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SUSTAINABILITY

in the credit sector

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Green securitizations and their future significance in the sustainable finance segment

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The effects of climate change are presenting extraordinary global challenges. As a result of the Paris Agreement on Climate Change of December 2015 (COP 21), the participating countries have therefore agreed to limit global warming to an increase of 2°C maximum and to reduce CO_2 emissions in the EU by at least 40 percent until 2030.

However, it is questionable if the objectives of COP 21 will be achieved. On June 1, 2017, US President Donald Trump declared the USA's withdrawal from COP 21. In June of 2018, Germany announced that it would not achieve the initially firmly guaranteed goal to reduce the CO_2 emission of 40 percent by 2020. As things stand, CO_2 emissions can only be reduced by 32 percent compared to 1990.

The fact that politicians do not seem to be able or willing to manage the climate change initiative tremendously increases the need for action in the private sector.

"Sustainable finance" – the means to an end?

In the years to come, the financial sector in particular will play a significant role in the implementation of the climate change objectives. The transition to an economy low in CO_2 can only be financed, and the increase of global warming can only be limited, by way of a close cooperation between public and private investors.

The global financial industry has recognized the need for action and has come up with corresponding financial products. Yet, the debate on sustainability in capital investments has only just now gained momentum. Currently, numerous initiatives of a variety of parties at the national, European and international level exist, each of them providing new impetus for sustainability and "green finance". However, there is still a lack of standardized definitions and framework conditions.

To counter this problem, various "green initiatives" have been instituted, such as, for example, the Climate Bonds Initiative (CBI), the Minimum Criteria of the KFW (KfW Mindestkriterien) and the World Bank Green Bond Process Implementation Guidelines. Two years ago, Luxembourg opened a platform for the trade of green, sustainable and social financial instruments: the Green Exchange. The Green Bond Principles (GBP), introduced by the International Capital Markets Association (ICMA) in April of 2014, which have recently been updated in June of 2018, are of particular importance in this context. The GBP are voluntary guidelines, which primarily aim to strengthen the integrity of the green capital market. The GBP contain a list of possible "green" projects and define the following components of green bonds: (1) use of proceeds; (2) process for project evaluation and selection; (3) management of proceeds; and (4) reporting.

Nevertheless, such definitions and guidelines are not legally binding and the standards differ significantly in some parts. The lack of harmonization of the terms "green" and "sustainable", which could provide guidance to investors and "green" issuers, often results in the criticism of "greenwashing". Investments are misleadingly portrayed as being green, but without implementing relevant suitable measures. Although without any legal consequences, this will damage the reputation of market participants. Such uncertainties are an obstacle to investors and originators alike and, ultimately, slow down the growth of the green capital market.

The EU Commission has recognised this issue and addressed it in the Action Plan: Financing Sustainable Growth, published in March of 2018. This EU Action Plan is based on the final report of the High Level Expert Group on Sustainable Finance (HLEG), which was exclusively established by the EU Commission for this purpose. The report aims to ensure an increased transparency of green and sustainable investments by creating standardized and reliable framework conditions. This includes an EU standard for green bonds (Green Bond Standard) and a "sustainable taxonomy". The latter takes into account the existing lack of a standardized definition for "sustainable" investments and is designed to create a classification system that clearly identifies the conditions under which a project may be regarded as sustainable.

In order to develop criteria for sustainability standards as introduced by the EU Action Plan, the EU Commission set up a Technical Expert Group (TEG) consisting of specialists. The TEG started to work in July of 2018 and will continue to work on the development of concepts, in particular for Green Bond Standards and the sustainability taxonomy, until June 2019. This period will probably be extended until the end of 2019.

It is to be expected that with the elaboration of Green Bond Standards and the sustainability taxonomy, the TEG will finally bring the discussion on the understanding of "green" to an end. It remains to be seen if, in the future, green investments will only be a label for already established asset classes or if these will become a new and definable asset class.

In addition to the introduction of a binding definition, the standardization of the documentation could result in reduced issue costs, which have increased due to the required certification of green bonds and the required documentation.

"Green finance": Motives for green securitizations

"Green finance" is an essential sub-segment of sustainable finance, focusing in particular on climate protection and environmental projects. The most prominent representatives and pioneers in the area of green finance are green bonds. Recently, however, banks and investors have equally turned their focus to green securitizations.

Green securitizations may play a predominant role, particularly with regard to the development of new funding opportunities for a variety of low-carbon and climate-resilient projects. "Green pressure" by climate initiatives and investors and the need for alternative financing methods for green investments can cause securitizations in the area of green finance to gain further momentum.

