The Covered Bond Report

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NORD/LB

The Southern European Covered Bond Roundtable 2023

Italian banks are poised to re-enter the covered bond market after their Spanish peers took centre stage in a buoyant opening to the year. In our southern European covered bond roundtable — sponsored by NORD/LB and featuring issuer, investor and rating agency representatives — we explore the dynamics driving issuance, credit quality and ESG initiatives.

Neil Day, The Covered Bond Report: After unprecedented levels of euro benchmark issuance last year, we have seen records fall in the first quarter. There's been a change in the rates environment and disruption from Silicon Valley Bank and Credit Suisse, but, come what may, the market has proven resilient. What's behind these dynamics?

Frederik Kunze, NORD/LB: We have seen quite a few episodes of market turbulence in recent years, but covered bonds have proven to be a crisis-proof funding instrument. And while, thanks to TLTRO III, covered bonds were not a public funding tool during Covid-19, in the last two crises — the attack on Ukraine and the recent bank stress — covered bonds were used for public issuance. Particularly in times of uncertainty, for issuers and investors alike, covered bonds represent a kind of rock they can cling to when volatility is high. Meanwhile, from an investor perspective spreads and in particular yields have become much more interesting and the asset class is much more attractive on a relative value basis. With the ECB leaving, there has been scope for spreads to widen, but performance has been quite robust, while real money investors have been coming back. Hence, the market has been working well and it is not surprising to see many jurisdictions coming back to the primary market and using the funding tool. To sum up, many investors see valuable and suitable investment opportunities in the covered bond universe. Overall, particularly taking into account the overall environment, we have had a very strong start to the year in the first quarter and with a lot of issuance following in April.

Casper Andersen, S&P: Covered bond issuance is rife across the market. We've seen interesting issuances from Spain, for example, with volumes that we haven't seen since 2016. Clearly a lot of progress has been made on the harmonisation front, with the legislative underpinnings coming into sync, which has supported issuance from many jurisdictions and is hopefully also bringing investors some comfort. We are also seeing the end of the TLTROs, with banks considering how best to repay or refinance. On the other hand, up to recently, deposits have proven sticky in Europe, which may lower or increase the need for covered bond funding for banks depending on their circumstances. So with the ECB set to play a smaller role in funding European banks, the question is, what is the optimal funding mix going forward? It will be interesting to see how that plays out, but what we've seen so far is that covered bonds definitely have an important role to play. As Frederik noted, they are also becoming an attractive target for investors again, after many years during which investor interest was lower.

We are also getting more questions about credit quality than we had for a long time. We actually think that European banks' asset quality should deteriorate only moderately this year. Even if we do expect house prices in a lot of the countries we follow to be very sluggish and probably falling, even on a nominal basis, we still believe that the strong employment throughout Europe will generally support mortgage performance. SME performance may cause some market disruption and credit performance could be an issue for some countries, but SMEs are less relevant for Italy when

Participants in the roundtable, which was held on 13 April *(left to right, top then bottom):*

Casper Andersen, senior director and covered bond sector lead, S&P Global

Ghazi El-Salmi, NORD/LB DCM Origination

Miguel García de Eulate, head of treasury and capital markets, Caja Rural de Navarra (CRN)

Frederik Kunze, NORD/LB Floor Research

Paolo Labbozzetta, head of group funding, Mediobanca

Stefano Marlat, head of finance, Crédit Agricole Italia

Niels Platz Bertelsen, fixed income analyst, Nordea Asset Management

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

it comes to covered bonds. There could also be some sovereign headline risk more generally and particularly when we're talking about southern Europe, sovereign performance comes into play, too. That's something investors are following closely, as are we are, of course, because the performance of the respective sovereign can impact our covered bond ratings. We believe that could impact how easy or difficult it will be for southern European covered bond issuers to fund in the near future.

Niels Platz Bertelsen, Nordea Asset Management: We have been quite bullish on covered bonds. They looked quite attractive during the whole of 2022, and even got increasingly attractive versus government bonds as the year progressed, given the significant widening of asset swap spreads. At the start of the year, we also saw unsecured debt as rather tight versus covered bonds. So we saw covered bonds as the place to be going into 2023.

That said, I have been quite surprised about the high level of issuance this year. We expected issuance to be front-loaded due to the ECB stepping out and the refinancing of TLTROs, but we had not expected this amount of issuance. We nevertheless see the net supply picture in 2023 as being much more favourable for covered bonds than government bonds, as we expect a flood of government bonds, and the EU will also have to do a lot of issuance this year. As I said, we also see issuers having front-loaded some of their funding plans in covered bonds and with a frozen housing market in most of the Western world, not much new mortgage production is happening. That — together with rather sticky deposits — can impact issuance negatively for the rest of the year. So on a relative value basis, we still see covered bonds as quite attractive looking forward.

