

Breaking new ground in Sustainable Investments

NAM's Sustainable Investments methodology for European Covered Bonds

May 2024

Key takeaways

- As a leader in both ESG and in the European Covered Bonds space, Nordea Asset management (NAM) has developed a methodology which we believe to be optimal for assessing Sustainable Investments¹ in Covered Bonds. This methodology applies to NAM's covered bond fund family
- The absence of mandatory ESG-related reporting requirements on the level of covered pool and the relative lack of voluntary reporting to date make the assessment of sustainable investment a challenge
- NAM's methodology uses a set of carefully designed proxy calculations to address this challenge and is complemented by NAM's engagement efforts with issuers to collect and publish cover pool climate data

What makes a covered bond sustainable – in practical terms?

Covered bonds are usually issued by banks, securitized against a so-called "cover pool" of mortgage loans (with property as collateral).

When asset managers assess the ESG status of fixed income instruments, they typically assess the issuer's ESG performance. For covered bonds, however, it is more appropriate to look at the sustainability of the cover pool – the asset behind the bond – rather than the issuing bank's sustainability status.

Ultimately, the cover pool's sustainability level is related to the sustainability of the buildings whose mortgages provide the security. And the key "sustainability" characteristic of a building will typically be its emissions².






Buildings' emissions are determined by the amount of energy used for heating or cooling of the building and the type of energy used.

We view a "sustainable" building as one whose emissions are low enough to meet the EU's Paris Agreement targets³.

What are covered bonds?

Covered bonds are securitized against a cover pool. They also have a favourable treatment under the EU's banking regulation. This combination gives investors a double layer of protection that has kept the asset class completely free from defaults over the last 200 years.

Housing emissions illustration: comparing emissions factors for two houses in Northern Europe

	External temperature	Insulation level	Energy source	Overall housing emissions
House A				Low
House B				High

1) Sustainable Investments as defined by the EU's Sustainable Finance Disclosure Regulation. 2) EU Taxonomy Regulation (EU) 2020/852 section 24, "An economic activity that pursues the environmental objective of climate change mitigation should contribute substantially to the stabilisation of greenhouse gas emissions by avoiding or reducing them or by enhancing greenhouse gas removals. The economic activity should be consistent with the long-term temperature goal of the Paris Agreement ..." and EU 2020/852 article 10 1(b) "improving energy efficiency, except for power generation activities ...". 3) In 2015, world leaders agreed on ambitious new goals in the fight against climate change. The Paris Agreement presents an action plan to the increase in global average temperature to well below 2°C above pre-industrial levels. <https://www.consilium.europa.eu/en/policies/climate-change/paris-agreement/>.

When comparing different buildings, their energy usage – typically driven by the combination of local temperatures and the building’s insulation – and the type of energy used will drive different emissions status. For example, a building with high insulation whose energy is fully renewably-sourced will have low emissions (Building A in the table above), while another building with the same weather conditions but that has poor insulation and relies on fossil fuels will be responsible for high emissions (Building B).

What makes a covered bond sustainable – in regulatory terms?

The EU’s Sustainable Finance Disclosure Regulation (SFDR) sets out three criteria that must be met when identifying an asset as a Sustainable Investment, but the regulation does not specify the methodology managers must use when meeting the criteria. Our methodology starts with a decision as to how we should assess each of the three criteria with respect to covered bonds.

Regulatory criteria for SI (all asset classes)	1 Environmental or Social Contribution	and	2 Do No Significant Harm	and	3 Good Governance
NAM/s approach for covered bonds	<ul style="list-style-type: none"> • Issuer’s sustainability not relevant • Focus on cover pool data • The key factor = cover pool’s emissions • Looking for Paris alignment 		<ul style="list-style-type: none"> • Cover pool’s “harm” is also its emissions • Other harm factors (e.g. biodiversity impact) are not considered because they are mitigated by building regulations 		<ul style="list-style-type: none"> • Governance is at issuer level e.g. sound management structure, employee relations, staff remuneration, tax compliance

In theory, to assess the sustainability of a covered bond, we establish:

1. How far the underlying houses are aligned with EU’s Paris Agreement targets	1 and 2 are both about cover pool emissions, which lie on a spectrum from sustainable up to high emissions. 2. We do not assess other harm factors (such as biodiversity impact), as they are mitigated by building regulations.
2. The harm caused by producing the energy	
3. Whether the issuer meets NAM’s standard Good Governance guidelines	You can read more about NAM’s assessment of Good Governance and our broader approach to Sustainable Investments here .

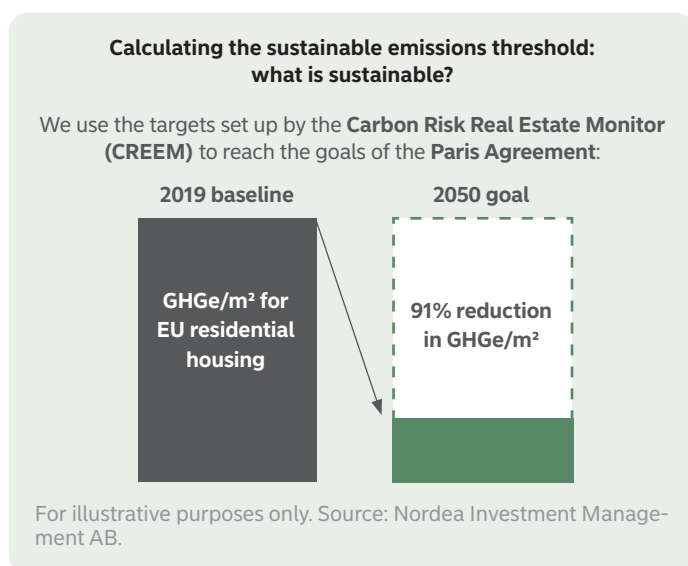
In practice, it is not so straightforward because in Europe, issuers currently rarely provide cover pool emissions data. Furthermore, there is currently no market-agreed measure of what level of housing emissions we could consider sustainable. As a result, we have established a thoughtful approach based on appropriate proxies for the missing data.

