European Banks – Quarterly ESG Update (4Q22)

- ESG bond issuance volumes set for moderate growth in 2023 as uncertainties set to subside
- COP15 puts biodiversity centre stage among ESG investors after landmark framework was agreed. Market-led initiatives could pave way for timely adaptation of disclosure requirements
- Primary market volumes declined in 4Q22 for SSAs and FIGs. 2023 ESG supply expected from inaugural transactions from smaller sovereigns as well as expanded agency and Supra mandates
- Secondary market spreads and greeniums less volatile in 4Q22 but remained exposed to liquidity constraints. New policies and greater investments into clean energy expected to provide relief

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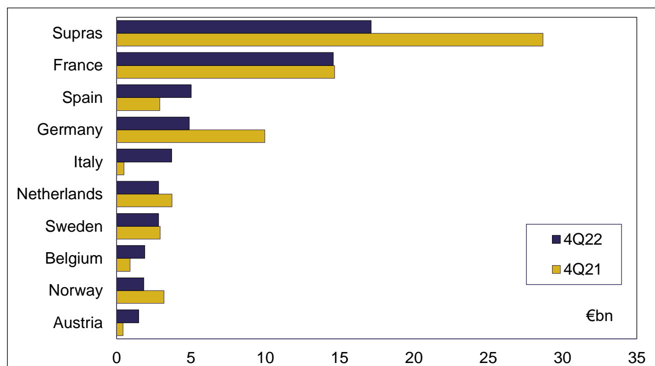
Overview: Declining 2022 ESG volumes expected to give way to modest 2023 growth

In 4Q22, ESG bonds across all sectors – comprising green, social and sustainable bonds – once more lagged volumes issued last year. This resulted in the first ever annual decline of sustainable debt supply. Global ESG bond issuance in 4Q22 amounted to EUR187bn (4Q21: EUR234bn), down 19.9% yoy. Headwinds from global rate hikes, supply-chain disruptions, Europe's energy crisis and recession expectations cooled ESG supply into debt markets in 2022, in line with the developments observed in broader fixed income markets. Total 2022 supply of EUR893bn fell short of our EUR1tr expectation for the year. The strongest annual declines were registered among SLBs (-54.8% yoy), Sustainability (-46.4% yoy) and green bonds (-17% yoy). Social bonds halted their downward trend and grew again (+42.3% yoy).

In Europe, ESG-linked bond sales from SSAs and FIGs reached EUR63bn in 4Q22 according to Bloomberg data, down 24.8% yoy. Of that total, green bond sales amounted to EUR36bn (-35.5% yoy), social bond volumes stood at EUR21bn (+87.9% yoy), and sustainable bonds accounted for EUR6bn (-65.3% yoy). Entities from Germany, France and Italy led European ESG debt issuance in 4Q22 alongside Supra-nationals. ESG-themed bonds issued by European financial institutions fell by EUR3.5bn from a year earlier to EUR25bn (-12.1% yoy) last quarter, and SSA volumes registered an even larger decline of EUR17.4bn to EUR38bn (-31.4% yoy).

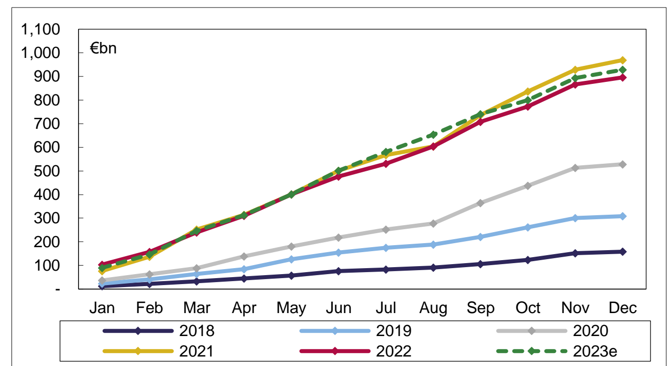
The 2023 outlook entails modest growth expectations compared to 2022. Uncertainties from last year around monetary policy, energy prices or funding conditions are expected to subside, reducing market volatility in favour of a more conducive environment. The cycle of rising rates should gradually come to an end as inflation slows, making funding conditions somewhat more predictable and bringing issuers that had previously put their deals on hold back to the market. Among SSAs, smaller issuers will likely contemplate inaugural ESG issuance in 2023, adding to the bulk of supply expected from larger players like the EU, CADES or IBRD. Bank volumes in contrast will likely stagnate or fall further as the expected recession should lead to lower lending requirements, limiting the potential for sustainable funding.

European ESG Bond Issuance by Country



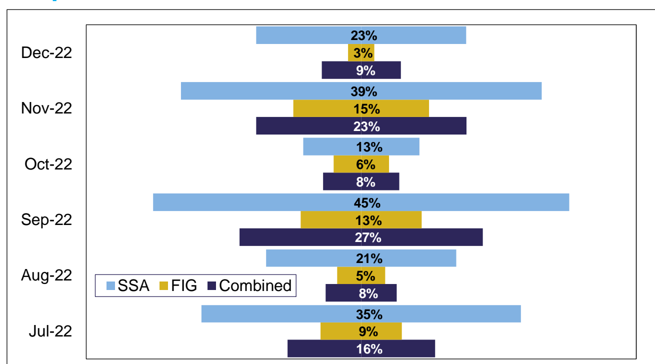
Source: Bloomberg; Daiwa Capital Markets Europe Ltd.; includes FIGs & SSAs

Cumulative annual sustainable debt transactions*



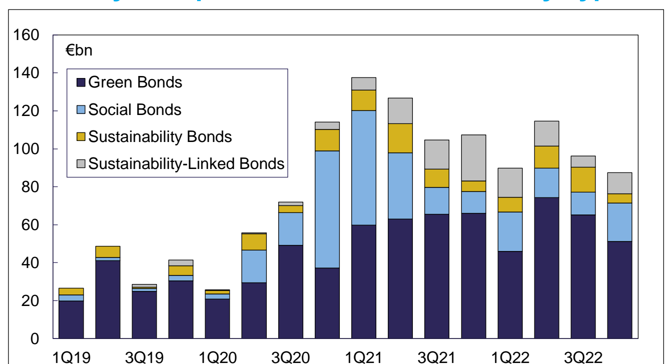
*Source: Bloomberg; Daiwa Capital Markets Europe Ltd.; FIG, SSA & Corporates; *excl. securitisations, green loans and sustainability-linked loans*

