

# Focus on: Covered Bonds

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## Meeting the taxonomy compliance challenge

Now that the Technical Screening Criteria for green properties are in place, the goal for issuers of green bonds is ambitious - and the standards demanding. Many issuers will have to revise their green frameworks.



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The beginning of 2022 marks the entry into force of Technical Screening Criteria for climate-friendly investments and climate change adaptation as part of the EU's taxonomy regulation. Just to recap: the EU's "NextGenerationEU" recovery programme is designed to strengthen the economies of EU member states and the "Green Deal" is a major component of this. However, it must be said that the goals of this drive for growth are exceptionally ambitious. Accordingly, the EU taxonomy defines which economic activities can be classified as environmentally sustainable. Although its application is voluntary, the taxonomy framework will become the industry benchmark for green bonds.

**EU taxonomy:** An economic activity qualifies as environmentally sustainable if it

- makes a substantial contribution to realising one of the following six environmental objectives: (1) climate change mitigation, (2) climate change adaptation, (3) the sustainable use and protection of water and marine resources, (4) the transition to a circular economy, (5) pollution prevention and control, and (6) the protection and restoration of biodiversity and ecosystems.
- does not significantly compromise any other environmental objective (the so-called Do No Significant Harm or DNSH criteria)
- is performed in compliance with minimum social safeguards (MSS), and
- complies with Technical Screening Criteria (TSC)

Indeed, the taxonomy is widely acknowledged as the **future standard for EU Green Bonds**, the final regulations for which are expected to be published in the spring of next year. In the medium term, these instruments could also play a key role in monetary policy<sup>1</sup>. Consequently, for issuers intending to place green covered bonds based on the EU Green Bond standard and who, as companies, fall within the scope of the Sustainable Finance Disclosure Regulation (SFDR), this is all the more reason to keep a close eye on the taxonomy requirements. This particularly applies to banks that already issue bonds on the capital markets to refinance green projects on the basis of a green framework.

### Timetable of the EU Green Deal



Sources: EU Commission, Helaba Research & Advisory

<sup>1</sup> ECB presents action plan to include climate change considerations in its monetary policy strategy ([europa.eu](https://www.europa.eu))

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However, the **complexity of the taxonomy rules** poses daunting challenges for market participants. The Technical Screening Criteria for the first two environmental objectives alone fill more than 500 pages, while the draft regulations for the remaining four objectives run to almost 1,000 pages. This is in addition to questions of comprehension and interpretation as well as assessment methodologies that are not only demanding but, in some cases, have not even been defined on a national level yet.

## Green covered bonds hold enormous potential

Of particular interest to banks are the taxonomy criteria for green buildings. As such, financing the building of energy-efficient properties is already a vital element in the overall push towards a circular economy. The potential here is enormous, since the scope for cutting CO<sub>2</sub> emissions in the construction sector is huge. As a result, many financial institutions have already issued green bonds in recent years to refinance climate friendly projects. Even the **green covered bond segment**, which is still relatively small, has experienced rapid growth and, in 2021, enjoyed a veritable boom. Altogether, sustainable covered notes accounted for a volume of around EUR 17 billion in 2021, equivalent to as much as 17 % of EUR covered bond issuance - more than twice the previous year's figure. What is more, the number of issuers across Europe is steadily increasing. So far, the instrument of choice

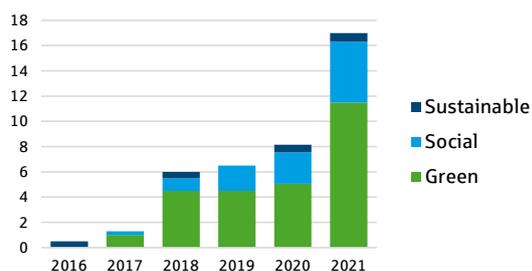
### A building block of the Green Deal: The construction sector

- Accounts for around 40 % of energy consumption and roughly 36 % of CO<sub>2</sub> emissions in the EU (BPIE, 2015).
- A key factor in achieving the EU's 2030 energy efficiency target and tackling energy poverty is a reduction in the energy consumption of residential and commercial properties.
- EU Commission aims to cut final and primary energy consumption by 36 % and 39 %, respectively, by 2030 compared to the projected 2030 consumption levels calculated in 2007 (proposed Energy Efficiency Directive, 14 July 2021).

has been green covered bonds with a share of approximately 70 % of sustainable covered bond issuance. In terms of the outstanding volume of green covered bonds, France currently dominates the field, followed by Norway and Germany. In view of the substantial volume of mortgage loans that are typically refinanced using covered bonds, we anticipate strong growth in green covered bonds over the medium to long term. This will be driven in no small part by burgeoning policy initiatives in connection with the EU's Green Deal.

