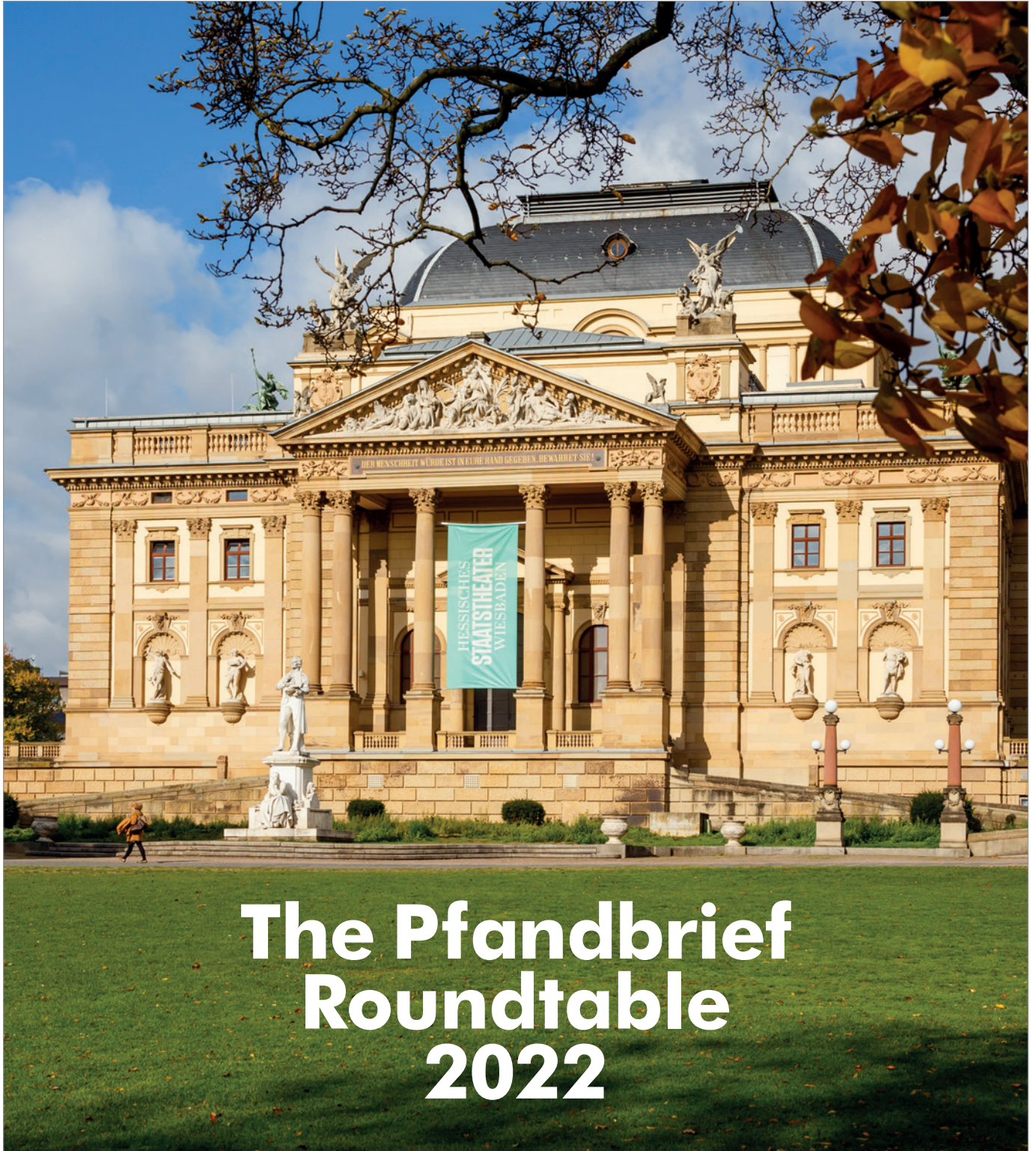


The Covered Bond Report

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The Pfandbrief Roundtable 2022

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As the ECB has stepped back from asset purchases and inflation has returned with a vengeance, Pfandbrief issuers and investors have been faced with fast-changing dynamics. In our latest annual roundtable — sponsored by the vdp and hosted by Aareal Bank at the end of June — participants tackle 2022's market, industry, regulatory and ESG challenges.

Neil Day, The Covered Bond Report: Benchmark Pfandbrief and overall covered bond supply has rebounded strongly from last year's lows to the extent that we have surpassed full-year 2021 issuance, even if this year hasn't turned out quite how we expected and conditions have been challenging. What can you tell us about how Pfandbrief issuance has developed among your members?

Sascha Kullig, vdp: Pfandbrief issuers indeed have been very active so far this year. As you noted, we've already exceeded last year's supply with €22bn in the benchmark segment, which is really impressive. What's more, we have seen issuers — including some big names — who hadn't been in the market for maybe one or two years, return with benchmarks — that's probably one reason why we've seen such impressive figures.

If you look at the overall market, the figures are quite comparable to last year: five months into 2022 we had roughly €36bn of Pfandbrief issuance, which is more or less the same year on year. The difference is that we have seen only about 25% of this as retained Pfandbriefe — so there are still some retained Pfandbriefe being issued, but last year and in 2020, too, the share of retained Pfandbriefe was about 50%. That to some extent explains the increase in benchmark issuance.

