1.3 SOCIAL/SUSTAINABILITY COVERED BONDS – GROWING FOCUS ON SOCIAL HOUSING

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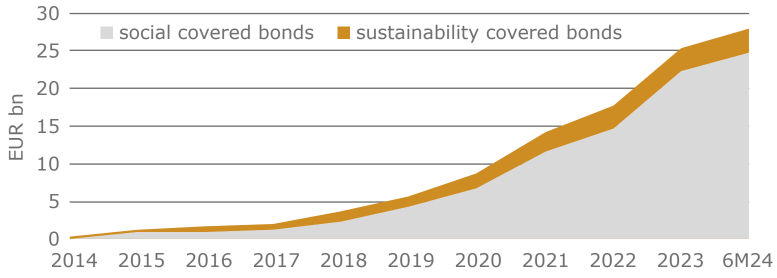
The issuance of social bonds gained momentum during the Covid-19 pandemic, when a large number of support measures to combat the resulting crisis – such as short-time working allowances or aid loans to SMEs – were refinanced via the issuance of social bonds. The issuance volume of social bonds in the EUR-denominated market reached a peak in 2021 of EUR 105bn worth. The total volume of new social bonds declined to EUR 61bn in 2022 and EUR 42bn in 2023, mainly due to the cessation of new funding needs for the EU's temporary Support to mitigate Unemployment Risks in an Emergency (SURE) program, and other socially focused investment themes have only slowly emerged. For the social-covered-bond segment, the main use of proceeds is for social and affordable housing, demand for which is increasing due to rising rents and growing populations. Moreover, use of proceeds includes infrastructure projects involving as water, sewage, public transport, health care and education, which are all in high demand in society. Next to social bonds, several issuers have decided to issue sustainability bonds. These instruments combine social and green projects and therefore extend the range of potential asset types on banks' balance sheets. This makes it easier, in particular, for small issuers to identify a sufficient amount of eligible assets and to reach the critical mass necessary to enter the bond market. In the last two years, five inaugural social covered bonds entered the social-covered-bond market. The programs behind these social covered bonds were mainly focused on social issues and affordable housing.

MARKET OVERVIEW FOR SOCIAL AND SUSTAINABILITY COVERED BONDS

Social and sustainability covered bonds emerged in 2014 when the first environmental, social and governance (ESG) Pfandbrief was issued. It had a social focus and was issued in a sub-benchmark format by Muenchener Hypothekenbank. In 2015, the first social covered bond in a benchmark size was issued by Kutxabank. Momentum has built since 2018. In 2023, a peak in issuance volume was reached, when ten deals were issued with an overall volume of EUR 7.7bn. In the first six months of 2024, there were five such deals issued with an aggregate volume of EUR 2.5bn.

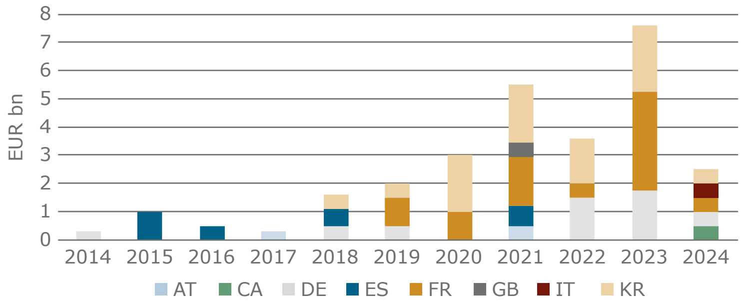
> FIGURE 1: AGGREGATE ISSUANCE VOLUME OF EUR-DENOMINATED SOCIAL AND SUSTAINABILITY COVERED BONDS



Source: Bloomberg, UniCredit Research

As of July 2024, the asset class comprised 39 social and sustainability covered bonds with an aggregate volume equivalent to EUR 26.0bn. Of these, 38 were of euro-denominated benchmark size: 34 in a social format and 4 in a sustainability format. With respect to the number of issuers, there are currently 17 active issuers from eight countries in the social and sustainability covered-bond market. With regard to the split of cover pool assets, 78% of issued social and sustainability bonds are secured by mortgages and 22% are secured by public-sector loans.

