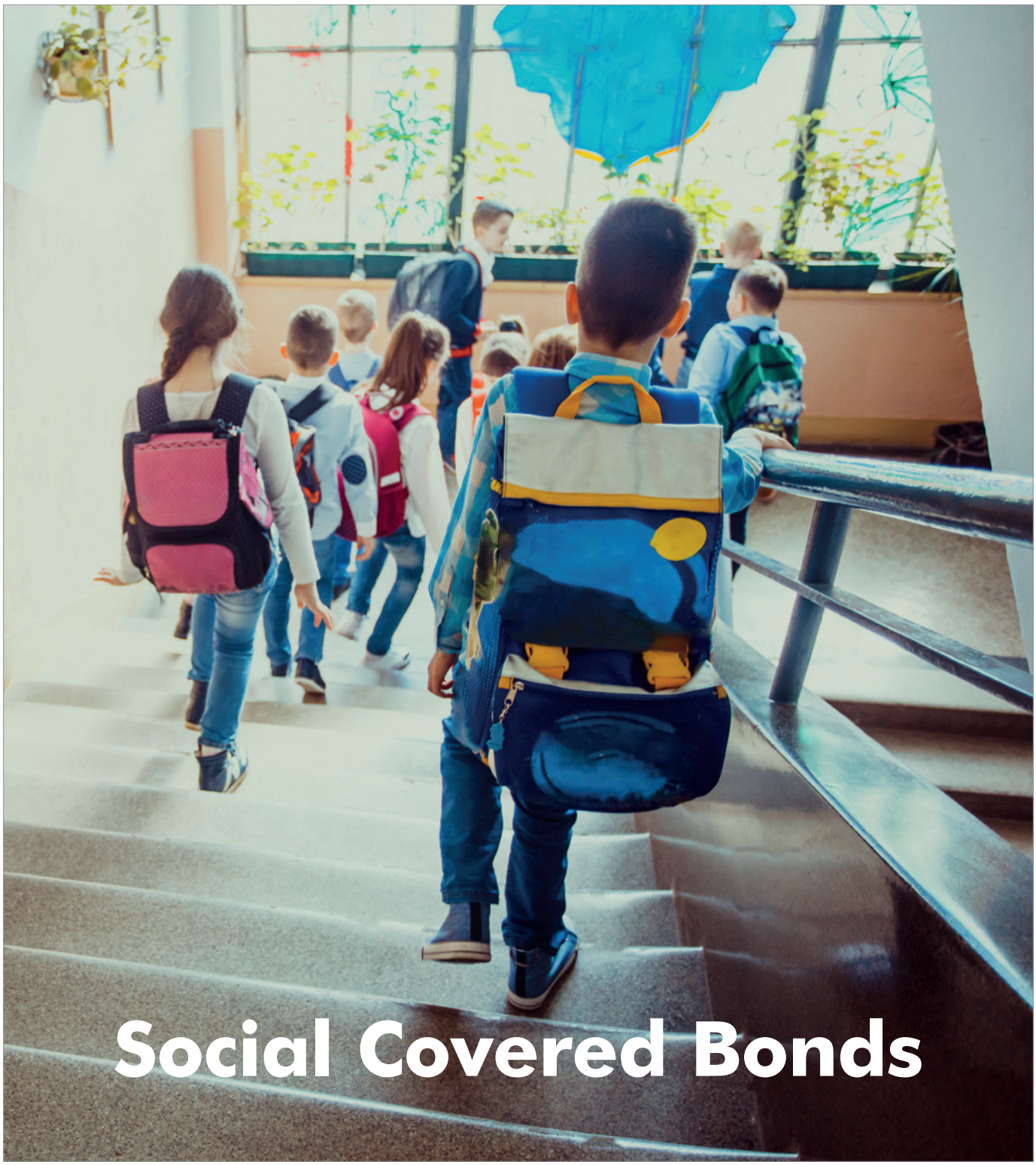
The Covered Bond Report

www.coveredbondreport.com September 2022



SOCIAL COVERED GROWING UP FAST?

Affordable housing Pfandbriefe have provided a fillip to social covered bond issuance this year and public sector investments in sectors such as healthcare and education could further boost social bond volumes, which have thus far remained in the shadow of green bonds. However, in order to do so, challenges in lending, defining, and reporting need to be met. *Neil Day* reports.

The social covered bond market took a big step forward this spring, with Deutsche Kreditbank (DKB) issuing the first social mortgage Pfandbrief and Berlin Hyp following with a second days later. And DKB's €500m 10 year "Berlin Social Housing" bond quickly attracted some €2.36bn of orders on 28 April, allowing it to achieve a new issue premium of just around 2bp.

