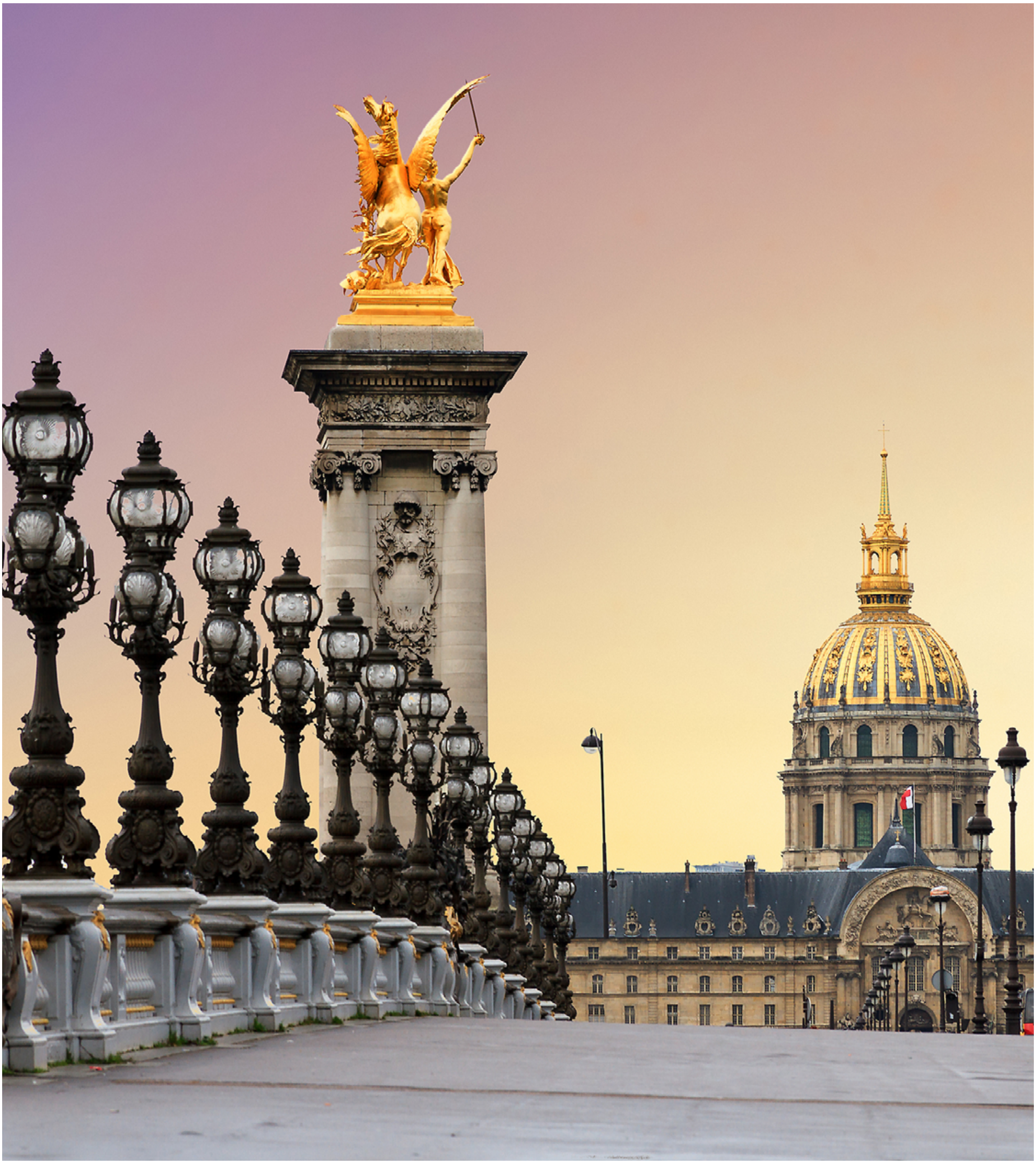
Paris Pfandbrief & Sustainability Roundtable

Paris, 12 October 2022



CRÉDIT AGRICOLE
CORPORATE & INVESTMENT BANK

vdp Die deutschen Pfandbriefbanken

With almost EUR200bn of EUR benchmark covered bond gross issuance year-to-date, the covered bond market is set to end 2022 on a record high. 2023 already sounds promising, however, markets will have to deal with a high degree of uncertainty and mounting risks for financial stability.

While the new regime of inflation, interest and growth rates has significantly impacted the pricing paradigm and market depth in unsecured and subordinated debt markets, covered bonds continue to deliver what they have been designed for: the safest and most cost efficient long-term wholesale funding tool banks have in their arsenal to refinance real estate and public sector assets.

Meanwhile, concerns surrounding the consequences of climate change and global warming have forced real estate market stakeholders to take drastic measures. How will covered bond issuers fare in light of this as well as the regulatory response to the environmental challenges? German Pfandbrief issuers, French investors and Crédit Agricole CIB reps shared their insights into these big trends and challenges ahead in this Pfandbrief & Sustainability roundtable.