Day, The CBR: Is the amount issued in line with what was expected in aggregate among your members for the year?

Kullig, vdp: It may even be a little bit more than expected. Issuers had a forecast of close to €50bn for the full year, implying

a net issuance volume of only around €1bn. We have asked our members to update their estimates and the outcome is that they intend to issue more than foreseen at the end of last year, so we may see a more positive net issuance volume, and a little bit more than €50bn of issuance.

But this very much depends, of course, on market developments, too. As you've mentioned, we have seen a great deal of volatility in the market — even if the Pfandbrief is the funding tool to access the market especially when the going gets rough. So, we will see what the situation looks like going forward, but if everything goes well, we will end up with a higher volume than initially expected.

Day, The CBR: Have the individual issuers been able to execute their funding plans as expected?

Peter Kammerer, LBBW: When it comes to Pfandbriefe, issuance has been more or less in line with our plans. We have already done two benchmark transactions this year, a euro and then a US dollar quite early in the year, in January and February. Looking back, going out early was a wise decision. For us, this has also to some extent reflected a return to market-based funding. We did a lot of retained covered bonds last year to take part in the TLTRO — this was not a funding exercise for us, but taking advantage of the favourable conditions.

Looking at the current situation and other funding options, we have seen, for example, a substantial widening in spreads in the senior market on the back of the Ukraine war and the increase in risk. Covered bonds are meanwhile an attractive option in both offering the cheapest funding and the ability to access the market,



Participants (above, left to right):

Peter Kammerer, head of debt investor relations, Landesbank Baden-Württemberg (LBBW)

Annalaura Capuano, portfolio manager, AllianzGI

Nicole John, head of strategic funding and investor relations, DZ HYP

Alexander Kirsch, head of funding, Aareal Bank

Neil Day, managing editor, The Covered Bond Report, and moderator

Sascha Kullig, member of the management board, Association of German Pfandbrief Banks (vdp)

Vessela Krmnicek, senior director, Fitch Ratings

which is something that issuers are recognising and may also explain why covered bond issuance is so strong this year. Those factors have been the key drivers for us, and for the rest of the year, we will need to look at how markets develop. We would not exclude further issuance, but we are advanced in our funding programme.

Alexander Kirsch, Aareal: We opened the covered bond market this year in the first week of January, and in the second week we followed up with a senior preferred. It is the first time we have done two benchmarks so early in the year, but while it would be nice to say that this was because we foresaw how the market would develop, it was actually related to the takeover by Atlantic BidCo. The news that the group of private equity investors wanted to acquire Aareal leaked out in autumn last year and since then we have gone through a lot of blackout periods. In such an environment, it's very difficult to issue. The announcement of whether or not the first public tender offer was successful was slated for 19 January, so we had to come to market before that date, or face another extended absence with an update to the debt issuance programme, maybe more questions, etc. So we

were in a way forced to go in these windows at the start of the year. But ultimately, it was good timing and we were happy with how things turned out.

Since having issued the Pfandbrief in January, we have done one in April and now one in June, and I have to say these were three totally different windows. January was totally fine: we did eight years at minus 1bp. Then April was already a little bit more difficult because the war had started and there had been this historic speech from Lagarde that interest rates were going up and inflation is increasing, and we did a seven year at plus 3bp, i.e. 4bp wider. And most recently we did a short five year at plus 8bp. I hope this trend will not continue until year-end!

We still have room for one more euro covered this year, or instead of that we could do a dollar and a sterling. We did announce a dollar covered bond mandate already, in March, and planned to do some investor work, because execution risk in dollars is much higher than in euros. But in the meantime, while we were doing this marketing, markets deteriorated on the back of a lot of bad news, with spreads widening and execution risk rising, so we decided not to proceed with the transaction. So this mandate is still



Vessela Krmnicek, Fitch:

'Downside pressure on covered bond ratings is more likely to come from negative rating actions on sovereigns'

pending and if markets improve by year-end, a dollar Pfandbrief and maybe a Sonia-linked sterling transaction could be doable. And if the environment is not conducive to these two, then we are probably good for a euro Pfandbrief of up to, say, €750m.

Nicole John, DZ HYP: DZ HYP was able to implement the funding plan for this year as expected. As a frequent issuer, we generally enter the covered bond market three to four times a year.

Our first transaction in 2022 was, as planned, our debut issue of a Green Pfandbrief in February in the amount €1bn. At the end of May we launched our second covered bond benchmark transaction. Due to the further increase in market volatility, spread widening and the geopolitical uncertainties, we issued this bond a little earlier than originally planned.

In addition, with our private placement activities we had already generated more than half of our funding needs in the covered bond segment by the end of the second quarter.

Day, The CBR: On the investor side, how have covered bond market developments played out compared with your expectations?

Annalaura Capuano, AllianzGI: We started the year thinking that net issuance overall would be kind of flattish — because we supposed that issuers would come to the market, but also expected a degree of redemptions — so we definitely underestimated the issuance volume. A number of factors led issuers to come to the market, some of which have been mentioned already.