"We were optimistic that we could reach a good result," says Uwe Jurkschat, DKB's head of funding and investor relations, "but I, at least, did not expect it to be so fast and so big."

The social covered bond's eligible assets are loans to Berlin municipal housing companies that run 330,000 state-owned flats in the German state. DKB is one of the biggest lenders to the sector in Germany and such loans constitute one of its largest loan portfolios, according to Uwe Jurkschat, its head of funding and investor relations.

"It's also a very relevant topic, especially here in our hometown of Berlin, where rents have been rising for years and you have big political discussions and initiatives to manage that," he adds. "That's why we took this topic and thought, how can we address that issue with a respective product? So the idea was born to combine that with not just a social housing bond, but one that specifically refinances loans for the Berlin municipal housing companies."

Affordable housing is a sector that has already been evident in the covered bond market, with issuers from the UK's Yorkshire Building Society to Korea Housing Finance Corporation. However, social covered bond issuance remains thin on the ground, particularly considering that MünchenerHyp sold a €300m proto-social covered bond as long ago as September 2014, while DKB's first mortgage Pfandbrief in social format was launched almost seven years to the day after the first mortgage Pfandbrief in green format, from Berlin Hyp in April 2015.

In the first half of the year, covered bonds in social format amounted to €2.35bn, equivalent to 22% of euro benchmark ESG supply, with sustainability issuance accounting for 5% and green bonds 74%, according to figures from LBBW (total H1 2022 euro benchmark ESG issuance was €10.85bn).

Overall supply of social bonds has meanwhile eased, from a peak of €111bn last year down to around €29bn in the first half of this year. The slowdown is widely attributed to the easing of pandemic measures, the refinancing of which had contributed to a surge in social bond issuance, notably in relation to the EU SURE programme.

Rodger Rinke, senior investment analyst at LBBW, sees the current, post-pandemic macroeconomic environment as one in which affordable housing as a segment that could contribute to renewed growth in social bonds.

"We have a lot of government-financed housing in countries such as Germany and Austria," he says. "And against a backdrop where prices have been rising and indeed exploding in many markets and construction costs are increasing, the need for support will grow and policymakers will have to find an answer to that. So there is definitely potential in the European market when


Photo: oksix/Adobe Stock

it comes to the topic of social housing."

However, he cautions that while there is scope for growth, the affordable segment of the housing will always by definition remain a somewhat niche proportion of the overall market, unlike the green side where energy efficient mortgages and the like have vast potential.

Public promise

Promise is also seen on the public sector side of the market. DKB's social mortgage Pfandbrief followed issuance since 2018 of social public sector Pfandbriefe from the German lender, while France's SFIL with covered bond issuer Caffil is working on expanding its social lending to encompass a wider range of categories than its current focus on public hospitals.

"We started financing green investments by local authorities in 2019 — tramways, water management and waste management, for example," says Olivier Eudes, head of ALM and financial markets at SFIL, "and we see that local authorities are very interested in having social loans — for example, to finance a school or day care facilities."

"Public education, for example, accounts for between 15% and 20% of all local government investments," adds Ralf Berninger, head of investor relations and sustainability at SFIL, "so there is huge demand from local authorities for this kind of lending."

Local government investments across

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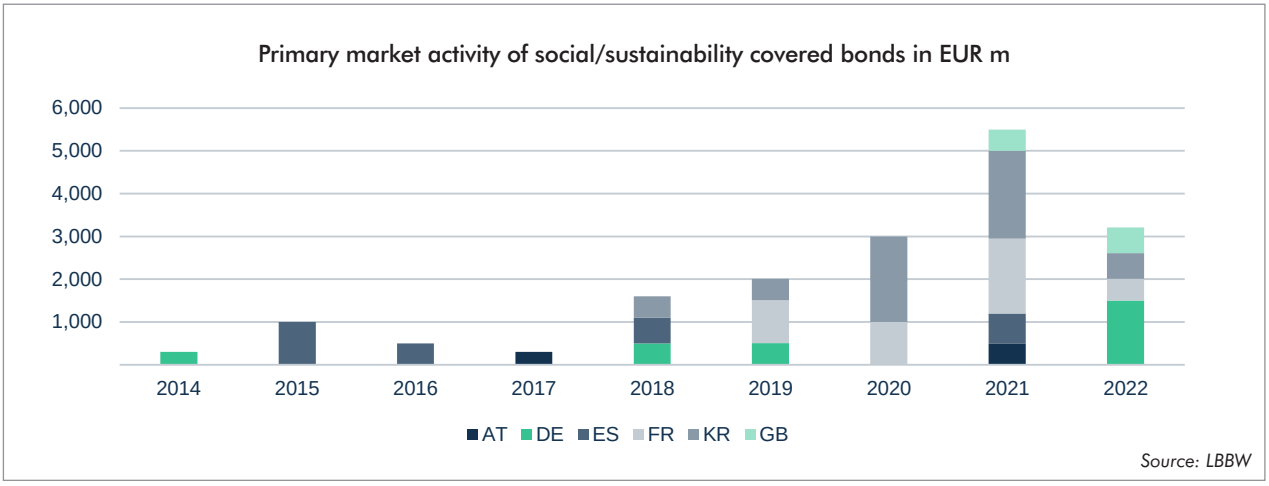


