1.5 SOCIAL/SUSTAINABILITY COVERED BONDS – GAINING MOMENTUM

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The issuance of social bonds attracted particular attention during the peak phase of the pandemic, when a large number of (acute) measures to combat the crisis, such as short-time working allowances or aid loans to SMEs, were refinanced via social bonds on the capital market. The issuance volume of social bonds in the EUR market reached a preliminary peak last year with EUR 111 billion (+24% vs. previous year). In the current year, the volume of social bonds has reached EUR 28.3 billion until the end of May. A decline in issuance is noticeable here – also caused by the cessation of EU Sure issuance activity.

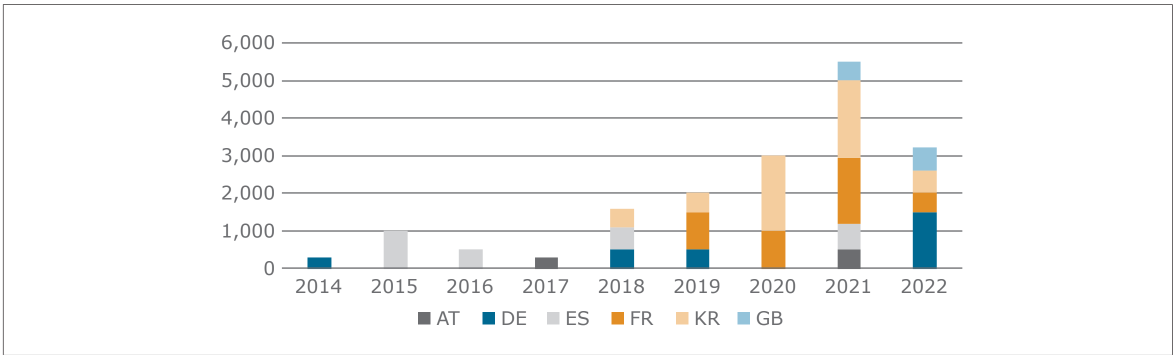
As the pandemic winds down, the issue of social housing in particular is coming into focus in the covered bond segment. Rising interest rates, inflation-related increases in construction costs and a price environment that has remained dynamic in the majority of European markets in recent years make the topic of housing one of the most important social issues of our time. Thus, in recent months, a number of newcomers have entered the social covered bond market whose programs focus on the issue of social housing. These include issues by Yorkshire Building Society and Berlin Hyp. DKB's latest issue also focuses on social housing, after the issuer had previously focused on water management. Nevertheless, the share of newly issued social and sustainability covered bonds compared with the overall covered bond market in the EUR benchmark segment is currently declining. After doubling to 6% in 2021, the share of social/sustainability issues in the new issue volume in the EUR segment is only around 3% this year - also driven by the generally higher issuance activity. The total issue volume of social/ sustainability covered bonds reached the equivalent of EUR 3.2 billion in 2022 ytd in all currencies – and we have seen the first issuance of a social covered bond in GBP. All other issuances are EUR-denominated.

MARKET OVERVIEW FOR SOCIAL/SUSTAINABILITY COVERED BONDS

As of the end of May 2022, 12 different issuers with 25 transactions (thereof 20 EUR benchmark deals) have been active in the social covered bond market. In addition, three issuers from two countries have issued a total of four EUR benchmark sustainability covered bonds. The total volume of currently outstanding social/ sustainability covered bonds currently amounts to EUR 16.8bn, which corresponds to less than 1% of the global covered bond market.

Nevertheless, the market for social covered bonds has had an impressive growth story since Muenchener Hypothekenbank eG issued the first ESG covered bond with a sub-benchmark volume and a social focus back in 2014. This was followed in 2015 by the first benchmark-sized social covered bond issued by Kuxtabank. Momentum picked up in 2018 with two EUR benchmark social covered bonds and one sustainability covered bond. Since then, the number of benchmark transactions has increased every year, reaching eight transactions in 2021.