Proportion of ESG themed debt to total issuance*



*Source: Bloomberg; Daiwa Capital Markets Europe Ltd.;*in EUR by European issuers*

Quarterly European ESG Bond Issuance by Type



Source: Bloomberg; Daiwa Capital Markets Europe Ltd.; FIG, SSA & Corporates;

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Biodiversity may become an investor priority after landmark agreement

After several delays, the second part of the UN's COP15 biodiversity conference took place in December with the aim of drafting a new global treaty to halt and reverse biodiversity losses and implement the Post-2020 Global Biodiversity Framework (GBF). The conference also raised awareness and interest in biodiversity among green bond investors and issuers, as currently only 17% of sustainable bonds globally reference biodiversity in one way or another in their use of proceeds. Unlike COP27, which took place the previous month and focused on adaptation and mitigation of climate change, COP15 managed to produce a framework on how humanity can restore, protect, and sustainably use biological diversity and natural resources. According to the UN's Open-ended Working Group (OEWG) that drafted the framework, the reason that these preservation efforts matter is because healthy ecosystems support 55% of global GDP and inaction towards preservation and conservation will inevitably result in further large-scale decline of natural resources and mass extinction of species.

The adopted framework, also referred to as the '30x30 pledge', comprises 195 countries that agreed to preserve 30% of land and sea ecosystems by 2030, as well as to restore 30% of the planet's degraded terrestrial, inland water, coastal, and marine ecosystems. Among the 23 articulated targets, it was also agreed to identify, eliminate, phase out, or reform incentives, including subsidies, harmful for biodiversity by at least USD500bn while mobilising some USD200bn per year for positive action by 2030. However, concerns may arise around the seeming lack of accountability that will likely test the resolve of signatories. Moreover, the US was conspicuous by its absence from the framework, as it is pursuing its own nature preservation law, in scope similar to the '30x30 pledge'. One of the stated goals of the OEWG's document is to direct public as well as private financial flows towards these objectives, thus targeting an increasingly interested investor base of corporates, FIGs and SSAs. COP15 has certainly raised awareness on the subject of biodiversity and will help issuers set tangible targets through the GBF and make these topics a more attractive investment proposition.

ICMA and Bloomberg project category mapping

To identify projects that are biodiverse, one can look towards ICMA's green bond principles that list 10 eligible green project categories and sort them by their biodiversity relevance. Sustainable bonds such as green bonds are generally use of proceeds bonds that fund environmental projects. To estimate the potential of biodiversity projects, we mapped ICMA principles against Bloomberg's ESG Project Categories in order to assess market data. Although Bloomberg's categories closely align with ICMA's, they do not entirely correspond to them. Nevertheless, we use them as a proxy to gauge the market potential of biodiverse projects. It should be noted, however, that biodiversity may be listed as one of several uses of proceeds, but issuers might not allocate funds towards it, despite their green bond or sustainable bond frameworks allowing them to do so. In fact, Bloomberg will list biodiversity as a project type even if the issuer does not, which may overstate the actual share of biodiverse or adjacent projects as a proportion of ESG bonds issued.

Bond Use of Proceeds - Project Mapping and Amount Outstanding*

Project Type	ICMA Green Bond Project Categories	Bloomberg Project Categories	% of ESG Bonds* (Global)	% of ESG Bonds* (Europe)
Biodiversity	Terrestrial and aquatic biodiversity	Terrestrial and aquatic biodiversity conservation	17%	21%
Biodiversity Adjacent	Pollution prevention and control	Pollution prevention and control	30%	30%
	Sustainable water and wastewater management	Sustainable water management	26%	24%
	Environmentally sustainable management of living natural resources and land use	Agriculture and forestry	17%	20%
Non-Biodiverse	Renewable energy	Renewable energy	56%	55%
	Energy efficiency	Energy smart technologies and energy efficiency	43%	43%
	Clean transportation	Clean transportation	44%	43%
	Climate change adaptation	Climate change adaptation	19%	23%
	Circular economy adapted products, production technologies and processes and/or certified eco-efficient products	Eco-efficient products, production technologies and processes	11%	14%
	Green buildings	Green buildings and infrastructure	30%	27%

Source: ICMA; Bloomberg; Daiwa Capital Markets Europe Ltd.; *Amounts outstanding against ESG labelled universe. Bonds referencing biodiversity as potential use of proceeds. Does not reflect how much has actually been allocated to biodiversity. Data as of 27.01.2023

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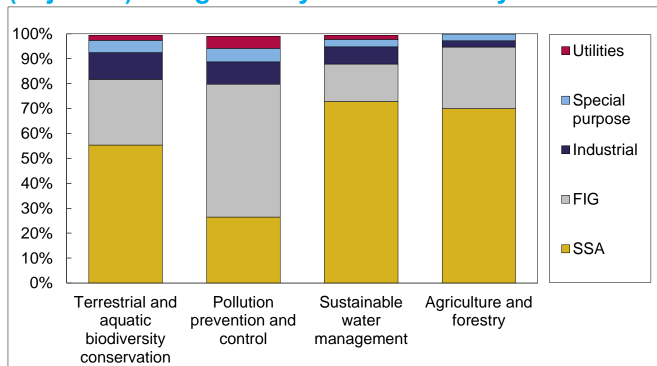
According to Bloomberg data, the biodiversity project category 'Terrestrial and aquatic biodiversity conservation' is referenced by 17% of sustainable bonds outstanding globally (21% in Europe), which in nominal terms amounts to EUR480bn and EUR382bn respectively. The three adjacent categories are listed similarly often with 'Pollution prevention and control' the largest of the three, referenced by 30% of ESG bonds outstanding both globally and in Europe. However, the data also show that the majority of the proceeds tend to reference traditional green bond projects such as 'Renewable energy' or 'Clean transportation' projects. Ultimately, for a more precise reflection of the market, one needs to look directly at the issuer allocation reports that list the types of projects that were financed with the capital raised.