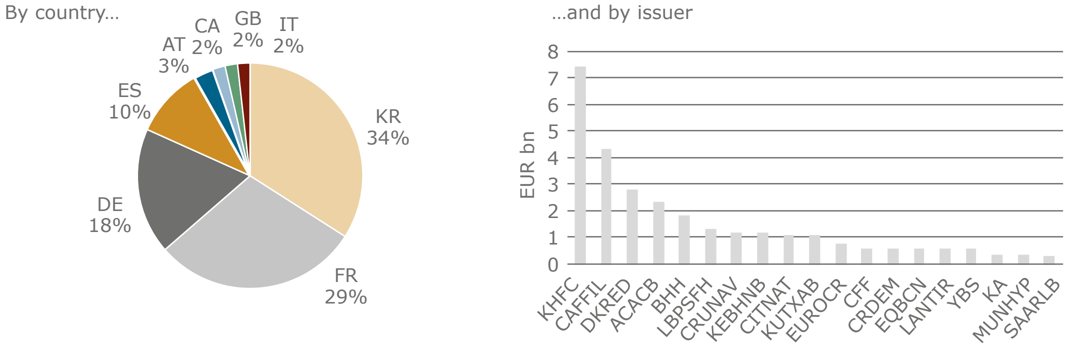
> FIGURE 2: PRIMARY-MARKET ACTIVITY PERTAINING TO SOCIAL/SUSTAINABILITY COVERED BONDS



Source: Bloomberg, UniCredit Research

With regard to the regional distribution of primary-market activity, initial focus was on Europe. Nevertheless, with a total of 15 issues from three different issuers for a total volume of EUR 9.5bn, Korean banks account for the largest share of issuance by country and have strongly contributed to the growth this market has experienced, especially since 2020. French issuers entered the market relatively late, in 2019, but now occupy second place, with a volume of EUR 8.3bn, followed by Germany, with EUR 5.1bn.