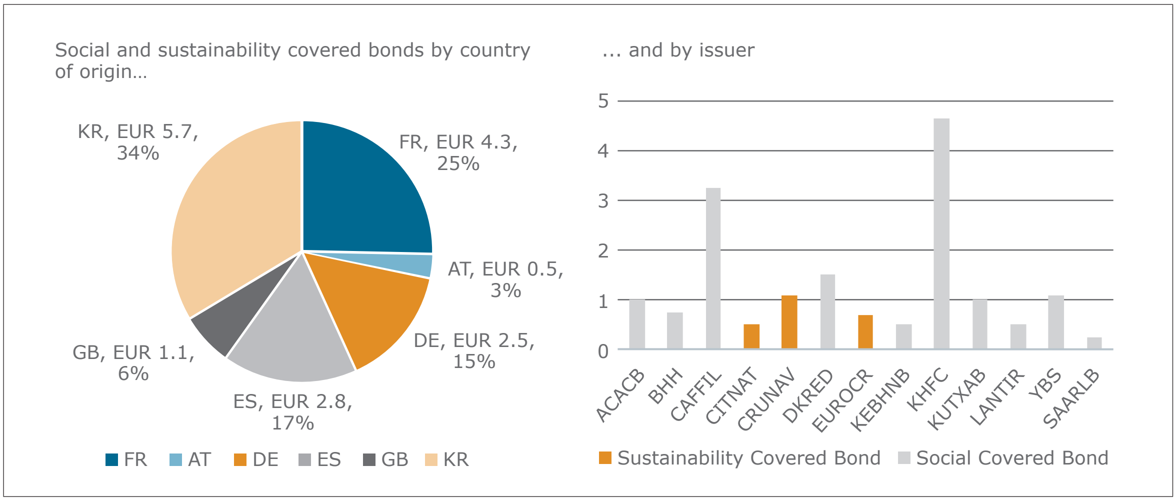
> FIGURE 1: PRIMARY MARKET ACTIVITY OF SOCIAL/SUSTAINABILITY COVERED BONDS IN EUR MN



Source: Bloomberg, LBBW Research

Looking at the regional distribution of primary market activities, an initial focus in Europe becomes clear. After starting with a sub-benchmark Pfandbrief from Germany, all issuers in the following years were Spanish except for one Austrian issue. In 2018, public sector covered bonds and the first issue from Korea followed. Subsequently, Korean issuers dominated the market and issued a total of around 1/3 of the total market volume for social/sustainability covered bonds, led by Korea Housing Finance. Since mid-2021, however, European issuers have again increasingly entered the market. French issuers entered the market relatively late (from 2019), but now occupy second place with a volume of EUR 5.7 billion. Meanwhile, CAFFIL became the largest issuer of social covered bonds in Europe.

> FIGURE 2: MARKET OVERVIEW (BONDS OUTSTANDING)



Source: Bloomberg, LBBW Research

PURPOSE AND USAGE OF SOCIAL COVERED BONDS

In general, social covered bonds fund projects that help to deal with a specific social issue and/or seek to achieve positive social outcomes for specific target groups. Sustainability Bonds provide the possibility to finance both green and social projects under the same format. Social and sustainability covered bonds have the same high security standards and risk profiles as "regular" covered bonds. Therefore, there should be no significant price differences between comparable covered bonds. However, possible (minimal) differences could result from the broader investor base and the associated higher demand for social and sustainability covered bonds. In the market, however, the question of price differences between social and sustainability covered bonds compared to "normal" covered bonds is difficult to answer. For most issuers, a comparison between a social/sustainability covered bond and a regular covered bond transaction fails due to transactions with similar maturities. In addition, there is the still compressed spread environment and liquidity considerations. With the few transactions where a comparison is possible, no significant premium of social/sustainability issuances can be identified compared to the "regular counterparts".

