



## Green covered bonds: The EU Taxonomy – a climate killer?

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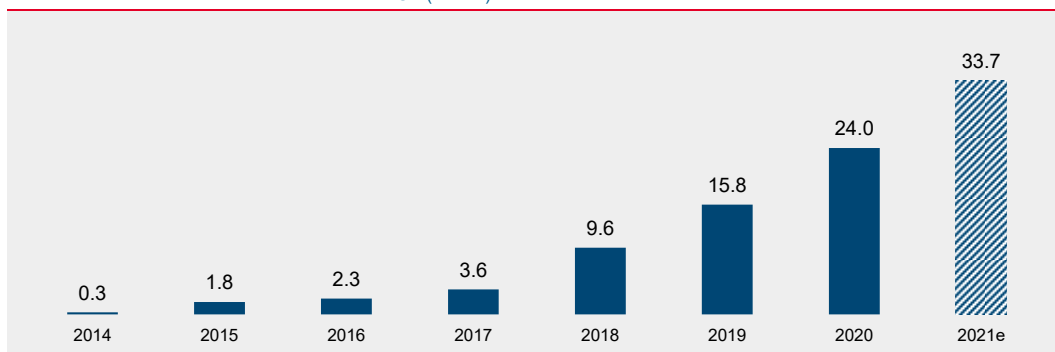
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- 2020 has once again proven to be a propitious year for the issuance of sustainable paper on the covered bond market. Not even the Covid-19 crisis has done anything to change that. Since the first issue in 2014, 30 banks have meanwhile successfully placed sustainable covered bonds. The German Pfandbrief banks share first place with Norwegian issuers, with five issues apiece, ahead of France in second place. Overall, however, the share of sustainable covered bonds as a proportion of total outstanding volume remains very low.
- The Covid-19 pandemic has led to the social covered bond segment taking on an even greater significance. Of the twelve sustainability-related issues that were placed during the year, three were covered bonds with a social focus.
- Currently, banks already play a central role in financing more energy-efficient buildings and there is enormous future potential in this area. However, question marks remain as to whether there are sufficient incentives for a large-scale, energy-efficient retrofitting of the crucial housing stock. For this reason, it is likely that demand for corresponding loans will only see limited growth.
- In addition, the criteria proposed under the EU's Taxonomy Regulation may act as a brake on the potential for financing green buildings. According to these criteria, buildings constructed before 2021 should only qualify as "green" if they are in the highest energy efficiency class "A".
- A market initiative by EMF-ECBC is supporting EU efforts towards promoting more energy-efficient buildings with a range of measures. These include ensuring quality and transparency in the financing of energy-efficient buildings. From the first quarter of 2021, a large proportion of covered bond issuers will therefore be providing additional information on green mortgages in their transparency reporting.
- We expect that the share of sustainable covered bond issues will rise further, provided that future EU criteria for green properties are not only forward-looking and ambitious but also feasible.

### Sustainable covered bonds – strong growth continues unabated

Sustainable euro-denominated covered bonds in EUR (billions)



Sources: BloombergNEF, Helaba Research





















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## Sustainable covered bonds maintain robust growth

Sustainable euro-denominated benchmark-size covered bonds, with a volume of EUR 24 billion, currently only account for around 4 % of the global EUR benchmark volume. However, with growth of 52 % in 2020 compared to the previous year, there is an unmistakable upward trend. We expect to see a further expansion in this type of covered bond in 2021, albeit at a slightly slower pace than this year. Although there is tremendous potential for improvements in energy efficiency in the property sector, and consequently for new green mortgage business, the planned strict EU taxonomy criteria for green buildings are putting a damper on hopes for additional issuance. What is more, NordLB Luxembourg is winding down its covered bond issuance business as a result of restructuring measures, having only recently made its debut this year with its renewable energy covered bond.

## Sustainable covered bonds - green bonds predominate

Issuers of sustainable notes by year of issue; social and sustainable bonds labelled separately