We have definitely somewhat adjusted our positioning vis-à-vis covereds in a more defensive manner. Covereds are still very much in focus, because they represent something of a safe heaven and they offer an interesting pick-up versus government bonds and SSAs also in relative value terms. However, since the war started we have adopted a relatively cautious stance on duration, focusing on tenors of five years and less. We are currently taking a more optimistic stance towards the five to seven and seven to 10 years spectrum, but after the war broke out and the aggressive

inflation figures, we didn't expect any near term improvement and that made us relatively cautious in our duration positioning, which was also reflected in covereds.

Day, The CBR: Can you share any colour on how you might have differentiated between Pfandbriefe and perhaps peripherals or other jurisdictions?

Capuano, AllianzGI: CEE names in particular were an exciting new development last year, and we even started a more systematic coverage of all CEE names towards the end of 2021. However, while these markets are absolutely interesting and will become bigger players in the market with increasing levels of issuance, we are now focusing more on core names. Even if we have definitely seen some peripheral issues with very good spread levels, such as PKO, we think it's a little too early to return to peripherals as we are not sure that the story is over yet. We don't think that investors are going to take the extra risk of going for something more exotic at these spread levels. So at the moment we are very much interested in core, such as Germany in particular.

Day, The CBR: How has the rating outlook developed in such a challenging year?

Vessela Krmnicek, Fitch: Pfandbrief credit quality has remained stable. Their ratings are protected by buffers against issuer downgrade and substantial levels of overcollateralisation. When it comes to the war in Ukraine, no Fitch-rated covered bond programme is directly exposed to Russia or Ukraine. However, most will be indirectly affected by weaker growth and higher inflation due to the war. So downside pressure on covered bond ratings is more likely to come from negative rating actions on sovereigns in countries close to the conflict in eastern Europe, rather than from cover asset performance deterioration. Such a sovereign rating downgrade could put downside pressure on the respective covered bond ratings, because it could trigger an issuer downgrade or result in a lower achievable covered bond rating if this was constrained by the applicable country ceiling or sovereign rating.

Day, The CBR: Looking in more detail at the primary market and how it has developed, how have issuers perhaps adapted their approach in light of the changing circumstances?

Kirsch, Aareal: Having up to four benchmarks to do across the year, we would currently consider ourselves a frequent issuer, and as a frequent issuer, sometimes you face a good environment, sometimes it's tough, but postponing transactions repeatedly because you think things could improve can be a dangerous approach if markets deteriorate even further. In other words, if you are planning to do more than two benchmarks a year, sometimes you have to take the markets as they are, and you have to pay the price that at that time is the fair pricing.

I didn't like the 8bp in June, of course. But when we had been marketing in Scandinavia the week beforehand, a lot of the feed-

back was that investors saw fair pricing for a covered bond in the double-digit area — 12bp, 13bp, 14bp — instead of the single digits — 2bp, 3bp, 4bp — given the impact of the war and macro developments. We then had a look at our curve and saw that there was a free spot in the short five year maturity and a lot of banks had recommended that we don't go too long. So we then asked for quotes, and I was very surprised that, in speaking to seven banks, the best pricing was plus 2bp and the widest plus 10bp — in other words, even the dealers are sometimes not really sure where the fair pricing for a bond is. In the bilateral discussions we had, there were good arguments for both sides. Then finally, being responsible for funding, you have to make your decision. I said, 10bp is too wide, but plus 8bp is definitely doable.

As a frequent issuer, you also have to look at how your transactions are performing in secondary, and this aspect is also why the market has been in bad shape: primary transactions are not performing in secondary, and as long as they do not perform in secondary, the books get smaller when you go out with a new issue. I'm not sure we are at the end of spread widening yet, and that contributed to us doing more funding in the first half of the year. We have done four benchmarks in total, three covereds and one senior, and we feel quite good. But we are not done for the year — we have done around two-thirds of our funding, but are definitely considering one covered and one senior by year-end.

Kammerer, LBBW: Markets have indeed become more challenging. However, we enjoy a bit more flexibility thanks to the majority of our funding being senior preferred and senior non-preferred that we can raise in the domestic market — covered bond funding is typically about 25%-30% of our needs. We have not issued any benchmarks in senior format this year because we can meet our needs in private placements, even in the more difficult conditions such as what we have seen recently. That could be with smaller institutional clients, mainly in Germany, but also the savings bank sector, among whom Landesbanks still enjoy preferential treatment.

I agree that when you have a large funding programme to do, you cannot just cease issuing. You need to continue, but within a certain timeframe you can look for the best windows and adapt the structure of your bonds. Recently that has meant looking more at shorter maturities — which have come back this year with the higher rates. It's nice to have that option again because euros is of course the major currency for us. With the negative rates in the past couple of years, nobody could issue short-dated covereds in euros, so you needed to go to other currencies if possible. We could use our short term dollar and sterling assets to do so, since we have these in the mortgage pool — there's a bit of dollars in the public sector pool, but it's predominantly euros.

Driven by our assets, we have been active in the US dollar market for many years. When we approached the dollar market in February, conditions were still excellent. We also added a green feature, as we have done previously on a dollar Pfandbrief, and that leads to slightly higher demand, partly from seeing big-



Nicole John, DZ HYP:
'If an issuer chooses a longer maturity, the execution process will be more difficult'

ger tickets from the usual accounts. We hear from some dealers that it doesn't make much sense to add a green feature to US dollar covereds, because they say buyers are not really incentivised, but we feel differently.

