



Pfandbriefe as a sustainable funding instrument

In May 2018, Commerzbank hosted the annual vdp Pfandbrief breakfast in Frankfurt. Besides general developments on the Pfandbrief market, the focus this time was on sustainable/ESG Pfandbriefe. The following is an abbreviated transcript of a panel discussion in which representatives of some sustainable Pfandbrief issuers and Commerzbank participated. The participants talk about obstacles to setting up a sustainable funding programme, their green plans for the future, greenwashing, SpaBoI's approach, the risks of premature regulation, the green investor landscape, the pricing of green bonds and more.

Participants:



Bodo Winkler,
Head of Funding & Investor Relations,
Berlin Hyp



Franz-Josef Kaufmann,
Deputy Head of Capital Management
& Funding, Commerzbank



Jürgen Klebe,
Head of Funding & Investor Relations,
Deutsche Hypothekenbank



Claudia Bärldges-Koch,
Head of Debt Investor Relations
& Client Acquisition,
Münchener Hypothekenbank

Moderator:

Ted Packmohr,
Head of Financials & Covered
Bond Research, Commerzbank



Ted Packmohr: The topic of sustainability has attracted a great deal of attention on the capital markets. This is also true of the Pfandbrief market. But how do we define a sustainable Pfandbrief? Bodo, what is it that distinguishes a sustainable Pfandbrief from a regular one?

Bodo Winkler: I cannot give you a general answer as to what are the key features of a sustainable Pfandbrief. But I can tell you the key features of a green Pfandbrief. When we issued our first green Pfandbrief, we took the following approach: The Pfandbrief itself is already a sustainable instrument. It has been around a very long time, it has never defaulted and it helps financing properties at reasonable costs. This already includes some sustainability aspects.

Berlin Hyp has specialised in green Pfandbriefe. That means our main focus is on the energy-efficiency of the buildings that are going to be financed or that have been financed already. Our first step thus was to define what we regard as "energy-efficient" and review the number of such buildings we finance. We have marked these assets in the bank's systems early on. We have now extended these systems in a way that they include all energy-efficiency data and sustainability certificates of the buildings, implying that they can be analysed at any time.

As our roots lie in the Pfandbrief market, Berlin Hyp's approach in the green bond segment has always been to have the green assets available prior to issuance. Temporarily allocating the issue proceeds from the green bond in non-green assets is not an option for us. That means that we have basically applied the Pfandbrief's collateralisation concept to our green bonds – even if we are speaking of senior unsecured bonds.



The Pfandbrief itself is already a sustainable instrument.

Bodo Winkler

Another requirement in the green bond market is annual reporting. How have the funds in fact been used? In what concrete assets have the funds been invested? How has the pool of assets developed over time? And the supreme discipline: assessing the impact of the issue.

The market's first sustainable Pfandbrief did not target the green segment though. Instead, Münchener Hyp placed the social component of sustainability at the fore in 2014. Why is that? Wouldn't the green aspect have been easier for a property financier? Or do you have a different understanding of sustainability?

Claudia Bärldges-Koch: 'Green' is definitely an important aspect of sustainability but not the only one. And when you come from Munich or work there, you see very clearly that affordable living space for example can also be an important pillar of sustainability. We have an internal Sustainability Committee that deals with such issues and is made up of colleagues from a wide range of specialist areas. A number of different ideas were discussed as to how Münchener Hyp should position itself in this area. This began with an analysis of the credit products we already had in our portfolio. In the

meantime, however, we have expanded our range of products and also offer our customers for example a green or another social loan facility. The range has thus also widened for us. But initially, the question was: What fits our business model and where is the greatest potential for us?

You entered the sustainable Pfandbrief market already in 2014 but have not been active since then. Why is that?

Bärldges-Koch: I hope that we will manage a follow-on issue before maturity. But in the meantime we are already working on the next project.