SFIL powers green and social impact across France

Loans to local government bodies large and small are behind SFIL's green bond issuance, and the French group anticipates complementing this with social lending, according to CEO Philippe Mills and colleagues.

Head down to La Rochelle and its environs along France's Atlantic coast for a well deserved post-lockdown holiday, and the more environmentally-minded among you could find yourself connecting with SFIL's green bond issuance.

One of the loans financed under the green bond framework is a green loan originated by La Banque Postale and refinanced by SFIL to the local public electricity distribution service of Charente-Maritime (SDEER) to help finance the deployment of 57 electric vehicle fast-charging stations across the department. The €2.1m investment, of which 25% is provided by the partner banks, expands the Nouvelle-Aquitaine region's MObiVE network into the agglomerations and attractions of the department, with a view to allowing tourists to charge their vehicles while partaking of the local sites and hospitality.

According to SDEER president François Brodziak, the loan offered by La Banque Postale and refinanced by SFIL was the only green loan on offer.

"In addition to the loan rate, which is very attractive," he adds, "we were seduced by the idea of opting for financing that was also in line with

national guidelines concerning the ecological transition."

The 0.01 tonnes of reduction in CO_2 from the loan contributes to a total of 4,572 tonnes per year for the pool refinanced by SFIL's green bond, according to its first allocation and impact report, published in November 2021.

"The green and social loans we provide are an important part of the overall sustainability strategy that we have developed over recent years," says François Laugier, SFIL deputy CEO.

Later in November, SFIL rounded off its 2021 funding programme with the group's third green bond, a €500m 10 year benchmark that was 1.5 times covered despite hitting a market characterised by increased volatility linked to the pandemic rebound and macroeconomic uncertainty.

"The success of this green transaction confirms our commitment to be a driving force for a sustainable world through our ability to finance territorial green projects," says Philippe Mills, CEO of SFIL.

"One of our key objectives," he adds, "is to provide access to green finance to small municipalities — we are now providing green loans with volumes as low as €300k."

Indeed, among the use-of-proceeds of the first green bond are 14 loans that financed investments by municipalities with fewer than 5,000 inhabitants. But in total, entities serving more than six million people across l'Hexagone have benefited from loans under the transaction.

All the loans to French local public authorities behind green bonds from

'Looking ahead, we see a lot of interest from local authorities for financial products with clear social objectives.'

— Philippe Mills, SFIL CEO

SFIL and its covered bond issuer Caisse Française de Financement Local (Caffil) are originated by La Banque Postale — a fellow Groupe Caisse des dépôts et consignations (CDC) member.

Post-pandemic relaunch

According to figures from Eurostat, local public sector finances have withstood the pandemic well, with revenues dropping just around 2% for the year 2020 and increasing to above pre-pandemic levels for the year 2022.

Some €30bn of France's €100bn economic recovery plan — "France Relance" — has been set aside to finance the ecological transition, including improvements in the energy performance of buildings and soft public transportation, much of it through local government.

"French local authorities will play a key role in the ecological transition over the coming years," says Mills at SFIL. "As the leading French lender to local authorities in France, we will make a significant contribution towards financing these investments."

Some €36bn of investments will meanwhile focus on social and territorial cohesion, including €6bn of additional investments in the healthcare sector. This expenditure will come on top of the large share of local authority investment that already has clear social objectives — for example, education represents around 15% of French local government investments.

"Looking ahead," adds Mills, "we see a lot of interest from local authorities for financial products with clear social objectives."

On top of the green loans SFIL already provides in partnership with La Banque Postale, local authorities have shown an increasing interest in a social loan product, and SFIL is looking at ways to expand social bond issuance beyond the public hospital sector.