Vincent Hoarau
Head of FIG Syndicate
Roundtable Moderator
Crédit Agricole CIB

The roundtable was held on 12 October, with the following participants:

- Bodo Winkler-Viti, Head of Funding & Investor Relations, Berlin Hyp
- Paul Weber, Funding & ESG Specialist, BayernLB
- Sascha Kullig, Member of the Management Board and Department Head Capital Markets, Investor Relations and Coordinator Sustainable Finance, vdp
- Hervé Boiral, Head of Euro Credit, Amundi
- Stéphane Taillepied, Financial Analyst, Amundi
- Théo Kotula, ESG/Responsible Investment Analyst, AXA
- Florian Eichert, Head of Covered Bond & SSA Research, Crédit Agricole CIB
- Laurent Adoult, Head of Head of Sustainable Banking – FI & SSA Europe, Crédit Agricole CIB

Vincent Hoarau, CACIB: The year has been extremely challenging so far, with extraordinary changes in many aspects. Could you summarize 2022's main themes in the asset class in terms of issuance & market dynamics and spread drivers?

Florian Eichert, CACIB: In terms of themes this year, for me it has been about the return of issuers and the return of investors. On the issuer side, we just left behind a number of years with heavy net negative issuance as issuers relied more on deposits and central bank liquidity than market funding. This has clearly changed this year. Counting in recent issuance activity, we are set to go beyond the EUR185bn record for EUR covered bond benchmark issuance from 2010 and issuers have also been active in USD and to a lesser extent GBP. This surge in issuance is largely driven by banks normalizing their funding away from the ECB. However, in some jurisdictions we are starting to see issuers preparing themselves for deposit outflows already. The deposit angle has been the main driver for the Canadian issuers for example. The main drivers depend a bit on the jurisdiction overall but the bottom-line has been resurgent activity across jurisdictions.

On the investor side, demand has surged too and a lot of names that had been away from the covered bond markets for the past few years are back. Covered bonds have been and will always be the lowest beta product banks can offer. And with covered being traded predominantly against swaps, the material swap spreads widening this year has resulted in the product sitting a good 100bp or more above Bunds, with very little volatility. This combination has led many investors back into the covered bond space with even some high yield portfolios parking money in short dated covered bonds.

There is another theme here that we expect to continue to see in the coming weeks. Some of these investors do not have a strong background in covered bonds. But even for the ones that do have this background, the higher rates, wider swap spreads and plentiful supply have meant that demand has focused on a much narrower part of this market. This is true in terms of tenors, i.e. a lot of the demand has shifted to the shorter end. It has also been true in terms of issuers and sectors preference. For example, a small debut issuer from a small jurisdiction will have a much harder time almost irrespective of pricing while short-end strong names have seen huge orderbooks.

In all of this, another element that we have not seen in a long time is also coming back: It makes sense again to look at issuers, look at the underlying quality, look at the regulatory treatment and to differentiate. Spread differentiation is coming back and it is increasingly becoming worthwhile again to put in time and effort to stock-pick. In previous years, everything was traded within 2-3bp, so there really was no point in doing this work. Nowadays, it is becoming more idiosyncratic again, for example when it comes to UK issuers and their LCR treatment or the underlying housing market for example. As a matter of fact, you could say that we have a functioning market again, which is really nice to see because we did not have that for quite a few years. The product is back - it is the most crucial funding instrument for banks in Europe and it is also becoming more so the case for non-European issuers.

Hoarau, CACIB: The involvement of the Euro-system with the various APPs has distorted the market significantly. How did it evolve lately?

"The surge in issuance coupled with lower ECB orders has taken us back to a normalized market"

Florian Eichert
Head of Covered Bond & SSA Research
Crédit Agricole CIB

Eichert, CACIB: The Euro-system started buying covered bonds years ago. They had a CBPP 1, a CBPP 2 and also with the current round of quantitative easing, covered bonds were the first product to be touched. Covered bonds have traditionally been designed for buy and hold investors rather than for trading accounts and the ECB taking out a large chunk of the otherwise tradable free float has meant liquidity has taken a big hit. Out of the existing eligible stock, they currently own roughly 45%.

For bonds issued in previous years, this squeezy element is not going away and the ECB is not doing much to improve liquidity apart from some securities lending. However, anything that has been issued since the start of this year is really starting to feel different. Orders in primary markets have gone down from peak 50% to 20% by now and therefore the free float from the onset of any new issue is already higher by definition. The ECB is still reinvesting portfolio redemptions and therefore they still produce sizeable flows in secondary markets. Nonetheless, liquidity is improving, especially for more recent vintages. The ECB is not stepping back actively, they are not selling, they are not stopping to reinvest their redemptions but the surge in issuance coupled with lower orders has really taken us back to a somewhat more normalized market. This can also be observed when looking at investment banks and trading infrastructure. Secondary desks are getting more seniority and trading flows becoming bigger again as a result.

Hoarau, CACIB: We recently observed that the Eurosystem has deviated a little bit from what it has done in the past, i.e. different order sizes or no orders in the context of CBPP3 with regard to certain new issues. It seems that it is not been as fluid and predictable as it has been in the recent past where you could anticipate how the Euro-system would behave with regards to the purchase program. Do you think this has created nervousness amongst issuers and investment banks?

Eichert, CACIB: I do not have the feeling that there are major concerns around how people see the ECB's order behavior. Indeed, you still have the individual national central banks that place orders on the domestic issuances. Regarding the examples you mentioned, maybe some central banks over-purchased certain issuers in primary and secondary markets earlier in the year and had to let other issuers from this jurisdiction catch up in the CBPP 3 portfolio. However, as far as I have observed central bank behavior, it has been very stable and steady and I would be surprised to see them change their approach and become utterly unpredictable with their order behavior going forward.

Hoarau, CACIB: How do you perceive the new situation in the current context of increased volatility? As far as you can tell now, how do 2023 funding plans look?

