

## PFANDBRIEFE UND COVERED BONDS

## COVERED BONDS AND THE TRANSITION TO A SUSTAINABLE ECONOMY

Issuers want to get more of them into the market. Investors can't get enough of them. And policymakers try to facilitate their growth. We are of course talking about the promisingly growing segment of sustainable covered bonds. The authors take a close look at its current developments and come to a cautiously optimistic conclusion. Among other factors, sustainable issuances may benefit from the ongoing normalization in monetary policy and rising interest rates. At the same time, upcoming bank regulation may reduce the costs of setting up ESG covered bond issuance programs versus an unsecured one. Red.

More and more banks have been issuing sustainable covered bonds to finance new and existing assets that meet certain sustainability criteria. These products have been issued in three formats – green, social, and sustainability bonds – and generally aim to contribute to the achievement of the sustainable development goals set in 2015 by the U.N. 2030 Agenda for Sustainable Development and the Paris Agreement.

The public sector alone cannot fund the investments required to achieve these targets. The EU, for example, estimates that more than 260 billion euro will have to be invested annually through 2030 to meet its climate and energy savings goals. Three-quarters of these investments should be committed for improving energy efficiency in buildings, in the EU's view.

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This is because the buildings sector is responsible for about 40 percent of energy consumption and 36 percent of carbon emissions. And this is where sustainable covered bonds can play a key role in the transition to a more sustainable economy. The covered bond market as a whole accounts for 2,9 trillion euro in outstanding funding and is a major financing tool for mortgage loans, especially in Europe.

### Sustainable covered bond markets are growing fast

The first sustainable covered bond was issued in 2014, with the first green and social covered bonds coming the following year. The market has expanded rapidly in the past few years and constituted almost 18 percent of benchmark European covered bond issuance in 2021, up from less than 5 percent in 2018. In 2022, there had already been 10 billion euro of sustainable covered bond issuance as of mid-May, putting the market on track for a new volume record by year-end (see figure 1).

Most sustainable covered bonds are backed by mortgages (87 percent of the amount outstanding), while the rest are backed by public sector loans. This reflects the fact that most sustainable covered bonds are green bonds that typically finance energy-efficient buildings.

The sustainable covered bond market is diversifying in terms of issuers and countries. A record number of financial institutions entered the sustainable covered bond market for the first time in 2021, and the number of green or social covered bond issuers increased from less than 15 in 2018 to more than 50 in 2022. The largest countries in terms of sustainable issuance are traditional covered bond markets, such as France, Germany, and Norway, but new

markets such as Korea are also growing fast.

### Three main reasons for lack of supply

Still, according to the European Covered Bond Council, sustainable covered bonds constitute only 1 percent of the total amount outstanding and supply volumes remain relatively low in absolute terms, despite strong growth.

Three main reasons explain the lack of supply. First, issuers may struggle to find eligible cover pool assets. Finding sufficient eligible green and/or social loans to at least match the amount of sustainable covered bonds outstanding can be challenging.

The underlying assets must meet the criteria of issuers' green or sustainable frameworks, as well as existing eligibility requirements for covered bond collateral pools. Banks may find it difficult to identify sufficient eligible assets on their balance sheets, due to a lack of loan-level data or access to public registries that may contain such data, including energy performance certificates.

In addition, setting up a green or social covered bond issuance program is more complicated and costly than an unsecured one. On the mortgage side for example, issuers must adapt their information technology systems, check energy certificates, and adapt loan contracts in order to receive the required information.

Finally, the pricing differential between green and vanilla issuance is greater in the senior unsecured space than for green and vanilla covered bonds. This may mean issuers favor the former.

### EU-initiatives: increased burden, but also greater clarity

However, as the regulatory framework becomes more supportive, banks may be incentivized to issue sustainable covered bonds, as both a funding strategy and a means to improve their environmental, social, or governance (ESG) credentials. The

EU has recently approved or amended several regulations that follow the full investment cycle, including the regulation on sustainability-related disclosures, the Taxonomy regulation for climate change, and the benchmark regulation.

While these initiatives may increase the burden on issuers and investors in terms of transparency requirements, they also provide greater clarity for banks planning green or social issuance. Moreover, investor demand for sustainable issuance continues apace.

To date, sustainable covered bonds have generally been significantly oversubscribed in the primary market. Bankers report that a more diverse investor base is looking at these instruments. On top of traditional covered bond investors, ESG-dedicated funds are also placing orders.

### Greenium could soon become a supportive factor

This additional demand has not consistently translated yet into a cheaper cost of funding for issuers – the so-called “greenium” – partly because accommodative monetary policy had, until recently, kept interest rates close to zero. However, market participants believe that this additional demand could become a supportive factor, for example in times of market correction or in the rising interest rate environment that we are now seeing.

Even traditional covered bond investors view sustainable issuance favorably. Most have introduced qualitative or quantitative

ESG considerations into their investment policies, and green or social covered bonds tend to perform better in their ESG analyses.

