

European Mortgage Federation – European Covered Bond Council (EMF-ECBC)

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Usability of the EU Taxonomy in the context of covered bonds

In the EU, buildings are effectively the largest energy consuming sector, responsible for around 40% of energy consumption, 36% of carbon emissions, and about 75% of the building stock is considered energy inefficient. Thus, the need for energy improvement is large and renovation rates must be increased. Therefore, it is important to incentivize and channel capital into energy efficiency investments.

Covered bonds are one of the largest asset classes in Europe throughout most jurisdictions. Covered bonds, being backed by mortgages on real estate, are thus essential in order to set the whole building stock on a net-zero emissions pathway. Therefore, it is important to ensure that the EU Taxonomy works in practice and can be applied to covered bonds markets in the EU, especially considering that mortgages are a long-term asset class. Also, EU Taxonomy should support credit market models that support long-termism, financial stability and low-cost financing for e.g. homeowners.

To ensure that the EU Taxonomy works in practice and supports credit market models, **we suggest that assets keep the classification of taxonomy aligned throughout the lifetime of the loan financing the asset as a way of providing certainty and predictability.**

The rationale is to provide certainty and predictability to borrowers, lenders (which in case of Covered bonds are in general also issuers of the bonds) and investors. Providing certainty and predictability is crucial for the transition towards more sustainable finance. Financial assets are directly linked to economic activities, such as real estate activities. The risk of losing taxonomy eligibility due to changes in the EU taxonomy creates possible barriers to long-term investments.

To illustrate how crucial certainty and predictability are, consider the following example:

A homeowner wants to renovate her house, and at inception the renovation is considered taxonomy aligned. The homeowner wants to finance the renovation with a mortgage loan, e.g. a mortgage loan labelled 'green mortgage'. The credit institution funds the loan using a bond, e.g. a green bond, to fund the mortgage loan, which is bought by an investor. Now, suppose that the EU Taxonomy changes one year after the renovation, and that the renovation no longer is considered taxonomy aligned.

If the renovation does not keep its status as taxonomy aligned, the homeowner's mortgage is no longer green, and the investor does not longer hold the green investment. This regulatory uncertainty will be a risk and a hurdle for the green transition.

Alignment between proposal and TEG recommendation for the EU Green Bond Standard

We would like to point to the TEG's recommendation in the report on the EU GBS, page 29

"... it is important to note that subsequent changes to the Taxonomy will not apply to outstanding EU Green Bonds", and point to the published Usability Guide on the EU GBS. The TEG recommends that:

Green Bonds issued under earlier Technical Screening Criteria be grandfathered for their entire tenor, that is EU Green Bonds maintain their status as 'EU Green Bond' for the entire term to maturity regardless of later changes to the EU Taxonomy criteria (p. 32 Usability Guide on EU GBS).

Covered bonds are securities backed by a defined pool of mortgage loans: the covered bonds therefore refinance the underlying pool of mortgages, which are identified and ring-fenced in favor of the investors. Therefore, in covered bonds there is a structural link between the asset and the liability side which cannot be ignored. Taking into account the TEG's recommendation, we consider the grandfathering of the EU Green Bonds for their entire tenor to be equivalent to considering both the covered bonds and their underlying assets as taxonomy eligible throughout their lifetime. Therefore, we suggest that the TEG's recommendation also applies not only to the covered bonds but also to the underlying assets, e.g. real estate mortgage loans.

A certain flexibility would ensure the transition toward EU Green financing

Generally speaking, 100% of the proceeds of green bonds issuances should be used to finance or refinance physical or financial assets or green expenditures that are green as defined by the EU Taxonomy. However, we believe there is a need for flexibility. This could apply at least for a transition period. The EU Taxonomy introduces a new significant risk for issuers in terms of validating whether the ESG requirements have been met at all times by customers – both in terms of minimum safeguards, DNSH-criteria but also the technical criteria that all require a very high level of expertise and control systems at the issuers' level.

In order to achieve the climate goals in the real estate sector, banks could grant Taxonomy compliant mortgage loans with a discount to borrowers. Assuming that the EU GBS will play an important role in the future, these banks should have the possibility to refinance these mortgage loans through GBS labelled covered bonds. However, this requires large volumes of Taxonomy compliant mortgage loans, since investors usually ask for a minimum issue size for green bonds of at least 250 or 500 mn EUR. If the banks have to collect Taxonomy compliant mortgage loans until they have reached such volume, it would take years before they could issue an EU Green Bond. This, in turn, could mean that the banks would not be able to offer favorable conditions for Taxonomy compliant loans to borrowers, which would hinder the achievement of the climate goals.

Covered Bonds and the EU Green Bond Framework

Loans serving as security for covered bonds may finance green, i.e. taxonomy eligible assets, such as buildings. Whether the building or loan financing the building is green is determined by the version of the EU Taxonomy applicable at the time of granting the loan. It is important that the EU Taxonomy can be applied to covered bonds using the same method, that the TEG recommends in section 3.3.4. p. 40 in the final report on Taxonomy, that is

“... Disclose the proportion of underlying investments that are Taxonomy-aligned, expressed as a percentage.”

We find that issuers of covered bonds should be allowed to base their periodic reporting on the greenness of the collateral in the cover pool using the version of the EU taxonomy in place at the time of granting the loans backing the bond. In other words, it should be possible to label the proportion of assets in the cover pool that are aligned with the EU Taxonomy.

These covered bonds should still live up to the same requirements as 100% Taxonomy aligned covered bonds – i.e. verification, 2nd party opinion, allocation reporting, impact reporting, et cetera.

The investors would still have an incentive to buy covered bonds from a cover pool with a high percentage of EU taxonomy aligned assets, which would give the issuers an incentive to promote lending to green projects.