Bodo Winkler-Viti, Berlin Hyp: As a German issuer, the market was there almost all the time. You could issue whenever you wanted and the bond would have been bought. But as Florian rightly mentioned, not all tenors at all times. When we did our last longer dated Pfandbrief, which was a 10-year Pfandbrief in May, we made use of a very good window. The book was in the context of EUR 3bn and we were overwhelmed with the demand. Only one month later, nobody wanted to issue a 10-year Pfandbrief anymore and no investors wanted to buy it in a volatile market environment, due to their need to avoid longer duration. Thus, the shorter end of the curve became more attractive, also for us as an issuer. Those who did their longer tenors at the beginning of the year should be indeed very happy. We started with a 7-year, followed with a 10-year and then could choose to issue a 3-year tenor at the beginning of summer. With the later one, we generated the largest orderbook ever achieved by Berlin Hyp.

Investors are coming back while some others are new in the market and not always the names you want to have your bond placed with. On the other side, we see that even traditional investors are returning. Also for the German product which was seen as a little bit too expensive by non-domestic investors in the past, perception seems to have changed. When we did our EUR 1bn 3-year transaction we could have placed the entire bond without any problem with high quality non-domestic investors. Basically, for this product, I think it is the perfect environment, I would even say the product is made for this environment.

What we have also witnessed is that in the past, it was more exotic to use sustainable assets for covered bonds because there was always this intervention of the central bank. Issuers felt that it is almost a waste, using these valuable assets in a market where you cannot differentiate and save them, instead, for senior funding purposes. This seems to have changed. Our perception is also that we see a small difference in pricing in conventional and non-conventional covered bonds, especially on German Pfandbrief. To some extent, it reconfirms ourselves that we have always done the right thing using assets if they are cover pool eligible and did not artificially try to make a relation between them and unsecured funding. If I only look at covered bonds, I really must say that I like the environment, especially as a German issuer with a higher differentiation within the jurisdiction. You have credit differences which are now narrowed down in pricing but also between jurisdictions. Differences that were lost during the course of the past years due to central bank intervention are back.

Hoarau, CACIB: Would you call the Pfandbrief a perfect Bund proxy with a juicy spread?

Winkler-Viti, Berlin Hyp: It is not a Bund proxy because it is lagging the liquidity of Bunds. However, you get a triple A product and you get it from a very established jurisdiction. In 2019, we celebrated the 250-year Pfandbrief anniversary which also represents a long history without any single default. As you would perceive the Bund not to default, you would also perceive the Pfandbrief to do the same. But indeed, the last Pfandbrief we issued was in the context of +90bp area over Bunds whereas in previous times, +40bp area over Bunds was already considered as an attractive result. The relative attractiveness within the triple A space got bigger and is one of the drivers of successful large issuance volumes and demand.

Looking ahead and into 2023, we will need to do about EUR 3bn in covered format, translating into at least three benchmark sized issuances in EUR. There might be some bits and pieces in CHF. We like that market, it is a nice differentiation to have and it is a totally different investor base. Covered bond is the easy part of the funding plan next year. The other part will be more demanding.

Paul Weber
Funding & ESG Specialist
BayernLB

Paul Weber, BayernLB: I can only agree with Bodo on the maturity part. We made the decision when we issued our green rail finance Pfandbrief that we specifically went for the longer maturity just for the same reasons Bodo outlined. You can always bring a short dated Pfandbrief at any time. In situations like we had this year, you should use a good window to try the longer maturities which we have done and will also do so going forward. I think there is nothing in the horizon that will change the current environment in the near term. Central banks won't come to the rescue, maybe the situation in Ukraine changes but this is also unclear.

Our plan for 2023 depends on the size of our new business plan and this is also dependent on the macro profile which is extremely unclear as we all know. Generally speaking, the picture looks similar to this year. But we also have to keep up with the Moody's LGF methodology, so there will be some unsecured funding. If we issue an unsecured benchmark, this would be subject to the level we would need to pay within the savings bank's network relative to the benchmark level. To be honest, right now, it is pretty expensive to issue in unsecured benchmark format. Even high spreads don't lead necessarily to a dynamic orderbook development. However, we are in the lucky position that we made our strategically important issues already in 2021 which now gives us some time. We can monitor the situation during the first months of 2023 and then take a look at potential windows.

Hoarau, CACIB: The world has changed drastically over the last 6 to 12 months. How does the new yield paradigm impact asset allocation in investors' mandates universe? How does an asset manager navigate through the new rate environment, new volatility regime and new regime in terms of inflation in the supply dynamic?

Hervé Boiral, Amundi: You have two types of investors. Spread driven investors and yield driven investors. If you are primarily interested in spreads, it begins to become interesting to buy covered bonds, swap it and use as liquidity buffer. On this side, we are gaining some interest from end accounts but I think that this is not the most important part. The most important part is coming from yield driven investors. Typically, when yields were negative on Govies, you had a lot of investors searching for positive yields and return. Many investors were switching into credit, i.e. low single A and triple BBB. As of today, you get on the 10-year SSA product something in the context of 2.5%+. If you add roughly 100bp swap spread, you are close to 3.5% on a triple A product which becomes really interesting so that you can ask yourself the following: it is really worth taking some credit and volatility risk for another 50bp or 100bp. I think that is where the increased interest for covered bonds comes from. As a classical investor, like an insurance company, you may ask yourself if you prefer 3.5% on a triple A or 4.5% on a triple BBB product. If you are also looking at your cost perspective, I think a lot of people may come back on the covered bond for these reasons.