### Sustainable covered bonds - green notes dominate

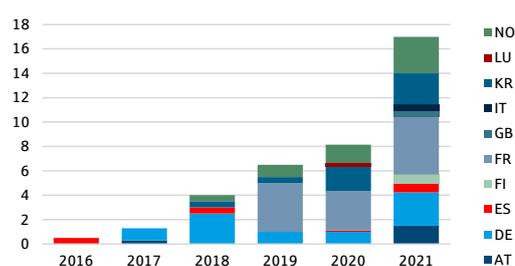
New issuance in EUR billions



Sources: Bloomberg, Helaba Research & Advisory

### Sustainable covered bonds - uninterrupted growth

In EUR billions



Sources: Bloomberg, Helaba Research & Advisory

## EU criteria ambitious in setting targets

In recent years, the framework underpinning bond issues (the Green Bond Framework) has built on established market standards - the ICMA's Green Bond Principles (GBP) - and already incorporates criteria from the EU taxonomy for green properties. However, as the Technical Screening Criteria for green buildings come into force, the EU criteria are likely to define the principal targets in the near future (unless they already do). In general, though, the task of complying with the planned requirements would appear, at least in the short term, to present a variety of challenges:

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For example, the legislation does not distinguish between residential and commercial real estate and for activities that contribute to climate change mitigation (the first environmental objective), it stipulates among other things that

- in the case of **new buildings**, the primary energy demand (PED) must be at least 10 % lower than the threshold set for the nearly zero-energy building (NZEB) requirements in national legislation. The energy performance must be certified using an Energy Performance Certificate (EPC). In addition, there are further requirements for buildings larger than 5,000 sqm.
- in the case of the **acquisition of buildings built before 31 December 2020**, the building must at least have an Energy Performance Certificate (EPC) class A. As an alternative, the building may be within the top 15 % of the national or regional building stock expressed as operational Primary Energy Demand (PED) and demonstrated by adequate evidence, which at least compares the performance of the relevant asset to the performance of the national or regional stock built before 31 December 2020 and at least distinguishes between residential and non-residential buildings.
- In the case of the **acquisition of buildings built after 31 December 2020**, the criteria for new buildings apply.
- In the case of the **renovation of existing buildings**, the applicable requirements for major renovations as mandated by the EPBD must be fulfilled. The energy performance of the building or the renovated part that is upgraded must meet the cost-optimal minimum energy performance requirements in accordance with the directive. **Alternatively**, the renovation must result in a minimum 30 % reduction in primary energy demand. The building's original energy efficiency rating and its improvement are based on (a) a detailed inspection of the building, (b) an independent energy audit, or (c) another transparent and proportionate method that is validated by an Energy Performance Certificate (EPC). The 30 % improvement must result from an actual reduction in the primary energy demand (excluding renewable energy sources) and may be achieved using a series of measures within a maximum of 3 years.

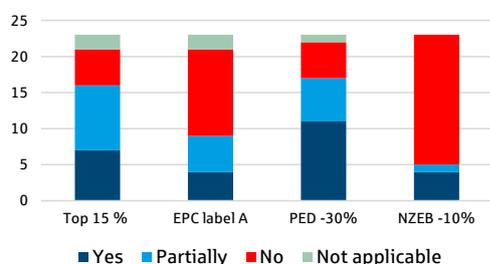
To complicate matters further, minimum social standards must be met and the building must not do any significant harm to other defined environmental objectives (the so-called Do No Significant Harm or DNSH criteria). For instance, the DNSH criteria for climate change adaptation require a climate risk and vulnerability assessment (CRVA) as well as possible solutions to adapt the building to climate change.

The building criteria for the second environmental objective, climate change adaptation, however, are less stringent and require, for example, an Energy Performance Certificate class C or inclusion in the top 30 % of the national or regional building stock for the acquisition of buildings constructed before 31 December 2020.

## Analysis: Green frameworks with different degrees of alignment to taxonomy requirements

### Greatest taxonomy compliance for renovation criteria

Number of issuers of green covered bonds by compliance with individual Technical Screening Requirements for green buildings



Sources: Issuer websites, Helaba Research & Advisory

Up to now, only a very small number of covered bond issuers have based their green bond frameworks on the Energy Performance Certificate class A when acquiring existing properties. As a result, the proportion of buildings with this certification rating is extremely small in most countries. One reason for this is that energy certificates are not publicly available in many cases. Furthermore, in Germany there is no system of categorising commercial properties into efficiency classes. What is more, only a limited comparison of the criteria can be made between countries, as classification is often based on different metrics<sup>2</sup>. The alternative "inclusion in the top 15 %" of buildings constructed before 2021 has already been used by the

<sup>2</sup> All EU member states were required to implement EPC systems in line with the Energy Performance of Buildings Directive (EPBD) by 2015 at the latest. The EPBD does not specify quantitative thresholds (e.g., annual kWh/m<sup>2</sup>), so that national EPC regulations and hence the energy efficiency of a building certified as EPC class A may vary from country to country.

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ICMA and the Climate Bond Initiative and can presumably be considered the most practicable criterion for green covered bonds that are designed to exclusively refinance taxonomy-compliant mortgages.