In the absence of corresponding legal foundations and a social taxonomy, which is currently still in the works, corresponding market standards have emerged in recent years in the form of the Social Bond Principles (SBP) and the Sustainability Bond Guidelines of the International Capital Market Association (ICMA). Both principles deliberately do not contain a final classification of project categories in order not to pre-empt corresponding national and international legislative initiatives.

Based on the Social Bond Principles, the following six areas of application are possible, but not limited to:

> Affordable basic infrastructure (e.g. clean drinking water, sewers, sanitation, transportation, energy)

> Access to essential services (e.g. health, education and vocational training, healthcare, financing and financial services)

> Affordable housing

> Creating employment and preventing unemployment stemming from socioeconomic crises, including through the potential effect of SME financing and microfinance

> Food security and sustainable food systems

> Socio-economic advancement and empowerment

In general, social projects according to the ICMA standards should be aimed at specially – but not exclusively – defined, specific population groups, which is an important element of the Social Bond Principles that might include people living below the poverty line, the unemployed, or vulnerable groups. The definition of these target population groups depends on local circumstances and may also include addressing the general public.

Many projects in areas like social housing or education serve social and environmental targets at the same time. The ICMA standards suggest that a classification of the proceeds as a social bond in this case should be based on the issuer's main objectives for the underlying projects. At the same time, issuers have the opportunity to intentionally mix green and social projects in a sustainability bond program. In the covered bond space, this can include for example energy efficient buildings, the reduction of waste or emissions. It can be attractive for issuers to pool both green and social project categories to generate sufficient lending volumes and sufficient assets for regular issuance.

Most issuance programs apply ICMA's voluntary market standards, which focus on transparency, disclosure and reporting. As a basis for a social or sustainability bond program, a corresponding framework should be created that addresses the following four core components:

> Figure 3

The four components of the SBP

Use of Proceeds	Process for Project Evaluation & Selection	Management of Proceeds	Reporting
Illustration of how the issuer uses the proceeds from the issuance of the Social/Sustainability covered bonds.	Issuer shall outline how it identifies and selects suitable projects.	Proceeds from Social/ Sustainability covered bonds should be treated separately from others. Internal control systems should ensure that revenues are allocated only to appropriate projects.	The issuer should provide regular information about its projects and the proceeds, so that investors can constantly track this.

Modified graphic; Sources: ICMA, LBBW Research

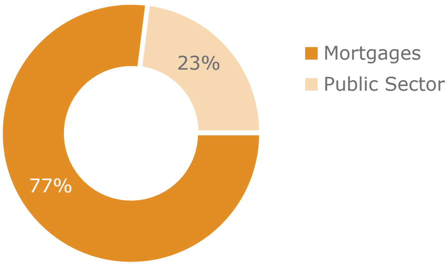
Additionally, the ICMA standards recommend that issuers have an independent third party to verify the alignment of their framework with the SBP (second party opinion). Furthermore, to facilitate the issuance of social bonds, ICMA published a "Pre-issuance Checklist for Social Bonds/Social Bond Programmes", which aims to give guidance on the necessary steps for establishing a Social Bond Framework. In addition, ICMA provides a standardized impact reporting for social bonds.

RAPID GROWTH OF THE SOCIAL BOND MARKET OVER RECENT YEARS

While the overall EUR social bond market has seen rapid growth in recent years, the development of the covered bond market has lagged behind the overall market development. One reason for the rapid growth of the overall social bond market was a big shift in the overall composition of the market. Growth in social bond issuance was driven by agencies and supranational issuers financing social investments and expenditures under social bonds format.

For the covered bond market on the other hand, issuance continues to be dominated by social bond transactions financing social and affordable housing. When looking at the overall split between public sector and mortgage covered bonds, the social covered bond market has been dominated by mortgage covered bonds which represent 77% of outstanding volumes.