> FIGURE 3: MARKET OVERVIEW: ISSUED SOCIAL AND SUSTAINABILITY COVERED BONDS

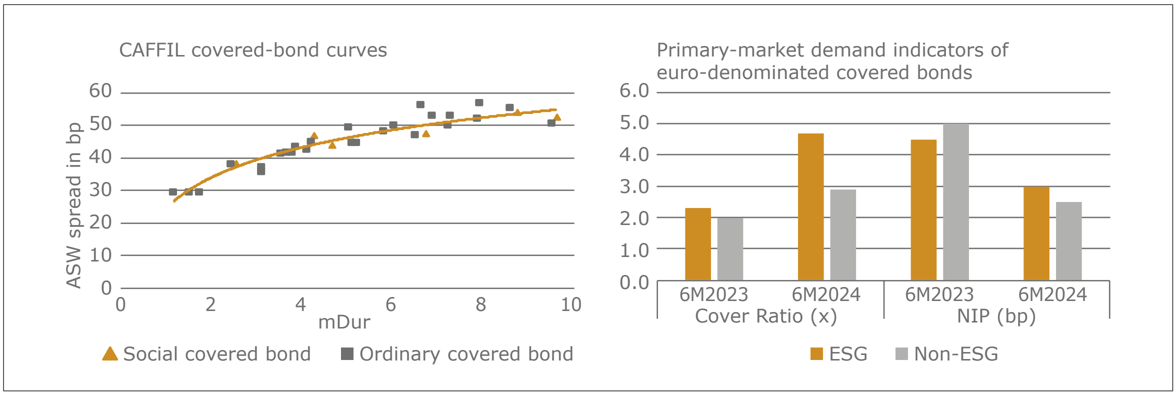


Source: Bloomberg, UniCredit Research

SOCIAL-BOND PRICING CONSIDERATIONS

It is challenging to analyze the premium applied to social and sustainability covered bonds compared to ordinary covered bonds. First, the spread landscape of covered bonds is low and offers limited scope for differentiation. Second, most issuers do not have covered bonds with a comparable tenor outstanding in both social or sustainability and in an ordinary format. We cannot find any meaningful pricing differentiation on secondary markets in a sample of eight covered bonds (pairs of comparable social and ordinary covered bonds) from four different social-covered-bond issuers. French issuer CAFFIL offers the most suitable example, and, as the chart below indicates, there is no visible difference between spreads of different types of covered bonds. With respect to primary-market performance, data show that ESG-labelled covered bonds benefit from larger order books leading to higher cover ratios compared to conventional covered bonds. However, data on new issue premiums (NIPs) are ambiguous. In 6M2023, the NIP of ESG-labelled covered bonds was, on average, 0.5bp lower, while, in 6M2024, it was 0.5bp higher. The latter can be explained by the fact that most 2024 ESG deals were printed earlier in 2024, when NIPs were still higher than they were in 2Q2024 (when NIPs were zero or even negative). There is currently no major secondary market pricing advantage of an ESG-format covered-bond issue, but the larger order books reduce execution risk in primary markets and might support more-stable secondary-market performance, as ESG investors tend to be hold-to-maturity investors.

> FIGURE 4: PRICING IN PRIMARY AND SECONDARY MARKETS



Source: S&P Global, Bloomberg, UniCredit Research

PURPOSE AND USAGE OF SOCIAL COVERED BONDS

Social and sustainability covered bonds (both are use-of-proceeds bonds) serve distinct yet complementary purposes in financial markets. Social covered bonds are tailored to fund initiatives aimed at addressing specific social issues or enhancing positive social outcomes for targeted groups. On the other hand, sustainability covered bonds are designed to finance a blend of green and social projects, offering a versatile funding solution.

The Social Bond Principles (SBP) and Sustainability Bond Guidelines (SBG) issued by the International Capital Market Association (ICMA) have laid the groundwork for these financial instruments. The latest update to these guidelines was carried out in June 2023. It deliberately refrained from defining project categories definitively to accommodate future legislative developments.

The SBP outline six potential application areas. These include but are not limited to the following:

- affordable basic infrastructure (e.g. clean drinking water, sewers, sanitation, transportation, energy)
- access to essential services (e.g. health, education and vocational training, health care, financing and financial services)
- affordable housing
- employment generation and programs designed to prevent and/or alleviate unemployment stemming from socioeconomic crises, including through the potential effect of SME financing and microfinancing
- food security and sustainable food systems
- socio-economic advancement and empowerment

These areas target specific, often vulnerable, population groups, which is an important element of the SBP. The definition of these **target population** groups depends on local circumstances and may also include addressing the general public.

The ICMA's standards suggest that projects with both social and environmental benefits could be classified as social bonds based on an issuer's primary objectives. Furthermore, issuers are encouraged to combine green and social projects under a sustainability bond framework. An example of this practice in the covered bond space is Eurocaja Rural, which has utilized SME financing for employment generation and has supported social housing and energy efficiency through its sustainability covered bonds. The same is true for Korean Kookmin Bank.

All social and sustainability covered bond programs adhere to the ICMA's voluntary standards, which emphasize transparency, disclosure and reporting. A successful program should include a framework covering the following four core components, supplemented by an independent review to ensure alignment with the SBP/SBG (known as a second-party opinion).

> FIGURE 5

The four components of the SBP		
	Use of Proceeds	Description of how the issuer uses the proceeds from the issuance of the Social/Sustainability covered bonds for eligible projects with clear social benefits
	Process for Project Evaluation & Selection	Issuer shall communicate the to social objectives, the process of identification and selection of suitable projects and information on environmental and social risks.
	Management of Proceeds	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. bond-by-bond approach or portfolio approach; high level of transparency encouraged.
	Reporting	The issuer should provide regular (annually) information on the use of proceeds and the projects to which proceeds are allocated, incl. their expected impact. The SBP recommend the use of qualitative and – where possible – quantitative performance indicators.