What is really interesting is that these levels are the highest we have seen for a while which should push investors back into the covered bond space. The only difficulty I can see is about liquidity in the secondary market: it is difficult to buy covered bonds in the secondary market and the liquidity is really poor. This is maybe, as of today, the last strain which prevents us to go even deeper in the asset class. Typically, we should have liquidity which corresponds to the spread against swaps. If liquidity comes back in the asset class, our interest will even get stronger.

"You are close to 3.5% on a AAA product which is really interesting"

Hervé Boiral
Head of Euro Credit,
Amundi

Sascha Kullig, vdp: Florian said that liquidity is already improving and might improve even further when the ECB gets more or less completely out of the market. Do you expect a similar development?

Boiral, Amundi: We do hope to see so. If we see more issuances, I hope to see bid ask getting tighter and so more liquidity in the asset class.

Hoarau, CACIB: Liquidity is a crucial point indeed. Over the past couple of years, it has been a one-way secondary market only. We know the Euro-system is long only, not providing any sort of liquidity in the secondary market while showing little price sensitivity. Hence, you end up with dealers having a limited inclination to show offer, afraid to get trapped in a short squeeze. With repo being extremely expensive, you lose money in a very short period of time in a bull market. Now the Euro-system is stepping back a little bit and market reprice wider, so we tend to see more and more two way flows beneficial to the overall liquidity in the product. It is a very slow process, but we are getting there obviously with the help of the new rate environment and increased granularity of the investor base.

Hoarau, CACIB: Stéphane, how do you perceive the product in the new rate environment? When I look at order-books, I also have the feeling that Pfandbriefe could get more love from French buyers. What's your view on that?

Stéphane Taillepied, Amundi: There is a new interest rate environment indeed, but there is also a new environment for house prices. Since the beginning of the year, we met with a lot of banks. All the banks expected no decrease in house prices. We met the same banks two or three weeks ago, and then all were expecting decreasing house prices. Australian banks for instance are expecting a decrease of at least 20%. This is a new topic for us because it was not the case for the last 20 years. As of today, the market expects a decrease of 10% of UK house prices but I think this number is too conservative, even not realistic. Global drop in house prices is going to be the new topic for 2023 and in some cases we could even see a decrease of 30% to 40%. Looking at the stress test of Moody's for European banks, they work on the assumption of a decrease of 30% for house prices and minus 5% for GDP. So far, we have no stress test working with the assumption of a 40% drop and we could have some negative surprise in some region – which is my personal feeling. For the next few years, house prices will be the topic for us.

In terms of direct impact on the asset class, if I look at Moody's stress test, the impact should be in the context of 200bp. So this is the way I approach the asset class across jurisdictions and in this context indeed the German market and Pfandbrief is gaining relevance in monitoring. And the couple of bp tighter given where we are on a yield basis should not discourage.

"Global drop in house prices is going to be the new topic for 2023"

Stéphane Taillepied
Financial Analyst
Amundi

Weber, BayernLB: During the course of the past years, there was no difference between public and mortgage covered bonds in terms of price. Since you are very sensitive to the real estate sector, do you think that there will be a pricing difference again with regard to public and mortgage covered bonds going forward?

Stéphane Taillepied, Amundi: Yes, this should be the case, but there again you need to look into details and the nature of the public sector assets. In any case, a stronger diligence is needed for mortgage backed covered bonds in the context of a possible serious correction of the housing market.

Boiral, Amundi: I think it depends on the bank itself and the cover pool structure. If you have a very strong bank, you might say that the cover pool is of less importance because the bank might be able to support easily. When you go into smaller banks, then the cover pool quality is getting more and more important and you will have more differences.

Weber, BayernLB: With regard to commercial versus residential cover pools, do you also make a difference here because commercial might suffer more than residential?

Boiral & Taillepied, Amundi: Yes

Winkler-Viti, Berlin Hyp: Where does the perception come from that commercial real estate could suffer more than residential real estate? With regards to past crises we have experienced, I cannot recall a single one that has emerged from the commercial real estate sector. Looking at crises like the US subprime crisis in 2008 which also affected parts of the European residential market, e.g. in Spain and the Netherlands, the commercial real estate market was more or less unaffected by this.

Hoarau, CACIB: Don't you think that the post Covid work situation, with people working more and more from home, leading to empty office spaces, is changing the picture? Ways of consumption are also evolving.

Winkler-Viti, Berlin Hyp: Yes, but the topic with the Covid situation is that this discussion already started in March 2020, i.e. what to do with all the office space. What we see now in Germany, one of the biggest markets, is that price growth first slowed down and then stopped, although we do not see big vacancies. There is more concentration on new real estate, especially on environmentally friendly real estate in top locations, but you can't say that Covid made the sector suffer. Indeed, if you now think of an environment where we enter into recession while we have ongoing inflation, I think we will see an impact on all real estate asset classes. You will have private customers that will not be able to serve the mortgage for their house. There will be more jobless people in the end. More jobless people means less consumption, so even less demand for retail space. I don't see why why there should be a bigger risk in commercial real estate versus residential one if the lender focuses on high quality.

Boiral, Amundi: I think it typically depends a lot on the jurisdiction. When you look at France, requirements for residential borrowers are much higher while commercial borrowers enjoy some kind of higher degree of freedom when borrowing money. That means that, at least in France, you have a higher probability getting paid back from a residential borrower versus a commercial one.