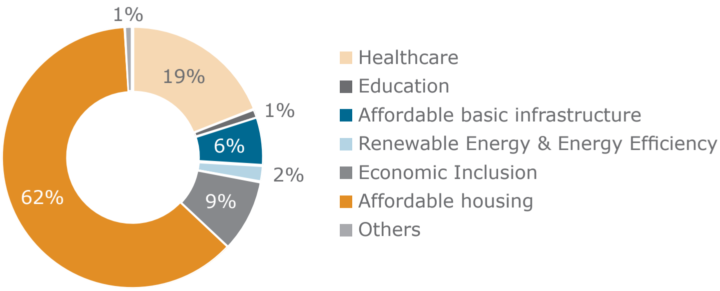
> FIGURE 4: DISTRIBUTION - IN VOLUME SOCIAL COVERED BOND - PER TYPE



Source: LBBW Research

When taking a closer look at the use of the proceeds (UoPs), of social covered bonds, affordable housing is by far the largest sector with a share of over 60%, followed by healthcare with a share of 19%.

> FIGURE 5: DISTRIBUTION - IN VOLUME SOCIAL COVERED BOND - PER SOCIAL UOPS



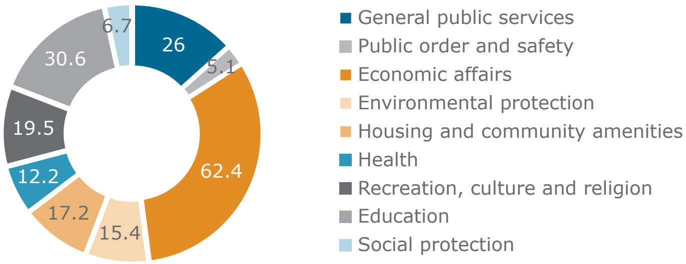
Source: LBBW Research

THE FINANCING OF LOCAL PUBLIC SECTOR INVESTMENTS AS A POTENTIAL AREA FOR GROWTH OF THE SOCIAL COVERED BOND MARKET

In many countries across Europe, including in Germany and France, public sector covered bonds play an important role in financing local government investments. A large of these local government investments have clear social objectives.

In 2020 European Union local government investments totaled EUR 295 billion[1]. A large share of these local public sector investments is closely linked to social objectives. Public education represented 16% of local government investments, followed by recreation and culture with a share of 10%, public housing at 9% and public health-care with a share of 6%. Taken together, these areas represented EUR 120 billion in public investments in 2020.

> Figure 6: 2020 European Local Government Investment by category (EUR billion)



Source: Eurostat

It is worth noting that local authority investments often have both environmental and social objectives at the same time. The construction of a new school will be an investment in public education, but at the same time, it may also be considered a green project, if the construction is an energy efficient building. Another example would be the construction of a new tramway line, with a focus on providing clean local public transportation and clean public transportation, but at the same time with important social objectives link to the same. Sustainable water management of the provision of drinking water is another area, where social and environmental objectives are closely linked. Very often, it will be up to the issuer to determine whether a specific local government investment mainly aims to address social or environmental issues.

One difficulty for the refinancing of local government investments via the issuance of social covered bonds is to identify specific social projects. Local government lenders typically finance the overall investment budget of a local authority and do not use a project finance approach. In some cases, local government lenders may finance public sector entities with a very specific mission, for example water boards, public transport authorities or public universities. However, in most cases local government lenders will need to adjust the lending process by setting up specific loan contracts linked to these social investments.

OUTLOOK

The social covered bond format is well established to finance affordable housing. However, as of today very few public sector covered bond issuers have set social public sector covered bond programs. Social projects represent a large share of local government investments, creating important opportunities for the growth of the social covered bond market. One of the obstacles that public sector covered bond issuers will need to overcome is the difficulty in identifying specific social investments when lending to local authorities.