Investors identify three main sources of concern. The first is the lack of asset segregation, because upon issuer insolvency green or social assets will be mixed with other brown assets in the cover pool.

The second is a lack of liquidity – sustainable covered bonds are generally easy to sell but very difficult to buy. Third is so-called “greenwashing”, or the risk that sustainability claims made by issuers might be overstated or unreliable (see figure 2).

While the structural issue of asset segregation will probably not be addressed until we see the first programs that are exclusively backed by sustainable assets, an increase in issuance volumes could assuage the second concern and recent regulatory developments may help with the third.

### The Regulatory Landscape

Sustainable finance plays a key role in delivering on the policy objectives under the EU’s international commitments on climate and sustainability. Two initiatives appear to be more relevant for covered bonds: The EU Taxonomy and the European Green Bond Standard.

The Taxonomy regulation, which came into force in July 2020, defines sustainable economic activities according to the EU. Its application will become progressively relevant to comply with various disclosure

requirements, such as the sustainable finance disclosure regulation and the corporate sustainability reporting directive. It will also be relevant for the development of official labels for financial products, such as the proposed EU Green Bond Standard.

The regulation identifies six environmental objectives. An economic activity should “substantially contribute” to one or more of these objectives to be classified as “environmentally sustainable” and thus Taxonomy compliant.

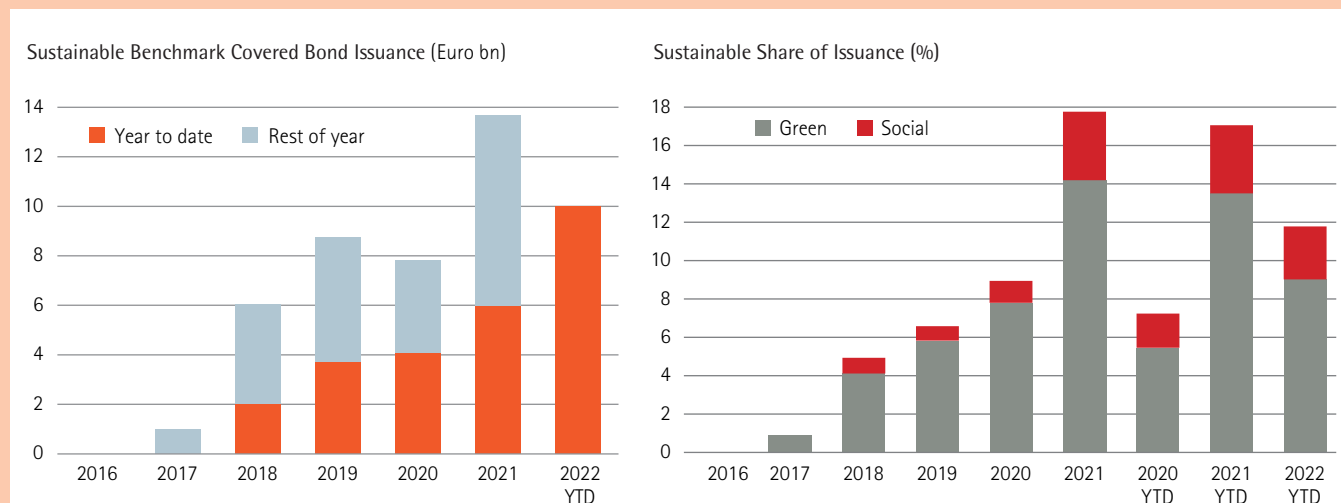
Furthermore, such activity should: i) “Do no significant harm” to any of these objectives (i.e., should avoid adverse environmental impacts); ii) Comply with the minimum safeguards (i.e., should avoid adverse social impacts); and iii) Comply with technical screening criteria (TSC).

Market participants have generally welcomed the Taxonomy as an important tool for defining what is sustainable, but the alignment of existing frameworks is expected to be time-consuming and challenging, particularly with respect to the “do no significant harm” and minimum safeguards criteria.

### EUGBS: voluntary and open to all stakeholders

The EU Green Bond Standard (EUGBS) is a proposed regulation which intends to set a common framework of rules for the designation of European Green Bonds: those that pursue environmentally sustainable goals as defined by the Taxonomy regulation.