John, DZ HYP: This year issuers must be far more flexible than in previous years with regard to the funding instruments, the terms and the spread landscape, because the market has changed to a buyers' market. And in the first half of 2022 investors' preference was at the shorter end of the curve. If an issuer nevertheless chooses a longer maturity, the execution process will be more difficult, i.e. with higher NIPs and a longer bookbuilding phase with lower oversubscription than in the past.

For DZ HYP these adjustments in the market meant that we issued our last covered bond benchmark somewhat earlier. In addition, we discussed more intensely the chosen maturity, as we had investors' preference for a shorter maturity in mind. All in all, we opted for a longer maturity of nine years in order to achieve the best possible match between assets and liabilities.

Day, The CBR: Annalaura, you mentioned PKO as an example of interesting pricing and we recently saw Deutsche pay 26bp for a €800m 15 year at the long end. I would have thought these were quite eye-opening levels. At the same time, we've heard about a possible vicious circle in the primary market with the underperformance of new issues in secondary affecting further new issues. What's been your stance vis-à-vis the primary market?

Capuano, AllianzGI: We apply similar rules to the primary market as to the secondaries, so overall, as I said, a very conservative stance. We have a strong preference for core names, for big names, because we can be sure that those books are going to be filled, and more confident in the secondary performance.

We think that, especially when it comes to German Pfandbriefe,

'Issuers must be far more flexible than in previous years'



Sascha Kullig, vdp:

'We definitely think it's a good development that this big investor steps to the sideline'

the primary market has adjusted much more than secondaries to the current level of market turbulence. So we like to participate in new issues when they fall into our guidelines of remaining conservative, because, as you mentioned, at least in the primary market we get spread levels that are quite interesting. A key reason why secondaries haven't adjusted so much for German Pfandbriefe in particular is because there is naturally less liquidity in them — there is a strong domestic market for these bonds and oftentimes most of the buyers are buy and hold investors.

We are now at a point where we are questioning at which level we will re-enter markets that we have decided to avoid so far. When it comes to German Pfandbriefe, I'm not sure that after Deutsche, for example, there is much more scope for higher new issue premiums and spreads. But for other, peripheral bonds, we are not sure that this is the end.

Kirsch, Aareal: Secondaries are indeed very illiquid and I asked some market participants why volumes are so low, and received a very interesting answer. Outstanding covered

are largely zero coupon bonds and nobody wants to invest in

zeros right now — we are in a new normal where you get 2% for Pfandbriefe and 4% for senior, and investors want to generate alpha, generate interest payments, get a coupon. Bank treasury accounts want to have it for their net interest income, but as far as I know asset managers also prefer to get 4% running than buy a zero coupon at 75 or whatever. And my understanding is that this is a reason why there is so little turnover in secondaries, because they're not interesting for a lot of investors, who prefer new issues. It's hard to do anything about that, but I assume that as we see more deals with 2%, 3% or 4% coupons there will maybe be more turnover in secondaries, more liquidity.

Day, The CBR: One of the questions that has been hanging over the market is how long the ECB will participate for and to what extent. We have seen them cut their CBPP3

orders a couple of times already, although ultimately perhaps to a lesser extent than had been expected. To what extent is that still an important factor in the market and possibly an influence on your view of new issues?

Capuano, AllianzGI: The reduction of the ECB's participation in the primary market is definitely a big factor. However, we don't believe the ECB can reduce its participation much more, because they still need to re-invest all the maturing bonds under the programme, so they will remain active for some time. And we expect primary market activity to slow over the remainder of the year — I feel we are perhaps two-thirds done for the year. So we do not expect major disruption from the reduction in the ECB's activity and we do not expect their participation in new issues to go below 10%. If this is the case, then they will need to invest the remaining amounts in secondaries, which will be very beneficial, because it will also stabilise secondaries. So, per se, the ECB behaviour doesn't make us extremely concerned at the moment.

Day, The CBR: The ECB's involvement is something the Pfandbrief community has from the very start been sceptical about and at times almost hostile to. Is it good that the end is nigh, even if there are the reinvestments to come?

Kullig, vdp: A clear yes and no, I would say. First of all, it's a good development that the market has to get used to how it was in the past. The market got somehow addicted to this liquidity and to this big investor, and we definitely think it's a good development that this big investor steps to the sideline.

But at the same time it is very important that there are no cliff effects. That's why it's really important for the ECB to stick to the commitment to reinvesting redemptions from the covered bond programme in the covered bond sector. Based on what I've heard, that is indeed what the ECB is planning to do — I had been a little concerned that all the redemptions might be reinvested in the sovereign markets because of the discussions around fragmentation.

So that's very good news for the market. The Pfandbrief can definitely succeed without the ECB, but there was a reason

behind the rush to issue before the end of June, right? We have to acknowledge that.

Kirsch, Aareal: Issuers have been afraid of execution risk. As I said, even syndicates are not sure whether the price should be plus 2bp or plus 10bp, but if there's an ECB order for, say, €150m, this gives you at least a nice anchor order to start with. If this disappears, you have to sell all the bonds to the market, and there is more execution risk, especially if you don't know where the fair price is.

