group on sustainable finance (**TEG**) to assist it in developing, *inter alia*, an EU classification system (**EU taxonomy**) to determine whether particular economic activity is environmentally sustainable, and an EU Green Bond Standard (**EU GBS**)[1]; and

c) the publication on December 11 2019 by the European Commission of the European Green Deal (**EGD**) which aims for the EU to become the first climate-neutral bloc in the world by 2050[2]. In order to achieve this, the European Commission envisages, *inter alia*, the implementation of the Sustainable Europe Investment Plan (**SEIP**)[3] which will mobilise at least €1 trillion in sustainable investments over the next decade in Europe[4].

## The Securitization market

As regards securitizations, in January 2019 the new regulatory framework for securitizations in the EU[5] came into force (the **Securitization Framework**), setting common standards for all securitizations and defining criteria for "Simple, Transparent and Standardised" securitizations, thus confirming the European regulator's confidence in securitizations as a key tool for the growth and development of the European economy within the capital markets union.

The new Securitization Framework may have an important role[6] in developing securitizations aimed at financing Green Projects (**Green Securitizations**) and convincing investors to invest in environmental projects to achieve the EU's green targets.

To date, however, the demand for asset backed securities issued within the context of Green Securitizations has not been developed at the same level as the growing market for green, social and sustainability bonds.

One of the main problems in developing the Green Securitization market seems to be the lack of incentives in establishing or investing in Green Securitizations (and green finance in general) and of an agreed definition of Green Securitization.

Both stakeholder associations and the European Union have introduced various initiatives to facilitate the green transition in the financial markets.

1 On June 18 2019, the TEG published its report on EU GBS. The TEG proposes that the European Commission creates a voluntary, non-legislative EU GBS to enhance the effectiveness, transparency, comparability and credibility of the green bond market and to encourage the market participants to issue and invest in EU green bonds.
2 https://ec.europa.eu/info/publications/communication-european-green-deal_en.
3 In this respect, please see the European Commission's communication on the SEIP https://ec.europa.eu/commission/presscorner/detail/en/fs_20_48.
4 In particular, the SEIP pursues three main objectives: (i) increase funding for the green transition - mobilise at least €1 trillion to support sustainable investments over the next decade through the EU budget and associated instruments (in particular through InvestEU); (ii) create an enabling framework for private investors and the public sector to facilitate sustainable investments; and (iii) provide support to public administrations and project promoters in identifying, structuring and executing sustainable projects.
5 Regulation (EU) 2017/2402 of the European Parliament and of the Council of December 12 2017.
6 The new Securitisation Framework already introduces a light attention to green securitisation. According to paragraph 4 of Article 22 (Requirements relating to transparency) of Regulation (EU) 2017/2402, if the securitisation's underlying exposures are residential loans, auto loans or leases, the originator/sponsor shall publish the available information on the environmental performance of the assets financed by such loans or leases.

## Types of Green Securitizations

There are three main types of Green Securitizations that can be identified in the market.

The first type of Green Securitizations is securitizations with "green" collateral, i.e. where the asset backed securities are backed by portfolios of green assets (e.g. mortgages to finance energy-efficient homes, electric vehicle loans/leases, solar leases and SME loans to fund environmental projects, etc.).

The second type is securitizations with "green" use of proceeds, i.e. where the proceeds of the asset backed securities are used for investment in Green Projects.

The third type is securitizations where the originator uses freed-up capital or leverage from a capital relief or synthetic securitisation to invest in "green" projects.

The second and third types of Green Securitizations are more similar to ordinary green bonds as the main requirement is that the proceeds or capital relief are utilised for green purposes, meaning that the securitised portfolio can be composed of non-green assets.

## Developing a Green Securitizations market: the AFME Position Paper

With the aim of outlining the key factors needed to boost the development of a Green Securitizations market, on September 11 2019 the Association for Financial Markets in Europe (**AFME**) published a position paper on Green Securitizations (**AFME Paper**) which sets out the following observations below.

### *Definition of Green Securitization*

The GBP defines a *"Green Securitised Bond"* as *"a bond collateralised by one or more specific Green Projects, including but not limited to covered bonds, ABS, MBS, and other structures; and aligned with the GBP. The first source of repayment is generally the cash flows of the assets"*.

The GBP definition of "Green Securitised Bond" needs certain refinements to reflect, *inter alia*, the limited recourse nature of securitizations and the differences between covered bonds and securitizations. Moreover, as some green investors may have flexibility but many will only have a mandate to invest in securitizations collateralised exclusively by green assets, the definition of "Green Securitization" should exclusively refer to transactions collateralised by green assets, thus excluding securitizations where the proceeds of the securitization are applied towards, or regulatory capital or liquidity relief achieved is allocated to, Green Projects and the underlying collateral is not green[7].

The GBP requirements relating to the Green Projects selection and the use of proceeds would be satisfied in Green Securitizations by applying the proceeds arising from the issue of the asset backed securities to purchase portfolios of assets that comply with the relevant eligibility criteria meeting the requirements set out under the applicable green principles/framework[8].

### *Green incentives*

The introduction of tax incentives, a preferential regulatory framework and other initiatives[9] will be fundamental to support the development of the Green Securitization market. For example, the introduction of improved regulatory capital treatment for green asset backed securities or tax incentives (to be introduced at national level) for investing in Green Securitizations could help promote Green Securitizations to all investor categories, not only to those with a green mandate.

### *Disclosure and reporting*

With respect to green bond transactions, under GBP and the TEG report on EU GBS, monitoring and reporting on the compliance with the relevant green requirements are key elements to ensuring the development of the green bond market. However, since the Securitization Framework already sets out high disclosure requirements for securitizations[10], AFME does not consider it necessary to introduce specific additional monitoring and reporting obligations for Green Securitizations [11].