Day, The CBR: Did you reshuffle your positions at all in light of the market developments we've seen this year, such as the bank problems?

Platz Bertelsen, Nordea AM: Not really. We got a lot of basic questions on covered bonds from our clients, on aspects like the structure and bail-in treatment. So some of the fears around the banking

Ghazi El-Salmi, NORD/LB: 'Southern European covered bonds are now one of the most in-demand products'

sector were also seen on covered bonds. But I think it showed the strength of covered bonds — there was rather limited volatility in the covered bond market during March. I just saw it as a buying opportunity — one issuer in particular was suddenly trading quite attractively in the covered bond space.

Ghazi El-Salmi, NORD/LB: Expanding on the point Frederik made earlier, higher re-offer yields and higher spreads are of course definitely attracting investors back, which was much-needed in an environment where the ECB was stepping out of the market. The main difference between now and the latter part of last year — when we already had higher spreads and rates, too — is that last year, we had all that volatility, especially in August and September, with a massive rise in swap rates, which scared away some investors or led them to place smaller orders. In the first quarter of this year, we still have an environment with higher spreads and rates, but now we have much less volatility and a new equilibrium that a lot of investors are comfortable with. This interest is reflected in order books — many investors have returned, while others who had remained loyal to the product are comfortable placing higher orders again — and that higher demand has enabled the high issuance volumes.

Day, The CBR: How have southern European issuers fared? We've already seen a pick-up in activity from Spain, and the first Portuguese deal since 2019 yesterday.

El-Salmi, NORD/LB: We've seen seven Spanish covered bonds this year, so these are probably the best proxy for southern European demand in general. They have outperformed the rest of the market, in both primary and secondary. On average, cédulas tightened almost 6bp from re-offer in the secondary market, for example. They were all — without exception — very successful in the primary market, too. Spanish deals paid on average 6bp of new issue premium — slightly more than the overall average of 4bp — and in return they achieved more dynamic bookbuilding, with 5.7bp of tightening from guidance to re-offer versus 3.7bp for the overall market, and higher bid to cover ratios, 2.7x compared to 2.2x. So while southern European covered bonds might in the past have been a bit behind in convincing investors to place orders, now they are one of the most in-demand products. That is encouraging, not only for Spain, but the other jurisdictions, too — as you mentioned, we have just seen Santander Totta issue their first bond since 2017, so quite a comeback — and then the Italian covered bonds that are still to follow.

> 'The Spanish economy is not going to be the problem child'

Day, The CBR: We will find out more about Italy shortly. But let's start with the Spanish issuance we have already seen this year. Miguel, did your experience correspond with the positives Ghazi described?

Miguel García de Eulate, Caja Rural de Navarra: We can offer a good point of comparison, in the sense that we issued in February 2022 and then in January 2023, and the environment is totally different. Last year, rates volatility had already begun, we were in the pre-war phase, and bookbuilding was much more complicated, whereas this year we got much more demand against a more stable backdrop for rates.

Also from the credit perspective, there is the view that the periphery and in particular the Spanish economy is not going to be the problem child of Europe anymore, at least not this time around. Look at the leverage of the private sector, the health of the financial sector, unemployment, house prices or many other metrics — from a credit perspective, the cédulas market is very strong and that will remain the case. It's true that we've had much more Spanish issuance this year, but it is still not huge — we are talking about €7bn-€8bn — and at this pace, we will still see flat or negative net supply for the year. This is very much related to the deleveraging of the financial and private sectors — the mortgage book of the Spanish financial system is not growing. And even though we have the TLTRO redemptions — which we will discuss more later — all in all there will be more issuance from Spain, but not huge amounts.

So the strong order book we enjoyed this year reflected all these arguments, and a combination of a more stable rates environment and strong credit fundamentals bodes well for cédulas issuance going forward.

Day, The CBR: Turning to Italy, how are covered bonds fitting into your funding plans?

Paolo Labbozzetta, Mediobanca: I should start by noting that we are just entering our Q4, since Mediobanca's fiscal year starts in July and ends in June. We were lucky and swift enough to have been able to issue our last covered bond in June 2022, and then were able to tap that at the beginning of August 2022, right after the Italian government crisis. The timing of our issuance was based on two elements.

Firstly, we were anticipating a potential delay in the transposition of the EU covered bond directive into national law, which indeed transpired — although the

length of the blackout period that the whole banking industry faced was completely unexpected. We were also aware that summer was approaching, and we then had a rapid rise in interest rates and challenging market conditions, so we issued in June instead of waiting until the autumn, which might otherwise have been the case.

Secondly, our decision to issue was also based on the fact that the ECB was still participating with some 30% of new issues and we wanted to take advantage of that last window of opportunity in terms of CBPP3. We were thus able to issue €750m, which was the target in our funding plan, so in practice the legislative blackout did not affect us at all, given that we typically issue one covered bond per year.