We are seeing wide spreads in Pfandbriefe, but if you go back to 2007, 2008 and the peaks after Lehman and then the sovereign crisis, there is the potential for more. I hope not, but there's a very uncertain outlook for the coming wintertime and this is my biggest concern. Some people are talking about Covid-spreading events

'The ECB behaviour doesn't make us extremely concerned'

around the World Cup in Qatar because of all the indoor parties. Others are saying these will not happen because it will be cold as there will be no gas for heating. So there are a lot of risks coming up until year-end and the uncertainty right now is very, very high — we could see spreads coming down again or at plus 20bp.

Capuano, AllianzGI: The ECB's exit would make you think that more attractive spreads would bring back those investors who were naturally crowded out for a while. Being a team that focuses on insurance investors, we also expected that at these spread levels and at these yield levels, we would get more demand from insurance companies, especially in certain maturities. A 15 year at 26bp over mid-swaps, for example, should be a no-brainer. But what we've seen is that, having experienced the first negative P&Ls on their investments in a decade, insurers are now having discussions on their P&L budgeting. The anticipated move back into covereds has therefore been somewhat delayed, as insurers have considered whether they will allow for a negative P&L, and how much. Some accounts have been blocked, being told they have reached the budget and cannot do any more active management, and cannot reinvest in longer maturities. So it's not that easy — there are some frictions and the adjustment takes time.

John, DZ HYP: In principle the intended normalisation of monetary policy is a good development. The fact that this is accompanied or amplified by a scenario of various extraordinary problems is certainly a special challenge for the central bank.

The positive effects for the market were already evident last year, when some investors returned to the covered bond market as interest rates came back to positive terrain. I also expect to see more differentiation between issuers.

Day, The CBR: How are higher rates playing through on the asset side?

Krmnicek, Fitch: The anticipated higher inflation has led to mortgage rates rising, particularly for residential loans. They started rising even before the ECB made any announcements. In Germany, however, the residential mortgage loans generally carry a fixed rate and we have observed that the fixed rate period has been growing longer and longer in the last years because borrowers wanted to lock in the prevailing lower interest rates for longer. Borrowers refinancing in the near future after their initial fixed rate period will do so after an average period of 11.5 years, so they will reset at a lower rate than they were paying and with lower loan-to-value due to amortisation. Therefore we do not anticipate meaningful pressure on their performance. However, new origination could be affected in terms of affordability, because more potential borrowers would not be able to pass affordability tests when mortgage rates are higher, all else being equal.

Kullig, vdp: One might get the impression there was a risk that credit quality will deteriorate. I doubt it. There is, of course, a risk of recession — there's a risk of gas shortages, maybe higher unemployment. Nevertheless, and you already mentioned it,



Annalaura Capuano, AllianzGI:
'The anticipated move back into covereds has been somewhat delayed'

relevant numbers are quite healthy. In Germany we have a quite low debt-service-to-income ratio and a huge share of fixed rate mortgages. And at the end of the day, especially when we are talking about residential real estate lending, even if people get unemployed, even if they get into trouble, the last thing they want to fail on is their mortgage loan — it's their home we're talking about. So, I hardly see any sizable risk to credit quality here.

One might have a different view when it comes to commercial real estate lending, but we have been talking about a deterioration of office prices because of Corona and working from home for a long time and what has happened so far? Nothing. We probably won't see increases in prices anymore, but the market is going to stabilise. Are we going to see huge empty office spaces? I don't know. But even if more empty spaces emerge, that's not necessarily a bad thing, since currently the vacancy rate of offices is very low, which is quite unhealthy, so a little bit more would bode well for the market.

So, there are risks, of course, macroeconomic risks. But a lot must happen before this feeds through to the cover pool side.

Kammerer, LBBW: Looking at the residential side, people who are now refinancing last refinanced maybe 10 years ago and are used to higher rates, because they faced them already, as Vesela mentioned. For the commercial side, it really depends on the underwriting standards. What LTVs are accepted? What are the cashflows from the transactions? What is the debt service capacity? There, you need to check that your assets are able to withstand higher interest rates. And as Sascha mentioned, the German market for certain sectors is still relatively healthy. Even if we look at retail, where we have seen price declines, they have not been as dramatic as some might have expected in the past.

Kirsch, Aareal: This is a very good point. I have been asked repeatedly about the state of our commercial real estate portfolio, especially in times of inflation, and actually a real estate portfolio is somehow hedged against inflation. Take the three most popular property types: hotels, shopping and office. In the hotel busi-



Peter Kammerer, LBBW:
 'Regarding the spread environment, I think it could now become even more interesting to issue green bonds'

nesses, you can change your rates from one day to the next, so if inflation goes up, you can adjust your rates. With shops, most of the contracts are related to their turnover or profitability, so if they have a higher turnover, the rates also go up. And turning to offices, rental contracts are often linked to CPI. Therefore, commercial real estate is perhaps better hedged against inflation than other asset classes.

And one last point regarding the relative safety of the assets and how they perform if you get into stress: if you do consumer lending, there is no collateral and no cashflow; if you do residential mortgages, you have collateral, but there's no cashflow; but with commercial, you have collateral, but also cashflow out of the business. So commercial real estate gives you much more certainty or much more safety, and not many investors are mindful of that.

