

## EBA Report on Sustainable Securitisation in Europe: Welcome Regulatory Pragmatism

*In a long-awaited report, the EBA offers timely recommendations for Europe's developing sustainable securitisation market in a world transitioning to green.*

### Key Points:

- The report champions a pragmatic approach to facilitating the development of a sustainable securitisation market in Europe in the context of current challenges, including the limited supply of available green collateral.
- The report recommends applying the proposed EU Green Bond Standard to securitisations on an adjusted basis and favours a use of proceeds approach at the originator level.
- The report concludes that the adoption of a dedicated framework for sustainable securitisation would be premature at this juncture.

On 2 March 2022, the European Banking Authority (EBA) published a report titled “Developing a Framework for Sustainable Securitisation” (the Report) setting out its recommendations for the development of the market. The publication follows a mandate in the EU Capital Markets Recovery Package, introduced last year in response to the pandemic, for the EBA to produce a report to develop a specific EU regulatory framework for sustainable securitisation, which the European Commission would take into account in its report to the European Parliament and Council on the creation of a sustainable securitisation framework.

Although the European sustainable securitisation market has been steadily growing in recent years, several factors have limited its growth. Among these, the applicability of sustainability requirements to securitisations within the EU regulatory framework requires clarification. Financial instruments issued in securitisations do not currently fall within the scope of the EU Taxonomy Regulation or the Sustainable Financial Disclosure Regulation (SFDR), contributing to inconsistencies in interpretation and a lack of harmonisation across different financial products with ESG characteristics.

This Client Alert analyses the Report's recommendations and highlights the disclosure and due diligence requirements.

## Overview

Pragmatism is one of the drivers of the Report's recommendations, which acknowledge not only the particularities of securitisation, such as the variety of products and the multiplicity of parties, but also the immaturity of the current EU sustainable securitisation market and the need for consistency with existing and still-evolving ESG standards. With market development as a priority, at this stage the EBA recommends a transitory approach to ensure that regulation does not stifle, but rather encourages, the growth of green assets, specifically financing new green assets rather than refinancing existing ones.

The EBA seeks to be reasonable and proportionate as to what can be achieved now as the market transitions towards a more robust supply of green collateral, while being mindful of greenwashing risk. Moreover, the EBA emphasises the importance of a holistic approach to ensure a consistent treatment of securitisation and covered bonds.

## Key Findings and Recommendations

According to the EBA, the EU green securitisation market remains small, particularly when compared to the US or Chinese green securitisation markets or the EU sustainable covered bonds market, with fewer than 15 securitisations specifically labelled as green or sustainable issued in the EU market so far. Stakeholders consulted by the EBA identified primary challenges, specifically a lack of:

- Available sustainable assets;
- Definitions, standards, and data to foster transparency and credibility; and
- Attractiveness of securitisation products more generally.

Based on this assessment, the EBA's key policy recommendations for the Commission are as follows:

1. The framework that the EU GBS would establish should apply to securitisations, subject to certain adjustments that enable a use of proceeds approach to financing new green assets.
2. It is premature to develop a dedicated framework for sustainable securitisation while the market transitions.
3. Sustainability-related disclosure and due diligence requirements should apply to sustainable securitisation, to provide transparency to investors on the sustainability-related characteristics of the underlying portfolio, the use of proceeds, and the originator.

## Application of the EU GBS to Securitisations

The legislative proposal for an [EU GBS](#) was introduced last year to establish a "gold standard" for green bonds, with the aim of improving transparency in the green bond market. The EU GBS label, which is initially intended to be purely voluntary (i.e., issuers would still be able to market bonds in the EU as "green" without complying with EU GBS requirements), would require the satisfaction of criteria related to disclosure, external review, and 100% use of proceeds of the green bonds to finance investments complying with the [EU Taxonomy](#) under the EU Taxonomy Regulation.

The proposed EU GBS regulation provides that only traditional "true-sale" securitisations should be within scope (thereby excluding green synthetic securitisations and social securitisations) and the requirements should apply at the level of the securitisation vehicle, i.e., the issuer. This arrangement would effectively

require the issuer to use the proceeds of the securitisation to constitute a portfolio of entirely green assets that comply with the EU Taxonomy in order to satisfy the EU GBS criteria.

Although the EBA agrees with the Commission's proposal that the EU GBS should apply to "true sale" securitisations only, the EBA proposes the following in the Report:

