Climate countdown

A green synthetic securitisation framework remains lacking, despite the current regulatory focus on ESG. **Stelios Papadopoulos** reports.

Green lending targets in use-of-proceeds synthetic securitisations are expected to become more of an obligation going forward, but such a change should be accompanied by clear parameters and consequences for failing to satisfy that obligation. Nevertheless, a framework for green synthetic securitisations that renders this task more realistic is currently lacking, among other challenges that will keep this segment of the market constrained for the foreseeable future.

According to Mira Lamriben, policy expert at the EBA: "Regulatory capital should be there to absorb losses. But with synthetics, we have the notion of capital relief, and this is the challenge within the prudential framework when you think about use of proceeds."

She continues: "The way issuers of green securitisations have dealt with this issue legally until now was to stipulate contractually that the redeployment of capital or funding from brown to green assets was carried out on a 'best-effort basis'. So, if banks can't meet their green lending targets for various reasons, there's no legal risk. However, the requirements will become more stringent going forward."

Leanne Banfield, counsel at Linklaters, responds: "Originators will often agree that any regulatory capital saving is plugged back into sustainability lending, but there is often very little in terms of contractual obligations, with this tending to be on a best-efforts basis. Yet this is akin to the issues faced by the green bond market, which has in part seen more sustainability-linked bonds with measurable KPIs."

She adds: "If regulation makes the use-of-proceeds application into an obligation, then the legal documentation will need to have very clear parameters around this and address the consequences of the bank failing to satisfy it. This could include higher paid coupons or an ▶

Mira Lamriben, EBA

Leanne Banfield, Linklaters

early termination. This will become an important point for investors to negotiate."

The EBA acknowledged the lack of a framework for green synthetic securitisations in its landmark report on sustainable securitisation *(SCI 2 March)*, but is leaving it to the market to decide the best practices that will then inform its conceptualisation. According to the EBA report: "More time would be needed to assess whether and how the specificities of synthetic securitisation should be reflected in a green framework, especially given that no green standard has been considered yet for any credit protection instrument. It is therefore proposed that the EBA is mandated to monitor the development of the EU green synthetic securitisation market and, if appropriate, further investigate the relevance and potential content of a framework for green synthetic securitisation."

Nevertheless, the supervisor has laid out the building blocks by clarifying the main challenges and questions pertaining to green synthetic securitisations, as well as the rationale for the use of these instruments. The report recognises that "synthetic securitisation may contribute to a more sustainable economy by enabling credit institutions to overcome capital constraints to generate new sustainable investments".

The idea here is to enable banks to free up capital held against brown assets that would then be redeployed towards green lending. The latter has been welcomed by market participants, given the limited supply of green assets.

Adelaide Morphett, associate at Newmarket, notes: "There is a limited supply of green assets, as evident by the low green asset ratios of EU banks, which was just 7.9% across a sample taken by the EBA in May 2021. So, if you want to catalyse more sustainable synthetic securitisations, then use of proceeds is an additive path forward, freeing up capital from brown assets to redeploy towards new green lending."

However, some investors argue that brown assets are actually a fraction of bank balance sheets. If that's the case, then the whole discussion over the redeployment from brown to green might perhaps be questionable.

> "THERE IS A LIMITED SUPPLY OF GREEN ASSETS, AS EVIDENT BY THE LOW GREEN ASSET RATIOS OF EU BANKS"

According to one capital relief trades investor: "The stated rationale behind use of proceeds is that brown assets are clogging up bank balance sheets, but for most large banks they are a small fraction of their books. Banks started to restrict lending to brown projects – such as coal – many years ago and, as these project loans have amortised over time, the extent of their representation has declined. It's useful to point out that this amortisation will persist."

He continues: "Active capital management allows banks to reallocate capital more frequently and with a very relevant view on the use of proceeds. With every (re)allocation decision, banks can incrementally improve the profile of their lending. Focusing predominantly on 'brown' to 'green' is sub-optimal."

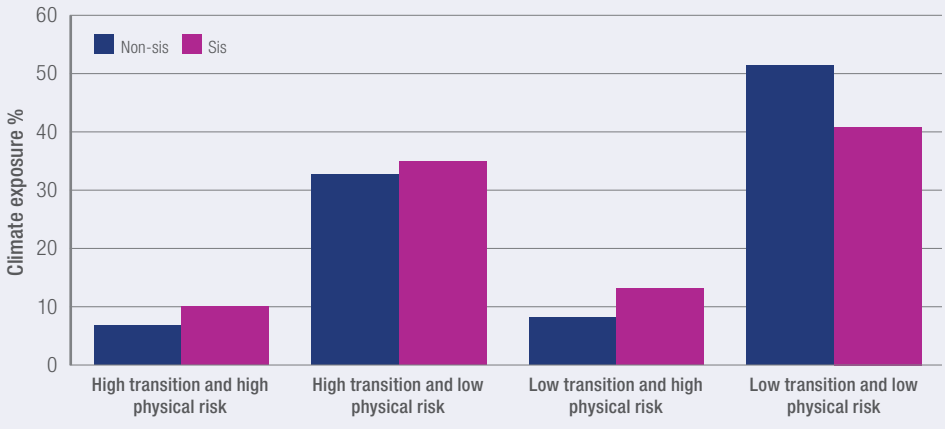
Moreover, ESG scores or ratings – which are available for most large public companies – should be a key component of credit risk analysis in any asset class. Governance and environmental issues lead to very fundamental credit risk considerations. Companies that don't pay attention to ESG issues will have to deal with the repercussions of that in terms of both reputational and credit risk down the line.