Key recommendations	
1. Bond Frameworks	**2. External Reviews**

Modified graphic; Sources: ICMA, LBBW Research

The ICMA also offers tools to assist issuers, including a Pre-issuance Check List for Social Bonds and guidelines for reporting in accordance with the Harmonised Framework for Impact Reporting for Social Bonds. These resources aim to standardize reporting practices and provide indicators for measuring the impact of financed projects. Social bond reports should detail fund allocation and project impact, with the latter often diverging from green bond impact metrics to encompass a broader range of potential outcomes. Therefore, for instance, the reporting framework offers a list of sample social indicators for different social categories. In addition, issuers are also encouraged to complete the Social Bond Information Template, which provides a summary that highlights the key characteristics of a social bond and demonstrates how it aligns with the core components of the SBP and which helps inform the market participants in a standardized format. With the expected growth of the market, increased transparency and reporting become critical for market integrity.

A crucial characteristic of use-of-proceeds bonds is that they fund a designated portfolio of new or existing eligible social or sustainable assets. This portfolio may include assets that are also eligible as cover pool assets, but it is not a requirement.

In June 2022, an annex to the social bond principles introduced a distinction between standard social use-of-proceeds bonds and secured social bonds. Covered bonds can carry the social label if the funds raised are used to finance or refinance social projects that (1) directly collateralize the bonds (Secured Social Collateral

Bonds) or (2) are not necessarily part of the cover pool (Secured Social Standard Bonds). The former adheres to a fundamental principle common to all covered bonds: the cover principle. Under the Association of German Pfandbrief Banks' (vdp) Minimum Standards for Social Pfandbriefe only this version is possible. On the other hand, the latter category allows for a separation between the collateral pool and the financed social projects. This flexibility expands the scope for issuers to allocate the proceeds of the bonds. However, most sustainability covered bond issuers typically aim to include an adequate number of eligible social loans in the cover pool. Investors are advised to scrutinize the details of these bonds, as the ICMA emphasizes the importance of transparency regarding the bond format. Issuers are encouraged to clearly define their chosen format in their Social Bond Frameworks to aid investors in understanding the nature of their investment. However, according to our analysis, transparency regarding this matter is still patchy.

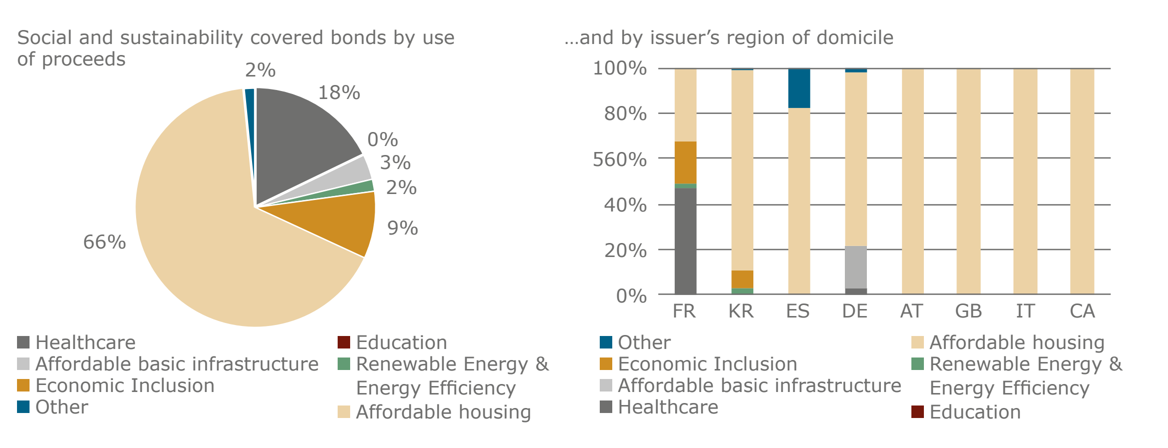
The 2023 edition of the SBP now includes references to "just transition" considerations and clarifies the requirements for target populations benefiting from eligible social projects. It provides guidance for issuers to identify mitigating factors for known material risks of negative social and/or environmental impacts. The new version also contains additional clarifications and updates regarding recommended market practices. Moreover, it incorporates important references to complementary guidance from the Harmonised Framework for Impact Reporting for Social Bonds and the Guidelines for External Reviews.