As I said: When the idea of entering the sustainable market was born, we first had to go through our loan portfolio, which already consisted then of almost 190,000 individual loans. Of course, this meant a lot of effort and a lot of persuasive work. More and more requirements were also added by oekom, with whom we have developed a framework. That is why we initially limited ourselves to housing loans with a social component. And still, the effort was considerable: we had to go through the statutes of the individual housing cooperatives for example, to check how democratic they are. The question of reporting is also not easy when it comes to 'social'.

We convinced several investors with this approach, but others were rather sceptical. They accused us of "greenwashing" along the lines of: "You granted the loans to make money. Don't tell us now that there was something noble about it." We also wanted to address this in future.

Another issue for us was the systematic recording of sustainable loans. How do I find the corresponding loans in the mass of more than 190,000 individual items? We initially lacked a suitable marking in our systems, which made reporting difficult. Consequently, we introduced fundamentally new products for which easier analysis is possible.

These new, sustainable products include for example private property financing geared to energy efficiency. We have also introduced a new social loan for families. We consciously invest in both product groups by offering reduced interest rates. Hence, we believe we have addressed the greenwashing aspect while at the same time broadening our future sustainable focus.



Investors we had never seen in our books before accounted for roughly 40% of our first green Pfandbrief issue. **Jürgen Klebe**

This proves the enormous initial obstacles new issuers in the sustainable segment can face. Deutsche Hypo is the latest addition to the green Pfandbrief market. What did it take to get this project up and running?

Jürgen Klebe: Of course, we monitored our predecessors' experience closely and recognised the relevance of the sustainable market. Based on these examples, we decided to address the green segment of the sustainable market.

Since Deutsche Hypo is a pure commercial property financier, we have a much smaller number of loans. While our portfolio is not small, it is manageable in that respect. Nevertheless, we too naturally had to completely re-vamp our IT landscape first, to permit coherent reporting. And if you don't keep that in mind right from the start, you tend to make mistakes. For this reason, we discussed at an early stage: What is such reporting? What does it have to show? Of course, we had

to prepare our IT landscape for this. This took up the greatest part of our preparatory period, which comprised a total of c. 18 months.

By now we have published our reporting, after issuing the first green Pfandbrief in November. So actually, we did not have to start our reporting before November of this year – but we managed it two weeks ago, i.e. half a year after the first issuance. This makes us glad. Hence, the targeted work towards reporting required a lot of effort, but it has paid off.

But of course there are always surprises on a roadshow. For example, we were asked what "additionality" we offer. This means whether we are merely a trend follower or whether we are doing something new. My answer to this is: "Yes, we take criteria that are known from other banks and have therefore been established, analyse them and have oriented our IT towards them. But we also establish additional criteria that we think make sense". In our case, taking account of the

distance from public transport and the sealing of surfaces are examples of new ideas. In part, we included such ideas from our roadshow activities, to integrate them into our reporting. This also took up part of the 18 months we needed to prepare.

Why hasn't Commerzbank become active in the ESG bond segment yet?

Franz-Josef Kaufmann: I think the other participants have illustrated this point very well: There are circumstances when entering the sustainable bond segment is easier and others when it is more difficult. Commerzbank, for example, is a universal bank active in the mass market rather than a specialist institution with a relatively low number of loans. Hence the IT systems needed for such a step are much more diverse. When establishing Commerzbank's Pfandbrief eligibility some years ago, we already noticed how much this increases the entry costs.

And we have a clear aspiration: If we enter the green segment, we want to make a sustainable market appearance, i.e. we do not only want to issue one green Pfandbrief or one green unsecured bond, i.e. a flash in the pan, but we would have a strategy for further transactions at hand.

Our first appearance would have been relatively easy. As many clients may know, Commerzbank is among the largest lenders in the renewable energy segment, with an almost €5bn book in this business segment. However, a major part of this relates to loans tied to KfW funding programmes which hinders the use for own green issues. And yet we have a portfolio that could be used as basis for a first green issue. It would be more difficult for a prompt second issue though. Therefore, we have not yet felt sufficiently comfortable to create a sustainable, green issuance strategy for Commerzbank.