Measuring sustainability in housing emissions

The real goal of sustainable investments is to meet the goals of the Paris Agreement. The Carbon Risk Real Estate Monitor (CRREM) has calculated that we need a 91% reduction in EU Real Estate’s Greenhouse Gas emissions (GHGe) from a 2019 baseline in order to reach a sustainable level of real estate emissions as per the Paris Agreement⁴.

From this, we define the level of emissions that is “sustainable” is the remaining 9% of the 2019 baseline GHG emissions. We have used this absolute emissions level to calculate a sustainable emission threshold per m² of a building⁵. Anything below this we consider fully sustainable. Most covered bonds are somewhere between the 2019 emissions level and our sustainable threshold.

The sustainability level of the covered bond depends on how close the cover pool’s emissions are to our sustainable emissions threshold.



4) <https://www.crrem.eu/stranding-risk-carbon/>. 5) Calculated according to PCAF: <https://carbonaccountingfinancials.com/files/downloads/PCAF-Global-GHG-Standard.pdf>.

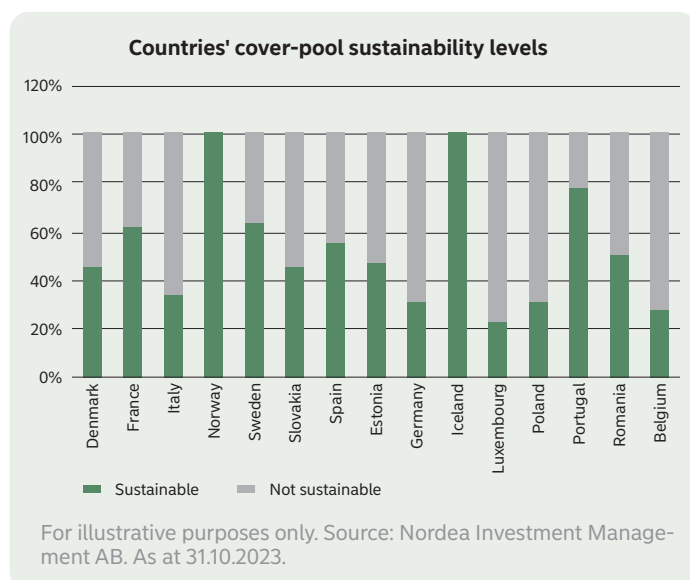
Finding a proxy for cover pool emissions data

In an ideal world, we would base our calculations on cover pool emissions data provided by the issuer. However, as of 2023, only 7 of the 200+ European issuers of covered bonds publish their cover pool emissions data so we need to find a suitable proxy.

Our starting point here is to look at housing emissions at the national level. The initial basis for this is data about residential energy use⁶. Combining the

- **energy use in kWh/m²** per country in residential housing energy use with
- each country's **proportion of renewables/low carbon** in their national energy mix

we can estimate a country's **national level housing emissions**. Using the sustainability threshold based on the CRREM data, we can therefore calculate the sustainability of a country's cover pool. In the absence of issuer cover pool data, we will use this national level emissions data.



If we are able to improve the granularity, with a certain amount of cover pool data from an issuer – albeit incomplete – we prefer to use that. Where we have incomplete issuer data, we combine it with national level data to calculate a better proxy at the issuer

level. For example, if an issuer has issued Green Bonds from the cover pool, we blend these “sustainable” emissions with the national level data to estimate a more specific cover pool emissions level for that issuer.

This issuer-level cover pool data would be our first choice of proxy, if we can calculate it. However, this applies only to a very limited set of issuers so we are more usually using national emissions data as our proxy.

Estimations forever? Engage for change

Although only a handful of issuers currently publish sustainability data about their cover pools, we are engaging with issuers to encourage them towards better disclosure (Energy Performance Certificate ratings, energy intensity and GHG emissions) using standardized formats such as Harmonised Transparency Template. In 2022 we engaged with 21 issuers across Europe, and in 2023 we have continued engagement with 5 of those and started new engagements with another 16 issuers. The engagements we have undertaken so far have confirmed the assumptions we have made in our methodology.

Conclusion

At NAM, we have been making ESG calculations with best-available data for many years. The EU's SFDR and Taxonomy regulations have already brought a raft of new data to the market (e.g. the Principal Adverse Impact metrics), both from third-party providers and also from companies themselves. The Corporate Sustainability Reporting Directive (CSRD) will ensure that more data is available for investors as we go forward. At NAM, we already had in place an ESG data platform that was able to manage and process a vast quantity of data, and greater disclosure is a key topic for engagement for us – across all the asset classes.

Drawing upon our ESG expertise and our deep knowledge of the European Covered Bond asset class, we have developed a unique methodology which we believe is optimal to assess the sustainability of covered bonds. This new methodology will enable investors to understand and measure their exposure to Sustainable Investments when investing in NAM's Covered Bond funds.

6) https://ec.europa.eu/energy/eu-buildings-factsheets_en.