1 Source of all local government data : Eurostat

REGULATORY DEVELOPMENTS – THE NEW PROPOSAL FOR A SOCIAL TAXONOMY:

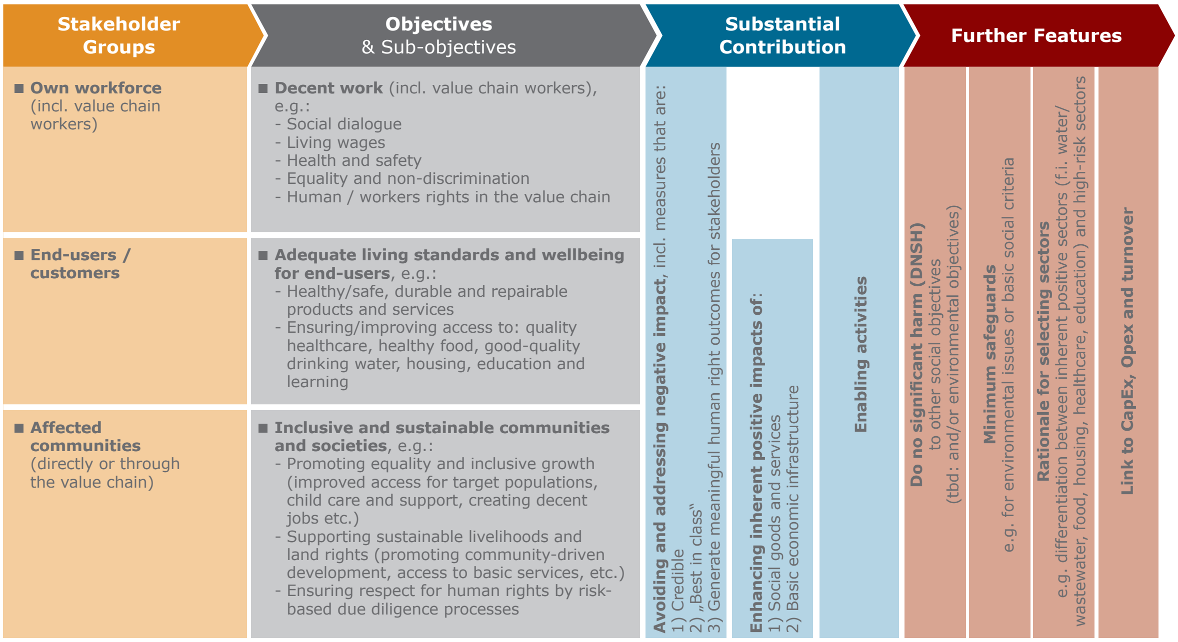
ORIGIN OF THE SOCIAL TAXONOMY

Besides the permanent discussions and measurements to strengthen the standardisation in the green sustainability space there is also an ongoing process in this regard especially on the social side. The main driver from a political and potentially future regulatory perspective is probably the concept of a social taxonomy. In February 2022 the "Final Report on Social Taxonomy" was published by the Platform on Sustainable Finance, an expert group to assist the EU Commission in developing its sustainable finance policies. The subgroup (4) within this expert group, which works on the social taxonomy, is still pretty small, so it is doubtful that the multitude of aspects associated with social questions and answers are adequately represented. Nevertheless, the signal effect should not be underestimated and the echo in the capital market has already been varied. Compared to a former proposal, the new concept discards the idea of a "vertical" and "horizontal" dimension and adheres closely to the structure of the current EU (environmental) Taxonomy. This is to be welcomed, because it creates a conceptual synchronization that makes it easier for market participants and leaves open the possibility of combining both taxonomies in the future.

GENERAL OVERVIEW

The taxonomy proposal distinguishes the addressees, the objectives and the contribution of social activities. This approach is complemented by other aspects to derive or substantiate this process in more detail.

> FIGURE 7



Source: own illustration

THE SINGLE ASPECTS OF THE SOCIAL TAXONOMY

The starting point of the suggested structure within the social taxonomy is the addressees of social action in the context of business activities, defined here as **stakeholders**. These include an entity's own workforce (including value-chain workers), end-users/customers and affected communities (directly or through the value chain).