For the coming fiscal year, we will naturally include covered bonds in the programme, although we will issue our funding plan at the end of May. We are working actively with the other Italian banking players to speed up the transposition process so that this saga should finally come to an end and banks will be ready to issue again towards the summer.

One factor that probably distinguishes us from other banks is that we never used covered bonds as collateral for TLTRO operations. Starting from the first TLTRO programme, we have always kept covered bonds as a pure funding tool. We have wanted to keep investors engaged so have worked hard to be able to have sufficient production to sustain our regular funding activity through covered bonds. And so today, we are not in say a rush to replace TLTRO with covered bonds, since we are replacing that funding from other sources. We are nevertheless looking forward to issuing covered bonds again, as per our regular funding activity, in the autumn, once the backlog of supply from Italian players should have cleared.

Stefano Marlat, Crédit Agricole Italia: Our fiscal year matches the calendar year. In 2022, we completed our issuance in the first half of the year. As Paolo said, we were then waiting on the transposition of the EU legal framework in Italy. It was therefore not possible for us or any Italian issuer to approach the market at the start of 2023. At the end of the day, seeing how crowded the market was at that time, having to wait had its upside. But for 2023, we have in our funding plan the idea of approaching the market with a covered bond, simply because from the beginning we have told investors that we would come to the market on a regular basis, which is what we have done in the past.

Stefano Marlat, Crédit Agricole Italia: 'When might issuance occur? Our best forecast is June — surely not before'

'The legislative blackout did not affect us at all'

Covered bonds are the only asset class that we issue on the market — our funding otherwise comes from a mix of our clients and, for bail-in-able instruments, our mother company. That's why we have in the past issued long and extra-long maturities — it is not so easy to achieve such duration via private customers, and covered bonds offer this possibility. So it's not a question of needing liquidity, but of managing maturity. For this reason, we prefer to be free to decide if market conditions allow us to approach the market. In this regard, we are not using market funding to pay back TLTROs. We can therefore wait to see how market conditions develop.

When might issuance occur? Our best forecast is June — surely not before, because it will be impossible for us to be ready given the timing of the Bank of Italy's final publications. So it will be interesting to see what the market looks like from June onwards. At the start of the year, everybody crowded into the market, but in the second part of the year, maybe it will be Italian issuers crowding in.

Day, The CBR: We'll look ahead at that shortly, but focus a bit more on TLTROs first. Miguel, what are your expectations on their influence on covered bond issuance?

García de Eulate, CRN: Having read many reports on the TLTRO situation across jurisdictions, I think on a European overall level you can conclude that this won't pose a problem for banks. In the case of Spain, specifically, liquidity levels are high. And so I wouldn't expect a jump in covered bond issuance because of TLTROs per se.

However, we are all taking a deeper look at liquidity coverage ratios (LCR) and net stable funding ratios (NSFR) because of the TLTRO redemptions. These were created at a time when they were not needed because liquidity was so plentiful as a result of the expansion of the ECB balance sheet. But these ratios will decline as TLTROs are redeemed. I think that covered bonds will be the tool of choice to manage these ratios, specifically the NSFR because although deposit-taking institutions have the liquidity of deposits, covered bonds — as mentioned earlier — allow us to go for long term financing and are hence something very interesting for these ratios.

So on the one hand, TLTRO redemptions won't lead to a rush of covered bond issuance, but on the other hand, going forward and structurally, covered bonds will gain renewed interest among issuers as a tool for lengthening the liability structure. It makes perfect sense as duration is one of the key features the covered bond product offers. And this is something we will see from Spain.

Kunze, NORD/LB: Following on from Miguel's and Casper's comments about banks' funding mix, it is important to bear in mind that TLTRO III brought about a high level of retained issuance for many jurisdictions, including Italy and Spain but also some core European jurisdictions, like Belgium, for example. This implies a kind of reserve for potential future covered bond issuance. We are in a situation where mortgage markets are not growing strongly — if they are growing at all — but cover assets are available: you just unwind the retained covered bonds to free up assets for public issuance. It is not a one-to-one relationship, but if you have, say, €2bn or €3bn of retained issuance, you will perhaps be thinking about using €500m or €1bn of this for public issuance instead. This is perhaps the most important aspect of TLTROs and is good news for those banks willing to issue covered bonds. It also gives us a degree of comfort in our overall supply forecast for this year, which, at €193.5bn, is at the higher end of forecasts — this would represent positive net supply of €78bn.

For Spain, we are quite progressive and expect €12bn for 2023. Italy is something of a black box, because we don't know how much activity there will be when it comes to the restart, and how investor appetite is, plus there can be headline risks. But we have a forecast of €9bn. Those figures would represent a net increase of around €2.7bn for Spain and €1.8bn for Italy.