Of course, we have a multitude of other assets that should also be suitable as basis for green bonds but this leads us back to the data issue. We are one of Germany's major mortgage lenders. In that business we naturally also apply many KfW standards so that – by virtue of this definition – one could say that the respective assets can be classified as green. But reporting remains important nevertheless: How can these new requirements be integrated into the existing systems?

This subject is under active discussion within Commerzbank and, of course, we also recognise the trend towards the green product. Personally, I think this is one of the major capital market themes in recent decades. Sustainable, green funding should become standard over time. Commerzbank's

market entrance should therefore be rather a question of time.

You have just mentioned two very interesting questions. Does a sustainable product have to come with sustainable issuance activity? And: How can the sustainable assets be integrated into the bank's overall strategy? Berlin Hyp has committed to certain sustainability standards at the level of the whole bank. How is that reflected in your area?

Winkler: First, I would like comment briefly on Commerzbank: I understand these arguments very well. But I think it is a pity if large banks do not proceed more courageously in this regard. We have seen quite different developments in other countries. Nor do I think that when the first bond is issued, it is absolutely necessary to know the second bond will definitively follow after a relatively short period of time. All large Dutch banks, for example, have now issued green bonds – some only one, others as many as three already. All large French banks have also done so, as have all large British and Swedish banks. The Italians and Spanish have also joined in, etc. In Germany, in contrast, it took a fairly long time before a large commercial bank, LBBW, finally realised the importance of the sustainable segment and put Germany on the map here. In our view, this is an issue not only for KfW and a few specialists, but for the whole market. I would therefore like to see large banks such as Commerzbank acting more bravely here. I think this would be a positive step, for both the institution and the market.

But back to Berlin Hyp and the "additionality" mentioned earlier: Green bonds have added value for us, be-

cause something bigger has developed from them. For us, too, the initial impulse came from the Treasury. But in the whole bank, the topic was very openly received, and it was found that this is, after all, one of our target areas: We would like to finance state-of-the-art buildings. And state-of-the-art buildings are always energy-efficient, and usually they also come with other sustainable characteristics. We have brought our systems to a level where we can document all this. At the same time, we have incentivised this business through more favourable financing conditions.

Last year, we took another step by setting a strategic target that was openly documented: By 2020, 20% of our property portfolio shall be classified as green. This compares with less than 3% when we launched the first green Pfandbrief. We currently stand at 14.24%. Growth is thus remarkable, but becomes more difficult, of course, the further this process progresses. This shows that our target is really very ambitious. But this is the only way to achieve real progress and changes at the institution.

The question that arises is, of course: Does this benefit the market? I think it certainly does. At the end of the day, this is precisely what investors want to see and what they consider "additional": That a bank not only sells business it would do anyway as green business, but makes an active contribution and sets itself broad-based and concrete targets. In the end, only this will also allow us to really come closer to attainment of the European climate objectives.

Deutsche Hypo plays a special role here, insofar as it is closely integrated into a larger banking group. How does your green strategy fit into the sustainability strategy of NORD/LB Group?

Klebe: It goes without saying that Deutsche Hypo's appearance is part of an overall group strategy. Here the term "one bank" may be familiar from the media. It means there is a common strategic framework, which each group member fills for itself though in the interest of the whole. For this purpose the Luxembourg subsidiary may look at the planned legislation for green Lettres de Gage, while NORD/LB checks its portfolio for renewable energy financing, and for us as a commercial property financier the focus is on energy conservation. In this regard the overlaps between us are limited. Rather, we complement each other within the group depending on the strong points of the individual entities.

For us as Pfandbrief specialists, it was clear that we want to use the Pfandbrief as an instrument also in developing our green strategy. However, since the Pfandbrief Act does not include any specific rules for this, we have developed a concept of our own and made it transparent. The other members of the group pursue similar objectives, but they are going their own way.