The next step in the concept is the definition of relevant goals that can have a positive influence on the live and livelihood of the groups of stakeholders. Based on the major social topics and established international norms and principles, three main objectives were formulated: decent work (including value-chain workers), adequate living standards and wellbeing for end-users such as inclusive and sustainable communities and societies. These main goals are complemented by a non-exhaustive proposed list of sub-goals to outline a wider range of social activities and to better illustrate the content of the keywords. Moreover, these explanations are required to meet the pragmatic requirement for the later application of the taxonomy.

A crucial question is which business activities promote the achievement of the proposed (sub-) objectives and how they can be measured. The current structure of the social taxonomy proposes, with reference to the environmental taxonomy, to use different types of substantial contribution to reflect these issues. The first one is to avoid and address negative impacts on workers, end-users and communities- where one or more stakeholder groups can be meant, depending on the respective objectives. Secondly, there are activities to enhance the inherent positive impacts of social goods/services and basic economic infrastructure, f.i. providing access to water, sanitation, housing, education or healthcare. Thirdly, economic activities are defined which enable a substantial contribution to be made in other activities. While the first and third types can be used for all objectives, the second one is applied for only two goals: 'adequate living standards and wellbeing for end-users' such as 'inclusive and sustainable communities and societies'.

This core structure of the social taxonomy, consisting of stakeholders, objectives and substantial contribution, is supplemented by further aspects, which are intended on the one hand to ensure consistency with the procedure of the environmental taxonomy and on the other hand to deal with questions and concerns that have arisen in the course of the previous discussion.

The proposed **Do No Significant Harm (DNSH)**-criteria play the same role as in the environmental taxonomy: to ensure that an activity which serves a certain social objective, does not violate other social goals. As in the environmental taxonomy, it will be challenging to define criteria that complement features used to concretize substantial contribution without overburdening the users of the future social taxonomy in terms of content and administration.

The same applies to the **Minimum Safeguards**, which are included in the existing Taxonomy Regulation (Article 18) and should therefore be used in the social taxonomy. However, various considerations still need to be specified.

Furthermore, the current proposal for the social taxonomy also discusses how special sectors can be assessed and selected. A basic distinction is proposed between so called high-risk sectors on the one hand and sectors with an implicitly positive social footprint on the other hand. While the negative impacts of the high-risk sectors shall be addressed and avoided, the positive impacts of the other sectors, e.g. the ones providing social or basic economic infrastructure, shall be enhanced. Once again, the NACE system could be used to build this sector framework.

Finally, the activities affected by the taxonomy are discussed in terms of whether they are **CapEx**, **OpEx or turnover** and how this could potentially be viewed.

Further explanations relate to questions of governance, metrics and the identification of so-called harmful activities. The relationship between social and environmental taxonomy is also discussed in detail. This is especially interesting because two models are presented that show how the two taxonomies can be aligned or, in any case, how they do not contradict each other.

EVALUATION OF THE "FINAL REPORT ON SOCIAL TAXONOMY"

All in all, the proposed structure of the social taxonomy tries to build on the existing EU taxonomy regulation and to reflect the basic elements of the environmental taxonomy, which is positive in terms of a coherent approach of social and environmental aspects and the future handling of the relevant business activities.

It is also important to note that there is thematic overlap between the proposed social taxonomy and other frameworks that already exist or are being discussed, e.g. the Corporate Sustainability Reporting Directive (CSRD). Therefore, it is pointed out that the social taxonomy relates to the activities of the market participants concerned, while most other regulations define reporting requirements for entities. Nevertheless, the boundaries are sometimes blurred or difficult to discern, which is why the present proposal for social taxonomy also attempts to include the perspectives of parallel regulations.

In any case, the final report contains a multitude of new ideas and considerations but also many question marks on the way to developing a social taxonomy.