According to an ECB analysis, as of September 2021, the share of bank loans exposed to climate risk and specifically high transition and high physical risk is 10% for 'significant institutions' and less than 10% for 'non-significant institutions'.

The ECB analysis conceptualised climate exposures as those subject to physical and transition risks. Exposures are categorised as high transition risk if a firm's absolute emissions fall into the 70th percentile of Scope one, two and three emissions for the entire sample. Exposures are categorised as high physical risk if a firm's probability of suffering from a wildfire, river or coastal flood within a given year is over 1%.

The Scope one, two and three classification is a widely used emissions classification scale

Figure 1: EU bank climate exposures



Source: ECB

David Saunders, Santander

among supervisors and academics. Scope one emissions refer to a company's direct emissions, Scope two encompass indirect emissions – such as purchased electricity – and Scope three emissions refer to all emissions along a company's value chain.

However, the modelling and data issues around climate exposures are well known, so any figures should perhaps be taken with a grain of salt. In fact, banks and investors are waiting for the results of the ECB's final climate stress tests for some answers *(SCI 3 December 2021)*. Hence, what counts as 'green' and 'brown' remains far from clear.

Another key obstacle is the data and monitoring of use of proceeds. Measuring and monitoring the redeployment of capital to green assets is difficult. According to the EBA, in a green use-of-proceeds synthetic securitisation, the amount of assets generated by the transaction would be dependent on the credit risk associated with the green assets.

As a result, to ensure proper monitoring of the green use of proceeds in the context of synthetic securitisation, the exact capital charges of the newly generated green assets would need to be known and disclosed. Moreover, the prudential implications of green synthetic securitisations are uncertain at present, due to the lack of data on the credit risk performance of green assets.

However, the EBA's position on this has raised eyebrows with originators, since the measurement and monitoring of redeployment isn't just an issue for synthetics. "Overall, it's an issue to link assets to the EU Taxonomy. However, since the challenge is similarly present in the case of green bonds, regulators should also consider this as a similar concern. From our perspective, our reporting frameworks are robust enough to address such issues," says David Saunders, executive director at Santander.

The EBA has responded to these concerns by stating that although there are "some challenges in the monitoring of the use of proceeds for green bonds, the situation is different for green synthetic securitisations – which are not green financing instruments by nature, but green protection instruments."

"OVERALL, IT'S AN ISSUE TO LINK ASSETS TO THE EU TAXONOMY"

Yet the equivalent in the case of synthetics would be the freed-up capital that is redeployed, rather than the lump sum cash resulting from the sale of green bonds. The latter is a mechanism that the EU's own institution – namely, the EIF – has utilised for its SME financing activities via its synthetic securitisation programmes.

The future of green synthetic securitisations will be determined by market practice and here the innovation is notable. Santander's Project Boqueron transaction is a case in point *(SCI 21 October 2021)*. The transaction was carried out with Newmarket last year and references a €1.6bn portfolio.

The significant risk transfer trade champions ESG lending through three unique features, both at inception and during reinvestment. First, the portfolio is focused on ESG assets at issuance, including projects across 21 countries and more than 50% in renewable energy projects. Second, coupon incentives exist to replenish the portfolio with further ESG assets during the revolving period.

Finally, the trade includes coupon incentives for utilising the capital released to further grow Santander's lending to new ESG assets globally outside the transaction, using a novel approach of linking growth to megawatts funded through green projects, as opposed to simply focusing on RWA metrics. Megawatts is an objective standard that investors desired, since it can be audited and reviewed.

However, the incorporation of environmental risks into the prudential framework will be equally important. Jo Goubourne Ranero, consultant at Allen & Overy, explains that the EBA is keen to keep reflection of environmental risks in the prudential framework risk-based and data-driven and has little appetite for introducing 'green' supporting factors or 'brown' penalising factors.

Ranero comments: "The EBA is wary of prudential regulation being used as a substitute for public policy, such as effective emissions pricing and of unintended impacts. This includes over-stating or under-stating capital requirements, relative to quantifiable risk, or incentivising a shift in 'brown' or transitional financing to shadow banking."

She concludes: "Several changes and clarifications to the Pillar One prudential framework – potentially including a large exposures-style concentration limit and/or reporting and monitoring requirement for significant exposures to environmental risk – are, however, contemplated. The EBA also notes that it is working on integrating environmental considerations into the Pillar Two framework, including in the Supervisory Review and Evaluation Process and stress tests." ■

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