Day, The CBR: As well as the end of TLTROs, the ECB is, as already mentioned, gradually stepping back from the market and already ended CBPP3 primary market purchases rather abruptly. How might the asset purchase programme (APP) develop over the rest of the year?

Kunze, NORD/LB: To be honest, I was really surprised by how fast they stopped buying in primary, because from their communication it was not so clear to us that there would be more or less a full stop within just a few trading

Paolo Labbozzetta, Mediobanca: 'Italian issuers have been able to fund themselves amply in recent months, even without covered bonds'

days. Nevertheless, in the end it proved a reasonable move, at least in that there was no big market turbulence or spread widening.

A lot of quantitative tightening has already been priced in for the covered bond market. The covered bond market does not operate in a vacuum — it interacts with the other market segments under APP and PEPP, which is something the ECB always has to bear in mind. Regarding covered bonds, I would say that a reasonable path would be to undertake substantially fewer reinvestments for the second half of the year. I'm not really concerned about the ECB turning its back on covered bonds — we just expect some minor spread widening up until the middle of the year.

Day, The CBR: Let's drill down a bit on when Italian supply is likely to pick up. We've seen other jurisdictions face pressure on spreads under the weight of heavy supply. What are your expectations for the restart of OBG issuance?

Labbozzetta, Mediobanca: Clearly it's difficult to assess how activity will develop, given the volatility in both credit spreads and rates, but also the discussions the Italian banking industry and the Bank of Italy are having to speed up the transposition process of the EU covered bond directive.

Indeed, Mediobanca and others will need to issue covered bonds, but as Stefano said earlier, Italian issuers have been able to fund themselves amply again in recent months, even without covered bond issuance. The bond market has been very active and Italian issuers overall have been nimble in accessing the market in every window of opportunity that has materialised. We had huge spikes in volatility in the autumn and again in March, but the market has reopened and just today we had a financial issuer like Generali out with a subordinated bond, so another testament to the resilience of the market. I don't see Italian issuers facing difficulties, as they might have done in the past, and hence being in too much of a rush to issue in the second half of the year. Of course, we have our funding plans to execute and covered bonds are one of the most important pillars of this, so we welcome the transposition of the directive, but I don't foresee a development whereby too many issuers are overcrowding the market.

And given the lack of supply in the Italian covered bond space over the past year and more generally in recent years on the back of the TLTRO dynamics, I tend to think that on the investor side — and probably Niels could answer this question better than me — they will probably have room to increase their share of Italian covered bonds holdings compared to current levels. So I see the capacity to sell bonds into the market without any risk of congestion. We will have the usual process when a market segment reopens, probably with the national champions or more frequent issuers tapping the market first, paving the way for other issuers.

And so I expect, as Stefano said, activity to start picking up in June at the earliest, because I do not see anyone being ready before that, also considering the approvals that we all need. So some activity in June-July, then we will have the summer pause — which we learned from the last two or three years is definitely shorter than it used to be — and from September, October a pick-up in

activity with all the other banks, not only the national champions, being out into the market.

Marlat, Crédit Agricole Italia: I had in mind €7bn-€10bn for the Italian market this year, so Frederik's €7bn figure fits into this. And regarding the collateral point, we usually transfer around 40%-45% of new mortgage production into the cover pool, meaning that if we see a big downturn in the market, 15%-20%, that should not pose a problem in terms of generating cover pool assets for new issues.

As Paolo said, we have greater visibility on the timing of the market reopening now, and I also expect national champions to pave the way. We will then see what tenors the market is ready to accept, and what spreads are required, because if the yield curve remains as it is, compensation in terms of spread will probably be necessary to go into longer durations.

Day, The CBR: Niels, what's your view, both on the supply dynamics as discussed by Paolo, and the maturity question raised by Stefano?

Platz Bertelsen, Nordea AM: I can confirm what Paolo said, in that I also think investors have saved some room for Italian covered bonds. When I'm in the market looking to buy Italian covered bonds at the moment, it's impossible to find any offers. So I believe the market should be able to absorb the Italian issuances that will come in the summer.

That said, I also hear rumours that a flood of Italian covered bonds is coming and we will probably need some compensation when we know that it's not only the first Italian covered bonds that are coming, they are also coming tomorrow and the day after that.

Touching on duration, if you look at French covered bonds at the moment, they have repriced their curve quite attractively in compensating for the longer duration. Even though there has been a lot of supply from French issuers — and I know that they're not done yet — I think that is the most attractive place to be, because they are willing to pay up and steepen the spread curve to come in longer duration.

Returning to the overall supply picture for covered bonds, when I talk to issuers — and also from what I've heard today — I get the impression that there's actually not a huge covered bond issuance need; rather, as long as the market is able to absorb issuance, it's a tool that they will use to manage duration, but if the market closes or freezes up a bit, we could then quickly see the market lose some momentum and issuance take a breather, and that's quite encouraging.