Biodiversity guidelines in sustainable debt markets today

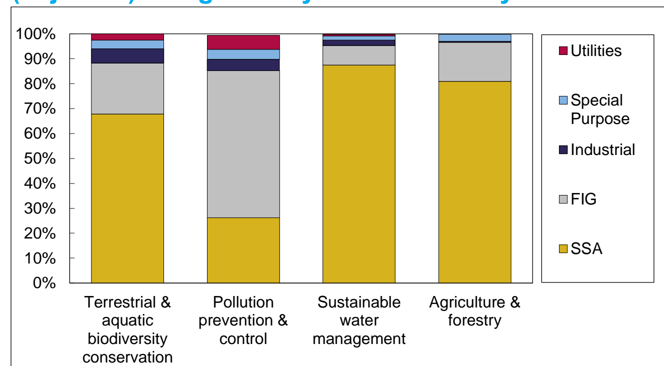
Although the majority of biodiverse or adjacent projects are financed under the green bond label, their specialised format may only appeal to a sub-segment of issuers and investors that are more exposed to deteriorating natural resources and environments such as oceans or forest spaces. This also raises the question of how to effectively measure the impact of biodiversity investments, as appropriate benchmarks will vary by sector and issuer and cannot simply be linked to a uniform indicator such as CO_2 reduction. One attempt to provide guidance comes from the International Finance Corporation (IFC) that published guidelines for financing the blue economy in January 2022. It outlines how green bonds can fund ocean-related projects. For instance, any blue bond project with the aim of financing offshore renewable energy facilities is encouraged to do no harm to marine ecosystems and should include additional features such as fisheries' sanctuaries for certain marine species, substantial artificial reef elements, and other additional measures promoting marine biodiversity. However, the creation of no-fishing zones or natural resource conservation requires environmental monitoring during operations, which adds effort and additional costs. Consequently, blue bonds remain a niche segment of the sustainable debt landscape.

Global ESG bonds referencing biodiversity (adjacent) categories by issuer industry



Source: Bloomberg; Daiwa Capital Markets Europe Ltd.

European ESG bonds referencing biodiversity (adjacent) categories by issuer industry



Source: Bloomberg; Daiwa Capital Markets Europe Ltd.

Market-led disclosure initiatives already underway

The Taskforce on Nature-related Disclosures (TNFD) that was launched in 2021 brings together a variety of financial institutions, corporates and market service providers with over USD20tr in assets. The stated objective of TNFD's members is to develop a risk management and disclosure framework for organisations to report and act on evolving nature-related risks, with the ultimate aim of supporting a shift in global financial flows away from nature-negative outcomes and toward nature-positive outcomes. The hope is to have the same impact as the Task Force on Climate-related Disclosures (TCFD) once had for climate risk. TCFD eventually transitioned from a voluntary initiative to a mandatory reporting requirement in a number of countries, including the UK and Japan, which has the largest number of TCFD supporting companies in the world. The TNFD published the third version of its framework in November 2022 with further interim iterations planned for 2023 before the final version is expected to be published in September.

In the wake of COP26 and sprawling regional climate-related disclosure requirements appearing, the International Sustainability Standards Board (ISSB) was formed to create a key global standard-setting body. So far, it has worked towards bringing together existing disclosure frameworks to deliver a consistent and harmonised reporting standard for capital markets. One of the key announcements coming out of COP15 was that the ISSB would seek to advance work on climate standards to incorporate connections to natural capital (e.g. forests, water, and biodiversity) and the just transition (e.g. human capital, supply chains, and indigenous rights). We believe the ISSB might therefore build on the work conducted by the TNFD once it is finalised, to more rapidly introduce these standards. When Japan hosted COP10 in 2010, governments agreed on the 'Aichi biodiversity targets', aimed at living in harmony with nature by 2050. However, a number of reports since then, most notably the 2020 UN Global Biodiversity Outlook concluded that governments had failed these targets. The GBF is an attempt to rectify this and formulated this intent across four overarching goals and 23 individual targets. The importance of integrating financial institutions and the private sector more broadly was recognised and is thought to be articulated in Goal D as well as targets 14 and 15. Integration of biodiversity into policies, transparency and financial flows is key. But successful implementation of COP15 agreements will likely only be visible by the time COP16 takes place in 2024 in Turkey, when national biodiversity action plans should be produced.

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Primary markets in 4Q22

SSA ESG issuance volumes in 4Q22 reached EUR38bn (-43% qoq) of which 47.5% had a social bond indicator, 40% were green and 12% were labelled sustainability bonds. Social bond volumes were up considerably during the quarter (+43.3% qoq) but this was largely attributable to a single EUR6.5bn transaction by the European Union closing out its SURE programme with a 15-year bond. The overall supply boost from social bonds was not sufficient to offset strong declines among green (-42% qoq) and sustainability (-83% qoq) bonds. Despite the overall number of SSA transactions rising slightly to 93 from 91 in 4Q22, the average amount issued per transaction almost halved to EUR409m (-44% qoq). 4Q22 SSA supply was focussed on the front-to-middle segment of the curve with the majority of deals carrying a 3-5-year tenor (49%) followed by 15-20 years (13%) and 1-3 years (8%).

