29 April 2020

COVID-19:
EMF-ECBC First Contribution to Joint EU Recovery Plan

Context

In the context of the current COVID-19 outbreak and the significant impacts that this is expected to have on the global economy, the **European Mortgage Federation - European Covered Bond Council (EMF-ECBC)** stands ready to act in the interests of consumers, lenders and investors to help secure financial stability and stimulate socio-economic recovery. To this end, the EMF-ECBC is keen to play its part as a market catalyst and think tank at European and global levels, fostering and coordinating market and policy actions focused on immediate measures to mitigate adverse systemic impacts.

In particular, we are acutely aware of and concerned about the potential consequences of this outbreak on the economic well-being of each and every European citizen in terms of changes in their income and ongoing living costs, as well as the potential impacts on the entire value chain, the functioning of capital markets and the ability of investors to conduct due diligence.

In this respect and being mindful of the role our Industry can play in supporting efforts to address this and future economic challenges, the EMF-ECBC is at the complete disposal of the European Institutions to offer its intelligence, expertise and network to support actions responding to this unprecedented crisis.

Current actions

As a first concrete step towards supporting efforts to address current and future economic challenges in the context of the COVID-19 outbreak, the EMF-ECBC has established a special Task Force on COVID-19.

The work of the Task Force is already underway to, in the first instance, analyse the impacts on mortgage and covered bond markets, compile relevant national, European and international measures and gather critical statistics (see here for dynamic reporting document). Using this intelligence, the Task Force will move into a second stage, during which it will identify market best practices and solutions with a view to delivering market coordination and support to a future recovery plan. Crucial to this will be a dynamic dialogue with EMF-ECBC members in Europe and globally, as well as European and international institutions and organisations.

The Task Force is composed of retail, funding and investment bank representatives appointed by the EMF Executive Committee and ECBC Steering Committee for each Member jurisdiction and meets virtually at least once a week and will do so for as long as is necessary.

Areas of Strategic Importance for Recovery Plan

Contribution to the Recovery Plan from Capital Markets & Sustainability

In the context of a European recovery plan, we believe that, in full alignment with the Capital Markets Union and Banking Union, long-term financial instruments will be of particular help in supporting the recovery from the capital markets side:

- Covered bonds supporting the recovery through long term financing of mortgage, public sector & ESG assets

Covered bonds offer huge potential to mobilise private capital to support the recovery. The covered bond is a finance mechanism linking financial markets and the real economy. The macroprudential value of this tool is deeply rooted in the high-quality nature of the collateral and the legal infrastructure protecting investors with a dual recourse mechanism. The

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focal point of this mechanism is the mortgage system and the lien to a real estate guarantee or public sector financing guaranteed by the State or other local authorities.

For centuries, the **mortgage finance** mechanism has been used to secure private capital inflows by providing a solid legal framework to protect long-term investors with a legal-financial safe harbour to boost private and public investments in relation to strategic objectives.

Covered bonds are one of the safest and most successful long-term financing instruments in use in Europe and played a central role in the crisis management toolkit of banks during the financial crisis by providing a safe and reliable source of funding. It is important to note here the fact that covered bonds are also recognised as eligible assets for the liquidity facilities of the ECB, which is crucial to preserve and, if possible, enhance the ability of credit institutions to weather crises such as the present one.

In many European countries, covered bonds play a key role not only for the funding of mortgages, but also for the refinancing of loans to the **public sector** (public entities, national, regional or local authorities). Around a third of the total outstanding loans to local government in countries like France, Germany and Spain are re-financed via the issuance of public sector covered bonds. There is evidence that huge amounts of public sector spending will be required in order to secure the recovery of the EU economy, not limited to the area of health and hospitalisation services.

Public sector covered bonds can secure private capital flows to the public sector and in doing so complement the actions already taken at EU and national levels. Mitigating the significant impacts of EU and Member States' measures on public debt levels, public guarantee schemes can also be used to mobilise private investors. Exposures to the real economy guaranteed by central or regional governments, by local authorities, public sector entities, multilateral development banks or international organisations are cover pool eligible and therefore suitable for covered bond funding. The major effect consists of private investors alleviating public budgets while ensuring continuous funding of businesses and households.