"One of the goals we have for this year is to extend as much as possible our issuance capacity on this side, because the market is deep and we have the capacity to issue more," says Olivier Eudes, head of ALM and financial markets at SFIL. "This means enlarging the production and qualification of ESG assets, so the strategy is to have a close look at what kind of social activity we may extend to the local authorities besides the green activity."

Green and social bond issues are anticipated within a funding programme for 2022 expected at between €6bn and €8bn for the year 2022 on a group level. Currently, SFIL has more than €5bn in outstanding green and social bonds. Looking ahead, SFIL Group aims for a share of ESG issuance of 25% of total funding by 2024. On the lending side, green loans represented above 25% of total lending to local authorities for the first sixth months of this year, compared to around 20% in 2021.

"As the first lender to public hospitals in France, we are proud to actively contribute to the financing of this sector in this period of a global pandemic," says Mills. "We have seen a big shift in the investor base, with more and more investment mandates with a specific focus on social bond investments." ●

Green bond 2020/2028 impact reporting

Reduction in CO_2 emissions and other key impact figures

Territorial mobility & soft urban transport
2885 t/year

Energy efficiency of construction & urban development
735 t/year

Renewable energy
952 t/year

482 386 t of household waste managed per year by the entities financed via this transaction

Creation of 217 km of bicycle lanes

323 km of water network added or renewed

Source: SFIL

the EU totalled €295bn in 2020 and a large share of these are closely linked to social objectives, notes Berninger: public education, recreation and culture, public housing and public healthcare together represented €120bn of the total.

One obstacle to growth that would capture some of this spending is difficulties lenders face in identifying specific social projects, given that lenders to local government typically finance the overall investment budget of a local authority, rather than taking a project finance approach. SFIL is tackling this with the introduction of its dedicated social loans, which like its green loans will be linked to specific spending on projects.

"It takes time to set this up," says Berninger, "but our feeling is that it is working out pretty well with clients, who are ready to fill out the additional paperwork because they are interested in developing the social loan product, too."

DKB has gotten around the issue by selecting loans to entities with specific public sector missions, such as the provision of water and waste water services in a "blue" social covered bond in 2019. The issuer has also found its clients keen to participate in such initiatives.

"We see, especially on the corporate side, a lot of interest in sustainable loans — whether green or social — irrespective of any pricing advantage," says Jurkschat. "They are asking how they can qualify for loans with the appropriate KPIs or criteria because they want to have that kind of sustainable stamp from the bank."

Tackling the taxonomy

Beyond identifying specific loans, issuers also face the challenge of determining which activities will be acceptable as social, something that has been seen as holding back growth of the social bond market.

"It's probably easier for issuers to go with green bonds, because it's easier to identify green assets, especially in light of the EU Taxonomy," says Théo Kotula, ESG/responsible investment analyst, AXA Investment Managers, which launched a social bond strategy last year.

Rachel Lionsquy, La Banque Postale

This naturally leads on to the issue of the draft social taxonomy. The Platform on Sustainable Finance released its final report in February, with significant and widely welcomed changes to its draft of July 2021, notably greater alignment with the green taxonomy. However, the idea that a workable social taxonomy will be along anytime soon is viewed with scepticism.

> 'They want to have that kind of sustainable stamp'

"The difficulty with the social part if we compare it with the green part, is that green is based on science," says Rachel Lionsquy, sustainable banking structurer, at La Banque Postale CIB. "With green, you can say, for example, that GHG emissions under a certain level mitigate climate change, but if you consider something as social, it may be more challenged, as the understanding of social indicators or level of impact may differ according to each system or location, leading to differences in interpretation."

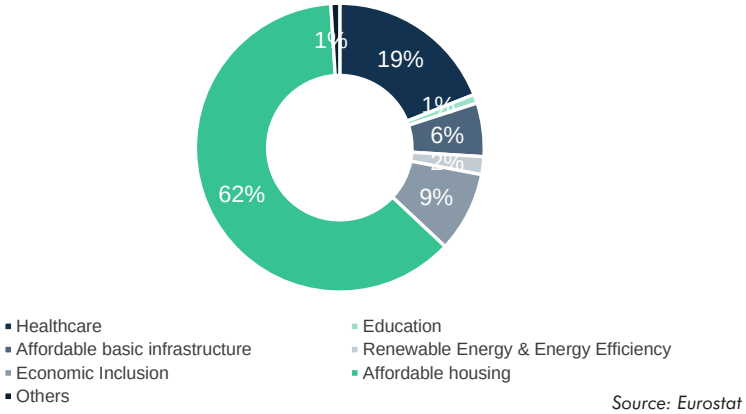
Efforts are nonetheless being made to anticipate the future introduction of a social taxonomy. Lionsquy says that as well as identifying which of the social categories within the Social Bond Principles potential assets fit, also being taken into consideration is the draft social taxonomy's approach through the three main objectives: decent work; adequate living standards and wellbeing for end-users; and inclusive and sustainable communities and societies.