2017			2018			2019			2020		
Maturity	Country		Maturity	Country		Maturity	Country		Maturity	Country	
Berlin Hyp	Oct-23		Deutsche Hypo	Dec-24		Nykredit	Apr 23 <sup>3</sup>		KHFC (social)	Feb-25	
Kommunalkredit Austria	Jul-21		DKB	Oct-28		KHFC	Jun-24		KHFC (social)	Jul-25	
Deutsche Hypo	Nov-23		Berlin Hyp	Oct-25		Berlin Hyp	Jul-27		Kookmin (sustain.)	Jul-25	
			KHFC	Oct-23		ING Bank Hipot.	Okt 24 <sup>3</sup>		Sparebank Vest	Jun-27	
			Münchener Hyp	Dec-23		DKB (social)	Nov-29		Berlin Hyp	Sep-30	
			SpareBank 1	Jan-25		CA Home Loan	Nov-29		SpareBank 1	Sep-27	
			CR de Navarra	May-25		SR-Boligkredit	Oct-26		NordLB Lux	Jan-25	
						Sparebank Soer	Oct-26		Société Gén. SFH	Feb-30	
						CAFFIL (green)	Nov-29		CAFFIL (social)	May-25	
						DNB Bol.	Jun24 <sup>1</sup>		BPCE SFH	May-30	
						Realkredit	Jul 22 <sup>2</sup>		SpareBank 1	Sep 27 <sup>1</sup>	
						Nykredit	Apr 23 <sup>3</sup>		Berlin Hyp	Jul-28	
						SCBC	Mrz 24 <sup>1</sup>				
						CAFFIL (social)	Feb-27				
						Nykredit	Okt 22 <sup>3</sup>				
						LBBW	Mai 22 <sup>4</sup>				
						PKO	Sep 24 <sup>3</sup>				
						SocGen	Jul-29				

<sup>1</sup>A flag represents the debut issue of each issuer. The number of flags of a country corresponds to the number of issuers of sustainable covered bonds for each country; 1SEK, <sup>2</sup>DKK, <sup>3</sup>PLN, <sup>4</sup>USD

Sources: Bloomberg, issuer websites, Helaba Research

## Issues of sustainable covered bonds unaffected by crisis

While the total primary market volume of euro-denominated benchmark covered bonds has fallen to around EUR 96 billion in the course of the year - 30 % below last year's volume - issues of sustainable EUR benchmark-size covered bonds in 2020 have risen from EUR 6.2 billion in 2019 to EUR 8.2 billion. New issuers attracted to the fledgling market segment included the French BPCE SFH and the Norwegian Sparebank Vest, both placing green covered bonds, as well as the South Korean Kookmin with sustainable notes and NordLB Luxembourg with renewable energy covered bonds. Other very active players were the Norwegian SpareBank 1 with EUR and SEK issuance and Berlin Hyp with its green Pfandbrief. Since the summer of 2019, there have been a whole host of minimum standards attached to the green Pfandbrief<sup>1</sup>. Among other things, they expand upon previously established market standards - the Green Bond Principles (GBP) - as well as EU proposals for classifying economic activities according to sustainability criteria.

<sup>1</sup> See Covered Bonds Special "[Mindeststandards wichtiger Erfolgsfaktor für Grünen Pfandbrief](#)" of 8 October 2019

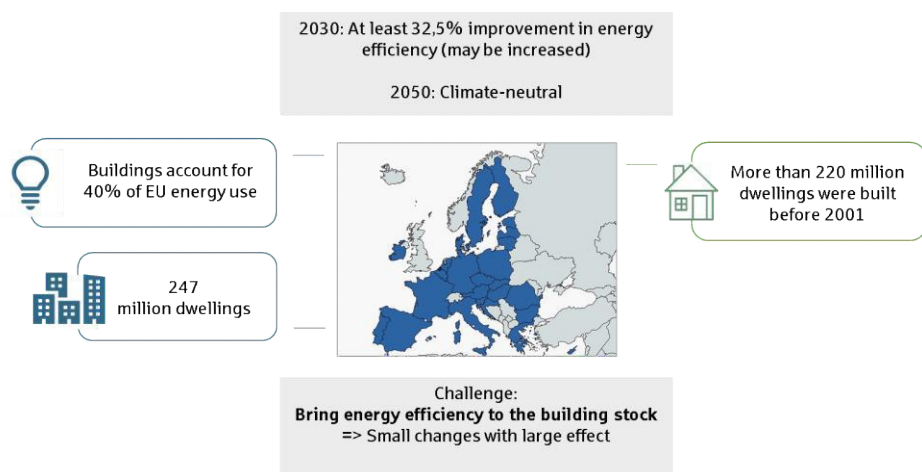
## Increasing significance of social component

The volume of sustainable covered bonds with a social focus has seen particularly strong growth since the beginning of the year. In 2020, the Korea Housing Finance Corporation and the Caisse Française de Financement Local (Caffil) both issued social covered bonds with volumes of EUR 1.5 billion and EUR 1.0 billion, respectively. The notes placed by Caffil in May were the first social covered bonds related to Covid-19 from the French underwriter, a subsidiary of the public development bank SFIL. This bank, together with its partner La Banque Postale, is market leader in municipal lending in France. The proceeds of the bond, which was several times oversubscribed, were earmarked to finance the French health system and public hospitals. Using covered bonds to fund its lending operations was cheaper for the Group than using SFIL's bonds in the SSA segment. This clearly shows that investors are increasingly seeking out opportunities in the education, health and employment sectors, especially in the wake of the Covid-19 pandemic, which will lead to further growth of the social covered bond segment.