Bodo called for courageous action right at the beginning, and this is precisely what Munich Hyp has done. However, its reporting shows that the cover pool allocated to the social Pfandbrief is melting. Will there still be room for further issuing activities?

Bärdges-Koch: Our initial offering of €300m was based on 652 loans. At Berlin Hyp, I think there were 17. At the same time, our average volume of private mortgage lending is only €129,000. So we are talking here of completely different scales to commercial property financiers. The path to a high percentage of sustainable loans is therefore naturally considerably longer in our case.

Why have we not come to the market a second time so far? Jürgen described earlier that they had been working on the development of their IT systems for about one and a half years before the market launch. We actually only started this work after our first issue because it became clear that repeated appearances would otherwise be difficult. This partly explains the delay.

However, in the meantime, every ninth loan we grant in the private property financing business is green and we support this product through a discount in the lending terms. Even so, it naturally takes time to create a sufficiently broad basis for potential benchmark issues

In addition, we have not decided internally yet whether we want to make both social bonds and green bonds separately in future or whether we want to mix the two. Of course, we are open to feedback from investors. We have the impression that interest in purely green bonds is higher than in issues with mixed sustainability criteria, but we have not yet made a final decision on this. (see subsequent note below).

This will, of course, also entail other reporting requirements, including the question of whether we want to report

on a bond-related basis, as is currently the case, or at the level of the bank as a whole.

Could you mix the social and green loans in the future without changing the existing documentation in which the Use of Proceeds is defined? And could this be done while the first ESG Pfandbrief is still outstanding?

Bärdges-Koch: This is one of the points that would speak in favour of two separate paths. In addition, the documentation and coordination effort with other departments should not be underestimated. I personally would be in favour of a separation of green and social issues because we also offer dedicated products on the assets side – the distinction would therefore be clearer. But other colleagues also have a say in this decision.

(subsequent note from the issuer: in the meantime, the bank has decided for two separate frameworks)

Jürgen, have you received similar feedback from the investors' side that they prefer pure green issues? Was that one of the reasons why you chose this option, or has this instead simply resulted from Deutsche Hypo's asset business?

Klebe: Our main focus was on the question of verifiability. For this reason we based our standards on the Energy Saving Regulations. For each green financing in our portfolio, we have an energy or sustainability certificate. This makes it relatively easy for us to then calculate and prove a reduction of carbon dioxide emissions. And this inevitably led us to the green bond, and not to the social bond.



We have the impression that interest in purely green bonds is higher than in issues with mixed sustainability criteria. **Claudia Bärldges-Koch**

Does Commerzbank also request these certificates and store them in its systems?

Kaufmann: In my opinion, the topic of certificates has two sides. On the one hand, there is the commercial property financing business where Commerzbank is active only at the margin. There, the certificates are in fact also taken into account. That is relatively easy.

On the other hand, there is the private property financing business. While energy certificates must be available for every new property here as well, enforcing this requirement in lending does not seem to be general market practice yet. This may also be due to the fact that this is a very competitive market segment in Germany. But without these certificates, evaluation will be difficult afterwards.

In Norway SpareBank1 Boligkreditt has developed a solution to this problem: Although they do not yet have electronic access to the certificates, there are legal regulations that certain

environmental standards must be met from certain years of construction. Younger properties can therefore automatically be classified as green. Is this a standard with which Berlin Hyp could also be happy? After all, larger volumes could be classified as green relatively easily in this way.

Winkler: That is difficult in my view, because Green Bonds are about knowing my assets. And if I only know how good they have to be at least, but I do not know exactly how good they actually are, I cannot make any concrete calculations on energy efficiency. Then I can only say that the standard is definitely not worse than so and so. This is not the most convincing approach for me.

SpaBol justifies this approach by stating that the certificates in Norway are not yet publicly available, but that also means that the model could well be changed in the future.