Day, The CBR: Ghazi, what's your take on the outlook for Italy?

El-Salmi, NORD/LB: I would definitely agree that the market should be able to absorb a series of Italian issuers tapping the market one after the other. Several factors support that. First of all, we haven't seen Italian covered bonds since June of last year, so as Paolo mentioned, there's quite a shortage. Secondly, we have seen, as we said earlier, strong demand for Spanish covered bonds, and Italian covered bonds pay even higher spreads than that. Plus the seven Spanish covered bonds we discussed were all issued in just two months, and there were no negative side effects from this at all. That convinces me the market should be able to absorb increased Italian supply in a short time span, and that it should also be open for smaller issuers or those who were absent for a longer period, since we have seen in other jurisdictions that the "comebacks" were well received by investors, too. Of course, the first three transactions will probably have it a bit easier than the last three transactions, so you will probably have to compensate that with a couple of basis points of new issue premium. But that is something that can be well navigated and organised by both the issuers and the syndicate banks advising, so this shouldn't be a huge problem.

'We are clearly in uncharted territory'

Niels Platz Bertelsen, Nordea Asset Management: 'I also think investors have saved some room for Italian covered bonds'

Kunze, NORD/LB: When you talk to investors, it's always an issue for Italian covered bonds how attractive they are vis-a-vis the government curve. But this should not lead to the wrong conclusions here — take the UK, for example: we also quite often hear that due to Brexit and LCR treatment, UK covered bonds are not so sought after by investors. However, at the end of the day, they see that those deals may also prove to be quite successful and hence want to participate. This is a dynamic we could anticipate for Italy as well.

Day, The CBR: Casper, what are your expectations for Spain and Italy?

Andersen, S&P: We are clearly in uncharted territory here due to the new covered laws and ECB stopping its asset purchases. As a credit agency, we're not too concerned about the supply as such; we're more focused on the underlying credits. Looking at Spain, we're quite broad in our range of expected issuance, reflecting the new situation we're in, so we're pretty close to Frederik, at €10bn-€15bn, but we could see even more.

Italy may see a bigger TLTRO effect

Frederik Kunze, NORD/LB: 'Some issuers will go down the road of paying a higher spread in relative terms for the longer end'

there than in Spain. But again, there are a lot of different factors at play in Italy, such as MREL requirements, so I would rather not put an actual number on it as it might not add much value. That said, we don't see any issues around the market's ability to absorb supply — in this roundtable, we've already heard about the rarity of covered bonds from Italy and even if there is a rush of issuance, we believe the liquidity and support for the product is there. We also think that the credit story is quite good in Italy, particularly on the residential mortgage side. The one concern issuers may have when issuing could be around any noise from the sovereign that can create pricing volatility. If that were the case, it will be a balancing act we expect Italy's financial system and its banks to manage.

Returning to Miguel's point, we also believe that Spain has a strong credit story, also at the sovereign level, although we do expect the unemployment story that has been very positive recently to continue but likely for unemployment levels to flatten out.

Platz Bertelsen, Nordea AM: Going back to the duration question, Frederik, I don't think you would expect the remainder of the €200bn to materialise if the long end of the covered bond curve is not open. As Stefano said, issuers use covered bonds for longer dated funding, so I think that supply very much depends on issuers and investors being able to meet at the higher spreads we will require to buy longer dated covered bonds. In recent years we saw the hunt for yield, with even bank treasuries buying long dated covered bonds just to get some yield, and that flattened the spread curve quite substantially. As the yield curve is now quite inverted, most investors require some compensation on the spread.

Kunze, NORD/LB: I think we are totally on the same page here — it is reasonable to expect more longer dated deals in the second half of the year, otherwise issuers would have an issue if they issued a whole year of €194bn of more or less short dated covered bonds. Not everyone, but some issuers will go down the road of paying a higher spread in relative terms for the longer end of the curve, because they do indeed want to have the longer term funding, thinking about their maturity structure in the years to come. So we are in a situation where issuers have to find their way into the market at a more costly level, while investors have to consider whether they are getting reasonable compensation for going into the longer end. It's going to be interesting to see how this develops, and I expect there will be winners and losers on both sides. The other factor to consider is that we are talking about euro benchmarks — some issuers could go into private placements or other currencies.

'We are quite bullish on southern Europe'

Day, The CBR: Looking more at the credit side of things, Niels, what is your view on Italy and Spain, and their covered bonds now they have transposed the covered bond directive?

Platz Bertelsen, Nordea AM: We are quite bullish on the southern European countries. As long as we avoid credit deterioration and the focus is still on fighting inflation, I agree with Miguel that southern Europe will not be the centre of the next crisis. We are much more worried about those countries with a high share of variable rate mortgages combined with high private debt, such as in Scandinavia, and we don't see that in southern Europe. There, it's the government who has the debt, but we have all these European programmes to transfer money to the southern European countries. We don't see higher interest rates impacting households there to the same extent.