Unlike green bonds, the use of proceeds of social and sustainability (covered) bonds are broader. A closer look at the second-party opinions of existing social and sustainability covered bond issuers reveals that these bonds can address a wide range of UN SDGs (social and development goals). However, there is a focus on SDGs 1 (no poverty), 3 (good health and well-being) and 10 (reduced inequalities). The top spot, however, is occupied by SDG 11 (sustainable cities and communities). Out of 17 active social and sustainability covered bond programs, 16 address this SDG through their social bond frameworks.

In contrast, the use of covered bonds is often more narrowly defined compared to the overall social bond frameworks and the second party opinions, as seen in the allocation reports of social and sustainability covered bond issuers. Unfortunately, only a few banks actually report the allocation at the bond level. We therefore based our calculation on the outstanding volume and the reported allocations available per use-of-proceeds category.

Approximately two-thirds of the outstanding issuance volume is allocated to affordable housing. Additionally, health and economic inclusion (often through SME loans) play a significant role.

> FIGURE 6: USE OF PROCEEDS OF SOCIAL AND SUSTAINABILITY BONDS



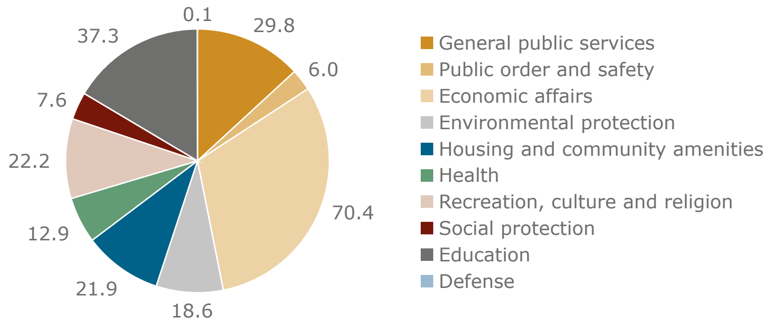
Source: Issuers, LBBW Research; project categories according to allocation reports and outstanding bond volume

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

Public-sector covered bonds play a significant role in financing local government investments in many European countries, including Germany and France, where these instruments are mainly present. Local authorities invest in various categories that serve the public interest, generating positive social and environmental impacts.

In 2022, investments in annual flows by European Union local authorities amounted to EUR 226.8bn, increasing year on year (EUR 207bn in 2021; EUR 196bn in 2020). A considerable portion of these investments is dedicated to categories linked to social objectives. More precisely, public education accounted for 16% of local government investments in 2022, followed by recreation & culture and public housing, each with a share of 10%, and public healthcare with a share of 6%. In total, the four categories we consider closely linked to social objectives represented 41.5% of local government investments in 2022. Furthermore, between 2021 and 2022, the public education and public housing categories recorded the largest relative increases in their investment volumes (EUR 3.5bn and EUR 3.3bn, respectively). These trends further reflect the demand for social housing in Europe as well as for infrastructure such as public and publicly subsidized educational services or facilities that support childhood development.

