Covered bonds will not escape tougher ESG disclosure requirements

The covered bond market would do well to prepare for sustainability transparency requirements stretching beyond issuing entity-level disclosures alone. These could encompass disclosures on adverse impacts and on the Taxonomy alignment of the assets in the cover pool

It is becoming increasingly likely that covered bonds will be subjected to distinct ESG-related reporting requirements

It is becoming increasingly likely that covered bonds will be subjected to distinct ESG-related reporting requirements on the level of the cover pool. In a joint statement, the European Supervisory Authorities (ESAs) and the European Central Bank recently committed to promote better sustainability disclosures for structured finance products. The advocated climate change-related disclosures for securitisations should also become relevant to covered bonds.

Moreover, in the absence of mandatory disclosure requirements, issuers are urged to make certain climate-related metrics available on a voluntary basis. However, indications that covered bonds would be subjected to separate cover pool sustainability disclosures are not new. The ESAs and the ECB have already made hints about this direction several times.

Taxonomy related disclosures

In March 2022, the EBA published a report on developing a framework for sustainable securitisation. It aims to make sure that the forthcoming **European Green Bond Standard (EuGBS)** can also be used for securitisation notes. To this purpose, the EBA proposed to apply the use of proceeds of the green securitisation notes, and the disclosures and sanctions related to EU green bonds, on the level of the originator instead of on the level of the securitisation special purpose entity (SSPE) issuing the notes. This would be more in line with the idea of issuing EU green bonds for the generation of new green assets. At the same time, it would prevent originators from using the proceeds of EuGBS' compliant securitisations to finance non-green assets.

However, according to the EBA, additional disclosure requirements would be needed on the level of the underlying assets to allow investors to perform their ESG due diligence assessment on these assets. Such disclosures should mitigate any unwanted incentives on the part of the originators to invest in environmentally harmful assets and securitise them through an EU green bond, while keeping their green assets on the balance sheet.

For that reason, the EBA proposed that the green asset ratio (GAR) and the banking book taxonomy alignment ratio (BTAR) of the originator and of the securitised exposures should both be disclosed in the EU green bond factsheet. For property loans, GAR disclosures will solely cover the taxonomy alignment of retail exposures to residential real estate assets. Instead, the BTAR will also measure the taxonomy alignment of commercial real estate exposures to non-NFRD companies such as SMEs.

> *EBA proposes GAR and BTAR disclosures for the issuer and the underlying assets*

The EBA did underscore that such additional EU GBS disclosures on the underlying assets should be of relevance to all EuGB asset-backed securities and not to securitisation alone. This was a clear first reference by the EBA that Taxonomy alignment disclosures should also apply to the cover assets securing covered bonds marketed as EU green bonds.

While the EU reached a provisional agreement on the European Green Bond Standard at the end of February, we yet must wait for the publication of the final text to learn about the provisions that will be applicable to the use of the EuGBS for securitisation notes. These include the disclosure requirements that may apply to the underlying assets.

Principal adverse impacts related to real estate assets

Elsewhere, Europe's **Sustainable Finance Disclosure Regulation (SFDR)** requires financial market participants to offer transparency on adverse sustainability impacts, both on an entity level (Article 4) and on a product level (Article 7). These disclosures are mandatory for large financial market participants or group entities with more than 500 employees.[1]

Securitisations and covered bonds are both not a "financial product" under the SFDR, even though they are considered investments for the purpose of the "entity level" **principal adverse impact (PAI)** disclosures. With the adoption of the Capital Markets Recovery Package (CMRP), it was decided, however, that originators of **simple, transparent and standardised (STS) securitisations** should have separately the option to voluntarily disclose whether adverse impacts on sustainability factors were considered. This would help investors scrutinise the adverse impacts of the underlying exposures on climate and other sustainability factors.

In May 2022, the ESAs published a joint consultation paper on such STS securitisation-related sustainability disclosures. Parallel to this, the EBA concluded in its report on a framework for sustainable securitisation that the voluntary principal adverse impact disclosures should apply to all securitisations and not only to STS securitisations. These disclosures should also become mandatory in the medium term.

For the monitoring of principal adverse impacts, the SFDR level 2 regulatory technical standards distinguish 18 mandatory indicators and 46 additional indicators for both climate-related and social impacts. Financial market participants must describe the adverse impacts for all the mandatory indicators but only for at least one of the additional climate-related indicators and at least one of the additional social indicators.

[1] All high-level and principle-based provisions (level 1) of the SFDR (Delegated Regulation 2019/2088 of November 2019) are applicable since 10 March 2021. The SFDR level 2 regulatory technical standards, as detailed in the European Commission Delegated Regulation (2022/1288) of 6 April 2022, apply since 1 January 2023. These include the details on principal adverse impact disclosures.