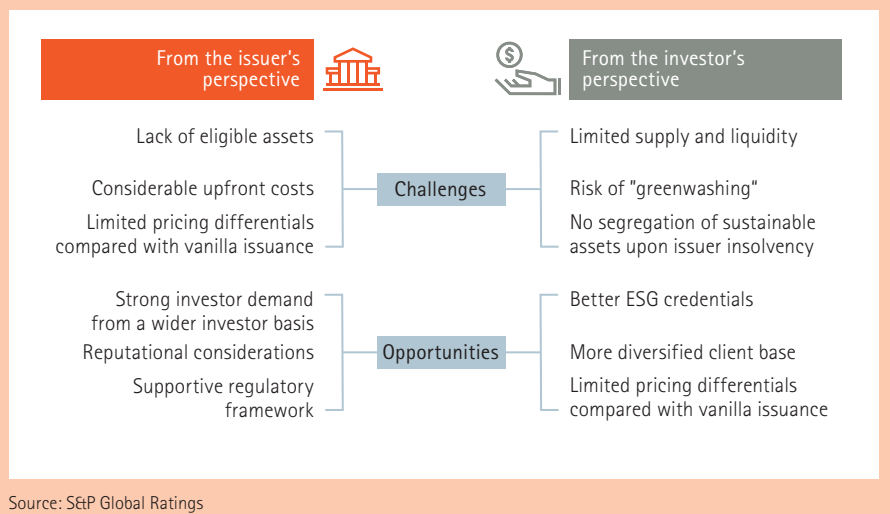
Figure 1: Sustainable Benchmark Covered Bond Issuances since 2016



Source: S&P Global Ratings

YTD figures as of May 31 each year.

Figure 2: Drivers Of Sustainable Covered Bond Supply And Demand



It also sets up a system for the registration and supervision of external review providers. The EUGBS will be voluntary and open to all issuers inside and outside the EU, including corporates, financial institutions, and sovereigns.

The proposed framework shares similarities with the current market standards, such as the ICMA principles, and is designed to be compatible with them. There are two key differences: a requirement that the funded economic activities are fully aligned with the EU Taxonomy and the regulation around external review providers.

### Potential lack of consistency raises concerns

Issuers will be able to issue European Green Bonds even if they are not Taxonomy-compliant at the time of issuance, but will be so within a period of five to ten years, according to a Taxonomy alignment plan. Furthermore, as the TSC will likely be reviewed and amended over time, issuers will need to apply bond proceeds under the amended criteria within a five-year period to keep the EU Green Bond designation.

This potential lack of consistency between criteria at issuance and throughout the bond's life raises concerns. Some market participants believe that the five-year period to adapt to new TSC requirements may be insufficient to find alternative eligible assets, which may lead some banks to prefer other formats of green debt – such as senior non-preferred – or the issuance of relatively shorter dated green covered bonds.

S&P Global Ratings recognizes external stakeholders' increasing desire for more

information about how ESG factors influence our credit rating analysis. We assess ESG factors through our applicable criteria, including our covered bonds criteria.

### S&P Global Ratings' Analytical Approach

Although these factors can influence our assessment of any analytical component described in these methodologies, they are most likely to affect (when material) our collateral support analysis and the issuer credit rating (ICR) on the issuing entity. ESG credit factors have a relatively limited impact on our rating analysis of covered bonds.

They can influence ratings, outlooks, and credit enhancement required for the assigned rating. Environmental and social factors typically affect the quality of the assets in the cover pool and the results of our collateral analysis. Governance factors, on the other hand, usually affect the uplift that we assign to a covered bond program above the ICR on the issuing entity.

Our recently introduced ESG credit indicators provide additional disclosure by reflecting our opinion of how material the influence of ESG factors is on the various analytical components in our rating analysis through an alphanumeric 1–5 scale.

### Existing credit ratings are not affected

Governance is the factor that influences covered bonds' collateral based uplift in most instances, generally more negatively than positively. About a quarter of our rated covered bonds have a governance credit

indicator of G-3 or G-4. About 15 percent of the rated programs have an S-1 assessment, while environmental factors have a very limited influence on our credit rating analysis of covered bonds.

Importantly, ESG credit indicators do not affect our existing credit ratings. Rather, they reflect how influential ESG factors are to our credit rating analysis. We incorporate in our credit rating analysis those ESG factors that materially influence creditworthiness and for which we have sufficient visibility and certainty. ESG credit indicators do not affect a rating committee's decision nor change our approach to credit ratings. They are not a sustainability rating or an S&P Global Ratings ESG evaluation.

### Positive issuance outlook

We believe that sustainable covered bond issuance should grow further, supported by strong investor appetite. Covered bond issuance has rebounded strongly since the second half of 2021, after dropping due to accommodative monetary policies introduced during the Covid-19 pandemic.

This has also lifted sustainable issuance: despite a weak start in 2022, volumes at the end of May comfortably exceeded issuance over the same period of 2021 – already a record year. The lack of a significant "greenium" could remain a negative factor for issuers in the near term.

However, the ongoing normalization in monetary policy and rising interest rates may allow for a greater differentiation between yields on vanilla and sustainable issuance, with the latter benefitting from a wider investor base. At the same time, upcoming bank regulation may reduce the costs of setting up a green or social covered bond issuance program versus an unsecured one.

Financial institutions will need to comply with new transparency requirements regardless. The lack of eligible assets appears the most significant constraint to further issuance for the foreseeable future, but several ongoing initiatives should facilitate the identification and ultimately increase the supply of eligible assets.

For further information on our covered bond research, please visit [www.spglobal.com/ratings/en/sector/structured-finance/covered-bonds](http://www.spglobal.com/ratings/en/sector/structured-finance/covered-bonds)