Daiwa Capital Markets

European Banks – Quarterly ESG Update (1Q22)

- Challenging start to 2022 ESG landscape sees first year-on-year decline in issuance, but events in Ukraine sharpen incentives for energy transition
- EU Social Taxonomy is taking shape with less reliance on quantitative technical screening criteria
- Lack of label likely to result in transition bonds to be subsumed by other sustainability categories
- Ongoing market volatility has led to further spread widening in both primary and secondary markets. Index greeniums have shown heightened sensitivity to recent selloffs

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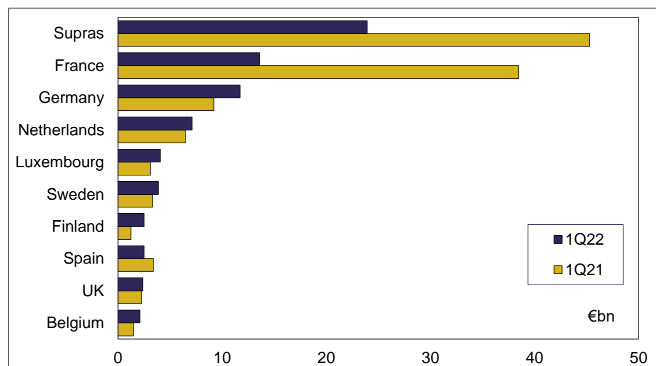
Overview: Challenging start to 2022 for ESG issuance but Ukraine war to spur energy transition

Issuance of ESG bonds – comprising green, social and sustainable bonds – in the first quarter experienced its first year-on-year decline since 2016. Global ESG bond issuance in 1Q22 amounted to EUR210bn (1Q21: EUR231bn), down 9.1% yoy. Geopolitical risks in Europe contributed to the setback as several issuers put on hold new transactions due to highly uncertain and volatile market conditions. The strongest declines occurred among social bonds (-58.6% yoy) while green bonds arguably weathered the declining trend better (-2.3% yoy). The reductions were partially offset by growth in issuance of sustainability bonds (+33.6% yoy) as well as sustainability-linked bonds (SLBs, +141.4% yoy). However, growth for these types of bonds occurred from low levels and thus was insufficient to halt the overall decline.

In Europe, ESG-linked bond sales from SSAs and FIGs reached EUR81bn in 1Q22 according to Bloomberg data, down 41% yoy. Of that total, green bond sales amounted to EUR34bn (-46% yoy), social bond volumes stood at EUR23bn (-63% yoy), and sustainable bonds accounted for EUR24bn (+83% yoy). SLBs totalled EUR2.2bn across an increasing number of deals, including the inaugural transactions by SSA issuers. Entities from France, Germany and the Netherlands led European ESG debt issuance in 1Q22 alongside Supras.

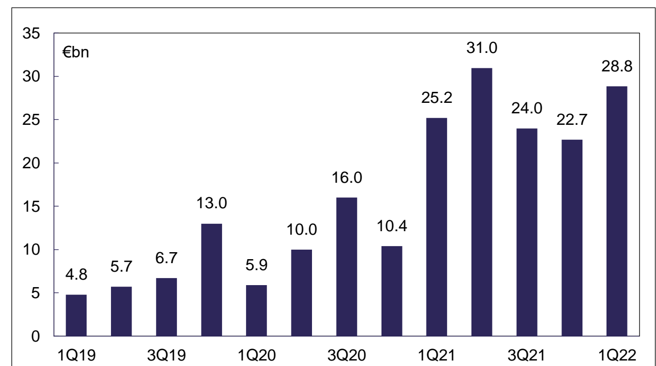
ESG-themed bonds issued by European financial institutions rose EUR5bn from a year earlier to EUR29bn last quarter, but issuance by SSAs fell. Within the euro-denominated space, ESG-themed debt issued by European entities as a share of total FIG and SSA issuance declined as the quarter progressed, reflecting in part the rising market uncertainty caused by events in Ukraine. However, while those geopolitical risks had a dampening effect on themed bond issuance, they strengthened European political urgency for a more rapid transition to renewable and low-carbon energy sources to ensure energy independence from Russia. Indeed, with fossil-based energy prices rises sharply and energy policy having become a security concern, we expect to see growth return to themed debt volumes in the coming quarters, with the possibility of additional EU issuance to fund new energy initiatives over the medium term too.