Day, The CBR: Turning to ESG, it's now a perennial topic, although each year brings its new developments — this year the Ukraine crisis has perhaps given it a new angle with the energy issue. But let's start off by talking more directly about bonds — Nicole, as you mentioned, DZ Hyp finally launched its first green Pfandbrief this year. What can you tell us about your strategy and how the deal went?

John, DZ HYP: First of all, with our debut green Pfandbrief issue, we have laid the foundation for DZ HYP to be able to establish itself as a permanent issuer in the sustainable segment in the future. With the green Pfandbrief, we want to give our investors the opportunity to invest specifically in green real estate. And from the issuer's point of view, green issues expand the circle of investors, and this also provide security in the issuing process, especially in challenging market phases. Not only for these reasons, the green Pfandbrief is an important element in our sustainability strategy.

In order to meet the quality requirements of a Green Pfandbrief, we have not only followed the ICMA Green Bond Principles, but in particular the minimum standards of the Association of German Pfandbrief Banks. After we established a stringent

selection process for green assets last year — also from an IT perspective — and after the framework was finalised and we received the second party opinion, we were able to start the marketing process for this green bond at the beginning of the year.

During our two-day virtual roadshow we received positive and constructive feedback from investors. Questions focused in particular on DZ HYP's sustainability strategy, the selection process for green assets and the EU taxonomy.

DZ HYP's first Green Pfandbrief transaction was very successful, despite a thoroughly challenging market environment due to the geopolitical uncertainties at the time. We achieved a high level of granularity, with more than 100 investors during the bookbuilding process, generated an order book of approximately €2.2bn and around 33% of the transaction was attributable to green investors.

With this transaction we have taken the first step as a sustainable issuer and we look forward to continuing on this path.

Day, The CBR: Peter, LBBW has been issuing in green and social formats for some time now, and in dollars as well as euros, as you mentioned earlier. How would you say things have been developing?

Kammerer, LBBW: One thing we see is that investors are becoming better educated. For example, if I look back to when we started issuing in green format, the deeper discussions we had with investors were when we issued in senior, as the more classical green investors came in and scrutinised the portfolio, whereas it was a bit different for covereds.

Regarding the spread environment, I think it could now become even more interesting to issue green bonds. In the past, the main benefit was additional demand — as Nicole mentioned, you see more investors in the book, and some accounts come in with higher orders. But because covered bonds and especially Pfandbriefe priced so tight, you didn't really have a pricing advantage in a green bond — it was evident in dollars, but typically not in euros. However, in a wider spread environment and one where markets are a bit more challenging, you could see greater differentiation between issuers and at some point adding a green feature, also to a covered bond, could pay off more and make it more interesting. Already in senior bonds, where spreads are wider, there is greater price differentiation. So having these green covered bonds, and especially the green Pfandbriefe — organised with the vdp — can be quite helpful, not only in supporting the sustainability strategy of the overall bank, of course, but also with regards to pricing and the performance of primary books.

Day, The CBR: Alexander, what is Aareal's stance vis-à-vis green and sustainable bonds?

Kirsch, Aareal: On the green side, right now we are able to issue in senior format — preferred and non-preferred — and also Tier 2, but not covereds. So although I like LBBW's idea of doing a dollar covered in green format, we are currently unable to do so. We have some IT issues, but they will be solved going forward.

Looking at the green market right now, my interpretation is that there is not really a greenium. Execution risk should be lower, and this is also an added value of a green bond, but pricing-wise, if I look at our curve and those of other issuers, I do not really see a big difference. At the moment everyone is focusing on credit risk, and green is therefore a bit subordinated to that. But as I said, execution risk is lower because of the potential investor base and this is helpful if you want to do something, so we are definitely looking towards another senior issue in green format. We aim for the short end, we go for green, so we try to fulfil all investors' wishes and hopefully will get there.

Day, The CBR: Annalaura, how involved are you in green and sustainable issuances? And what are you looking for from issuers?

Capuano, AllianzGI: We see more and more demand from our clients for sustainability strategies. Our main client, Allianz, is very much committed to having a sustainable investment portfolio and the reduction of the carbon footprint, so we have clear objectives and green covereds are definitely attractive in this regard. We have also observed that they perform significantly better at the primary level. However, the feedback that we have been getting from issuers is that not all of them want to issue green covered bonds, not all of them are convinced that it's worthwhile because the paperwork behind it is not compensated with a substantial greenium — we've seen greeniums of up to maybe 2bp, 3bp — although we will see if this changes in this increasingly challenging spread environment. But on our side, we are definitely interested.

We would welcome a higher level of transparency. With green Pfandbriefe and other covered bonds, the assets behind them are not separated, there are no green cover pool figures that you can compare with the overall cover pool figures, which is a problem. And from an investor perspective, we are very much trying to encourage issuers to provide more transparency and granularity on the greenhouse gas emissions, but at the moment, you do not get a separate number on greenhouse gas emissions for the entire cover pool, you either get it for the green assets or for the entire bank. So there's still some work to be done there and we encourage issuers, as much as we understand the operational burden behind it, to give more transparency. We like as a tool, for example, the transparency template, so if more and more issuers could fill in the additional part of this about the carbon footprint, that would already be a big step forward for us to have very easy access to this kind of data.