## Building sector a key area of action in Green Deal - potential for financial sector

With its "NextGenerationEU" recovery plan, the EU aims to strengthen the economies of member states and the "Green Deal" is a major part of it. The latter involves all sectors of the economy and represents a very substantial growth initiative by the EU with extremely ambitious goals. The fact that the building sector will be a key element in this was inevitable; after all, there is huge potential to reduce CO<sub>2</sub> emissions here. Within the EU, buildings account for as much as 40 % of total energy consumption and around 36 % of CO<sub>2</sub> emissions (BPIE, 2015). Therefore, reducing the energy consumption of residential and commercial buildings is a crucial first step towards achieving the EU's energy efficiency target for 2030. The aim is to improve energy efficiency by 32.5 % compared to 1990 and discussions are even underway about raising this figure. In terms of funding the necessary investments in more energy-efficient buildings, banks already have a key part to play and there is considerable scope for growth. However, while the demand-led trend towards sustainability has already made itself strongly felt in the commercial real estate sector (including in the refurbishment of existing properties), retrofitting the housing stock is progressing at a very slow pace.

## Ambitious EU energy efficiency targets for the housing stock



Sources: EEMI, Helaba Research

## An immense challenge: increasing the energy efficiency of the housing stock

For the real estate industry, the fact that it is generally easier to incorporate environmental aspects when planning a new building at an early stage than to retrofit existing properties is not without problems. Due to the large number of ageing dwellings, however, a gargantuan programme of renovation would be needed. After all, 89 % of all existing residential buildings in the EU were built

before 2001. According to the EU, the current renovation rate of around 1 % is expected to at least double by 2030<sup>2</sup>, meaning that 35 million buildings would require energy-efficient retrofitting. In view of a high level of capacity utilisation in the construction industry - at least in Germany - there is little prospect that the existing housing stock can be rapidly upgraded. Consequently, the goal of making significant progress in the small-scale residential property market is particularly ambitious.

### Low financing costs a key incentive - but not sufficient

Although, in our opinion, the Green Deal presents an opportunity to more decisively address obstacles in the building and construction sector, it is debatable as to whether sufficient incentives exist to bring about the necessary efforts needed to achieve the energy efficient targets. The last few years have shown, for example, that favourable lending conditions alone are not enough. A requisite drive to retrofit old buildings will only be forthcoming if a combination of future savings in energy costs and state support is made sufficiently attractive for homeowners. In this respect, national campaigns to raise awareness could also make a valuable contribution.

### Numerous unresolved issues

The main obstacles to overcome and areas of action to address in increasing the renovation rate

#### Homeowners:

- Lack of incentive to retrofit existing properties
- High capacity utilisation in the building sector
- Availability of cheap finance and simple financing process

#### Legislation:

- Harmonisation of energy efficiency labelling
- Systematic assessment of entire housing stock

#### Financial sector:

- Ambitious EU requirements for „green“ buildings
- Lack of clarity about regulatory treatment of „green“ mortgage loans (better risk profile and higher property value)

Source: Helaba Research

### Proposed EU criteria for green buildings rather ambitious

Besides the challenge of stimulating demand for more energy-efficient housing and increasing the renovation rate, proposed EU standards also risk jeopardising green property financing as well as the issuance of green covered bonds.

Draft legislation by the EU Commission of 20 November as part of the EU taxonomy<sup>3</sup> sets out very stringent criteria for defining green properties. Overall, it would appear that there is little prospect - even in the medium term - that compliance with the planned requirements will be achieved in a variety of aspects:

For instance, the proposal makes no distinction between residential and commercial property and stipulates, inter alia, that

- for **new buildings**, primary energy requirements must be 20 % below what national legislation has defined for a nearly zero energy building (NZEB)
- when purchasing **existing properties**, only buildings with an energy certificate in the energy efficiency class "A" may be designated as green buildings

<sup>2</sup> The Renovation Wave strategy published by the Commission on October 14, 2020 calls for faster and deeper renovation

<sup>3</sup> See Credit Special [European Bank Bonds: "Supervision wearing green-tinted spectacles"](#), page 6 "EU taxonomy to enhance transparency" of 8 December 2020

This is aggravated by the fact that such buildings are not permitted to have any particularly detrimental effects on other defined environmental goals (the so-called "do no significant harm" or DNSH principle). Examples of these include conserving water resources or minimum requirements for fittings. What is more, the burden of having to ensure these criteria are met would have to be borne by the lender if there are no national statutory provisions for such requirements.