SSA - Top 10 European ESG Issuers FY22

Issuers	Total Issued (€m)*	Average Tenor (years)
CADES	36,507	7.4
European Union	25,718	17.4
IBRD	25,366	7.9
EIB	14,726	6.2
KfW	9,695	3.2
IDA	6,339	15.1
IADB	6,078	6.8
Italy	6,000	12.6
BNG Bank	5,275	9.7
Germany	5,000	5.1

*Source: Bloomberg, *Cumulative issuances FY22*

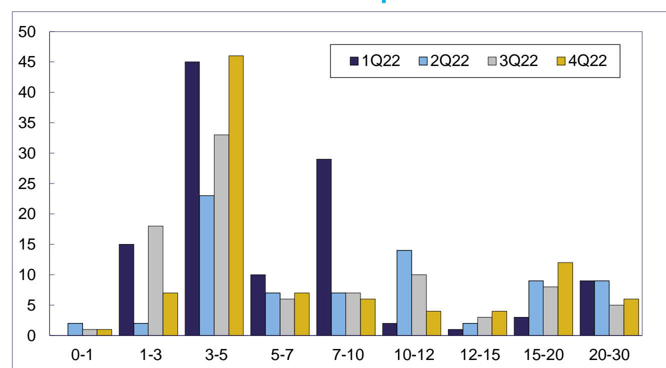
Total sustainable debt issued by SSAs in 2022 (EUR212bn) lagged volumes by 26% yoy after enduring a year of volatility and transition. However, we expect overall funding to pick up again in 2023, driven by the need to address the ongoing energy crisis, which includes finding sustainable alternatives to fossil energy. The list of sovereign issuers with ESG offerings will likely expand to smaller European countries contemplating their inaugural transactions, in addition to the continuous and steady supply from Supras and agencies such as the EU, CADES, UNEDIC or BNG.

In December, the Commission, on behalf of the **European Union**, announced its intention to issue EUR80bn of long-term bonds during 1H23, which at this pace would imply a new full-year record in 2023. The new funding plan was presented alongside a new strategy that will launch single-branded “EU-Bonds”, which in turn will fund the NGEU (EUR70bn) and Macro-Financial Assistance (MFA) programmes (EUR10bn). However, the green component will continue to be financed through separately designated NGEU green bonds. The intention behind the unified label is to more coherently communicate funding requirements and streamline issuance by centralising the lending and borrowing process. This should reduce fragmentation stemming from policy-related bond issuance and support liquidity across the curve. In recognition of their increasing liquidity, the ECB has recently placed EU-Bonds on par with sovereign debt by moving them up to the highest ‘haircut category’. This will inadvertently reignite the debate around the safe-haven potential of these bonds.

We also expect additional supply of sustainable debt from the **European Investment Bank (EIB).** As one of the largest supranational issuers, in 2022 it started to issue its Climate Awareness Bonds under its Euro Area Reference Note (EARN) programme, which makes up ~35% of its total funding. EARNs are typically larger in size than the EIB’s other Euro issuance, coming in at EUR3bn-5bn, thus we expect the share of the EIB’s green and sustainable bond issuance (27% of total at 1H22) to continue to rise. Total 2023 funding volume is expected to be EUR45bn.

Another European institution, the **Council of Europe Development Bank (CEB)**, is also likely to expand its funding base over the near term as demands on the development bank increased following the Covid-19 pandemic and Russia’s invasion of Ukraine. This is already reflected in its funding authorisation for 2023 that has risen to EUR7bn. Given the update to its Social Inclusion Bond Framework in early 2022, we expect growing social bond supply from CEB. The humanitarian crisis brought on by the war in Ukraine has resulted in increased initiatives required to assist migrants and their host communities as well as other social challenges across Europe. To meet these new challenges the governing board of the CEB approved the strengthening of its capital base as part of its new strategic framework 2023-2027. The significant strengthening of the capital base with EUR1.2bn in new paid-in capital was agreed by shareholder governments, of which Germany, France, Italy and Spain hold a combined stake of 61% as at 1H22. The improvement in CEB’s capital position will likely play a role in upcoming credit rating decisions from major agencies as it is currently rated ‘Aa1/ AA+/ AAA’ by Moody’s, Fitch and S&P. Fitch currently maintains a positive outlook on the rating and Moody’s has recently placed CEB’s ratings under review for upgrade. Positive rating action would solidify its position within the ‘AAA’ rating category and would have a beneficial effect on future funding costs. However, these considerations would need to be weighed up against downward pressure on credit quality stemming from the bank’s borrowers. The prospect of Ukraine soon becoming a member state and borrowing from the bank, coupled with large exposure to Turkey may add pressure to capitalisation and asset-quality metrics over the foreseeable future.

Number of SSA transactions per tenor bucket



Source: Bloomberg; Daiwa Capital Markets Europe Ltd.

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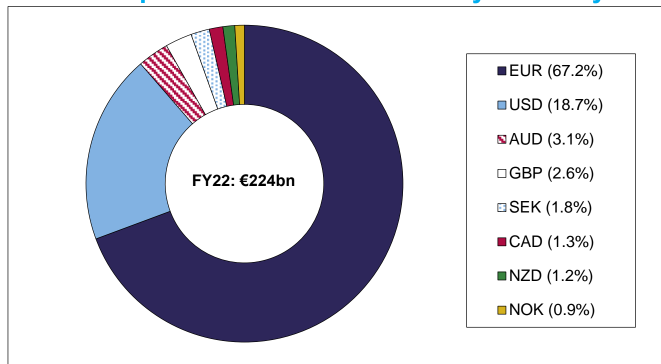
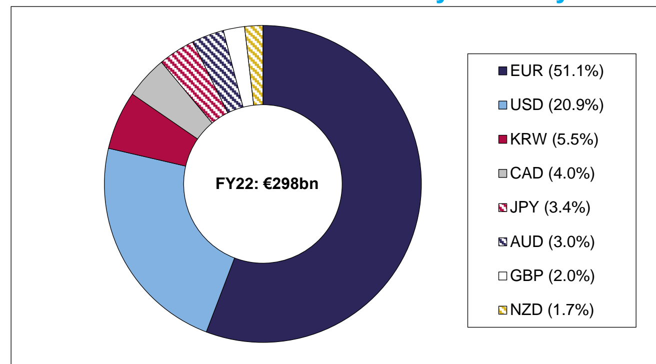
FY22 European ESG SSA issuance by currency



Source: Bloomberg; Daiwa Capital Markets Europe Ltd.

