Climate Bonds INITIATIVE

Green Covered Bonds: building green cover pools

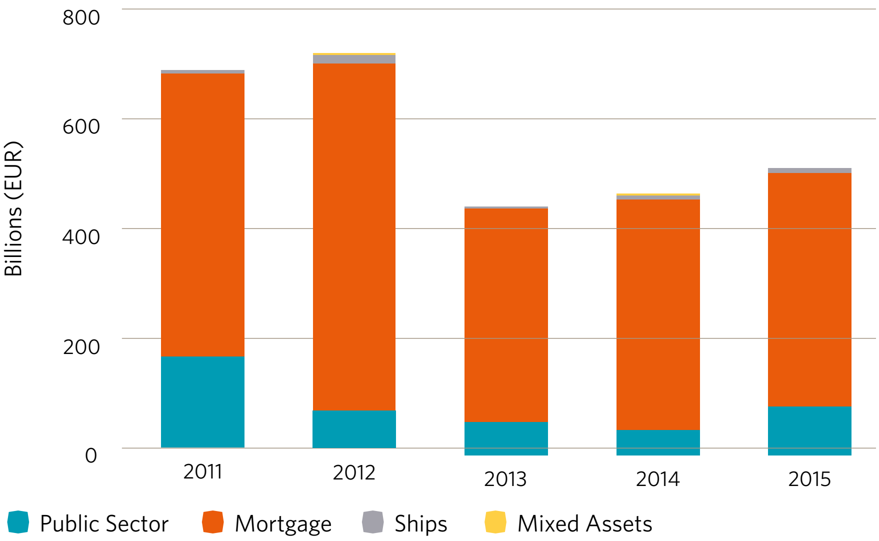
Covered bonds are an ideal tool to finance low carbon infrastructure, having been used in other public priority areas. Identifying existing green cover pools and developing frameworks for other low carbon assets will help scale up investment.

The first green covered bonds were issued in 2016

The green bonds market has seen increased diversification in 2016. One of the new green debt products that entered the market was the first green covered bond issued in Germany.

The Bank of China also issued a 'dual recourse' green bond in November 2016 (not technically a 'covered' bond given the lack of dedicated legislation). The USD 500m issue is the first of its kind, not only because of the dual recourse structure, but also due to the cover pool, which is made up of Chinese climate-aligned bonds on the banks' balance sheets. The bonds are part of the ChinaBond China Climate Aligned Bond Index, developed by CCDC, CECEP and Climate Bonds.

Covered Bonds issuance (2011–2015)



Source: European Covered Bond Council Fact Book, 2016

Covered bonds support cheaper lending in public sector priority areas

Covered bond markets have proven to be a reliable source of long-term financing for banks to on-lend to specific priority sectors, in particular housing and public infrastructure. The covered bonds opportunity is present in many markets, as legislation has now been introduced in almost forty countries. However, only a handful of nations dominate the market (see graph).

The advantage for banks issuing covered bonds is that they can access large pools of money easily and at better rates than unsecured borrowing. This enables them to make loans for eligible assets at a lower cost.

Differently from pure asset-backed finance, where investors are directly exposed to the financial performance of the underlying asset, the covered bonds stay on the issuing bank's balance sheet. Only performing assets are included in the cover pool.

Covered bonds are highly-regulated securities with superior credit ratings and lower funding costs than unsecured debt, thanks to a dual recourse structure where bond investors have a claim over a dedicated 'cover' pool of assets, as well as a general claim over the issuer. Banks are the sole issuers of covered bonds.

BerlinHyp's first green Pfandbrief

The Pfandbrief market is governed by dedicated legislation and accounts for around one quarter of the global covered bond market.