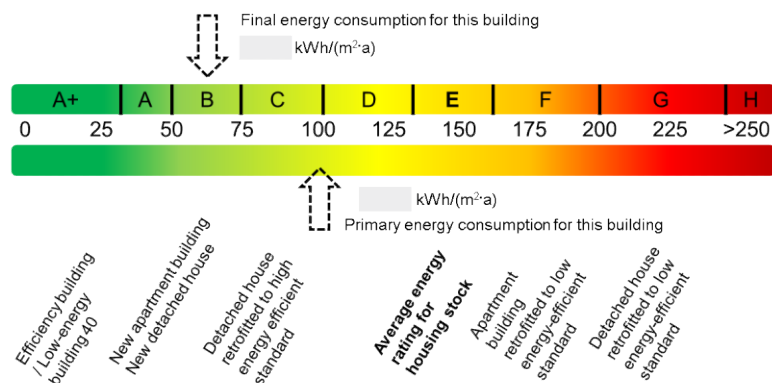
### Current minimum standards for existing properties already tough

Yet we believe that many existing green energy efficiency frameworks already contain demanding standards, which also include provisions for future tightening. For example, they only allow proceeds from bond issues to be used for properties as long as they are among the top 15 % of a country's most energy-efficient buildings. In the case of commercial properties, an alternative minimum standard currently consists of having a sustainability certificate with a top-class rating.

In the past, in the absence of EU requirements, issuers turned to information and assessments from the Climate Bond Initiative and other EU institutions when it came to fixing terms and conditions. However, due to the current energy efficiency level of buildings in most countries, the types of permitted buildings not only include those in energy efficiency class "A" but also those in classes "B" and "C". Compared to the variety of energy efficiency classes, which range from "A" to "H", and the fact that the bulk of many countries' housing stocks fall within classes "D" and "E" (almost 54 % of the housing stock in France is classified in energy efficiency classes "E" to "G"<sup>4</sup>), in our view this range of classes already provides quite a reasonable way of classifying buildings.

### Average energy efficiency rating for German housing stock in class "E"

Energy consumption indicator in energy certificate for residential properties and benchmark values, 2019



Sources: German Consumer Association, Helaba Research

### Limiting cover pool to efficiency class "A" would spell the end of green bonds

The aforementioned taxonomy criteria would therefore present issuers with enormous challenges at this stage. Market reports suggest that, if standards are tightened as proposed, this could lead to the number of mortgages eligible for the issuance of green bonds falling by around 90 %. The stock of buildings rated in energy efficiency class "A" is still very small in many countries. For the reasons outlined above, it is practically inconceivable that older buildings could be retrofitted and upgraded in the short term. In addition, there are no efficiency classes for commercial real estate in Germany and, consequently, there is currently no way of demonstrating that commercial green buildings comply with the new standard.

As a result, there would be very few assets left to be included in the cover pools of green covered bonds in order to finance green properties that satisfy the planned EU Green Bond standard. This is

<sup>4</sup> Investor presentation BPCE SFH, May 2020

because there is hardly any doubt that this new standard for green bonds is based on the EU taxonomy. This would be a severe impediment to the small but hitherto fast-growing segment of green covered bonds.

### Final text of legislation not yet decided

Nevertheless, we believe it is still too early to identify a turning point in the trend towards a growing issuance of green covered bonds. While some market participants are already calling the future of existing programmes into question and looking for alternatives, such as sustainability-linked bonds, their eligibility as sustainable notes is not based on any specific requirements attached to the use of their proceeds but rather on the achievement of certain sustainable key performance indicators or special ratings. However, it first remains to be seen how the EU Commission will react to the market consultation. At the very least, these consultation rounds will provide an opportunity to discuss and negotiate the details. Covered bond associations could also present the compelling argument of the better global comparability of standards for green buildings.

For the EU, the taxonomy is undoubtedly an important framework law for the implementation of the Green Deal. At the same time, in our opinion it will fail to achieve its objective if requirements that are too strict are imposed prematurely and without sufficient consideration and if funds are no longer channelled into projects to improve energy efficiency because they do not (yet) meet the excessively high standards.

That is why expectations are high that the proposed legislation will be amended, since the European Council and EU Parliament can only accept or reject proposals in full but not amend them. Feedback to the draft law can be submitted until 20 December and the delegated act is apparently not expected to come into force until January 2022.