The SFDR principal adverse impact (PAI) indicators

	Universal mandatory indicators (18)			Opt-in additional indicators (≥2)		
	Environmental	Social	Total	Environmental	Social	Total
Investee companies	9	5	14	16	17	33
Sovereigns & supras	1	1	2	1	7	8
Real estate assets	2		2	5		5
Total	**12**	**6**	**18**	**22**	**24**	**46**

Source: European Commission, ING

Non-green asset ratio as mandatory indicator for residential assets

For securitisations backed by real estate exposures, the mandatory and additional environmental indicators proposed by the ESAs mostly mirror the SFDR PAI indicators for investments in real estate assets. The only difference is that STS securitisation-related disclosures make a distinction between **residential real estate assets** and **commercial real estate assets**. They also introduce a new transversal mandatory indicator for residential real estate assets: the non-green asset ratio.

Mandatory indicators for voluntary PAI disclosures for real estate assets
The ESAs distinguish **three mandatory indicators** for real estate securitisations:

- The **non-green asset ratio** measures the share of retail exposures to residential real estate and house renovation loans that are not taxonomy aligned per the applicable technical screening criteria for the EU Taxonomy's climate change mitigation objective.
- Exposures to **energy-inefficient real estate assets**. This indicator measures the share of real estate assets built before the end of 2020 with an EPC label of C or lower, plus real estate assets built after 2020 with worse primary energy demand (PED) than nearly zero-emission buildings (NZEB). This share is presented as a percentage of the real estate assets required to abide by EPC and NZEB rules. The indicator is mandatory for residential and commercial real estate assets.
- The share of investments in **real estate assets involved in** the extraction, storage, transport or manufacture of **fossil fuels** (exposure to fossil fuels through real estate assets). This indicator should apply only to commercial real estate.

Voluntary PAI disclosures for real estate securitisations

Mandatory indicators (all)		Residential	Commercial
Energy efficiency	Exposure through fossil fuels through real estate assets		✓
	Exposure to energy-inefficient real estate assets	✓	✓
Non-green exposures (100%-GAR)	Proportion of loans to households secured by residential immovable property that is not contributing to the climate change mitigation objective as per 7.2-7.7 CDA	✓	
Additional environmental indicators (at least one)			
GHG emissions	Scope 1, 2, 3 and total GHG emissions real estate assets	✓	✓
Energy consumption	Energy consumption real estate assets in GWh/m2	✓	✓
Waste	Real estate assets without waste sorting/recycling	✓	✓
Resource consumption	Share raw materials/total building materials used	✓	✓
Biodiversity	Share non-vegetated surface area/total surface area	✓	✓

Source: ESAs, ING

Substantial contribution and 'do no significant harm' metrics

The SFDR principal adverse impact (PAI) indicators do differ from the do no significant harm criteria set under the European Commission's Climate Delegated Act of June 2021.

For instance, buildings built after 31 December 2020 would not do significant harm to the climate change mitigation objective if their primary energy demand (PED) meets the threshold for nearly zero-emission buildings (NZEB). Buildings built before 31 December 2020 would not be significantly harmful if they are in the energy performance class (EPC) of C or better or - alternatively - belong to the top 30% of the most energy-efficient buildings. For the principal adverse impact reporting under the SFDR the definition of 'inefficient real estate assets' refers to buildings for which an EPC of C or lower applies. Real estate assets involved in extracting, storing, transporting, or manufacturing fossil fuels would be classified as harmful in both cases.

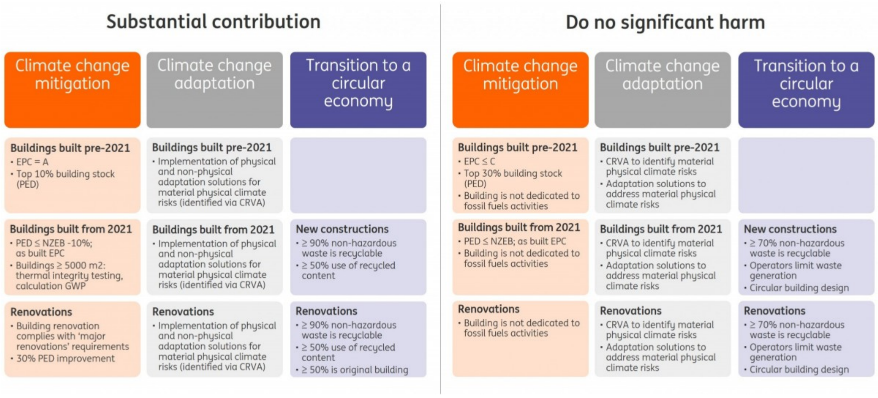
The principal adverse impact and do no significant harm metrics differ

When it comes to providing disclosures on the level of the cover pool, it could therefore be useful to give separate information on some of the significant contribution and/or do no significant harm metrics. After all, the GAR and BTAR measure exposures to activities that deliver a significant contribution to one of the Taxonomy's six environmental objectives and, at the same time, do no significant harm to any of the other objectives. However, for activities without significant contribution, it would also be good to know that they do no significant harm to the environment.