- **The EU GBS requirements should apply at the level of the originator rather than the issuer:** Given that the originator is the entity of broader economic substance in a securitisation, compliance with the EU GBS criteria should apply at the originator level rather than the issuer. It would be a counterintuitive outcome if the originator could, theoretically, use the proceeds of a sustainable securitisation to finance non-green assets. Furthermore, this approach would allow for broader application of the EU GBS by enabling securitisations of non-green assets to obtain the EU GBS label, provided that the originator commits to using all of the proceeds towards financing new green assets. In other words, securitisations that are used solely to finance new green assets should be able to benefit from the EU GBS label, even if the underlying portfolio is not green or not entirely green, given the current scarcity of green assets to securitise. The approach is also more consistent with that adopted for other types of asset-backed bonds, thereby encouraging the transition toward a greener economy. In case of transactions with multiple originators, however, clarity will be required as to which originator the requirements should apply to. The Report states that, in the medium term, EU GBS compliant securitisation structures should increasingly also rely on underlying green assets as more green assets become available in the economy.
- **Additional originator-level disclosure should be required:** The EBA recommends that additional disclosure be required to ensure that investors are aware of the green characteristics of the underlying portfolio (or lack thereof) and minimise the risk of an "adverse green selection of assets" (for instance, when originators are incentivised to originate brown assets in the knowledge that these could be securitised in accordance with the EU GBS to finance green assets). The EBA proposes that the green asset ratio and the banking book taxonomy aligned ratio (if and when applicable) of both the originator's overall balance sheet and the securitised exposures be disclosed in the EU GBS factsheet for comparability and accountability.
- **Monitoring the use of proceeds:** While the Report does not spell out the reporting or monitoring requirements for an EU GBS compliant securitisation to assess whether the originator has complied with the intended use of proceeds, the Report does refer to the EU GBS requirements for European green bonds. The EU GBS proposals would require an external reviewer to be appointed to conduct a pre-issuance review of the EU GBS fact sheet, an allocation report every year until full allocation of the proceeds, a post-issuance external review following full allocation of the proceeds, and an impact report after the full allocation of the proceeds at least once during the lifetime of the bond. Further clarity on how these requirements would apply to ESG securitisations at the level of the originator would be welcome.

The use of proceeds approach at the level of the originator can be seen as prudent at this stage of the market's development. The EBA stresses in the Report that this approach should be viewed as an intermediate step to finance the creation of new green assets. In the absence of this approach, the development of a market for sustainable securitisations would likely be constrained. However, at the appropriate moment in the future, the use of proceeds approach could move gradually towards or even be replaced by the collateral approach.

## Establishing a Dedicated Framework for Green Securitisation

The EBA concludes that the adoption of a dedicated framework would be premature given the current state of the market, even though it would offer an additional label and promote standardisation and consistency in the use of the term “green securitisation”.

For **traditional “true sale” securitisations**, the EBA points to the small size of the market and lack of green assets, recommending a wait-and-see approach to gain a more holistic view on all asset-backed securities as the EU GBS has not yet been adopted and no green framework is considered for other asset-backed securities. The EBA recommends:

- Avoiding a dedicated framework for sustainable securitisation in addition to the EU GBS, noting that a collateral-based approach would likely be inconsistent with the goal of encouraging new green asset financing, and such a framework may be more appropriate once the EU economy has further transitioned with the availability of more green assets; and
- Undertaking a future re-evaluation based on holistic assessments of dedicated green frameworks for other asset-backed securities to ensure a consistent treatment across different securities.

For **green synthetic securitisations**, the EBA believes the adoption of a dedicated framework is premature, despite synthetic securitisations falling outside the scope of the EU GBS proposals, as they are considered credit protection rather than financing instruments. According to the EBA, the private and bespoke nature of the synthetic securitisation market, the difficulty in measuring and monitoring the redeployment of capital, and the lack of a green framework for other types of credit protection instruments support the wait-and-see approach. The EBA expects that, with time, the knowledge gap will be narrowed and the holistic view necessary for designing such a framework will be acquired.

While such an approach is pragmatic given the current state of the market, the EBA should avoid being too cautious and should not wait too long before seriously engaging with the adoption of a dedicated framework for synthetic securitisations. This is especially the case given that treating synthetic securitisations differently from true-sale securitisations because of their financing status is not fully justified. After all, synthetic securitisations structured as direct issuances by the originator or another entity in the originator's group serve funding as well as risk mitigation purposes — in addition to their credit protection and risk mitigation function. In addition, the redeployment of released capital in a green synthetic securitisation involves equivalent levels of green loan origination as the use of proceeds in a “true sale” securitisation, again bringing into question whether singling out synthetic securitisations is justified from a transactional perspective.

For **social securitisations**, the EBA takes a similar position as for green synthetic securitisations, recommending that the adoption of a dedicated framework is premature and should only be considered following the adoption of an EU social bond framework and further development of the market.

## Potential Dedicated Green Securitisation Frameworks

Although the Report does not recommend the adoption of a dedicated green framework for securitisation, it nonetheless explores three alternative approaches for establishing such a framework whereby a “green securitisation” label would be introduced.