Since 2019 and building on national legislative frameworks, the covered bond product has been rooted at EU level in a dedicated legislative framework which crowns a series of significant achievements in developing the European Single Market, reinforcing financial stability in financial markets and supporting the concrete implementation of the Banking Union and a Capital Markets Union (CMU). This framework also represents a clear legislative benchmark at a global level. Indeed, the recognition of the macro-prudential value of this instrument by the Basel Committee in 2010 provided an impetus for global development, especially in emerging countries such as Brazil, Malaysia, Indonesia, Morocco, Turkey, South Africa, but also in established economies such as Australia, Canada, South Korea, Japan and Singapore.

- European Secured Notes providing financing for SMEs and green & infrastructure assets

A key challenge and priority of the recovery of the European economy will be maintaining financing of Europe's businesses. It will be extremely important to identify practical and operational long-term solutions to secure liquidity especially to SMEs.

Building on the success of the covered bond product as described above, the EMF-ECBC has been working on a market initiative to create a new pan-European dual-recourse long-term funding instrument called the European Secured Notes (ESN). This instrument would allow for the financing of asset classes beyond the traditional covered bond collateral types of mortgages and public sector assets such as SMEs and/or green/infrastructure assets. This initiative combines existing techniques and market best practices for the establishment of a funding solution for lenders that is also accessible in a stress scenario.

One of the key success factors of traditional covered bonds is the common adoption of the same set of micro foundations and technology, in particular in terms of eligibility criteria, definitions, legal infrastructure and public supervision, risk parameters, data disclosure and IT solutions across European countries. If correctly implemented, supported by a minimum level of regulatory recognition as a very high-quality product under a clear legislative and supervisory framework, ESN could replicate the contribution of covered bonds to ensuring financial stability and access to finance for SMEs during this time of crisis.

On several occasions, the ESN project has been welcomed by institutions such as the European Central Bank, the European Commission, the European Investment Bank, the European Banking Authority and several national regulators.

We are ready to take action with our specially dedicated ESN Task Force and support the introduction of ESN across European markets, based on a new, distinct framework for this instrument. The financing of private sector business is key to the recovery of the European economy after the pandemic.

- Energy Efficient Mortgages & Green Recovery

In recent weeks as the COVID-19 crisis has unfolded, EU heads of state, MEPs and market stakeholders among others have emphasised the importance of preparing **a comprehensive plan which also integrates the green transition in the economic recovery**.

The EMF-ECBC has been leading for almost five years on **an Energy Efficient Mortgages Initiative (EEMI)** comprising three EU-funded Projects: the Energy Efficient Mortgages Action Plan (EeMAP), the Energy Efficient Data Protocol & Portal (EeDaPP) and the Energy Efficient Mortgage Market Implementation Plan (EeMMIP)[1]. The EEMI is intended to develop an "energy efficient mortgage" product to support energy efficient housing and infrastructure and secure market development over an accelerated timeframe.

Significantly, the EEMI **responds to the European Commission's overall aim of mobilising private finance** to fund the energy transition and **specifically to key priorities of the European Commission's Sustainable Finance Action Plan** through: (1) standardised classification and well-aligned benchmarks for what assets can be considered as significantly contributing to environmental goals through the **EEM definition** agreed in December 2018, which is aligned with the EU Taxonomy, (2) a labelling initiative, the **Energy Efficient Mortgage Label**, aligned with the European Commission's Plans for the widening of the scope of the EU Ecolabel[2] to financial products and (3) by demonstrating a **correlation between energy efficiency in buildings and mortgage performance**, in the context of the European Commission's commitment to explore the feasibility of the inclusion of risks associated with climate and other environmental factors in institutions' risk management policies and the potential calibration of capital requirements of banks as part of the Capital Requirement Regulation and Directive. Finally, the EEMI is also making an important contribution to the **Renovation Wave**, part of the European Green Deal, which could be a key element of a post-COVID recovery plan because of its benefits for stimulating economic activity.

The EEMI represents the first time that a group of almost **60 major banks**, as well as data providers, companies and organisations from the building and energy industries together with the valuation profession, from across the EU and beyond, have proactively come together to consider and develop private financing of energy efficiency. As the largest source of external financing, banks are the backbone of the EU financial system. Considering that the EU's building stock is responsible for 40% of the EU's total energy use, and that the value of the European mortgage market is equal to 53% of the EU's GDP, there is huge potential to unlock the benefits of mortgage financing to support energy efficiency, whilst at the same time helping to ensure that the recovery from the COVID-19 crisis is also a green one.