7 In any case, according to AFME, a securitisation transaction with non-green underlying collateral where the proceeds are invested in, or regulatory or liquidity capital relief allocated to, Green Projects, could qualify as a green bond under the GBP.
8 E.g. the eligibility criteria on a green RMBS transaction would typically include the minimum requirements relating to Energy Performance Certification (**EPC**) and on an auto loan transaction the minimum requirements relating to emissions standards.
9 According to the AFME Paper, other potential incentives could include: (i) reduced hair-cuts for central bank eligibility schemes; (ii) bespoke LCR limits; (iii) ongoing governmental and regulatory support by way of guarantees and the related regulatory benefit; and (iv) subsidies for establishing new Green Projects.
10 E.g. information related to environmental performance of "residential loans or auto loans or leases".
11 The repercussions of any breach of a green asset warranty would be limited to the usual repurchase obligations of an originator and the ongoing reporting would be no different from that of a standard securitisation transaction.

## *Need for specific eligibility criteria and trigger events*

Green Securitizations need to set out green eligibility criteria to provide a framework for policing compliance with the applicable green principles or taxonomy of the underlying assets in order to avoid greenwashing practices.

On most public Green Securitizations, the green requirements will be tested on the closing date (or, in the case of a revolving transaction, on each transfer date) by the application of eligibility criteria that comply with the relevant green principles or taxonomy. Disclosure of the green aspects of the transaction in the prospectus would be limited to the description of the eligibility criteria and no bespoke green triggers or default events would be required[12].

However, additional green triggers or default events may be required in certain circumstances. For example, where the underlying collateral contains ongoing green obligations[13] the transaction would need to consider what the repercussions would be of a breach of any such ongoing obligation and how this should be reflected in reporting.

## *Evolution of green technology over time*

As standards evolve over time, a securitization originally considered to be a Green Securitization could lose its green status, which would impact pricing and liquidity in the secondary market. Ongoing reporting and transparency will therefore, be important for when standards change on legacy transactions, and long-term securitization structures may require flexibility to evolve over time in order to remain green as standards develop and become more stringent[14]. Furthermore, any regulatory capital or similar incentives introduced for Green Securitizations should include grandfathering for securitizations that have ceased to be considered green over time as a result of the evolution of technology to mitigate any sudden detrimental impact on pricing and liquidity in the secondary market.

---

12 This would be the case for any transaction where the green aspects of the deal cannot change over time (e.g. any RMBS transaction or auto loan transaction where the relevant EPC certificate or emissions standard is certified upfront).

13 E.g. key deadlines for achieving a minimum energy efficiency improvement. In such cases, details of these ongoing obligations will likely need to be included in the relevant prospectus.

14 Consideration should be given to whether the appropriate green bond criteria and/or taxonomy requirements against which a portfolio is tested should be those that applied on the date the relevant receivable was originated to ensure that where a green portfolio is refinanced the new securitisation transaction could still qualify as a Green Securitisation.

## *The green securitization framework*

Both GBP and TEG's report on EU GBS provide for the publication of a "green bond framework" by the issuer to explain how the issuer's strategy aligns with the environmental objectives, and provide details on all key aspects of the proposed use of proceeds, processes and reporting of green bonds. Whether a green framework will be required for Green Securitizations needs to be clarified. As the green framework is deemed by ICMA and TEG to be a key element in ensuring transparency for investors and market participants in general, we would expect the publication of a green framework will be needed in order to obtain the Green Securitization label[15].

## Final thoughts

The green transition requires the engagement and the commitment of all capital markets players' for the implementation and the development of Green Securitizations.

The capital markets union (similar to the growth of the green bond market in recent years) may constitute a key part in achieving the EU's green targets, allowing the investment community to make full use of the emerging EU framework for sustainable investments.

With the aim of creating a fertile ground for the development of the Green Securitization market in Europe, the regulators and policymakers need to:

i) clarify the Green Securitization concept, including the specific requirements to be satisfied;

ii) permit originators to grant green loans with a quicker credit process and more favorable risk-weighting treatment;

iii) increase the appeal of Green Securitizations to enlarge the community of investors (currently limited to niche green funds);

iv) create a clear and certain labelling process for Green Securitizations; and

v) introduce incentives for Green Securitizations, allowing investors to benefit from more favorable pricing for Green Securitizations.

**Protecting** the existing green initiatives, **restoring** and increasing the interests of originators and investors in Green Securitizations and **funding** Green Projects seem to be the key elements needed in order to achieve the goal of a green transition and a more sustainable market; not just for securitizations but for the whole EU debt capital markets.

## Contacts

Corrado Fiscale
Partner, Milan
T +39 02 720 2521
corrado.fiscale@hoganlovells.com

Federico Del Monte
Partner, Milan
T +39 02 720 2521
frederico.delmonte@hoganlovells.com

Annalisa Feliciani
Counsel, Rome
T +39 06 6758 23 1
annalisa.feliciani@hoganlovells.com

Giulia Arenaccio
Counsel, Rome
T +39 06 6758 23 1
giulia.arenaccio@hoganlovells.com

Matteo Scuriatti
Associate, Rome
T +39 06 6758 23 1
matteo.scuriatti@hoganlovells.com

As standards evolve over time, a securitization originally considered to be a Green Securitization could lose its green status, which would impact pricing and liquidity in the secondary market.

15 Taking into account the nature of securitisation transactions, regulators and policymakers should consider whether such framework should be prepared and published by the issuer, the originator or other parties of the transaction. As originators or other transaction parties may already have a green bond framework in place for green bond issues, coordination between green bond and Green Securitisation principles/regulations should also be considered.