	Approach	Pros	Cons
Green collateral approach <b>(Light Green)</b>	<p>A “green securitisation” label would apply if the collateral backing the transaction is composed of predominantly green assets, even if the proceeds are not used to finance green assets.</p> <p>This label would apply as an alternative to and in parallel with the adjusted EU GBS (100% green use of proceeds approach), so that securitisations that do not have sufficient green assets can still be eligible for the EU GBS.</p>	<ul style="list-style-type: none"> <li>✓ Simplified framework for securitisations that already have sufficient green collateral for origination.</li> <li>✓ Easy to comprehend for investors (for whom a collateral based approach is more tangible than use of proceeds).</li> <li>✓ Serves as an alternative to the EU GBS.</li> </ul>	<ul style="list-style-type: none"> <li>▪ Lack of green assets to securitise.</li> <li>▪ Inconsistency with current market practices, which favour a combined approach.</li> </ul>
Combined approach in parallel to EU GBS <b>(Medium Green)</b>	<p>A “green securitisation” label would apply if a transaction has a minimum share of green use of proceeds <u>and</u> a minimum share of green collateral in the underlying portfolio.</p> <p>This label would apply as an alternative to and in parallel with the adjusted EU GBS (100% green use of proceeds approach), so that securitisations that do not have sufficient green assets can still be eligible for the EU GBS.</p>	<ul style="list-style-type: none"> <li>✓ Pragmatic and flexible — during the transition phase, the share of green use of proceeds may be higher than the share of green collateral; conversely that ratio may be reversed once the economy has further transitioned.</li> <li>✓ Reflective of current market practices.</li> </ul>	<ul style="list-style-type: none"> <li>▪ Complex to implement as the two different thresholds would need to be calibrated.</li> <li>▪ May not accommodate different types of securitisations.</li> </ul>
Combined approach integrated to EU GBS <b>(Dark Green)</b>	<p>The “green securitisation” label would consist of the adjusted EU GBS (100% green use of proceeds) <u>together with</u> a minimum share of green collateral in the underlying portfolio.</p>	<ul style="list-style-type: none"> <li>✓ Creation of a high-quality standard (requiring both use of proceeds and green collateral).</li> <li>✓ Consistent with the EU GBS.</li> </ul>	<ul style="list-style-type: none"> <li>▪ Unlikely to be used in practice due to the lack of green assets.</li> </ul>

In addition, the EBA provides further recommendations and safeguards for the Commission to consider in case it decides to publish a legislative proposal for the creation of a dedicated green framework for securitisation:

- The adjusted EU GBS should remain applicable to securitisations and the dedicated framework should act only as an alternative voluntary standard.

- The relevant definitions (green assets, green use of proceeds) should be aligned with the EU Taxonomy definitions, and the implementation of the EU Taxonomy in this area should be assessed from a broader, holistic perspective.
- Although transitional assets under the EU Taxonomy should be considered green during the transitional phase, assets “which significantly harm the environment” should be excluded from the green securitisation framework.
- Although the [Simple, Transparent, and Standardised \(STS\) label](#) from the EU Securitisation Regulation should be kept separate, synergies between the STS and green labels (such as streamlining the procedure for obtaining both labels for a single transaction) should be considered.

Finally, although the EBA admits that additional disclosures may effectively complement the existing framework, any additional disclosures should be kept voluntary until the overall EU disclosure regulations for the EU Taxonomy aligned products are finalised and related uncertainties are resolved.

### **Disclosure and Due Diligence Requirements**

Currently, securitisation products are not within the scope of the SFDR as they are not considered “financial products” within the meaning of the SFDR. In this context, the EBA was also mandated to investigate the potential integration of sustainability-related disclosures into the EU Securitisation Regulation.

Considering the importance of standardised data on the principal adverse impact (PAI) of securitisation investments on ESG factors (as applicable to certain asset classes under the SFDR) in supporting the transition to a sustainable economy, the EBA backs the extension of PAI disclosures to securitisations beyond currently requirements under the EU Securitisation Regulation. The current requirements only cover STS securitisations in respect of residential loans or auto loans underlying assets. However, the EBA is careful to state that such disclosure requirements should only be mandatory once the market has reached further maturity.

On the other hand, the EBA did not deem any additional ESG due diligence requirements necessary, given the existing requirements under the EU Securitisation Regulation and the additional disclosure requirements from the EU GBS.

### **Conclusion**

The Report’s recommendations are timely and welcome given the still-incipient status of the sustainable securitisation market in the EU, and the recent regulatory changes imposing additional compulsory disclosures under the EU Securitisation Regulation with which the EU securitisation market still needs to contend.

While stakeholders in the market continue to support a collateral-based approach in the long term, the use of proceeds approach at the originator level in the near term has the potential to be a powerful tool to enable originators to monetise existing brown assets and divert funds towards financing new green assets. The EBA recommends taking a transitory approach given the competition for green assets between covered bonds and securitisations, and the limited size of the current EU market for sustainable securitisations. Such an approach would enable the financing of new green assets and reduce the focus on refinancing a currently limited pool of existing green assets, until adequate disclosures ensure that concerns over adverse asset selection are addressed and proceeds are appropriately redeployed.

Whether the Commission will issue a legislative proposal for a dedicated green securitisation framework, and whether any such framework will incorporate a collateral approach to some degree, remains to be seen. Hopefully, the Commission will take into due consideration the EBA's keen awareness of the state of the market and strong focus on the EU-level policy objective of supporting the transition to a green economy without stifling the development of securitisation.

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