To give an example, for real estate exposures to properties built before the end of 2020, the 'EPC of A' and '15% best in class' metrics are measures of substantial contribution to the **climate change mitigation** objective. Instead, having an EPC label of C or better or belonging to the 30% least energy-inefficient buildings should reassure that no significant harm is done to the climate change mitigation objective. For buildings built after 2020, the same would apply to the share of exposures to NZEB -10% buildings (substantial contribution) and the share of exposures to buildings that at least meet the NZEB requirements (do no significant harm).

Moreover, the share of recyclable non-hazardous waste involved in the construction or renovation of buildings could give an impression of the substantial contribution or no significant harm done to the objective of **transitioning to a circular economy**. If more than 70% is recycled, one of the thresholds for not doing significant harm to the transition to a circular economy is met. If more than 90% is recycled, one of the possible substantial contribution thresholds for the circular economy objective could be met as per the 2022 Platform on Sustainable Finance proposals regarding the technical screening criteria for the remaining four environmental objectives (Taxo 4).

Selection of substantial contribution and do no significant harm criteria for 3 environmental objectives



Substantial contribution			Do no significant harm		
Climate change mitigation	Climate change adaptation	Transition to a circular economy	Climate change mitigation	Climate change adaptation	Transition to a circular economy
Buildings built pre-2021 • EPC = A • Top 10% building stock (PED)	**Buildings built pre-2021** • Implementation of physical and non-physical adaptation solutions for material physical climate risks (identified via CRVA)		**Buildings built pre-2021** • EPC ≤ C • Top 30% building stock (PED) • Building is not dedicated to fossil fuels activities	**Buildings built pre-2021** • CRVA to identify material physical climate risks • Adaptation solutions to address material physical climate risks	
Buildings built from 2021 • PED ≤ NZEB -10%; as built EPC • Buildings ≥ 5000 m2: thermal integrity testing, calculation GWP	**Buildings built from 2021** • Implementation of physical and non-physical adaptation solutions for material physical climate risks (identified via CRVA)	**New constructions** • ≥ 90% non-hazardous waste is recyclable • ≥ 50% use of recycled content	**Buildings built from 2021** • PED ≤ NZEB; as built EPC • Building is not dedicated to fossil fuels activities	**Buildings built from 2021** • CRVA to identify material physical climate risks • Adaptation solutions to address material physical climate risks	**New constructions** • ≥ 70% non-hazardous waste is recyclable • Operators limit waste generation • Circular building design
Renovations • Building renovation complies with 'major renovations' requirements • 30% PED improvement	**Renovations** • Implementation of physical and non-physical adaptation solutions for material physical climate risks (identified via CRVA)	**Renovations** • ≥ 90% non-hazardous waste is recyclable • ≥ 50% use of recycled content • ≥ 50% is original building	**Renovations** • Building is not dedicated to fossil fuels activities	**Renovations** • CRVA to identify material physical climate risks • Adaptation solutions to address material physical climate risks	**Renovations** • ≥ 70% non-hazardous waste is recyclable • Operators limit waste generation • Circular building design

Source: European Commission, Platform on Sustainable Finance, ING

EPC = Energy Performance Certificate, CRVA = Climate Risk Vulnerability Assessment, PED = Primary Energy Demand, NZEB = Nearly Zero-Emission Building

ECB turns up the heat on climate related disclosures for covered bonds

In July 2021, the ECB published its climate action plan for the inclusion of climate change in its monetary policy strategy. As a follow-up, the central bank outlined further steps to incorporate climate change into its corporate bond purchases, collateral framework, disclosure requirements and risk framework in June 2022.

Once the Corporate Sustainability Reporting Directive (CSRD) is fully implemented, the ECB will only **accept as collateral** marketable assets and credit claims from companies and debtors that comply with CSRD. The central bank expects to apply these eligibility criteria as of 2026. This means that covered bonds issued by EU and non-EU G10 issuers will, as of that date, only be accepted as collateral if the issuing bank meets the CSRD disclosure requirements, as detailed through the European Sustainability Reporting Standards (ESRS). These requirements include, for instance, the publication of a transition plan ensuring that the issuer's business model and strategy are compatible with the 1.5°C global warming target of the Paris Agreement and the 2050 climate neutrality objective of the EU Climate Law.