The EEMI was born from the realisation that banks, in financing the purchase of property, can play a **game-changing role in supporting the EU's energy savings targets**, by bringing energy efficiency into the conversation between banks and consumers by means of a standardised approach to the financing of energy efficient buildings/renovation. As the Initiative got underway, it also became clear that our efforts would furthermore (i) **deliver a new asset class**, an energy efficient mortgage, which could be used **for the purposes of green bond and green covered bond issuance** and (ii) **contribute to financial stability** as a result of such an asset class proving to be less riskier.

We remain absolutely committed to this Initiative at this crucial time.

[1] EeMAP (Grant No. 746205) developed a standardised "energy efficient mortgage" product framework, including building energy performance measurement parameters and property valuation guidelines. EeDaPP (Grant No. 784979) is intended to deliver a market-led protocol which will enable the large-scale recording of data relating to energy efficient mortgage assets, via a standardised reporting template. Finally, EeMMIP (Grant No. (894117) will build on efforts to develop EEM by delivering an integrated market and a blueprint for established and emerging markets around the globe. A key deliverable will be the EEM Label to support recognition of and confidence in EEM and facilitate access to quality information for market participants.
2 The Commission proposed the creation of a voluntary EU-wide labelling scheme through the extension of the EU Ecolabel to financial products (Action 2.3 of Action Plan).

Energy Efficient Mortgages as a Risk Mitigant

As indicated above, one of the key premises of the Initiative is that **energy efficiency has a positive impact on credit risk and can contribute to financial stability**. Energy efficiency frees up disposable income which can positively impact borrowers' ability to service their loan, thereby lowering the Probability-of-Default (PD). Improved energy efficiency can also increase the value of the property, thereby lowering the loss for the bank in the case of default, i.e. the Loss-Given-Default (LGD). Given the fundamental role of these risk indicators in the calculation of banks' capital requirements, establishing a correlation between energy efficiency and PD and LGD provides a strong business case for lenders to originate energy efficient mortgages.

In this respect, existing literature already points to a correlation between building energy performance and increased property value and lower probability of default. The innovation brought by the EEMI is to conduct analysis on banks' current loan books and to enable banks to track performance over time. With regard to the latter, the EEMI has delivered a data protocol and is designing a portal to collect and access large-scale empirical evidence relating to energy efficient mortgage assets allowing a comprehensive analysis of de-risking energy efficient features.

Early research conducted under the EEMI confirms the correlation between building energy performance and lower credit risk but also points to the fact that a correlation cannot be concluded only by looking at one-time snapshots of narrowly defined market segments. As such, this preliminary analysis laid the foundations for additional research and, at the time of writing, banks and other stakeholders are participating in a more in-depth and extensive quantitative assessment, the results of which will be available by August at the latest.

Once this positive correlation has been established under the EEMI using the large-scale empirical evidence described earlier, **we believe that the lower risk of energy efficient mortgages could be recognised by regulators via a realignment of the capital requirements for these exposures.** This recognition would help to reinforce the business case for lenders, underpin the virtuous circle of positive spill-overs for all stakeholders in the value chain and scale-up market development.

EEM Label: Market Enabler focussed on Transparency & Quality

In parallel, as a concrete and robust sign of the Industry's commitment to supporting the transition to a more sustainable economy and, at the same time, to contributing to a **green recovery**, the EMF-ECBC is accelerating its preparations for the launch of an Energy Efficient Mortgage Label which is considered to be one of the key market enablers of the large-scale uptake of energy efficiency mortgages. Such a Label will be consistent with the EU Taxonomy. The launch date, depending on the further evolution of the Covid-19 outbreak, is scheduled for 24-25 September 2020 in Venice. The Label will be built mirroring the success of the Covered Bond Label.

The primary objective of the Label will be **to reassure markets and regulators** that mortgages comply with the EEM definition and guidelines as well as **demonstrate a responsible commitment to transparency and common reporting** on quantitative and qualitative performance indicators. A Label Committee will ensure oversight and ongoing alignment of the EEM definition with high quality standards and market best practice at EU and national level. It will also be responsible for improving regulatory and market recognition of EEM as a new asset class.

The origination of energy efficiency mortgages may include additional challenges for defining, assessing, monitoring and maintaining the improved environmental performance, and transparently communicating performance to regulators and other market actors over the lifetime of the mortgage. In this sense, the Label will help lending institutions to follow the defined EEM criteria to effectively de-risk their portfolios by identifying energy and climate risks by determining which loans and underlying assets are better. By improving the access to relevant and transparent mortgage information for investors, regulators and other market participants via a consistent reporting template, the Label can become a powerful communication tool to further help the securitisation and issuance of green bonds and covered bonds.