Regarding the covered bond directive, we are in general positive about its impact. It's good to have a set of harmonised minimum requirements that set the standard for a premium covered bond, which makes sure that the strong features we all like about covered bonds are in place. Spain had a lot of work to do, but all in all, I find the implementation pretty positive. We now get a cleaner and segregated cover pool, which is actively managed. We get the liquidity provisions and better valuation of the assets in the cover pool, among other things. The other side is the lower OC levels, but all the other elements very much offset that. I don't know what Casper thinks, but that's my impression on how the directive has been implemented, that it is a credit positive for both Italian and Spanish covered bonds.

Andersen, S&P: The harmonisation drive is a positive. We expressed that when the Royal Decree was passed in Spain.

On 31 March this year, the Spanish government further amended the Royal Decree to allow issuers to actively manage the available OC and to clarify that the administrator's right to accelerate the covered bonds upon issuer insolvency applies only if the value of cover pool assets is less than the value of the covered bonds. The added strength from the introduction of the liquidity coverage is important from a rating perspective. As Niels pointed out, of course, you go from a situation where you had basically the whole bal-

ance of the bank securing your issuance to now having fewer available assets in your cover pool. Further, you may previously have had the benefit of high margin-earning assets reflecting the whole bank book. When you then start to cut and limit the eligible assets, that gets you to lower OC levels but likely more comparable with what you have in other countries where similar limits on available OC exist. And one could ask, in the previous case, would you in reality have had all those assets in the event of an issuer's difficulties? In our view, the investor now has more clarity as to actual OC. Yes, it comes at a bit of a potential cost, but we have seen examples where cover pool managers mitigate it by including assets that fit to the liabilities, and not by just having low margin assets, because they are the most credit-sound assets, but mixing it up in terms of what the assets earn compared to what is paid on the covered bonds. There's maybe a learning curve there for the issuer, in terms of picking the best mortgage portfolio.

Generally, we don't expect significant issues achieving the highest possible rating from the recently-finalised Italian legislation.

I should mention that we at S&P believe this is only the first step in terms of harmonisation. Therefore, we don't like to start ranking implementations and state one is better than that the other. We continue to observe local flavours still present in the updated laws, which is fine, as you may not want to make too big a jump from one legal regime to another. However, we do eventually expect those differences to make their way out of future legislation — for example, the ECB may indeed step in after the EBA review and state, there is still a need to clarify or be more harmonised, and so, we expect there will be a new round of harmonisation. We consider it part of an evolution towards an eventual pan-European covered bond market. But for now, we see it as a strong first step.

Day, The CBR: Beyond the timing and internal approvals, does the substance of the updated Italian legislation pose any challenges to issuers?

Miguel García de Eulate, CRN: 'What is important in being a bank is how you lend, and whether you are improving the ESG performance of your loan book'

Marlat, Crédit Agricole Italia: The issue was the process rather than the content. For example, in terms of overcollateralisation, the reference is not the previous level nor the updated level, but the level assigned in terms of committed OC by the rating agency — so it's not a game-changer.

It's a question of internal steps. You will typically have the latest financial statements approved in April and you then have to notify Bank of Italy followed by 30 days before approaching the market — luckily, because in the draft they had proposed 60 days. That's why we are talking about June.

Labbozzetta, Mediobanca: The 60 day authorisation period seemed too harsh to the banking industry, but we had an open and fruitful dialogue with the regulator to halve this period. There were some other minor points of discussion — regarding the role of the asset monitor, for example — but these were mere technicalities that we overcame pretty easily. From a regulatory perspective, it was a massive effort, so even if there was a bit of a delay, we have the final legislation in place while some other countries have further updates outstanding, and that's partly why it took so long. The update to the documentation only needs to be done for the first issuance, and going forward we do not see any further hurdles to regular funding activity through covered bonds. As Casper said before, there are some regional nuances in the transposition of the EU covered bond directive, but the substance is not significantly different and we now have a level playing field.

Day, The CBR: Turning to our final topic, ESG: Miguel, you are not only the issuer that did the most recent benchmark covered bond, but this was also green — like your issue last year. What are the positives in issuing green covered bonds? And what, if any, challenges are you facing on the ESG front?

García de Eulate, CRN: We have four benchmark-sized covered bonds outstanding, and two are sustainable, two are green — the last two — so you can say we are quite committed to that. Being a midsize or small bank, we really have seen richer books as a result of the covered bonds' green label, so it's a positive. There is much discussion about the greenium, whether it exists or not, but we don't count on having a greenium in our strategy. The main focus of green covered bonds for us is to help put our strategy in front of investors and explain our story as a regional cooperative bank with a clear focus on ESG matters. Discussions with investors are then not just focused on the credit metrics — which are of course key and always will be — but on a longer term perspective of the bank.