In a securitization transaction, a pool of illiquid assets (such as loan or leasing contract receivables) are converted into fungible securities (so-called asset-backed securities (ABS)), thereby securitizing the cash flows from such illiquid assets. The advantages of a securitization are obvious. In a securitization investment, investors receive a share of a pool of assets in the form of a security. The underlying assets are transferred to an insolvency-remote securitization special-purpose vehicle, thereby shifting the focus on the recoverability of the assets.

Unlike a green bond, a wide range of green leasing contracts or loans may be bundled in a sufficiently large portfolio through the securitization technique so that a number of individual finance projects can be refinanced on the capital market. Leasing companies or lenders (each an "originator") may not only use the securitization technique as a refinancing tool, but also for reducing their regulatory capital requirements, thus leveraging their business model. The proceeds gained and the released equity capital may be used for new leasing contracts and new loans.

The legislator has equally recognized the advantages of securitizations in its need to comply with climate targets and, as a result, provided incentives for green transactions in the new framework for Simple, Transparent and Standardized Securitization (STS). For Auto ABS and Residential Mortgage-Backed Securities (RMBS), the new securitization regulation provides that the originator, the sponsor and the securitization special-purpose vehicle have to publish the available information related to the environmental performance of the assets financed by such residential loans or auto loans, or leases in order to qualify as STS securitization and thus to use the more favorable STS risk weights. For these particular asset classes, legal disclosure requirements exist that would also be necessary for the qualification as a green financial instrument. Consequently, investors could be inclined to meet all the requirements for a green financial product as well in order to attract new groups of investors.

Green ABS

The discussion described above equally applies to the question in which case an ABS transaction can be considered to be "green". In addition to the use of the GBP as an orientation, a securitization can – according to CBI – be defined as green, if the cash flows underlying the assets of the securitization transaction originate from low-carbon and climate-resilient assets. Likewise, a securitization may be considered a "green securitization" if its proceeds are dedicated to green infrastructure projects.

In addition, the question arises as to which assets are appropriate for green securitizations. Among the asset types that are already being securitized are loans to green small- and medium-sized enterprises (SMEs), loans for electric and hybrid vehicles and mortgages to green buildings. More recent asset types are, inter alia, financing contracts for solar and wind power plants, for projects to upgrade energy efficiency and for battery and storage projects.

2017 also saw another new market development when the first synthetic green securitization was completed, Premium Green 2017-2, a US$3 billion transaction of Crédit Agricole CIB. In synthetic securi-

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The current developments provide the opportunity of a comeback for securitizations: The innovative and flexible structures allow green securitizations to mobilize previously untouched funds for sustainable purposes. They may therefore serve as a multiplier in the sustainable finance sector and can be considered as an essential pioneer of a global green revolution.

White & Case is an active member of the ICMA Green Principles Working Group and sole Legal Knowledge Partner of the G20 Sustainable Finance Study Group.

tizations, the assets remain on the balance sheet of the originator and only credit risks are being transferred, thereby freeing up equity. Such synthetic securitizations have the potential to make a positive contribution to broaden financing opportunities for small climate-resilient and low-carbon projects. It would be conceivable to impose an obligation on originators to invest the released capital into new green projects.

However, the question remains if the originator greenwashes the balance sheet through a synthetic securitization by using the capital relief applicable to the classic portfolio to subsequently set up a green portfolio, or if a green portfolio is already underlying such transaction. Furthermore, the cash collateral provided by the investor for the purpose of credit default protection can be used to finance other green projects.

The introduction of special PACE, Auto and Solar ABS as new financing instruments is a further significant step for the initiation of a green securitization market.

PACE ABS

PACE financing (Property Assessed Clean Energy) allows public institutions to fund the investment costs for energy improvements on commercial and residential properties by means of PACE bonds that are subsequently paid back by the investing owner. They are repaid over time through an assessment on the property owner's tax bill. Successful PACE programs now exist in the US, Canada, Australia and South Africa. The concept also increasingly gains in importance in Europe as a solution to the enormous investment deficit in respect of sustainable infrastructures. The EuroPACE initiative is currently promoting the PACE model in Europe. Today, Spain, Italy, Great Britain and Poland are already among the European supporters of the model. Similar to other sustainable financing, PACE funding can be aggregated and securitized, thereby relieving the balance sheets of the originators, and facilitating the investment in this asset class for institutional investors.

Auto ABS

Auto ABS involves the refinancing of a portfolio of auto loans or leases. Since hybrid and fully electric vehicles currently only account for a small proportion of road vehicles, considerable investments are necessary in the research and development of environmentally friendly vehicles. Auto ABS will play an important role in releasing such funds. Thus, the use of "brown" assets in order to release capital for more "green" funds is a key component. This mechanism could be improved, however, by issuing Auto ABS including exclusively low-emission or emission-free vehicles, and to use these proceeds to generate further green assets in the form of leasing contracts and car loans. Recently, several renowned car manufacturers issued Auto ABS secured by leasing contracts of existing electric vehicles.