Taillepied, Amundi: We had a big crisis in France in the mid-90s with a lot of exposure from real estate developers and a lot of losses for the banks.

Winkler-Viti, Berlin Hyp: Developments are a big topic and I think you see that in all markets in Europe at the moment. Transaction volumes are going down. Banks active in this space ask for more equity. At the same time, interest rates and spreads are higher which makes developing much more unattractive. Though, I think this is a normal limitation that the market puts to it at the moment. What is currently coming to the development market are only the premium projects because these are the only ones that get debt financing from banks.

"This is the perfect environment for Pfandbriefe"

Bodo Winkler-Viti
Head of Funding & Investor Relations
Berlin Hyp

Kullig, vdp: With regard to commercial lending, you always have to be aware that it is a very heterogeneous market, so you always have to look at the different asset classes. Our own subsidiary calculates the mortgage price index for Germany and when it comes to offices for instance, we saw the first and second quarter 2021 where prices declined slightly and subsequently increased again, which was a surprise to all of us. This might not continue but we do not believe that prices will decline sharply for offices.

The situation is different when you look at retailers where prices have declined for several years now and they may continue to decline. In the hotel business, prices have declined as well during Covid. Nevertheless, we have seen a good recovery in the market. The question is if this is a substantial development or just transitional with prices declining again in the near future. You always have to look very closely at these different asset classes. In Germany, there are a lot of specialized lenders who really know their business and they are well diversified. On top of that, you always have to remember that the eligibility requirements for Pfandbrief cover assets are extremely high. The German mortgage lending value is very conservative. It provides a huge safety cushion, especially when it comes to commercial lending. Plus, you may only include 60% of the mortgage lending value in your cover pool. The mortgage lending value, compared to the market value, is in the context of 60% to 70%, i.e. prices would have to decline extremely before something happens to the cover pool.

With regards to residential, we do expect prices to decline because demand has dropped in Germany for several reasons. High inflation rates, high energy costs and the interest rates for mortgage loans have increased sharply. However, there also are problems on the supply side. There is still a lack on the supply side given the distortion in supply chains. The German government has the objective to construct 400,000 new dwellings per year, which seems very ambitious. In the end we might see lower prices, but probably not beyond 20%, at least not in Germany.

Winkler-Viti, Berlin Hyp: Coming back to the mortgage lending value. When we add an asset into the cover pool, the mortgage lending value is already well below the market value. Then, there is a specialty. If we see decreasing prices, the mortgage lending value needs to be adjusted. If we see an increase in prices, the mortgage lending value remains unchanged. In the example of decreasing prices, where the mortgage lending value will be decreased first, it will increase again on the back of price recovery.

Boiral, Amundi: For having a problem with the covered bond, you first of all have to have a problem within the bank. The problem is more the bank than the cover pool because if you as an investor get the pool at the end, the bank has a really big problem. This is why as a first step we tend to focus on the bank in general and afterwards on the pool because the bank is really important for the safety of the covered bond. The difficulty with Pfandbrief is that the German banking sector is more difficult to assess compared to other jurisdictions. If you exclude issuers like Deutsche Bank and Commerzbank, you have less senior or other classical bonds outstanding which makes it difficult to compare how the market is pricing the safety of a bank.

Winkler-Viti, Berlin Hyp: I can understand each investor, especially with regard to internal lines and limit process, that first the bank needs to be analyzed. You do not want to experience the situation where the bank is away and the cover pool administrator is stepping in.

Eichert, CACIB: When assessing covered bonds, it is sensible to start with assessing the sovereign risk of the jurisdiction in question. If you are happy with the country, you then look at the bank. If you are happy with the bank, you look at the framework, i.e. how likely will you actually have access to these assets. Only at the very end do you look at the underlying assets as investors will really only need to rely on them when the issuer is gone and the covered bond structure has failed too.

"With regard to commercial lending, it is a very heterogeneous market"

Sascha Kullig
Member of the Management
Board & Department Head CM
IR and Coordinator Sustainable Finance *vdp*

Kullig, vdp: When it comes to commercial versus residential, from an investors' point of view, what is better - a bank that is focused on pure residential lending in a specific region or country only, or a bank which is more diversified, both active in residential and commercial, across Europe or even on a global note? Do you have a preference and why?

Taillepied, Amundi: It depends. You can have an issuer like UniCredit who issued a covered bond via their Czech entity. On the one hand, this is UniCredit, though it is Czech Republic and the cover pool comprises a certain amount of hotel and offices, which at the end might not work for some investors. We have a clear preference for pure residential in the cover pool and if possible with some kind of diversification.

Hoarau, CACIB: When looking at order-books, the higher the beta, the higher the participation of French investors. What needs to change to see increased participation from French buyers in the Pfandbrief sector?

Boiral, Amundi: The problem is that when spreads are not elevated, you want to have liquidity and simplicity. In this case, it is easier to go to big national champions where you always have better liquidity and most likely no problems. When you look at smaller banks, it demands more work and you will have less liquidity. These factors also need to be considered in an environment where you enter into recession or more complicated situations.

Hoarau, CACIB: So by definition, it is not a matter of price with Pfandbrief being the tightest product in the covered bond space, it is a matter of the profile and the fragmentation of the German banking sector.

Winkler-Viti, Berlin Hyp: What about ESG? My experience is that Berlin Hyp gets interest from French investors, but only when bonds are issued in ESG format.