Our feeling is that there will be further requirements regarding the ESG performance or ESG features of the cover pool. The feedback we get from investors, those more advanced on ESG matters, is not so much focused on the use of proceeds, or even the ESG features of the cover pool, but on the overall ESG credentials of the bank and its strategy, which is really what matters at the end of the day. Of course, you can argue that it's a dual recourse instru-

Casper Andersen, S&P: 'Issuers can help shape the future of sustainable covered bond issuance by gathering performance data'

ment, and then in the event that you end up with the cover pool, you are interested in its ESG characteristics. But this is a quite a remote scenario that is not in investors' perspective, which is more focused on the real strategy of the bank. What is important with investors, even if you do not print a green covered bond, is that you are open about your ESG strategy and able to communicate on what is relevant. Labelling the covered bond as green is another step, which signals your commitment and increases your transparency on that front, but what is important in being a bank is how you lend, and whether you are improving the ESG performance of your loan book, which is something that is developing every year.

Day, The CBR: Stefano, Crédit Agricole Italia has been active in green covered bonds and your group overall is very active on that front. What are the positives for you in doing that? And what are the challenges to further issuance and growth in Italy?

Marlat, Crédit Agricole Italia: A positive is that it brings great personal satisfaction — but you do it because you want to do it, not because it is convenient — it brings many challenges.

For us, being green and sustainable is one of the main pillars of our business identity, but reflecting this in the covered bond asset class in Italy was one of the most difficult challenges. This is because the stock of real estate at a national level is old — we try not to develop new housing on new ground. This means that a lot of the cover pool is based on old buildings, which are not appropriate for green issuance.

We were the first Italian bank to issue a green covered bond and it was a good experience (no need to discuss the greenium, which was not relevant). We would like to continue along this path and are looking for solutions to the issue of eligible collateral, such as renovations. But again, we find new problems. For example, we have in our systems the energy class of the building at the end of the renovation, but maybe not the starting level because it was not relevant in the past, so it becomes difficult to measure the upgrade of the building and to say if it's eligible or not.

Day, The CBR: Paolo, what is Mediobanca doing on this front?

Labbozzetta, Mediobanca: We have been active in issuing ESG bonds since 2020, when we debuted, and we issued a second ESG bond at the end of last year. Both were senior preferred, so we have not yet issued an ESG-labelled covered bond. This is basically a function of how we look at ESG issuance activity in the broader context of the overall ESG strategy of the group, and I very much agree with Miguel that ESG issuance is just one of the bricks in the overall ESG strategy. We prefer to concentrate our ESG issuance efforts on higher beta instruments, like senior preferred. Given also the timing of those bonds, we wanted to have more traction in terms of bookbuilding. It's not, as Miguel correctly pointed out, to have an advantage in terms of pricing — we had this in both cases, but that was not our main goal. Our main goal was to expand our investor base, including also specialised ESG investors who probably would only have participated in a deal in ESG format.

> 'Green covered bonds bring many challenges'

Even though our funding activity has been concentrated on these two bonds in the last three years, we have updated our framework twice in the same period, so we are very active in trying to be up to date with the latest regulation and best market practice. The market is gradually switching from a, let's say, market-based approach towards a regulatory-based approach, with the whole process of drafting and implementing the EU Taxonomy that is underway. We have aligned the framework to the Taxonomy where possible and try to incorporate different asset classes compared to the first version of our framework in order to include ESG issuance as one of the pillars of our broad ESG strategy at group level, which also embeds efforts in ESG lending and a more cautious and more coherent approach on the asset side. It's a journey that we embarked upon a few years ago, but we want to continue to be best in class as much as we can. And we do not exclude also tapping the covered bond market in ESG format in the future.

El-Salmi, NORD/LB: Most of the feedback we receive on transactions from German ESG-focused investors is at the issuer level, rather than the issuance level, so less focus on the ESG label, whether it is green or not, and more on the ESG ratings of the issuer, for example.

And while the greenium is probably limited in terms of any pricing advantage, the big advantage an ESG label offers versus conventional bonds is the differentiation it offers, giving issuers an additional selling point to get investors involved, which is especially important when markets are choppy or crowded.

Day, The CBR: Niels, on the investor side, how do you see covered bonds fitting into broader ESG developments?

Ferreres Aqueduct, Tarragona
Credit: Modes Rodriguez/Flickr

Platz Bertelsen, Nordea AM: We are not seeing any huge demand from our clients to have a specific focus on ESG-themed bonds — green, sustainable or sustainability-linked bonds. The ESG strategy that we have implemented in our investment strategy is to look at the issuer — in line with what Miguel said. We have a responsible investment team that scores the issuer on all the three ESG factors, so not only environmental or social aspects, but the governance of the issuers is also very important.