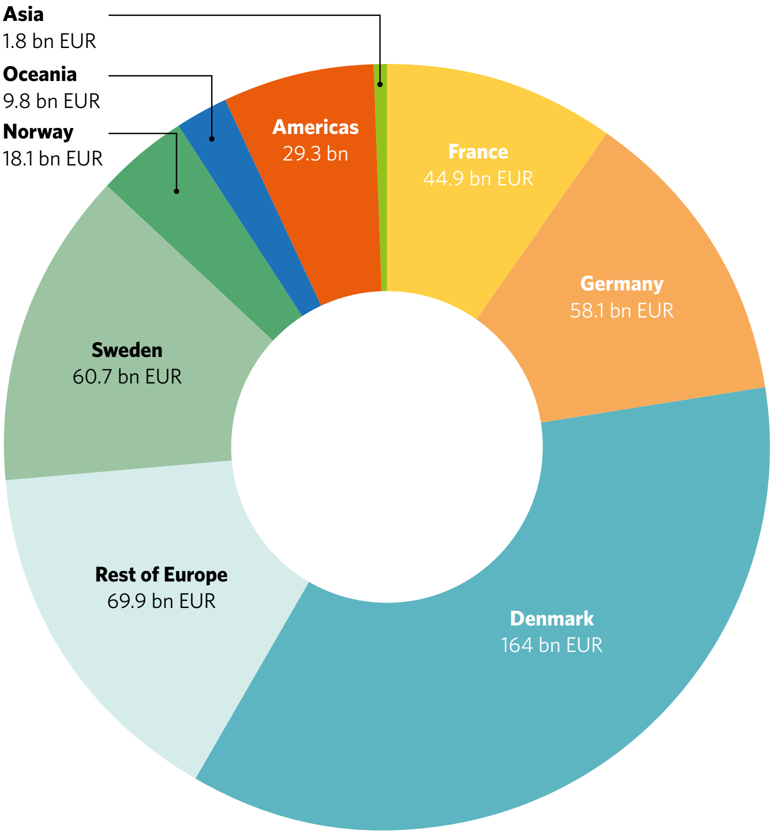
A EUR 500m (USD 545m) green Pfandbrief with a 7-year tenor and coupon of 0.125% was issued by the German real estate and mortgage bank giant BerlinHyp in May 2015. The issue was 4 times oversubscribed and resulted in 15 new investors for BerlinHyp. The cover pool was made up of mortgages to green buildings, which were identified via green building certifications. Assets were located in Germany, France, UK, Netherlands and Poland.

Green Covered bonds can increase financing to low carbon sectors

By issuing green covered bonds, banks will be able to access cheaper and longer-dated funds to on-lend to designated low carbon projects. At the same time, highly regulated institutional investors will be able to increase the exposure of their portfolios to low carbon assets because of the high level of security offered by covered bonds.

A further benefit is that the transparency over underlying covered pools will enable analysts to better track the financial performance of low carbon assets and compare them to their

Covered Bonds issued (2015)



Covered bonds receive favourable regulatory treatment

Covered bonds are being treated preferentially compared to many other asset classes, reflecting the strengths and low risk profile of the product. For example, the Liquidity Coverage Ratio (LCR) under Basel III classifies these bonds as highly liquid assets and Solvency II grants them low risk spread factors. Recent EU regulation exempts covered bonds from bail-in processes and assigns them low risk weights.

In terms of monetary operations, covered bonds tend to receive more favourable treatment where they play a large role in funding the domestic banking sector; they can be eligible as collateral for repurchase operations in the discount window for emergency lending and have low haircuts.

Including green covered pools in these frameworks would help facilitate capital flows to low carbon sectors.

higher carbon alternatives, improving the level of information available to fund the transition to a low carbon economy.

In order to enable covered bonds to be adapted for low carbon finance it will be necessary to create a consensus on what type of assets will be eligible, how these will be managed, and what definitions apply to low carbon assets.

Towards a green covered bond market

Existing covered bond markets

In existing covered bond markets, earmarking green assets in existing cover pools can be the first step to develop the market.

Mortgage covered bonds currently account for the largest share of covered bonds. In the EU, the amount of outstanding mortgage covered bonds is equivalent to around 30% of outstanding residential mortgage loans. More green tagging of loans based on certificates and energy efficiency performance of commercial and residential real estate could help quickly identify green mortgage pools.

Criteria for assets and projects suitable for a 2-degree pathway, as is being developed under the Climate Bonds Standard, could be applied to identify green loans also within shipping, aviation and the public sector lending segments of the covered bonds market.

Emerging markets: Green dual recourse bonds

The same principles can apply in emerging markets that lack covered bond regulation, where banks can issue bonds with a dual recourse structure, covered by a pool of green assets. Green definitions developed at the national level would support issuers.

Making green assets eligible for covered bonds

The public sector can further help develop and grow a green covered bond market by:

- Supporting the development of green definitions to help issuers identify low carbon assets in existing cover pools
- Building on existing legislation to include low carbon assets, such as wind and solar energy leases. This will be possible provided the underlying assets adhere to the strict criteria of the legal frameworks. The increasing maturity of renewable energy assets means these could qualify as cover pool assets in the near future.

Climate Bonds Standard

The Standard provides clear, sector-specific eligibility criteria for assets and projects that can be used for green covered bonds. It is used a screening tool for investors and government to allow them to identify and prioritise climate change solutions.

www.climatebonds.net

Want to know more? Please contact beate@climatebonds.net