Client Alert | Banking / Capital Markets

2018 Set to be the Breakthrough Year for Green Loans and Green Securitisations

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While green bonds have been a high profile and popular instrument in the capital markets for the past few years, we expect 2018 to be a transformational year for the green loan market with the emergence of the first green CLOs and green residential mortgage-backed securities ("RMBS") which may ultimately become the primary source of financing for green loans (in particular longer dated green loans).

As discussed below, unlike the frameworks which have been developed and applied to green bond transactions there are currently no universally agreed principles that define what constitutes a green loan or a green securitisation, with both terms being used generically to describe loans or securitisations designed to have a positive environmental impact (for example, through providing financing for energy efficient housing). However, for the reasons described below, we expect 2018 to be the year that such standards begin to emerge, as both regulators and market participants turn their attention towards green investments.

At the forefront of these developments, White & Case is working with The Bank of England and The People's Bank of China, as co-chairs of the G20 Sustainable Finance Study Group, to help develop global standards for green CLOs, with recommendations expected at the G20 Leaders' Summit (30 November to 1 December 2018) later this year.

Favourable Regulatory Tailwinds

Global securitisation markets have been subject to considerable regulatory uncertainty since 2008, with the multi-year introduction and implementation of the Capital Requirements Regulation in the EU and Dodd-Frank in US.

In 2018, however, much of this uncertainty has finally passed, with the US risk retention rules now fully implemented and the EU Securitisation Regulation entering into force on 18 January 2018 (with effect from 1 January 2019). As a result, regulators have begun to turn their focus away from issues raised by the financial crisis towards considering how they can actively encourage the use of finance to support green initiatives.

While most of the MEPs' proposed amendments to the Securitisation Regulation were not included (increasing the risk retention requirement and closing the EU securitisation market to all but EU-regulated sponsors and investors) in the final text, one proposal welcomed by the market was a requirement for sponsors or originators of securitisations to publish information on the energy efficiency of the underlying assets in RMBS and auto loan securitisations (securitisations of debt products financing car purchases)

designed to receive beneficial regulatory capital treatment under the STS (simple, transparent and standardised) regime.

The Securitisation Regulation does not make energy efficiency a condition of STS; rather, the purpose of these disclosure requirements is to allow investors to "consciously decide to invest greener".[1] It seems likely, however, that regulators will soon take a more active role in promoting sustainable finance, both by developing common standards for green investments and making preferential regulatory capital treatment conditional on achieving certain environment outcomes (and penalising activities with a negative environmental impact).

The European Commission High-Level Expert Group on Sustainable Finance published its final report (the "**Expert Group Report**") in January 2018, which recommends that the European Commission investigate whether there is a risk-differential justifying the introduction of 'green supportive' and 'brown penalising' factors.[2] In response, the European Commission's Action Plan on Sustainable Finance, published on 8 March 2018, includes a commitment to "explore the feasibility of the inclusion of risks associated with climate and other environmental factors… in the calibration of capital requirements of banks".[3]

Untapped Investor Demand

Regulatory initiatives have the potential to supercharge demand for green loans and green mortgages at a time when investor demand for green investments already far outstrips supply, with investors representing US$24 trillion calling for the creation of more green investments[4] (compared with a green loan market in 2014 of US$165 billion, representing only 15% of the value of all syndicated loans).[5]

From an investor perspective, green loans offer a number of advantages, in addition to the headline benefit of helping to combat climate change. Compared with a standard loan, green loans require more detailed analysis of the underlying assets, allowing banks to gain greater insight into the credit-worthiness of the borrower. Using proceeds to improve efficiency and reduce negative environmental effects also tends to increase the value of the underlying assets and reduce the risk of depreciation as markets become more sensitive towards concerns about energy efficiency and sustainability.

Compliance with use of proceeds restrictions requires companies to have systems in place to record the environmental impact of their activities. Many companies are already implementing these systems in response to pressure both from government policy (e.g. the recommendations made by the Task Force on Climate Related Financial Disclosures (TCFD)) and from investors and shareholders (see e.g. shareholder legal action against Commonwealth Bank for failing to make environmental impact disclosures in its annual report), reducing the additional burden of compliance for companies interested in green loans.

Green loans also have certain advantages over green bonds. Green loans are accessible to a much broader range of borrowers than green bonds, including SMEs and individuals, and can be made for lower amounts than are economically feasible for a bond offering. Because they are entered into directly with one or more lenders, green loans also offer greater scope for monitoring and enforcing the use of proceeds and other covenants than widely-held green bonds, with penalties for breach tailored to the specific circumstances (for example, if the quantitative sustainability targets set in a green loan facility agreement are not met, a higher interest rate can be charged).

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[1] Paul Tang (who also acted as rapporteur for the Securitisation Regulation on behalf of MEPs), quoted in 'S&Ds back new rules for a stable securitisation market in Europe', 26 October 2017.

[2] Expert Group Report, p. 69. The European Commission has also proposed reforms which would require EU regulators to promote sustainable finance when exercising their regulatory discretion (European Commission, 'Reinforcing integrated supervision to strengthen Capital Markets Union and financial integration in a changing environment', 20 September 2018, p. 11).

[3] Action Plan: Financing Sustainable Growth, p. 8.

[4] Global Investor Statement on Climate Change.

[5] IFC, 'Green Finance: a bottom-up approach to track existing flows', 2017.

Green Loan Principles

One of the barriers to achieving preferential regulatory capital treatment for green loans and green securitisations, which is highlighted in the Expert Group Report, has been the lack of universally agreed principles which can be used to define a class of 'sustainable assets'.[6]

While some green loans also include restrictions on the use of proceeds, in others the borrower is rewarded with a lower cost of funding the 'greener' their business as a whole is deemed to be by the lender(s) after a given time period. Similarly in the residential mortgage market homeowners are now able to obtain a 'green mortgage' over a property, under which the money saved through energy efficiency in the relevant property is added on to the mortgagor's income for the purposes of calculating the level of funds that may be borrowed.

By contrast, growth of the green bond market has been facilitated by the development the Green Bond Principles[7] (GBP), which allow for comparisons across green bond products and mutual recognition across markets and national authorities. The GBP include restrictions on the use of proceeds and reporting systems to monitor the use of funds and their environmental impact, and have been developed in parallel with the emergence of the first green bonds.

We expect to see a similar dynamic emerge in the green loan and green securitisations markets over the course of 2018, with a set of unifying principles emerging organically as loans are originated to comply with the eligibility criteria negotiated with investors in the first green CLOs and green RMBS, and those standards in turn being codified by industry associations and regulators as part of their initiatives to promote sustainable finance (the Loan Market Association, for example, published its set of Green Loan Principles on 21 March 2018). This process should set in motion a virtuous circle, with issuances of green securitisations providing funding to and increasing demand for green loans, while also helping to develop common market standards which can form the basis for future preferential regulatory capital treatment for green loans and green securitisations.

Strong investor demand for green investments allied with a desire by regulators to promote sustainable finance points towards 2018 being the year that green loans, funded by green CLOs and green RMBS, begin to transform finance into a tool for combating global climate change, one of our greatest challenges.

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[6] Expert Group Report, p. 32.

[7] https://www.icmagroup.org/assets/documents/Regulatory/Green-Bonds/GreenBondsBrochure-JUNE2017.pdf

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