FY22 Global ESG SSA issuance by currency



Source: Bloomberg; Daiwa Capital Markets Europe Ltd.

Total **FIG ESG** volumes in 4Q22 reached EUR25bn (-12.1% yoy). Primary market activity was mainly geared towards November (44% of all deals), followed by October (36%) and December (20%). Throughout the quarter, conditions remained challenging for issuers, with spreads remaining at elevated levels. Market sentiment started to improve somewhat towards the end of the quarter as select data pointed towards a gradual slowdown in the pace of rate hikes even as central banks maintained relatively hawkish guidance. However, frantic primary market activity in January 2023 also implies that many issuers maintain a rather uncertain outlook for the rest of the year, as they front-loaded some of their annual funding requirements. From a credit perspective, banks entering this period come from a position of relative strength, but they will likely feel the diminishing benefits of rising rates as the credit focus increasingly shifts to rising asset risks, increased borrowing costs and rising operating expenses.

FIG - Top 10 European ESG Issuers FY22

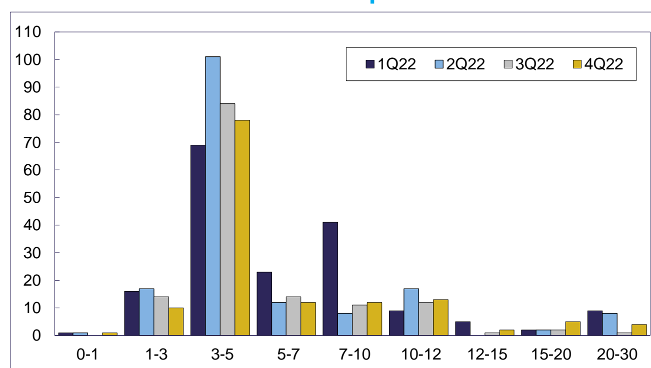
Issuers	Total Issued (€m)*	Average Tenor (years)
Helaba	4,892	6.8
Vonovia	4,122	5.7
DNB Bank	3,099	4.4
CaixaBank	3,000	7.0
ABN Amro	2,750	7.4
Berlin Hyp	2,551	5.0
ING	2,500	7.5
AIB	2,500	5.4
Deutsche Bank	2,453	5.6
SEB	2,000	4.7

*Source: Bloomberg, *Cumulative issuances FY22*

4Q22 saw a continued overhang of senior trades with shorter tenors but eventually longer-maturity trades returned and more subordinated deals were placed. Average bond maturities were mostly concentrated in the 3-5 year maturity bucket (57% of total), followed by 7-10 years (10%) and 5-7 years (9%). The treatment of subordinated debt will likely be a key theme in 2023, as mostly smaller FIGs still need to access markets to meet their MREL requirements. Call risks of AT1s and Tier 2 bonds are likely elevated in 2023, particularly for AT1s, as they do not lose their regulatory treatment past their call date, making a non-call more likely for economic considerations. The general outlook for FIGs' ESG-themed bond supply in 2023 is somewhat difficult to determine as it is indirectly driven by the overall balance sheet loan growth and increasingly its composition. The higher rates environment and a possible recession certainly dampen expectations for strong organic growth but persistently high demand for sustainable debt will continue to act as a growth driver. Additionally, the finalisation of the voluntary EU Green Bond Standard and greater transparency from Taxonomy related disclosure requirements as well as the introduction of the Green Asset Ratio in 2024 should be conductive to growth. However, downward pressure on issuance may stem from the greater focus on net-zero efforts and the difficulties that banks face in measuring financed emissions, particularly those with granular loan books. Investor reluctance to purchase debt from entities that are funding carbon-intense activities may increasingly curtail demand.

Peripheral lenders were the most active in 4Q22, generating a combined issuance volume of EUR7.6bn or 30% of the quarterly total. This was split by entities from Spain (53%), Italy (40%) and Portugal (7%). We expect them to continue adding significant supply in 2023 in order to build out their curves, as these are still somewhat underdeveloped compared to some of their core European peers. Sizeable EUR1bn green bail-in deals from repeat issuers **UniCredit** and **Caixabank** were placed, alongside deals from less frequent ESG issuers such as Italy's **Mediobanca.** The latter placed its inaugural sustainable SP bond for EUR500m. The 6NC5 tightened by 30bps on the back of strong interest (3.2x), leaving a new issue premium (NIP) of 10-15bps on the table. When the bond was issued in November, it priced with a similar concession to that observed from other top-tier Italian banks (i.e. Intesa) in prior weeks. As markets improved, lower-tier issuers such as **Banco BPM, Unicaja Banco** or **Caixa Geral** found enough support to place EUR1.8bn in senior deals in late 4Q22.

Number of FIG transactions per tenor bucket



Source: Bloomberg; Daiwa Capital Markets Europe Ltd.

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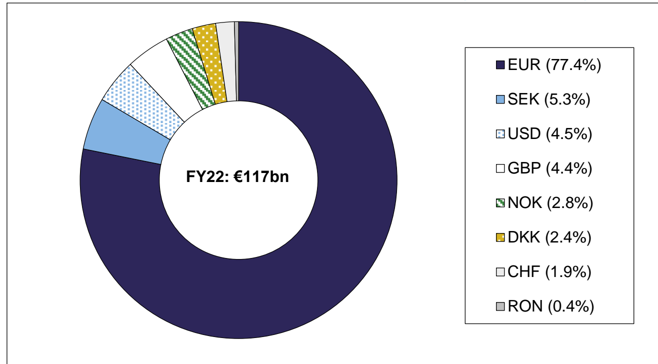
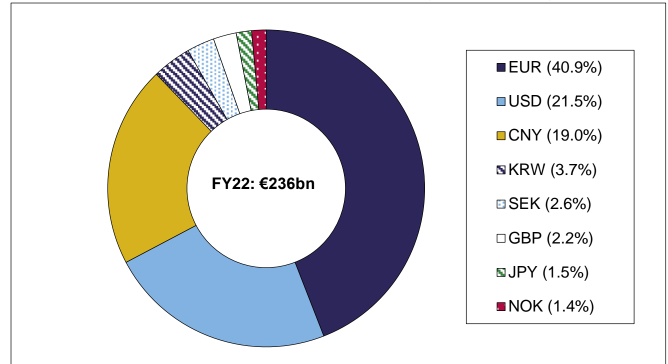
FY22 European ESG FIG issuance by currency



Source: Bloomberg; Daiwa Capital Markets Europe Ltd.