Kullig, vdp: I fully understand your view and I assume that most of the Pfandbrief banks would be happy to be able to deliver those figures. But carving out the green assets from the cover pool is legally not possible in Germany. And more generally, we have to keep in mind that not only Pfandbrief banks, but the banking industry as a whole is confronted with a huge wave of regulatory initiatives when it comes to sustainable finance. There are plenty of new requirements that are keeping banks busy, such as ECB stress-testing, the Green Asset Ratio and many others. So, banks



Alexander Kirsch, Aareal:
'Commercial real estate is perhaps better hedged against inflation than other asset classes'

are already working hard to fulfil all those requirements and they will probably have to work harder to fulfil more requirements that are not yet regulatorily binding.

You mentioned the operational burden, which is indeed an issue, and on top of that it's extremely difficult to get figures, especially in the real estate sector. Insurance companies are invested in real estate directly and I assume you have the same problem there: it's extremely difficult to get figures on greenhouse gas emissions. That's why you have to make proxies, and that's what some banks do.

Some banks have already committed themselves to a carbon footprint reduction target over the next seven to 10 years, and we know that other banks have internal goals but haven't communicated them so far but are probably going to do so going forward.

Regarding the transparency template, I expect it will take a few years yet until banks — not only German Pfandbrief banks, but many other banks — will be able to fill in the relevant section, because it's extremely difficult.

At the vdp, we already have our minimum standards for green Pfandbriefe and we acknowledge the need to improve and we will endeavour to do so, perhaps moving more towards the EU Taxonomy. Meanwhile, at the European level, we have the ECBC and the transparency template. But again, it is complex and will take time to deliver the appropriate figures.

Kammerer, LBBW: And when it comes to moving towards the EU Taxonomy, some of the details are an issue for a bank with international business like us. Only a part of our cover pool is in the EU and it's very difficult to align your foreign business, like in the US, with the taxonomy — there are different concepts on what's green and that needs to be worked on.

Furthermore, we are not only active in the real estate sector, but many different industries that we need to screen and find the decarbonisation path and data for. From a carbon footprint perspective, real estate is not the most important one for us; much more important in terms of carbon emissions is financing for the electricity industry in Germany. So I understand the desire for

fuller transparency and in time more disclosure will come, but it's a question of when.

Kirsch, Aareal: An important point to mention when it comes to commercial real estate is that the average duration of the assets is around three-and-a-half years. So sometimes the bond matures before you actually get through all the data. This is also something of a challenge.

John, DZ HYP: I know that coping with all the requirements of the EU Taxonomy is a major challenge for many institutions and their customers. It will take a lot of time and further development until the criteria can be implemented. I think it is important that there is a certain degree of standardisation, but the requirements should also be achievable.

Day, The CBR: Vessela, how are such developments playing into your analyses?

Krmnicsek, Fitch: We publish ESG relevance scores for every covered bond programme indicating the level of influence an environmental, social or governance issue has had on a credit rating decision. For example, in some countries social housing schemes result in better loan performance as well as stronger recoveries compared to normal mortgage lending. This will be positive for the credit profile of a programme and lead to a higher positive ESG relevance score. We publish the ESG relevance scores as part of the covered bond credit rating analysis. In addition, in September 2021, Fitch Group launched Sustainable Fitch to provide ESG ratings which focus specifically on the quality of an issuer's framework from an ESG perspective.

Day, The CBR: You mentioned social housing there, and we recently saw the first social mortgage Pfandbriefe from DKB and Berlin Hyp. On top of that, we have proposals for a social taxonomy. What do you make of these social developments?

Kullig, vdp: First of all, we are extremely happy about the momentum we are witnessing in the market. We have seen eight new issuers this year coming in either green or social, and almost €5bn of green/social Pfandbriefe, which is a fantastic development. Most of these bonds are issued in benchmark format, but we also have smaller issuers who have issued very small amounts in either green or social, which is interesting to see. And then we have seen some innovations: we had the green railway deal from BayernLB, which was a green public Pfandbrief. But yes, we have also seen those two social covered bonds on the mortgage side for the first time, and this is certainly something that's going to develop further in future, I'm quite confident about that. Social housing has become an extremely important issue in recent years — although I wouldn't necessarily say social housing, which can have negative connotations in the Anglo-Saxon arena; it's more a question of affordable housing, which the two issuers have also referred to. I expect more momentum there.

In my personal view — rather than an official vdp view — it is good that we have no social taxonomy yet, and I hope we won't see it any time soon. The EU Taxonomy thus far has dealt with environmental issues and it's very good for issuers to have a regulatory framework to guide them towards the overall goals — when it comes to climate, we all know the goal is to reduce CO₂ emissions to zero. But having extremely detailed requirements doesn't actually help the market. It makes things more complex and could even stop the market developing further, especially when something like the EU Green Bond Standard requires a 100% taxonomy compliance — there are hardly any issuers able to say, our cover pool is 100% taxonomy compliant, for now, at least. I know some institutions in the real estate sector claim that their assets are 100% compliant, but there's some reputational risk there — if people dig into the details, I don't know what they will discover. A social taxonomy could even be worse. While we can discuss what is green based on science, such as net zero targets, when it comes to social, what does this actually mean? Everybody has different views on social, right? And there are different layers of social.