### EEMI supporting the EU with various initiatives

In order to promote green mortgages, energy efficient buildings and retrofits for existing properties, a European market-led initiative by the EMF-ECBC called EEMI (the Energy Efficient Mortgage Initiative) has been preparing for some time to introduce an **Energy Efficient Mortgage Label**. It was initially supposed to launch at the beginning of December; for the time being, though, the focus has shifted to giving feedback to on the EU Commission's consultation. Furthermore, the extent to which the label should correspond to the taxonomy remains an open issue.

The driving force behind the initiative is an assumption that energy-efficient properties result in comparatively higher property values and to improved serviceability by the borrower. In this way, mortgages to finance energy-efficient buildings represent a lower risk for banks thanks to their reduced probability of default and expected higher recovery rates while being eligible for preferential capital treatment. Meanwhile, this correlation has been substantiated by a number of studies and even a variety of EU papers<sup>5</sup> refer to the initiative and its results. Recognition by supervisory authorities may lead to more attractive lending terms, encourage more borrowers to upgrade their properties to a higher energy efficiency class by retrofitting them and support the EU's goal of reducing the energy consumption of buildings.

Currently, the pan-European initiative with its 47 participating banks<sup>6</sup>, 17 national, European and

<sup>5</sup>[https://eur-lex.europa.eu/resource.html?uri=cellar:0638aa1d-0f02-11eb-bc07-01aa75ed71a1.0003.02/DOC\\_1&format=PDF](https://eur-lex.europa.eu/resource.html?uri=cellar:0638aa1d-0f02-11eb-bc07-01aa75ed71a1.0003.02/DOC_1&format=PDF), p.11

<https://www.buildup.eu/en/news/overview-de-risking-energy-efficiency-investments-eu-building-stock>

<sup>6</sup> Including Berlin Hyp, Deutsche Hypo, DZ Bank, Helaba, LBBW, NordLB, Münchener Hypothekenbank and the UniCredit Group

international authorities, data providers and other market players (including energy utilities) is working on the data, procedural and reporting infrastructure to support the integration of energy efficiency into risk management and loan origination processes<sup>7</sup>. It will not only ensure and increase quality and transparency in the financing of energy efficient buildings, but also help to implement the EU Green Deal across a range of sectors. Three EU funded projects<sup>8</sup> are being implemented under the umbrella of EEMI for this purpose.

### More transparency for investors: Reporting expanded to include ESG information

As green mortgages become more widespread, covered bond issuers whose bonds have been certified with the ECBC's Covered Bond Label will additionally be publishing ESG information on their cover pools from the first quarter of 2021. The Harmonised Transparency Template (HTT) has been updated for this purpose. In future, investors will be able to consider the following information in their assessments:

- Information on the EPC of the buildings financed
- Information on average energy consumption (kWh/m<sup>2</sup>)
- Information on the age structure of the buildings financed (year of construction in 10-year increments)
- Information on the type of building (detached house, semi-detached house, multi-family dwelling, apartment etc.)
- Information on new buildings

At the same time, these statistics should support the implementation of the Green Deal and debates over the EU taxonomy.

### Outlook: Strong increase in growth rates some way off

We expect that the share of sustainable covered bond issues will continue to rise going forward. However, there are a number of factors that suggest that it will be some time before annual volumes see any significant increase. On the one hand, for economic reasons, banks often focus on issuing unsecured sustainable bonds. The significantly higher risk premiums of these notes compared to covered bonds generally allow for a higher spread difference between green and non-green bonds. Furthermore, there are usually less restrictions attached to the use of proceeds than is the case with green covered bonds while less effort is needed during the pre-issue stages. On the other hand, the green portion of the cover pools only fills up slowly due to the aforementioned aspects in respect of the low renovation rate. The share of finance for new green buildings normally only partially offsets the shortfall in volume for benchmark issues. Despite this, banks are increasingly issuing green covered bonds as a complement to green unsecured bonds as part of their sustainability strategies.

The debate over the EU taxonomy for green properties described above should, at least for the time being, act as a brake on issuance activity as well as ongoing preparations for new green covered bond programmes. However, we are extremely confident that, in the interest of achieving the goals of the EU's energy and climate package, a compromise solution will emerge in the first quarter of 2021 that is not only forward-looking and ambitious but also feasible.

<sup>7</sup> See Credit Special European bank bonds: "[Supervision wearing green-tinted spectacles](#)", page 5 "Pressure from European banking supervision" of 8 December 2020

<sup>8</sup> The Energy Efficient Mortgage Action Plan (EeMAP), the Energy Efficiency Data Portal & Protocol (EeDaPP) and the Energy Efficient Mortgage Market Implementation Plan (EeMMIP)



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