European ESG Bond Issuance by Country



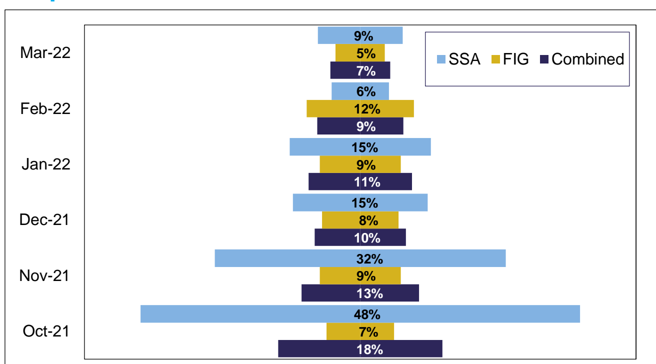
Source: Bloomberg; includes FIGs & SSAs; Daiwa Capital Markets Europe Ltd.

Quarterly ESG Bond Issuance: European FIGs*



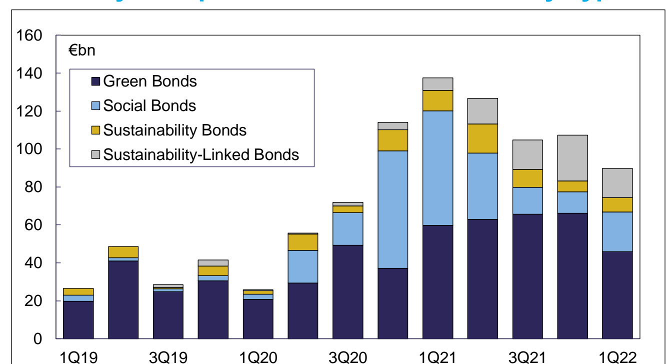
*Source: Bloomberg and Daiwa Capital Markets Europe Ltd.; *Green, social and sustainability labelled bonds >€250m.*

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

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EU Social Taxonomy taking shape with emphasis on qualitative criteria

With some delays, the European Commission's (EC) technical expert group, the Platform on Sustainable Finance (PSF), presented its final recommendations for an extension of the existing EU taxonomy to include social objectives. Unlike the EU's environmental taxonomy the emphasis is placed more on consistency with international standards and consensus documents such as the 'European Pillar of Social Rights' or the 'UN Sustainable Development Goals' rather than science-based technical screening criteria. The development of a social taxonomy is considered to be an important step in ensuring that human rights and improved working conditions feature prominently in a 'just transition' to net zero. The proposal seeks to establish a conceptual framework to support social-policy goals such as the need to minimise hardship for workers, consumers and communities affected by the move away from a fossil-fuel reliant economy. The PSF's prior recommendation of horizontal and vertical social dimensions has been replaced by a simplified framework focused on three groups of stakeholders: 1) Employees; 2) Consumers; 3) Communities.

Main objectives of the proposed social taxonomy		
(i) Decent work Sub-Objectives	(ii) Adequate living standards and wellbeing for end-users Sub-Objectives	(iii) Inclusive and sustainable communities and societies Sub-Objectives
Social dialogue	Healthy and safe products and services	Access to basic economic infrastructure
Living wages and decent working hours	Products to be durable and repairable	Child care and support to children
Providing excellent health and safety	Protection of personal data and privacy	Inclusion of people with disabilities
Avoidance of precarious working conditions	Responsible marketing practices	Community driven decision making processes
Life-long learning and skills programmes	Access to quality healthcare and care services	Avoid and address negative impacts on communities by businesses operations
Social protection in national context	Access to healthy and nutritious food	'Free, prior & informed consent' for indigenous groups
Ending of forced and child labour	Access to good-quality drinking water	Ensure safety & security of affected communities
Equality and non-discrimination at work	Access to good-quality housing	Avoidance of impacts on customary land
Human & workers' rights in the value chain	Access to education & lifelong learning	Freedom of assembly and expression, incl. protection of human-right defenders

Source: Platform on Sustainable Finance; Non-exhaustive list of sub-objectives

Conceptual considerations – The relationship between environmental and social taxonomies

The 'Do No Significant Harm' (DNSH) principle in the social taxonomy will play the same role as under the environmental one. Activities that make contributions to social objectives shall not harm other social objectives. The PSF recognises the complexity of identifying and developing quantifiable criteria to assess the contribution of an activity to social objectives and the DNSH principle, and more work needs to be done in this area. The future relationship between the environmental and social taxonomies is explored and evaluated by conceptualising two possible models, with the goal being to find common ground between them. The first model describes two independent taxonomies defining environmentally and socially sustainable activities respectively. They would be related through minimum safeguards set by the UN and OECD and the respective social and environmental DNSH criteria would form the basis for detailed criteria. The second model suggests a single taxonomy, defining economic activities that are both socially and environmentally sustainable. One drawback of this approach is that it would drastically reduce the number of sustainable activities, as they would have to meet both sets of environmental and social criteria. Whatever solution is selected, the DNSH criteria and minimum safeguards must be comparable. A taxonomy in which these are much stronger or weaker than the other will struggle to gain acceptance.