Kammerer, LBBW: I somewhat agree with what Sascha said. We have seen different approaches from issuers to social bonds, but as long as you have transparency, then investors can decide if they agree to the format or not. Some standardisation can make things easier and support the overall market, and so some form of guidance from the regulator can make sense. But what we have seen on the green side is very, very detailed — as I mentioned, it is very difficult to fit foreign assets into the EU framework, for example, which is a shame.

We are only issuing senior in social format because the assets are not related to the cover pool. Our programme has been in place for a number of years now and, with the potential regulatory changes in the future, we are currently checking if we need to review our programme.

Day, The CBR: Would you be hoping for similar standardisation and transparency from issuers for social covered bonds?

Capuano, AllianzGI: We don't have clear rules or standards in mind, because it is a relatively new product. And it is indeed very tricky to define what is a social or, say, affordable housing covered bond — especially to create a standard that works for different countries. But what we would welcome would be if similar and clear objectives could be outlined for the different social covered bonds. Sometimes things get a bit blurred — I remember a “blue” covered bond being issued a while ago, for instance. When there is a lack of clarity around the objectives, that makes me a little concerned as an investor. So it would be helpful if there were some general ground rules, even if they don't go into too much detail, so I could say, OK, your social bond and Aareal's social bond have the same objective of, say, maintaining rent levels below a certain average — something that is tangible for me to check out. That would definitely be welcome.



Day, The CBR: For covered bonds, the key regulatory topic of perhaps the last decade has been the EU Covered Bond Directive, which comes into full effect at the end of next week. Some countries seem to have left things quite late, but Germany was very advanced in implementation already last year, so is the Pfandbrief ready for the new era of harmonisation?

Kullig, vdp: Yes, I think so. Indeed, the German Pfandbrief Act was amended last year. The first part came into force 1 July 2021, with the second part coming into force only at mid-year. And with that, the whole Covered Bond Directive, and the new requirements according to Article 129 LCR, will have been transposed into German Pfandbrief law. The important message here is that all Pfandbrief investors will continue to benefit from every preferential treatment that you can imagine, both for outstanding Pfandbriefe and for new Pfandbriefe. It's important to note that this is also for outstanding Pfandbriefe, because we have been slightly concerned that there could be a misunderstanding when it comes to the new labels, European Covered Bond and European Covered Bond (Premium). The situation in Germany is that this new label, European Covered Bond (Premium), will automatically be granted to all new Pfandbriefe (except aircraft Pfandbriefe, but there are no aircraft Pfandbriefe currently), while outstanding Pfandbriefe won't get this label but will still enjoy every single preferential treatment. So, there's a distinction between the label and the regulatory treatment, and this is very important to understand.

Capuano, AllianzGI: We were confident that Pfandbriefe would adjust to the necessary measures quite early on and were therefore not particularly concerned about Germany, although we were aware that there were significant challenges ahead for other geographies. In general, we welcome the directive as something that provides clarification, transparency and somewhat stronger protection for investors.

Krmnicsek, Fitch: We have been following closely the final law amendments in the different jurisdictions that have been coming through lately before the deadline next week. In general, we view the transposition of the EU Covered Bond Directive positively as it ensures a minimum standard for liquidity protection across the different European jurisdictions. We are looking forward to more

issuers from a variety of European countries starting to use the updated legislation in the near future.

Day, The CBR: What is your view on things, Peter? Is there much work involved now for issuers to be compliant?

Kammerer, LBBW: Implementation accomplished, I would say. Changes can often be burdensome, but for German issuers, it was not a dramatic change. The most important one was the maturity extension and you need to get used to how you calculate and manage that, in case it were to happen. It's a matter of implementing it in your IT systems and reporting. It doesn't hinder you in going about your normal business or require any change in your covered bond issuance strategy. And we are used to implementing regular updates to the German Pfandbrief Act, so we are used to and well prepared for the changes, particularly as it was helpful that the German regulator and lawmakers acted quite early, so we had sufficient time.

Day, The CBR: What's next to be tackled on the regulatory front?

Kullig, vdp: There are many things keeping us busy from a regulatory perspective. There's Basel, of course, which could have a huge impact, especially depending on whether you are a commercial lender or a residential lender, whether you use the Standardised Approach or the Internal Ratings-Based Approach. It could potentially have quite a big impact on the business models of a few banks.

We have already discussed some of the green regulations, such as the EU Green Bond Standard, and then there are initiatives such as the amendment of the Energy Performance of Buildings Directive, which could have a huge impact on the mortgage market in Europe. Then we have a review of the Mortgage Credit Directive, which is also very important, for two reasons. Firstly, there is a discussion whether they should introduce a definition of green mortgages within the directive — which doesn't make any sense, in our view. And a second aspect relates to the prepayment penalty customers have to pay if they want to get out of their fixed rate mortgage loan before 10 years — this is always being discussed when it comes to the Mortgage Credit Directive.

So, there are plenty of topics that keep us very busy. ●



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In volatile times the Pfandbrief is an especially reliable investment. Its first-class credit quality and stable returns on investment are valued by investors in Germany and abroad. Thanks in particular to the stringent German Pfandbrief Act, it is the undisputed benchmark in the covered bond market.