Boiral, Amundi: We do like green Pfandbrief but we do not want to pay more on a green bond compared to a conventional one. That is important because you cannot tell your clients that you will have less return because you are going to green the portfolio. We are supposed to engage on a green product only if the price is the same one as for a conventional one.

Weber, BayernLB: How do you determine the price limit for green in advance? Can it be a disadvantage for an issuer if they have an outstanding conventional Pfandbrief and a green Pfandbrief and there is difference and the limit is for the conventional one?

Boiral, Amundi: It is difficult to find the right balance. Our clients do not provide us with money to have less performance but to be greener. Green can bring you some new clients, which can then also be seen on ESG Pfandbrief for instance in which we are invested, but it is also difficult to justify to be more expensive compared to a conventional bond.

Hoarau, CACIB: Coming back to your question on how you can know in advance, it has also to do with the communication around the transaction. As an issuer you are always happy to advertise on the price advantage of the ESG label while for an investor, it is very difficult to advertise this in front of their clients. We are not helping each other. Maybe we have to reconsider the communication around this item in order to help investors.

Winkler-Viti, Berlin Hyp: When it comes to covered bonds, the price differential between a green and a conventional bond might be 1-2bp in a good market. It is due to the much larger and granular orderbook.

As a lender, you ask everybody to help you make the market more sustainable and that also includes investors. Berlin Hyp grants on every green and social loan a price incentive of 10bp. If the loan is taxonomy compliant, then it is even 20bp. We as Berlin Hyp pay it and take our share of responsibility here. I would like to invite others i.e. investors to share this with us. I think funding providers should have a natural interest that somebody who is able to evaluate the quality of the asset focuses on ESG assets.

Boiral, Amundi: I do understand your point, but the problem is that on the official mandates that we hold, we need to optimize the return. We cannot say that instead of doing 10%, our client will only have 9% because the client is more ESG compliant compared to others. However, although for the time being this is not the case, together with our clients, we could challenge the mandate in order to embed more ESG, even if in the end it means lower return.

Weber, BayernLB: With regards to the new MiFID rules, I think it depends if you outline the main driver of the investment decision, one ESG target or purely ESG. Then, I think you are on the safe side as an asset manager.

Kullig, vdp: Another party that could contribute to this development is actually the regulator. Any kind of benefit could be introduced, be it on the issuer or investor side. Clearly, it would help but this is a tricky discussion because the last thing we want to have is a political greenium on the regulatory side. Though, it would clearly help if there would be some kind of regulatory relief when it comes to green assets.

Théo Kotula
ESG/Responsible Investment Analyst
AXA

Théo Kotula, AXA IM: From our perspective, an ESG label, be it green or social, will probably attract portfolio managers that usually would not have a look on certain issuances. They will be further attracted because they have objectives in greening their portfolio. From the difference I have seen, three to four years ago, when we asked for interest for a green bond, there were maybe four to five portfolio managers coming back. Now, it is almost the entire platform that is interested in green bonds. I agree with Hervé, ideally we do not want to pay more because it is green. On the other hand, our clients are pushing us towards ESG. In the fixed income space, ESG labeled bonds are a great tool to do so. There is obviously more interest if it is ESG labeled, not only around Pfandbrief, but generally speaking.

Hoarau, CACIB: Let us dive further into the ESG element. How can renovation play a key role towards net zero real estate?

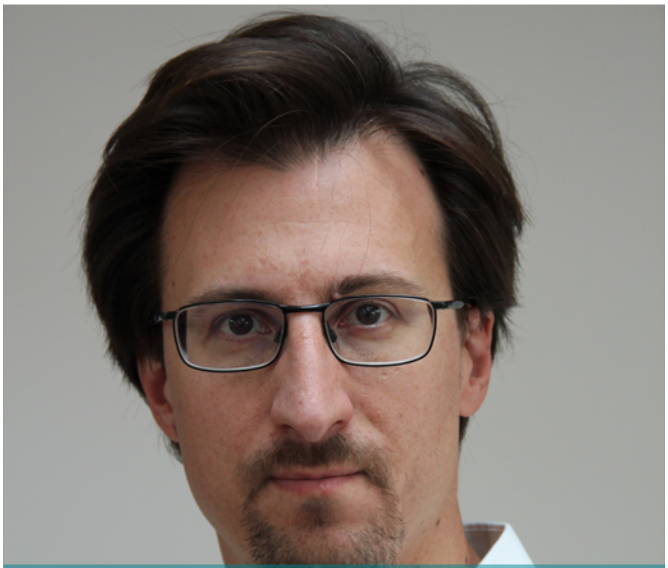
Kotula, AXA IM: I think that renovation of existing buildings is probably the most important challenge for the real estate sector to achieve net zero and decarbonization. Most of the existing buildings will still be there in 2040 and 2050 and will have a significant impact on the long term overall net zero objective. Also, and that is maybe most important, most of the carbon footprint of the real estate sector comes from these existing, often very old, buildings. If I just look at the residential buildings here in Paris, most of them are pretty old and from former centuries, i.e. they have a pretty poor energy performance.

Having new buildings that have a high performance from an energy and carbon perspective is one thing, but renovation is as equally important, if not even more. Though, the issue here is that as of now, the renovation rate is too low to really achieve the net zero ambition. I think here, regulation has to play a role. We have seen that in the French context. By 2025, a house owner will not be able to rent out a flat or a house that has an EPC level of F or G. Regulation helps the financial sector in general. Banks can also play a role by encouraging individuals to renovate: applying a kind of discount when it comes to renovation for example is going into the right direction.