> Figure 7: 2022 European Local Government Investment by category (in EUR bn)



Source: Eurostat

Despite the large number of local authority investments with social objectives, it can sometimes be difficult to refinance them via the issuance of social covered bonds as local government loans generally finance a local authority's overall investment budget. In order to be eligible for financing via social bonds, the use of proceeds for local government loans needs to be linked to specific social projects. This can be done by setting up specific loan contracts linked to local authorities' social investments, with annexes to identify eligible investments and to collect the appropriate impact-reporting data. An alternative approach for lenders to the local public sector is to refer to the social nature of the financed entity, e.g. public hospitals, public schools, water boards, etc.

Another point to underline is that these social-investment categories are generally partly allocated to public infrastructure, such as the construction of social housing, public schools, cultural facilities, etc. Thus, depending on its characteristics, public infrastructure can also generate a positive impact at an environmental level, for example by applying high environmental standards of energy efficiency during the construction or renovation of buildings. This also applies to green investment categories: for example, the construction of a tramway reduces the generation of greenhouse gas emissions and is socially beneficial for users at the same time. This duality of positive impact, known as co-benefits, is a recurring feature of project financing by local authorities. Thus, in seeking to identify potential positive synergies, a more holistic view of the investment is adopted to ensure better consideration and management of the environmental and social aspects. This concept reflects the logic of the European taxonomy, with the "do no significant harm" and "minimum social safeguards" criteria, which assess the impact of the investment on factors beyond the original purpose of the investment. Overall, the use of this term is increasingly supported by best market practices. However, collecting the data needed to demonstrate co-benefits remains a challenge at the local authority level, which is not necessarily subject to the same sustainability reporting standards as the private sector. As a result, at the issuer level, the analysis of co-benefits is at an early stage and mature management of these indicators is still in development.

OUTLOOK

Public sector covered bonds are not a growing asset class in all jurisdictions. In Germany, for instance, the volume of outstanding public sector covered bonds shows a declining trend in recent years. This reflects the competitive landscape in Germany as state development banks have become the largest lenders to local and regional authorities and these banks refinance themselves not via covered bonds, but via bonds with an explicit state guarantee.

To date, the use of the social-bond format for public sector covered bond issuance remains quite limited. Nevertheless, thanks to their relatively strong social nature and the recent increases in investment by local authorities in Europe, social public sector covered bonds still have growth potential, most notably in France, which is not in the same situation as Germany.

Another potential area of growth could be in the financing of export contracts with public guarantees via covered bonds. More recently developed than the local authorities' financing activity, public sector covered bonds are used to refinance export loans backed by state or export-credit-agency guarantees, particularly in France and Germany. In many cases, these export loans finance green investments, but as mentioned before, green investments can also have social benefits, particularly in developing economies. For example, an investment in clean drinking water in a region where a high percentage of the population does not currently have this access will generate social as well as environmental positive impacts. Another example would be investing in a tramway in a city where traffic is congested, which would result in greater mobility for local residents and a reduction in traffic-related greenhouse gas emissions. These investments would not automatically lead to the same impacts in European countries. As a result, the location where the project is implemented has an impact on the benefits generated and thus on the nature of the bond format.

THE PROPOSAL FOR A EUROPEAN SOCIAL TAXONOMY

On the European side, there have been no significant developments concerning the establishment of a social taxonomy since the publication of the Final Report on Social Taxonomy in February 2022 by the Platform on Sustainable Finance, an expert group set up to assist the EU Commission in developing its sustainable-finance policies.

Meanwhile, a number of local working groups have developed. In France, for example, a group of investors, members of the Forum pour l'investissement responsable (French SIF), have initiated a multi-stakeholder working group to "relaunch" work on the social taxonomy in September 2023. The group, led by former French SIF chair and Finance Watch chief economist Thierry Philipponnat, includes investors such as Mirova and private equity association France Invest[1].

1 "Stalled EU social taxonomy work to be 'restarted' by French investors", Environmental Finance 21/07/2023. Available here: https://www.environmental-finance.com/content/news/stalled-eu-social-taxonomy-work-to-be-restarted-by-french-investors.html