Reporting requirements and next steps

Ultimately, a successful social taxonomy should minimise and filter out harmful social practices from commercial activities and operations while promoting goods and services that generate positive social contributions. It should be noted that the Commission is not bound by the PSF's recommendations and will likely present its own conclusions from the proposal by end-2022. Further clarification is required on the extent to which the social taxonomy will contain technical screening criteria, the definition of substantial contributions to DNSH, and clarification of minimum social safeguards. We expect entities to be in a good position to meet these requirements as there already are many minimum safeguards such as workers' rights or tax transparency enshrined in national legal texts. Furthermore, data on matters of equality or living wages is already broadly available. Potential complications arise from the PSF's proposal that adds to existing reporting and disclosure requirements companies face under the Corporate Sustainability Reporting Directive (CSRD), the Sustainable Finance Disclosure Regulation (SFDR), and the Sustainable Corporate Governance (SCG) initiative. However, the European Financial Reporting Authority Group (EFRAG) has drafted an approach for non-financial sustainability reporting by companies under CSRD, which in turn is based on the three stakeholder groups mentioned above. By aligning the structure of the social taxonomy to the structure considered by EFRAG, the first step towards avoiding double reporting structures and unnecessary additional administrative costs was taken.

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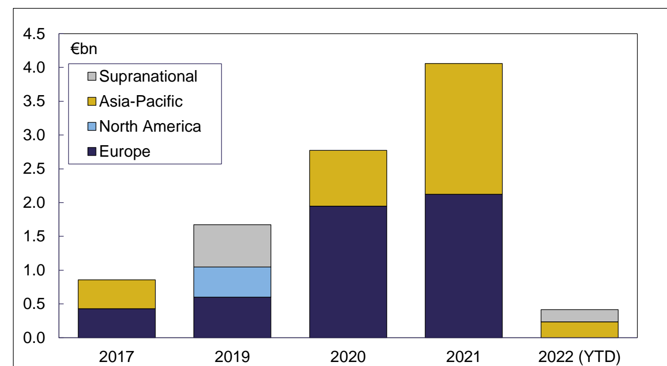
Transition bonds likely to be subsumed by other sustainability labels

Transition bonds often have a mixed reception among ESG investors. For some, they are seen as helping issuers in high carbon-emitting industries to raise the necessary capital to fund their transition from 'brown' or polluting business activities to more environmentally friendly, green business activities. For others, the lack of clarity on what constitutes financing under a transition label and associated fears of potential 'greenwashing' have been major hurdles towards acceptance. The latter likely contributed to slow volume growth across a limited number of transactions. Bloomberg data shows that in 2021 only 11 (self-labelled) transition bonds were issued globally. 2021 issuance reached EUR4.1bn, which is relatively insignificant in a year when global ESG bond issuance totalled some EUR850bn. Of the EUR9.8bn in transition bonds issued since 2017, sector concentration was geared towards Industrials (45% of total), Utilities (17%) and Banking (16%). Despite a growing focus on transition finance to be incorporated into existing frameworks we don't expect to see a surge in transactions under this label. Instead, such issuance is likely to grow under other labels.

Global transition bond volumes by region



Source: Bloomberg; Daiwa Capital Markets Europe Ltd

As it stands, transition finance doesn't have a dedicated framework to which investors and issuers can orient themselves. ICMA published its Transition Finance Handbook in December 2020, essentially an eight-page pamphlet, which only provided basic guidance and common expectations to capital market participants on the practices, actions and disclosures to be made when raising funds in debt markets for climate transition-related purposes. Although ICMA is working to provide further clarity on the existing handbook, the update is unlikely to lead to a standalone label according to statements from its senior management. Some transition projects are already being financed under existing green or SLB labels, and other leading industry bodies are looking for ways to incorporate transitory activities into existing frameworks, recognising their importance in pursuit of net zero. SLBs will likely benefit most from this development as issuers can communicate science-based decarbonisation targets without having to point to specific projects whose greenness or transitory status may be challenged by investors.

Integration of transition activities into existing frameworks

Integration into existing frameworks is already well underway, and in early 2021 the European Commission asked its expert group, the Platform on Sustainable Finance (PSF), to clarify the role of transition activities within the wider EU-taxonomy framework. The PSF responded with an initial report and a public consultation on a conceptual framework. The final report, published in late March 2022, outlined an extended environmental taxonomy encompassing a traffic light system that would move past the dichotomy of green and non-green activities, with the aim of boosting sustainable finance. The report lists 'red' activities that are environmentally harmful, 'amber' activities which do no significant harm and could make a substantial positive contribution; and 'green' activities which are taxonomy-aligned. It also lists a new category of low environmental and climate impact activities (LEnvl) that should not be regarded as either red, amber or green. Rather it would allow enterprises to show that their overall activities that are not considered green do not cause environmental or social harm, thus enhancing their sustainability credentials.