As the CSRD disclosures only apply on a bank entity level, the central bank is also said to support better and harmonised climate-related disclosures for asset-backed securities and covered bonds to ensure a proper climate risk assessment for these assets as well. This underscores that the collateral treatment of covered bonds may, at some point, also become dependent on climate-related cover pool disclosures.

Climate related disclosures will be key to the ECB's collateral acceptance and bond holdings

Distinct sustainability disclosures for covered bonds and asset-backed securities would probably not only be important for collateral purposes. They could also become relevant to the ECB's future reinvestments (if still applicable) and bond holdings under the third **Covered Bond Purchase Programme** (CBPP3) and Asset-Backed Securities Purchase Programme (ABSPP).

The ECB already tilts its reinvestments of redemptions under the Corporate Sector Purchase Programme (CSPP) towards issuers with a better climate performance since October 2022. The central bank measures such climate performance not only through an issuer's emission intensities and emission reduction ambitions but also via the quality of the company's climate-related disclosures. The ECB reported for the first time on the decarbonisation achievements of its corporate bond portfolio in March, indicating that the scope of these disclosures will be expanded over time to include, among other things, its covered bond portfolio.

Covered bonds are indeed still outside the scope of the decarbonisation of the ECB's bond holdings. However, judging by comments from Isabel Schnabel earlier this year, the ECB is deliberating a move from a flow-based to a stock-based tilting approach for its corporate bond portfolio. The stock-based approach should then also apply to the other private sector portfolios, such as covered bonds. This would be under the condition that a framework for assessing the climate impact of these exposures is in place.

This underscores that good quality climate-related disclosures, including on the level of covered bond collateral pools, could become a more relevant performance driver to eurozone-covered bonds. From an ECB purchase perspective, this may both be primary market and secondary market-related. After all, since March 2023, the ECB still buys non-bank corporates with a better climate performance and green corporate bonds in the primary market. The remaining CSPP reinvestments are also tilted even more strongly towards bonds of issuers with a better climate performance ever since. A similar approach may, at some point, be taken by the ECB with reference to covered bonds.

Transparency requirements under the Covered Bond Directive and the HTT

ESG-related disclosures are currently not an explicit requirement for covered bonds. However, Article 14 of the Covered Bond Directive does require issuers to provide information on their covered bond programmes that is sufficiently detailed to allow investors to assess the profile and risks of that programme and to carry out their due diligence. To this purpose, investors should be provided with the required minimum portfolio information on an aggregated basis quarterly. This includes details in relation to market risks, such as interest rate and currency risk, and credit and liquidity risks.

In that regard, one could argue that ESG-related disclosures should be part of the portfolio-level transparency provided on the cover assets. A simple example is the energy performance of buildings securing the mortgage loans that are part of the collateral pool. Cover pools with poorer mortgage loan energy performance metrics could be seen as more exposed to a negative (or less positive) evolution of property prices due to better demand for energy-efficient houses. The lower energy bills for energy-efficient properties could also reflect positively on the payment default metrics of energy-efficient mortgage loans.

> *The CBL HTT provides for helpful voluntary climate-related disclosure options*

Consequently, the simple disclosure of EPC label information, if available, or on primary energy demand, would be quite insightful. In our view, voluntary industry disclosures such as through the Covered Bond Label's (CBL) harmonised transparency templates (HTT) are of high added value against this backdrop. While not many issuers use this option yet or in full, the HTT allows banks to disclose information on EPC labels, the average energy use intensity, and/or CO2 emissions per property type. This disclosure option is available for the total cover pool and for the energy-efficient mortgage loans included in the cover pool.

Conclusion

Offering investors transparency on the green characteristics, adverse impacts, and taxonomy compliance of the cover pool on a portfolio basis will likely become increasingly important for regulators and investors in covered bonds. Covered bonds are a dual recourse instrument. This means that in a post-issuer insolvency situation, investors would be reliant on the cover pool for full repayment.

Under the assumption that energy-efficient mortgages have lower default risks, covered bond investors (green and vanilla) will probably find it beneficial to receive information on the energy efficiency metrics of the cover pool. Such information may also become important for the collateral treatment or ECB holdings of covered bonds. Information on green assets in the cover pool financed through green covered bonds will probably be of secondary importance to information on the greenness of the whole cover pool.

However, strong sustainability metrics on the level of the overall balance sheet of the bank rather than on the level of the cover pool alone will likely remain most important to investors. Not least because for asset managers, the bank's green asset ratio, as a measure of the bank's taxonomy compliance, is the most important input variable for vanilla bonds in the calculation of their own taxonomy KPIs.

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