Energy certificates cannot be queried electronically in Germany either. At Berlin Hyp, however, they are among

the standard documents that must be available and recorded. And because every building sold or constructed from 2014 onwards has to have an energy certificate, all you have to do is ask for it and create the technical possibilities to record the data.

What I definitely welcome about the SpaBol bond is that another EU country has taken the path towards green refinancing. And it looks like this model will also serve as a blueprint for other issuers. Hence, this will strengthen the green movement as a whole

Bärldges-Koch: I share Bodo's view that the energy savings achieved should be more precisely demonstrated, but I also think that the SpaBol way is acceptable for a start if you subsequently build on it.

Even so, I need the energy performance certificate to be able to carry out the CO2 calculation afterwards. We have certainly not made ourselves more popular with our credit colleagues because they now also have to acquire those additional documents.



The ESG market is still in its infancy. And although we Germans like to set up fixed rules it should be helpful to just let the market go and widen at this stage.

Franz-Josef Kaufmann,

But we also provide incentives in the form of better conditions for such financing. Generally speaking, this also increases the customer's motivation to make such documents available.

[I see that, initially, you are happy as long as the sustainable market grows. But does this not bear the risk of uncontrolled growth of different standards? Should this be harmonised in a law for the green Pfandbrief?](#)

Winkler: First of all, the Green Bond market only celebrated its tenth birthday last year. So it's a young market. And although issue volumes are growing quite dynamically and have at least doubled from year to year, its share of the total bond market worldwide is still less than 0.2%. One should keep that in mind.

In such young markets, the question always arises: Does standardisation provide clearer guidelines and thus make even more issuers jump on the bandwagon? Or does it instead hinder

creative solutions and thus further market growth? I think it is a relatively fine line between the two.

There is an action plan for sustainable financing at EU level, focusing on green assets and green bonds. Consequently, a few first guidelines have been created here at least. On the one hand, these must be strict enough to define green assets adequately. On the other hand, this must not be allowed to deter potential participants. This is a challenge, but success is possible.

When we talk about the German Pfandbrief, I feel very comfortable with the current legal framework. I also think it is good for our green Pfandbrief investors that they would ultimately have access to all cover assets in the theoretical event of issuer insolvency rather than to a much smaller green pool. After all, legally speaking, the green Pfandbrief is a normal mortgage Pfandbrief that enjoys the same rights. I think that is a good thing.

Of course, as in the case of the Luxembourg legislative initiative for green LDGs, one could also examine in this country whether other types of assets could separately be suitable for green Pfandbriefe. However, this also depends on the access rights to such assets, which may differ from country to country.

[Speaking of Luxembourg. Franz-Josef, Commerzbank still has a covered bond subsidiary in Luxembourg. Is the group looking at the opportunities to issue green LDGs?](#)

Kaufmann: It is true that Commerzbank still has a covered bond subsidiary in Luxembourg. But its cover assets stem from the traditional public finance business which we have largely earmarked for wind-down. We do not want to continue this business in this form. Therefore using the new LDGs is not an issue for us at the moment. In addition, the Luxembourg market has generally only gained limited acceptance. This is already evident from the low number of active issuers.

One brief comment as to standardisation: The ESG market is still in its infancy. And although we Germans like to set up fixed rules it should be helpful to just let the market go and widen at this stage. Against this backdrop, I believe the SpaBol concept is certainly helpful. In the end, the market itself will decide which standards are sufficient.

On the investor side, too, this development has only just set in. For many investors, sustainability is not a major theme yet; others are open to it but do not make it a condition. Therefore, the name of the game currently is to gain critical mass first, both on the investment and on the issuance side, rather than already submit to too tight constraints now which would create additional hurdles.

After all, if you want to establish a new instrument in an organisation, you have to offer sufficient economic incentives to find internal supporters. The tighter the conditions in this environment, the more difficult the implementation may turn out and the longer the whole process. Therefore, I would initially let the market go and set guidelines only gradually. I think this is also the idea of the aforementioned EU initiative: to initially promote what is politically desired and channel and prioritise afterwards.