"Even though it is not officially in force, we are trying to be innovative in that respect," she says. "In this way, issuers will be able to qualify for the social taxonomy at the European level the day it is applied — even if for the time being the ICMA principles are the most important, because they are the ones that will be validated by the SPO."

And Kotula at AXA IM says that a social taxonomy could ultimately prove beneficial.

"I think that when we'll have a final version of the social taxonomy, that will probably be a very useful tool for market players and help the development and growth of the social bond market," he says. "Because — and this is even more

Social covered bond distribution by volume per social use of proceeds



Source: Eurostat


Ralf Berninger, SFIL

relevant on the social than the green side — there is a big need for commonly accepted standards on what is social and what is not.

"But in the meantime," adds Kotula, "we as investors are not going to wait for the taxonomy to keep acting on the social side investing in social bonds."

The mother of invention

In the absence of such definitions, market participants are drawing up their own standards, with some sectors proving more amenable to this than others. Jurkschat at DKB notes that affordable housing is one of the easier sectors, with rent levels being used as thresholds, and Kotula at AXA IM echoes this.

"One of the main things we look at when considering a social bond — where we don't have the same technical definitions or threshold — is how the target populations are defined," he says. "It plays a similar role as the eligibility criteria for green projects.

"With a clear definition on a social housing bond," he adds, "we as an investor know that we are really targeting populations in need of affordable housing and bringing some kind of additionality, which is what we are looking for on social bonds as well as green and sustainability ones."

For German loans in Berlin Hyp's framework, for example, it bases eligibility on whether the underlying housing is eligible for subsidy under the German Housing Benefit Act, which takes into account regional variations.

Kotula suggests that within France concepts such as "priority education zones" and "medical deserts" that are used in government policies could be similarly used to carve out target populations, while supporting the roll-out of 5G and fibre networks to underserved areas of the country could prove worthy goals.

"We won't penalise issuers if they don't do that, because education and healthcare projects are generally social by nature," he says, "but we prefer that issuers target areas where there's the most important needs, as this would be a way of bringing additionality."

For public hospital loans in its social programme, SFIL makes use of a "healthcare value added" concept that it had already used in its risk management, and is currently working on other


Théo Kotula, AXA IM

sectors. Berninger at SFIL says that as well as determining appropriate target populations, reporting on impact can be a challenge.

"Some people call for reporting on actual impact," he says, "so if you finance healthcare, for example, reporting could include changes in life expectancy. But for issuers, that's often difficult: if life expectancy goes up, it's probably not due to the lending of just one bank — there will be many other factors at play.

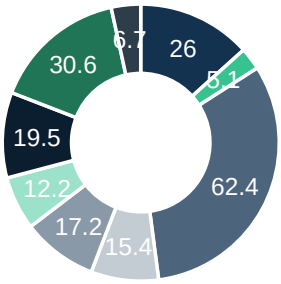
"So there's always a debate, whether we should report on the financing of a hospital for 2,000 patients or a school for 500 pupils, or whether we should go beyond that and try to measure the overall health or educational impact?"

While such questions pose challenges for the social bond market, the fact that it is less regulated and still being forged also presents opportunities, according to DKB's Jurkschat.

"On the green side, regulation threatens to disrupt the market and there are fears that you may be accused of greenwashing," he says. "But there is more room for manoeuvre and innovation within the social sphere, and a lot of potential, because social encompasses such a wide range of topics." ■

For more information on social covered bonds, please see the relevant chapter of the 2022 ECBC Fact Book, authored by Berninger, Jurkschat and Rinke.

2020 European local government investment by category (EUR bn)



Source: LBBW

FINANCING GREEN AND SOCIAL INVESTMENTS ACROSS FRANCE

SFIL is the leading lender for public investments in education, local public transportation, water and waste management, and public healthcare. Since 2019, SFIL and its subsidiary CAFFIL are regular issuers of Green and Social Bonds financing these investments.

More information on **sfil.fr/en/sfil-group-investors**