Solar ABS

Solar ABS are securitizations secured by cash flows from solar systems. Most of the transactions are hedged by lease payments and power purchase agreements. Solar energy is one of the leading alternatives to fossil fuels as a source of power generation, for commercial as well as private use. In contrast to the fossil-generated power, solar energy can be generated by anyone. Once the technology is installed, the owner produces energy effectively and free of charge and any surpluses of the production can be fed into the national power grid. In 2017, solar securitizations achieved a volume of more than US$1 billion, quadrupling the volume compared to the previous year. In the US, solar systems are often financed through PACE loans.

In Europe, the lack of standardized documentation, uncertainties regarding the feed-in remuneration and the insufficient volume of green investments by individual banks or lease companies hindered the introduction of Solar ABS for renewable energies. The concept of financial warehousing, where loans and/or leasing contracts are pooled together by several sponsors, would be beneficial in order to expand the market.

Regulatory treatment of green securitizations: Green supporting versus brown penalizing factor

Currently, certain regulatory measures are considered to promote the sustainable finance market. In particular, there are two opposing models with regard to the regulatory treatment of green securitizations: the Green Supporting Factor (GSF) and the Brown Penalising Factor (BPF).

The proposed GSF acts as a multiplier of the capital risk weight of the banks in order to reduce the relative weighting of sustainable assets. The supporters of the GSF concept, among them several French and German bank lobbyists, argue that, along with fostering the growth of the sustainable financial market, favorable risk weightings are justified in most cases since sustainable investments are typically less risky than their unsustainable counterpart.

Whether green and sustainable investments are actually less risky to legitimize a lower risk weighting, is currently being reviewed within the context of the EU Action Plan of the Commission. However, it could be argued that risk weightings do not exclusively reflect the actual risk of an investment, but could also be influenced by other factors, since the security of an investment is not only based on the return (e.g., the risk weightings of government bonds or SMEs).

Finally, the question remains how a GSF should be applied. The GSF could already apply at the level of the loans themselves. This would primarily help to grant new green loans more quickly. As an alternative, the GSF could be applied at the refinancing level only so that the respective capital market instruments are privileged for regulatory purposes. This option is particularly favorable since the requirements for a green investment in a capital market transaction can be critically verified again.

In contrast to the controversial GSF, the BPF acts as a sanction as it would require higher equity for carbon-intensive investments. Doing so would prevent the problem of reducing capital requirements, while at the same time sending a political signal in favor of sustainable financing. Additionally, a BPF reflects the fact that, in the near future, carbon-intensive investments will increasingly be considered risky investments.

The significance of impact

As things stand, it is still unclear whether a GSF or a BPF will finally be implemented. Accordingly, it largely depends on the market participants if green capital markets products can make the breakthrough in the same way as it was the case with the creation of the first- framework conditions for a green capital market. Against this backdrop, investors have to query whether or not the common two-dimensional chance-risk profile needs to be extended by a third dimension such as impact.

In particular, private investors currently often question the effects of their investments and if the yield is reconcilable with a good cause. As a result, the number and volume of sustainable funds have increased rapidly in recent years. Investors in so-called impact-oriented investments are prepared to sacrifice percentage points of their rate of return if, in addition, the investment is dedicated to sustainability. Many studies show that sustainable investments in a portfolio are better suited to improve the risk-return profile of the investment. In this light, the so-called impact reporting plays an increasingly significant role. The report on the impact of an investment provides investors with the opportunity to prove an effective and responsible investment approach.

From the banks' and professional investors' perspective, new opportunities and risks emerge which can only be countered by adapting the existing business model to green investments. On the one hand, a growing proportion of investors in the capital markets explicitly look for green and sustainable investments. On the other hand, the same green or sustainable mentality also pervades other kinds of consumer behavior, be it shopping in the organic supermarket or the purchase of an electric vehicle. If this trend continues, not only the industrial sectors with fossil fuels are endangered, but also numerous other sectors, such as a supermarket chain with no range of organic products. This was also recognized by the European Central Bank, which consequently has identified the climate risks as risk drivers in its priorities for the year 2019.

Green securitizations are particularly suited to counter such changes. The character of a securitization as an asset-based capital markets solution can best reflect the global change from the status quo of today to a green and sustainable investment behavior in an unparalleled way.

The securitization technique enables market participants to strengthen their balance sheets with green assets in a flexible way, in line with the social change, and at the same time to reduce the risks associated with brown portfolios.