Consequently, most frameworks have already adopted the top 15 % criterion for green buildings or apply it as an alternative to sustainability certificates for commercial real estate finance (some German and French issuers) or for older residential properties that do not automatically have to meet standards for low energy consumption due to national regulations (Norway). Green building certificates or environmental certifications are not recognised as energy performance certificates in the scope of the taxonomy, even though they assign different ratings to buildings based on various sustainability indicators. Some frameworks define buildings with energy performance certificates in efficiency classes A and B as well as A, B or C as green buildings. That means they do not meet the single "EPC A" criterion despite the fact that buildings with these efficiency classes in their respective countries often rank in the top 15 % of buildings of this usage type. For example, as far as we know, residential properties in Finland in efficiency classes A, B and C account for around 10 % of total building stock, while in France, buildings rated as efficiency classes A and B represent approximately 7 % of all residential real estate. Obviously, the criteria do not apply if the acquisition of existing properties, new buildings or the renovation of existing properties is not the intended financing purpose.

In the case of the renovation of existing buildings, the conformity of green frameworks to the taxonomy requirement of "a minimum 30 % reduction in primary energy demand" is highest, even though additional requirements, such as the three-year deadline for completing the measures, are rarely applied.

When it comes to the acquisition of new buildings constructed after 31 December 2020, there are still only a small number of frameworks that reference the taxonomy criteria for new buildings, and thus requirements for primary energy demand, which must be at least 10 % below national standards for nearly zero-energy buildings (NZEBs). For instance, Norwegian frameworks specify strict requirements for the energy consumption of residential properties depending on their year of construction (so-called building codes), but at the same time lack any reference to criteria for nearly zero-energy buildings. More recent frameworks from covered bond issuers, on the other hand, already incorporate the applicable taxonomy criteria.

### Frameworks likely to be updated

As the new Technical Screening Criteria enter into force, we expect that most green frameworks will be revised in order to achieve the highest possible level of compliance with taxonomy requirements. However, this will necessitate national or regional definitions and the specification of relevant criteria, such as what constitutes the "top 15 % of the most energy-efficient buildings" and how quantitative thresholds for nearly zero-energy buildings are defined<sup>3</sup>. It would also be helpful to have a recognised classification of green building certificate classes for commercial properties. We expect that these gaps will be addressed at various speeds in the relevant member states. In Germany, new standards are likely to come sooner rather than later thanks to extensive efforts on the part of banking associations. Furthermore, it would be desirable if lawmakers were to respond swiftly in the other member states as well; after all, it is not just a matter of supporting credit institutions in financing sustainable economic growth, but also of providing greater clarity and transparency for investors.

<sup>3</sup> A standard for NZEBs was introduced in the EU in 2010 via the Energy Performance of Buildings Directive (EPBD), which has been transposed into national law by EU member states. However, the directive does not specify quantitative requirements.

## Glossary

CRVA	Climate risk and vulnerability assessment to determine risks such as temperature changes and flood disasters.
CSRD	<b>Corporate Sustainability Reporting Directive:</b> Under the CSRD, which the Commission unveiled in April 2021, the EU is revising the current rules (NFRD) for sustainability reporting by larger companies based on its Action Plan for Financing Sustainable Growth and expanding its scope. It is being implemented in stages: For all major publicly listed companies, disclosure requirements will apply from January 2022 for the first two environmental objectives in the non-financial reporting and for all six objectives from 2023.
EED	Energy Efficiency Directive: The previous directive on energy efficiency that was adopted in 2018. In July 2021, the EU Commission published a new <b>draft directive</b> with more stringent energy efficiency targets.
Major renovation	Major renovation: Refers to the renovation of a building for which (a) the total cost of the renovation with respect to the building envelope or technical systems is greater than 25% of the value of the building, excluding the value of the land on which the building is located, or (b) more than 25% of the surface area of the building envelope is undergoing renovation.
GBP	<b>Green Bond Principles:</b> The Green Bond Principles require issuers to establish rules on the use of the proceeds of the issue, individual project selection, management of the proceeds and reporting. They therefore primarily define the framework for green bonds, while the specific requirements are defined individually.
Nearly zero-energy building	Designates a building with very high energy efficiency. The buildings nearly zero or very low energy consumption should be covered to a very significant extent by renewable energy, including energy generated on site or nearby from renewable sources.
SFDR	<b>Sustainable Finance Disclosure Regulation:</b> Sustainability-related disclosure requirements for financial service providers have applied since the beginning of March 2020.
TSC	Technical Screening Criteria: The Technical Screening Criteria ( <b>Annex 1 and 2</b> of the <b>Taxonomy Regulation</b> ) are used to determine the conditions under which an economic activity can be assumed to make a significant contribution to climate change mitigation (Annex 1) or adaptation (Annex 2) and whether this economic activity does not significantly harm any of the other environmental objectives.
Energy poverty	Energy poverty: In 2010, the World Economic Forum defined energy poverty as a "lack of access to sustainable modern energy services and products".



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