I can only encourage issuers to include or emphasize renovation in the green building category in their framework and to look into that for future issuances. I am pretty sure investors with an ESG focus will appreciate it.

Eichert, CACIB: There are just two problems. One is costs: asset owners are already faced with a lot more than before and even if you get a 20bp discount on a taxonomy compliant mortgage, rates in Germany for 10-years have gone up from below 1% to 4.3% now. Secondly, even if there is the money available to renovate, then you are faced with the issue of availability of labor and material. At the end of the day, banks can only do so much. They can incentivize through lending rates, but the asset owners are the ones that actually have to do the lifting.

Winkler-Viti, Berlin Hyp: I do not fully agree that this is the only thing that banks can do. I think we all had a little bit of time now to prepare for these challenges. What is very important is not only the lending, but also the consultation and advice. A similar approach like the French one regarding renting out subject to EPC level is also in place in the Netherlands for two years now. In the Netherlands, it is not allowed to sell any building with an EPC level below C. What does that mean? No matter what the costs are, you will renovate your building if it is at level D. In that context, it is then good to have the know-how in banks that also provide the lending.



"Taxonomy is very binary. Either you are aligned or you are not"

Laurent Adoult
Head of Sustainable Banking –
FI & SSA Europe
Crédit Agricole CIB

Laurent Adoult, CACIB: I agree with Théo on the renovation rate. If you look at European net rolls, the renovation rate and rent ranges from 0.4% to 1.3%, so that is relatively low. If you compare it with what a 1.5° net zero trajectory for Europe would imply, you would probably be more in the context of 3%. If you look at EU current policies, or what they would like to aim for, it is around 2%. So you see that between the current situation and what we would need to achieve, there is a huge gap. Even with the EU Renovation Wave policy that has been launched in 2020 we are still far away from what we would need to achieve. Although the aim is to double (coming from 1% up to 2%), this might not be sufficient. The other point that we need to have in mind is that there are two ways of renovation. When you look at overall figures, a high percentage of buildings are actually being renovated every year (partially or full). But in a number of cases, it is not an energy renovation, i.e. it is only making the building nicer but not necessarily improving the energy efficiency of the building. The other pillar is about greening the heating system to a certain extent, i.e. changing from a gas heating system to a heat pump.

When it comes to the green bond market, there might be a difficulty as well. How can you identify the share in your financings that is really dedicated to renovation? In some cases, you can identify it as dedicated loan. Though, in a number of cases, you grant a loan to a customer who buys a poorly energy efficient house and only a part of this loan is dedicated to renovation. How can this be identified in the banks' system in order to reflect the loan correctly in the green portfolio if only a small part of the loan is dedicated to renovation?

Further, we should also have in mind the social costs. It is good to state that you cannot sell, like in the Netherlands, a house below EPC level C. But if you have people that do not have the financial means for renovation, we need to think about that as well because at the end of the day, these people are stuck on two ends, i.e. living in a poorly energy efficient house with not option to sell it. Finally, everything with regards to the transition is about the role of government.

Winkler-Viti, Berlin Hyp: I fully agree. But these days, living in a more energy efficient house has something social as well because we are still thinking in terms of when energy was more or less for free. It is not affordable to live in a non-energy efficient place anymore.

Adoult, CACIB: I agree with you, but this is the role of government and budget allocation. When you look at the share that is dedicated to renovation programs versus the emergency measures that governments have put in place so that people can cover their energy bills, it seems imbalanced. In the current context and in a very short time, governments have been able to mobilize billions of EUR for helping people facing their energy bills. On the other hand, for years, they have not been able to spend the same amount of money to help all the people to renovate their houses.

Kullig, vdp: This discussion already shows that it is extremely difficult for banks to encourage customers to improve the energy efficiency of their buildings. We currently have the revision of the energy performance of buildings directive. As of 2030, everywhere in the EU houses need to have an EPC level of a least F. Though, banks do only lend money to customers. They do not own the building and they cannot force owners to renovate their buildings. In addition to that, banks are not engineers. We should be really careful not to force banks to give some advice on something they are not expert in. Of course banks can encourage, but not more. There are some parliamentarians in the EU parliament who actually want to force banks to improve the average energy efficiency of their mortgage portfolio.

This is clearly going too far because this is definitely not in the hands of the banks to do this.

Winkler-Viti, Berlin Hyp: I think it really is. At the end the bank decides what to lend money for. Berlin Hyp has its own pathway to climate neutrality of its own portfolio because we want this and because we think that only then we can have also a financially sound portfolio, if the portfolio is climate neutral at a certain point.

Kullig, vdp: Maybe there is a difference between commercial and residential. When it comes to residential, there is still a lack of savings after an energy efficient renovation compared to the costs of such a renovation. If nobody steps in to subsidize it, and this probably has to be the government, we will end up with problems.

Hoarau, CACIB: How are you currently coping with your ESG framework alignment with the EU taxonomy?