FY22 Global ESG FIG issuance by currency



Source: Bloomberg; Daiwa Capital Markets Europe Ltd.

Key ESG Transactions 4Q22

Bank	Rank	Amount	Maturity	Final Spread (bps)	IPT (bps)	Book Orders
SSA						
EU - NGEU	Sr. Unsecured (Green)	EUR6bn	10Y	MS + 1	MS + 3	>EUR41.9bn
EU - SURE	Sr. Unsecured (Social)	EUR6.55bn	15Y	MS + 21	MS + 23	>EUR25bn
CADES	Sr. Unsecured (Social)	EUR5bn	5Y	OAT + 56	OAT + 58	>EUR16.25bn
CADES	Sr. Unsecured (Social)	USD4bn	3Y	SOFR MS + 46	SOFR MS + 47	>USD5.1bn
AFD	Sr. Unsecured (Sustainable)	EUR1.25bn	10Y	OAT + 55	OAT + 55	>EUR1.3bn
Hungary	Sr. Unsecured (Green)	EUR1bn	4.25Y	MS + 250	MS + 285	>EUR4.1bn
KfW	Sr. Unsecured (Green)	AUD750m	3.25Y	ASW + 24	ASW + 25	n.a.
KfW	Sr. Unsecured (Green)	GBP850m	3Y	G + 90	G + 90	>GBP1.1bn
IFC	Sr. Unsecured (Social)	NZD300m	7Y	MS + 41	MS + 41	n.a.
IDB	Sr. Unsecured (Social)	EUR650m	5Y	MS + 12	MS + 15	>EUR1bn
ADIF	Sr. Unsecured (Green)	EUR500m	7Y	SPGB + 45	SPGB + 45	>EUR560m
SNCF SA	Sr. Unsecured (Green)	EUR500m	5Y	OAT + 73	OAT + 78	>EUR1.3bn
Aut. Com. of Madrid	Sr. Unsecured (Green)	EUR500m	7Y	SPGB + 23	SPGB + 23	>EUR500m
CDC	Sr. Unsecured (Sustainable)	EUR500m	5Y	OAT + 57	OAT + 57	>EUR790m
Eurofima	Sr. Unsecured (Green)	EUR500m	9Y	MS + 19	MS + 22	>EUR1.5bn
FMO	Sr. Unsecured (Sustainable)	EUR500m	5Y	MS - 12	MS - 12	>EUR1bn
NWB Bank	Sr. Unsecured (Green)	EUR500m	5Y	MS - 11	MS - 11	>EUR700m
IBB	Sr. Unsecured (Social)	EUR500m	5Y	MS – 15	MS - 13	>EUR1.7bn
Kommunalbanken	Sr. Unsecured (Green)	CAD500m	5Y	MS + 19	MS + 19	>CAD650m
FIG (Senior)						
ABN Amro	SNP (Green)	EUR1.25bn	7Y	MS + 145	MS + 170	>EUR2.5bn
BBVA	SP (Green)	EUR1.25bn	7Y	MS + 155	MS + 175/180	>EUR1.7bn
UniCredit	SNP (Green)	EUR1bn	5NC4	MS + 285	MS + 315	>EUR2.6bn
Credit Agricole	SNP (Social)	EUR1bn	4NC3	MS + 135	MS + 150	>EUR1.5bn
CaixaBank	SNP (Green)	EUR1bn	8NC7	MS + 240	MS + 265	>EUR1.75bn
SEB	SNP (Green)	EUR1bn	4Y	MS + 118	MS + 140/145	>EUR2.5bn
Sabadell	SP (Green)	EUR750m	6Y	MS + 225	MS + 230	>EUR2.9bn
Intesa	SP (Social)	EUR750m	7Y	MS + 235	MS + 255	>EUR1.3bn
AIB	Sr. HoldCo (Green)	EUR750m	6.25NC5.25	MS + 285	MS + 305	>EUR1.3bn
Credit Mutuel	SP (Social)	EUR750	7Y	MS + 110	MS + 135/140	>EUR1.8bn
Unicaja Banco	SNP (Green)	EUR500m	5NC4	MS + 425	MS + 425	>EUR680m
Caixa Geral	SP (Green)	EUR500m	6NC5	MS + 275	MS + 295	>EUR1.6bn
Jyske Bank	SNP (Green)	EUR500m	5NC4	MS + 250	MS + 265	>EUR850m
Banco BPM	SNP (Green)	EUR500m	5NC4	MS + 330	MS + 360	>EUR1.1bn
Achmea	SP (Green)	EUR500m	3Y	MS + 90	MS + 135	>EUR2.4bn
Argenta Spaarbank	SNP (Green)	EUR500m	5NC4	MS + 275	MS + 300	>EUR1.25bn
Mediobanca	SP (Sustainable)	EUR500m	6NC5	MS + 195	MS + 225	>EUR1.6bn

Source: BondRadar, Bloomberg, Daiwa Capital Markets Europe Ltd.