Our focus at the moment — and this is also to cope with the SFDR requirements — is to try to assess what level of sustainable investment our funds are. When looking at covered bonds, we assume the proceeds are used to finance the mortgages in the cover pool, so the task is to quantify a level of sustainability of the assets in the cover pool. Around 40% of total energy consumption in the EU stems from buildings, and according to the Carbon Risk Real Estate Monitor there needs to be a 91% reduction of greenhouse gas emissions (GHGe) by 2050 for that sector to be Paris-aligned, so meeting this target is where we see sustainability make sense for covered bonds.

So you can draw a trajectory from where we are now to where we have to arrive at in 2050, and at any point in time you can look at what share of a cover pool is above or below, and in our view that is the level of sustainability of a covered bond.

Calculating that requires a lot of data at the cover pool level that we don't have. Ideally, we'll have GHGe from all the assets in the cover pool. That is not possible, so the next best thing would be to have how energy efficient the assets are and combine it with the energy mix used to proxy the GHGe. Energy performance certificates can play an important role in this but some issuers have also estimated or modelled the part of the cover pool that doesn't have an EPC score. Our responsible investment team have been doing a lot of work on this method which we would like to implement. The idea is use this to overweight issuers or countries with better cover pools to construct a more sustainable portfolio for clients who have that as a target. We see that as more "real world change" than just buying green covered bonds. I've entertained Miguel with this story before and they have actually been quite good at mapping the energy efficiency of their cover pool, so I know it's possible in Spain even though EPC scores are not that widespread. It is something we will encourage issuers to look at.

> 'There needs to be a 91% reduction of GHGe by 2050'

Andersen, S&P: Data availability is also a challenge from our perspective: when we have to come to a decision on credit risk, we can't do it on the basis of a hunch or a feeling; we need historical performance data to support our views. We can probably all agree that a house price decline is likely to be lower if you have all the newest technology, insulation and so on, but can we say how much less such a house price decline will be for an 'A' than for a 'D' EPC house? That's one of the challenging questions. We are all here working on trying to gather more information to guide our actions. The covered bond issuers can help shape the future of sustainable covered bond issuance by gathering performance data, identifying and sharing the key sustainable credit characteristics. ■

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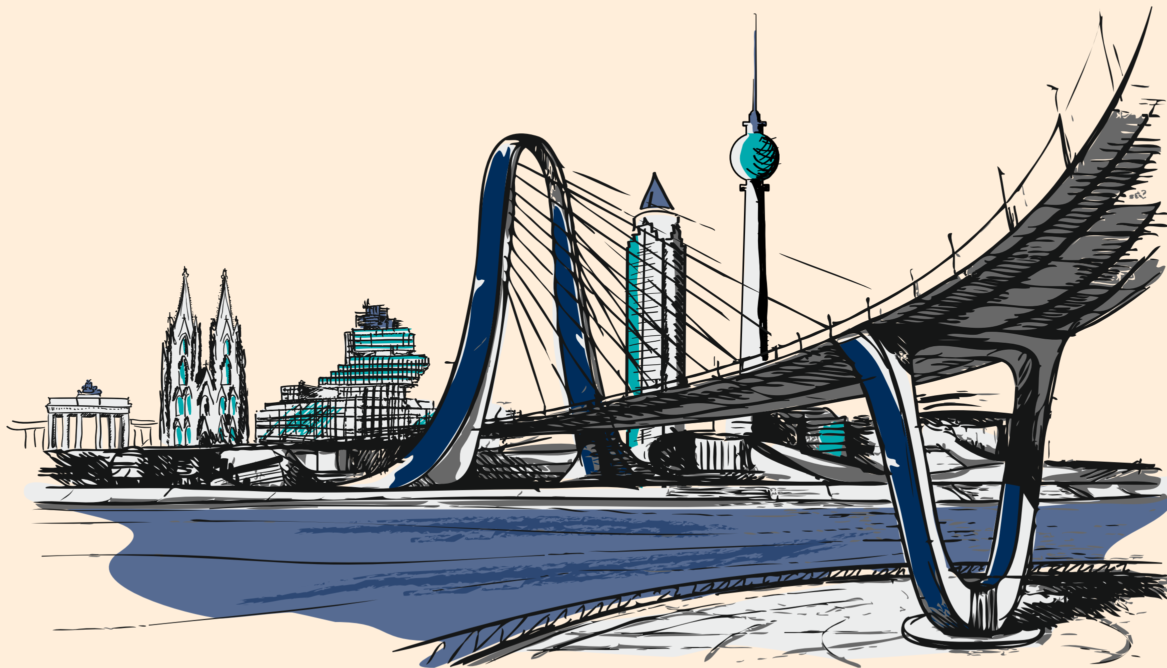

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