[You mentioned the investor side. Münchener Hyp has the longest history in the sustainable Pfandbrief segment. Have you noticed from your investor meetings that clients are increasingly interested in and open to this product class?](#)

Bärdges-Koch: I can already see this from our investor presentation: Today, the topic of sustainability is right at the fore.

Apart from that, the picture among investors is still very mixed. For some, it's not an issue at all. Others already find the cooperative concept of Münchener Hyp sustainable and do not even look deeper into the product level. But of course there are also the real green investors, who use electric cars and first ask you how you travelled to the meeting. The spectrum is very wide.

It is therefore not possible to make every investor happy and convince them with your concept. But I think that as long as everyone makes some contribution with their concept, this is still to be viewed positively, and I believe that every bank could and should actually do its bit.

As already said, not all investors were enthusiastic about our first concept but later, when we introduced dedicated green credit products, this perception changed. The important thing is that the issue is addressed in concrete terms

Winkler: On the investor side, a distinction has to be made between investors with only general sustainability requirements and special green portfolios.

In Germany, too, it is now mainstream that investments are checked for sustainability at least with a minimum filter. This means that a bond is only taken into account if, for example, oekom has at least one prime rating on it. This kind of thing has become widespread. As Berlin Hyp, we are an investor ourselves, and we also have such a sustainability filter in our Depot A. This is also important in my view, to protect us from reputational risks.

On the other hand, there are dedicated investors in green bonds, making this a special discipline. But here too

I can imagine that the standards will become more mainstream. In France, for example, a regulation has been in place since 2017 that requires fund managers to calculate and report the carbon footprint of their assets. It is therefore no coincidence that the proportion of French investors in the order books of our green bonds is very different from that of our conventional bonds. And since disclosure also plays a role in the EU Action Plan, it is quite conceivable that similar regulations will also appear in other countries in the future.

[Do Deutsche Hypo's investor statistics speak a similar language? Have you successfully broadened the investor base with your first issue?](#)

Klebe: Yes, by all means. Investors we had never seen in our books before accounted for roughly 40% of our first green Pfandbrief issue. These were mainly French, Benelux and Scandinavian investors, some of which even carry the idea of sustainability in their name. We had specifically addressed such names on the roadshow.

But we have of course also had negative feedback, where the Pfandbrief as such did not go down very well or it was suggested that we – and others – would only launch a green issue to push through even tighter spreads. But this was precisely what we didn't do: We priced the green Pfandbrief in just the same way as we would have priced any other Pfandbrief. Our primary target is not the price function but the diversification approach. And we have clearly achieved this goal.

[When will you expand your footprint in the green senior segment?](#)

Klebe: We have already started to do so. After the €500m green Pfandbrief, we issued €54m on an unse-



cured basis. This included a €50m green bearer bond and €4m Schuldscheine. Our reporting also shows both the covered and the unsecured portion of the green refinancing

Bodo, do you think the price differentiation between green and non-green bonds will grow when sustainability requirements become increasingly common on the investors' side?

Winkler: This discussion has been underway for as long as we've been in this market, and usually the arguments are always the same: Issuers want to

be compensated for the higher costs of their green loans, and investors do not want to be punished for a more sustainable investment policy. Both arguments are understandable.

We have so far placed five green bonds in benchmark format, including two Pfandbriefe and three senior unsecured bonds. We priced all these bonds on their respective curves, i.e. exactly like conventional benchmarks. However, we have then seen a better secondary market performance of the green bonds. Depending on maturity, we are talking about two to five basis points.

As a consequence, a separate green spread curve could develop over time, which should then be used as benchmark. So far, few issuers have such a complete curve of green bonds. But with regard to KfW and EIB, for example, we can indeed argue that green bonds can come to the market at slightly tighter levels.