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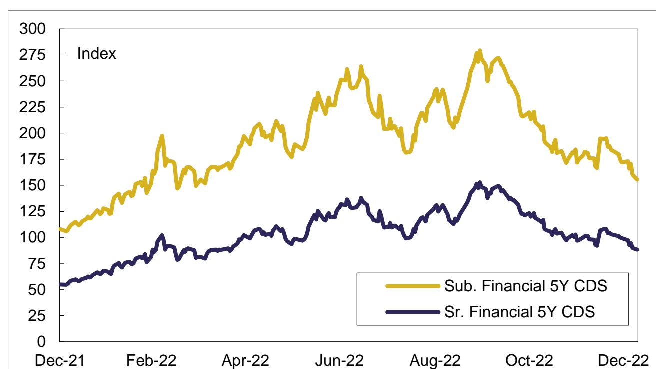
Secondary markets in 4Q22

Market volatility and perceived risk subsided during the quarter, as reflected in the falling CDS price indices of European senior and subordinated financials. Tentative easing of inflation indicators and the expected slowing pace of interest rate rises encouraged trading activity and new bond issuance. Nevertheless, the decision by the ECB's Governing Council to hike rates by 50bps to 2.5% at its December meeting was accompanied by hawkish tones. Despite the moderation in the pace of tightening after two successive hikes of 75bps, the ECB's message was unambiguously hawkish, hitting euro area government bonds. In particular, the policymakers signalled further tightening in 2023, stating that they "judge that interest rates will still have to rise significantly at a steady pace to reach levels that are sufficiently restrictive". The subsequent publication of the meeting's account in January underscored that the policy decision was a compromise between hawks and doves as a large number of members initially expressed a preference for increasing rates by 75bps. Ultimately, the strength of forward guidance and the start of QT in March was considered “broadly equivalent” to a 75bps hike. Looking ahead, Daiwa economists forecast another 50bps hike from the ECB in February. Ongoing tightness in the labour market and persisting concerns of second-round effects on wages, as well as signs of a less severe economic downturn are likely to be cited by Governing Council members who are arguing that "significant" interest rate hikes beyond the February policy meeting are still required.

iTraxx Financials Index 2022



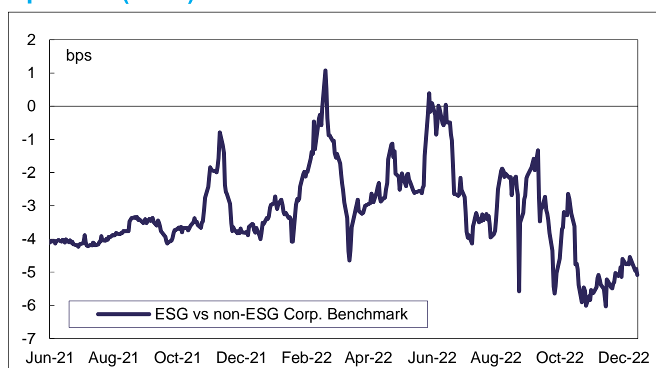
Source: Bloomberg; Daiwa Capital Markets Europe Ltd.

Having hiked by 75bps in November, as expected the Bank of England's (BoE) Monetary Policy Committee (MPC) reverted back to raising rates by 50bps in December - as in August and September - taking Bank Rate to 3.50%. The MPC's statement also signalled the likelihood of additional tightening in 2023 in order to achieve a sustainable return of inflation to its target. In January, BoE Governor Bailey acknowledged improvement in the inflation outlook but remained concerned about upwards pressures on pay growth from labour market tightness. He therefore did not criticise current market pricing of the outlook for Bank Rate, which foresees a terminal rate of no more than 4.50%, before an eventual pivot to easier policy around the turn of the year. Daiwa economists expect a rate hike of 50bps at the next MPC. In the US, meanwhile, the Federal Open Market Committee (FOMC) raised the target fed funds rate by 50bps in December to a range of between 4.25% and 4.50%. While the minutes of the meeting, released in January, underscored that the FOMC anticipated that the tightening process would be ongoing, Daiwa economists share the consensus view of a further slowdown in the pace of hikes to 25bps in February.

Renewable energy investment could result in widening ESG and non-ESG bond spreads

Despite the multitude of challenges in 2022, demand for sustainable debt as a proportion of total debt issued remained broadly stable. In 4Q22, this stability contributed to the development of the option-adjusted spreads (OAS) between the ESG and non-ESG themed indices, which widened for the second consecutive quarter. The median negative OAS differential between the Barclays MSCI Euro-Corporate ESG Index and Barclays Pan-European Aggregate Corporate Index was -5.07bps (from -3.66bps in 4Q21 and -2.70bps in 3Q22). Heightened concerns around energy supply and security earlier in the year contributed to the strong performance of a sub-segment of the non-ESG index comprising oil and gas companies among others. However, the aforementioned energy security concerns have also led to new policies that should result in greater investment into clean energy.
In this context, the [International Energy Agency (IEA)] announced its largest ever upward revision in its forecast for renewable power. Over the 2022-2027 period, global growth in renewables is expected to experience an 85% acceleration compared to the previous five years to be almost 30% higher than what was forecast in last year's IEA report. In Europe, the EU's REPower EU plan will allocate nearly EUR300bn by 2030 towards reduced dependence on fossil fuels, notably from Russia. These measures should ensure a steady supply of projects that require financing, supporting lower spreads while continuing to build out sustainable bond yield curves. As markets absorbed a variety of shocks in 2022, the prospect of a less volatile operating environment and policy tailwinds should support ESG bond spreads.

Spreads (OAS) of ESG vs non-ESG benchmarks

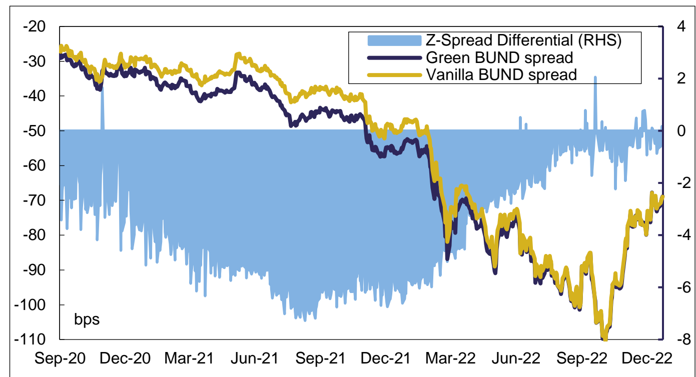


Source: Source: Bloomberg; Barclays MSCI Euro-Corporate ESG Index vs Barclay Pan-European Aggregate Corporate Index