Weber, BayernLB: As probably everybody knows, data remains the main challenge. We included the rail part into our framework this year, i.e. 100% electric rail in Germany. By definition, this should be easy to estimate and to prove that it is taxonomy compliant. Though, even this was a challenge for us. For the renewable energy part of our framework, where our portfolio is very international, it becomes even more complicated. With regard to the taxonomy, we already have an internal rating system where we rate an asset on an ESG scale with the top being taxonomy compliant. Though, it is hard to prove to an external validator because the international context of the portfolio makes it difficult to compare rules and methodologies applied across jurisdictions. For now, we are very happy with our asset pool. It comprises very high quality assets in all three categories (renewable energy, rail and real estate). The market still does not demand 100% taxonomy compliance but there is always a race to ESG quality. We always strive to improve the ESG quality of our assets but we cannot force our clients to provide us with all the data we might need and want. Also in hindsight it is very difficult. I think that for older assets it is nearly impossible to prove taxonomy compliance. But our new asset stock is growing and maybe in the next few years we might be able to be 100% taxonomy compliant, but it will take some time.

Winkler-Viti, Berlin Hyp: In our case, it is of course a little bit different because we do not have three different portfolios. We only do real estate lending. We have included the EU taxonomy or the criteria for the environmental target goal number one for the real estate sector into our green bond framework. We also have translated this into labeled loan products. One of these loans is the taxonomy loan. After having introduced this loan in May this year, it took us until August to complete the first real 100% taxonomy aligned loan. Fortunate for us, it was a big one which helped us on our pathway and brings us into a good position to keep our speed. At the same time, it demonstrated very well, how difficult it is and that you really need a client who shares the same goal. When I read other green bond frameworks, I often read this language that somebody somehow embraces the technical screening criteria but does not lose any word about all the do no significant harm criteria (DNSH) – which is different compared to our case. It must all be 100% fulfilled and it is a lot of documents you need. This requires a lot of goodwill from your client and his own will to achieve something there as well.

Adoult, CACIB: The difficulty is also that the taxonomy is very binary. Either you are aligned or you are not. If you are missing one DNSH criteria, it is over.

Winkler-Viti, Berlin Hyp: We have experienced that several times in the past. Clients were willing to provide the input needed but then there was something in the climate risk assessment that was missing.

Kullig, vdp: From an investors' point of view, since you also have ESG clients, what is your expectation with regard to the EU Green Bond Standard that we will probably get at the end of the year? This will require 100% taxonomy compliance. Do you expect that many investors will require this official green bond standard label or do you think it is a nice to have but not really necessary?

Boiral, Amundi: We have our own internal ratings, so to say our own green bond approval, to be sure that the bond actually is green when it is labeled as such. So in fact for us, it should not change a lot because our analyst can rely on our internal ratings. We try not to depend too much on external providers because you always have a risk of being accused of green washing. Though, the label helps us because it shows if we are moving into the right direction or not, and if you have same kind of philosophy. But at the end we try to have our own assessment.

Kotula, AXA IM: With regard to the EU Green Bond Standard and the inclusion of taxonomy requirements in green bond frameworks, I think for the moment that it would be a nice to have. We have our own internal assessment methodology for green bonds as well and over the past few months we have been working a lot on integrating the EU taxonomy requirements into this assessment methodology. In particular, the use of proceeds and the technical screening criteria, because we understand that technical criteria can be benchmarked and challenged while the DNSH and minimum social safeguards is a different conversation. It is less clear to comply with the requirements. In the near future, we will not say that we are only going to invest in green bonds that are taxonomy aligned or comply with the EU Green Bond Standard, because if we do that I don't know in what kind of green bonds we will invest in. However, we want to invest only in high quality green bonds. Gas and nuclear will be excluded from our green bond investments even though they are part of the taxonomy.

When we look at green bonds, we also look at many other factors. One is actually becoming more and more important and it is the consistency and alignment with a climate or environmental strategy at issuer level.

In the case of banks notably and especially those focusing on the real estate sector we look at their ambitions and commitments to make their portfolio greener. We also look at scope three of financed emissions.

Maybe in some point in time we will say that we will only have EU Green Bond Standard compliant bonds in our portfolio, but I do not see that coming in the near future.

Then, there is another question: what about green bond issuers outside of the EU? With regard to the taxonomy, they will be fully right to say that this is not their jurisdiction. What we want to avoid is to have an assessment methodology for EU issuers and another one for issuers out of other regions. We want to have the same demanding approach on all green bonds so we looked at the EU taxonomy, but also at the climate bond initiative criteria which are very similar on many aspects. The EU taxonomy and the EU Green Bond Standard are nice to have, but we cannot only rely on that in our green bond investments.

Hoarau, CACIB: To conclude, we are living in unchartered territory. Another Lehman moment could be just around the corner. How do you see things evolving from where we currently are? What is the direction of travel?

Boiral, Amundi: I think it is a bit difficult to be optimistic before year end. More and more people are expecting that we will be in recession next year. Looking at credit, what we heard is that sometimes it is already embedded in the pricing, which I am not so sure. The reason is that we have seen that the market is usually very short term and I have some difficulties to imagine that it could be worse during the next six months.

For the time being, we stay very cautious. As soon as we see less volatility in the rates universe, then we could see credit coming back again. It is difficult to say that you are going to have 1% more on your credit if on the rates side we don't know if we are going up or down 1% during the day. I think the first step is really to calm down on the rates side and so to have an idea about where the ECB is going to end up. As of now, I am not sure we are totally agreeing where the ECB or even the FED are going to end up.

Coming back to my previous point, this is why we are very much more interested in covered bonds: it's a good in-between. You can have swap spread without credit spread which could widen by a lot. So you are not totally excluded from the carry. But we are staying cautious.

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