Liquidity remains key driver for narrowing sovereign greenium

The average greenium for liquid sovereigns such as German Bunds continued the trend towards spread equivalence, despite the reduction in the observed spread oscillation. The 4Q22 median spread differential was -0.50bps compared to -6.02bps one year prior. (3Q22: -0.76; 2Q22: -2.45bps; 1Q22: -5.06bps; 4Q21: -5.55bps; 3Q21: -6.02bps; 2Q21: -5.24bps; 1Q21: -4.39bps.) Demand for German Bunds was elevated during most of 4Q22 given the prevailing risk-off sentiment. Investors seeking assets with safe-haven status drove the demand but the narrowing of the 'Twin Bund' spread also implied investor demand for the most liquid assets. As per Bloomberg data, we see that Germany's green bonds tend to be somewhat less liquid than their conventional counterparts, which is a function of the significantly lower amount outstanding. Additionally, sovereign green bond investors tend to have a buy-and-hold approach, limiting liquidity in the market and thus contributing to the narrowing of the greenium. The lower trading frequency in the secondary market also manifests itself in higher bid-ask spreads on average, which in turn results in higher transaction costs.

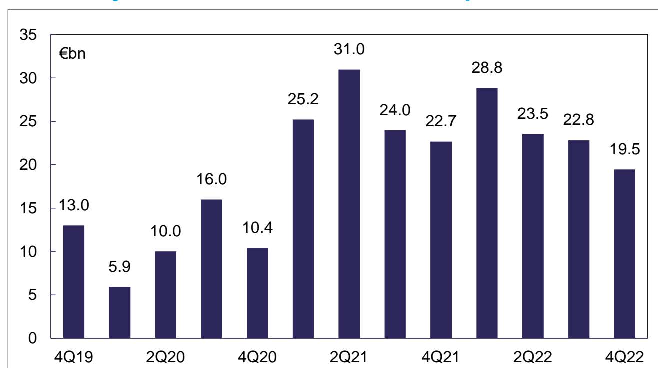
Green vs Vanilla BUND Z-spreads



Source: Bloomberg; Germany Aug-2030 Twin; Daiwa Capital Markets Europe Ltd.

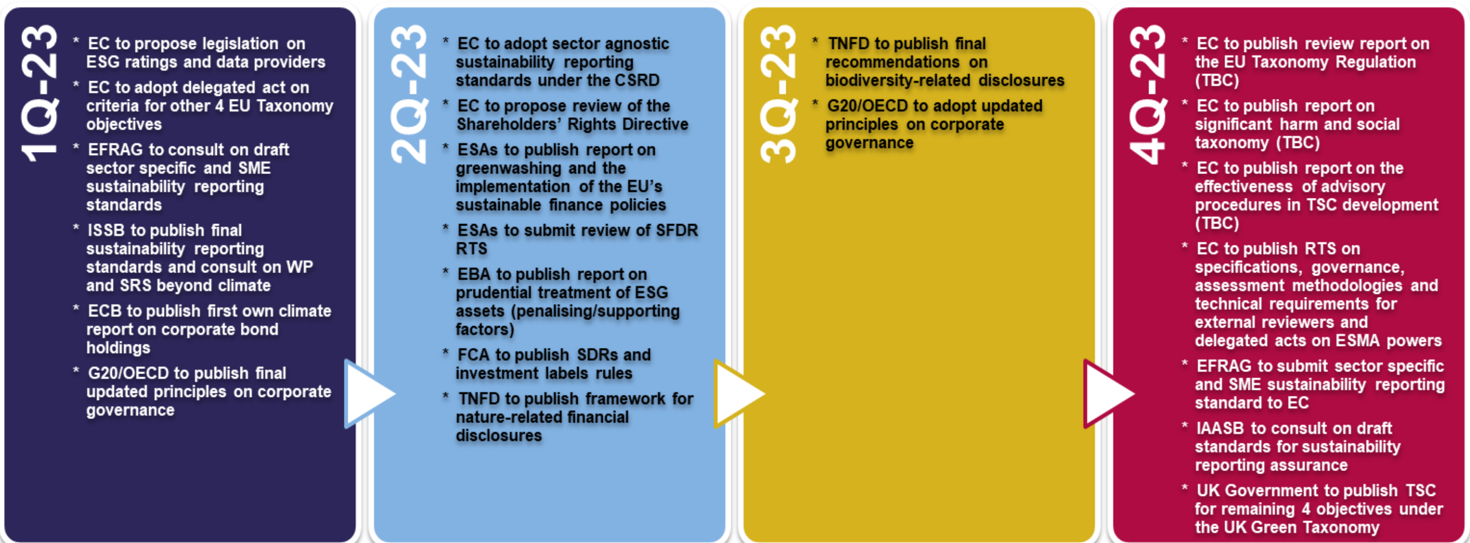
Appendix:

Quarterly ESG Bond Issuance: European FIGs*



*Source: Bloomberg and Daiwa Capital Markets Europe Ltd.; *Green, social, SLB and sustainability labelled bonds >€250m.*

Regulatory Timeline



Source: Association for Financial Markets in Europe (AFME)

Glossary Regulatory Abbreviations: (EC): European Commission; (EFRAG): European Financial Reporting Advisory Group; (ESMA): European Securities and Markets Authority; (ISSB): International Sustainability Standards Board; (SRB): Sustainability Reporting Board; (SDR): Sustainability Disclosure Requirements; (RTS): Regulatory Technical Standards; (TSC): Technical Screening Criteria; (SFDR): Sustainable Finance Disclosure Regulation; (CSRD): Corporate Sustainability Reporting Directive; (IAASB): International Auditing and Assurance Standards Board; (TNFD): Taskforce on Nature-related Financial Disclosures; (FCA): Financial Conduct Authority; (DA): Delegated Acts; (NFRD): Non-Financial Reporting Directive; (PAI): Principle Adverse Impact;

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