There are several other initiatives currently being developed, many of which have been reviewed in a report by the OECD. The report provides a definition of transition finance, identifying three core eligibility criteria. These are distilled from existing approaches: (i) substitutability (absence of a zero or near-zero alternative); (ii) a commitment by the borrower/issuer to a low-emissions transition trajectory; and (iii) avoidance of lock-in, i.e. investments that prevent the implementation of green alternatives available in the future. The G20 Sustainable Finance Working Group (G20 SFWG) references the OECD report in its G20 Sustainable Finance Roadmap, urging financial regulators to account for the effects of the transition on local communities and SMEs and to address potential adverse effects, such as unemployment, suggesting that this may become an important dimension of sustainable finance in future. The G20 deems these considerations important for developing best practice and standards to guide transition finance.

With many international bodies highlighting the need for a more coordinated and unified approach towards transition finance, the work by the International Platform on Sustainable Finance (IPSF) could be critical in harmonising the various international approaches. The IPSF offers international policymakers a forum for dialogue on sustainable finance regulation and it has recently created a new working group co-led by the EU, Japan and Switzerland to explore how taxonomies, labels as well as corporate strategies and disclosures can integrate transition considerations. The working group aims to develop a report that will inform the G20 SFWG on this subject, having put the integration of transition finance high on its agenda, with initial outputs expected by the summer.

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Primary markets in 1Q22

SSA issuance volumes in 1Q22 reached EUR45bn (-19.2% qoq) of which 44% had a sustainability bond indicator, 42% were social bonds and 14% were social. Green bond volumes in particular experienced significant declines (-81.2%) the shortfall of which could not be made up by rising social bond volumes (+156.1%) and sustainability bond growth (+25.9%). As events in Ukraine unfolded after the Russian invasion in late February, we subsequently observed a 'flight to quality' within primary market issuance. The risk-off sentiment meant that in early March the first couple of transactions came predominantly from certain SSAs or covered bonds. But while some agencies had a strong outing in 1Q22, the supply of sovereign and supra transactions lagged last year's volumes.

SSA - Top 10 European ESG Issuers 1Q22

Issuers	Total Issued (€m)*	Average Tenor (years)
IBRD	12,471	7.7
CADES	11,139	9.4
BNG Bank	3,525	9.6
NWB Bank	2,391	19.6
European Union	2,170	15.2
ADB	2,014	4.7
IDA	2,000	20.0
EIB	1,956	6.4
AIIB	1,129	4.8
NIB	769	7.5

*Source: Bloomberg, *Cumulative issuances 1Q22*

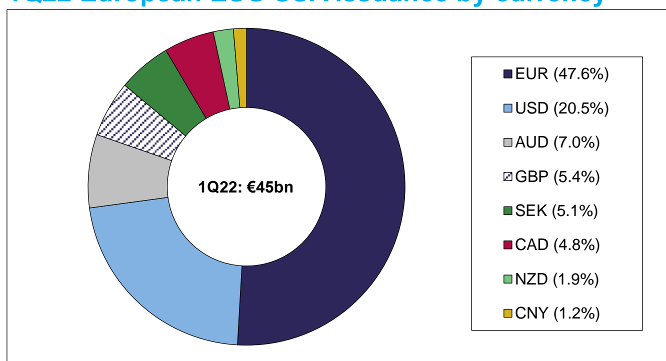
As at 1Q22, the **International Bank for Reconstruction and Development (IBRD)** leads our ESG issuance table having issued 50 themed bonds since the start of the year with total volumes at EUR12.5bn. The IBRD forms the largest part of the World Bank Group, providing loans to governments of middle-income countries as well as promoting sustainable economic development. The bonds issued were either labelled sustainable (93% of total) or green (7%) and are aligned with the issuer's sustainable development bond framework published in March 2021. Of the USD50bn-60bn in themed debt issued by the World Bank Group annually, some USD21.4bn went towards climate finance in 2021. The group aims to increase these flows by 35% between 2021-2025.

Daiwa Capital Markets Europe (DCME) arranged several transactions for **Nederlandse Waterschapsbank (NWB Bank)** in 2022, including two Australian Dollar deals in January and March. Particularly noteworthy is the AUD650m Kangaroo bond placed just before the outbreak of the war in Ukraine, as it represents NWB Bank's inaugural SDG housing transaction in AUD. The proceeds of the bond are to be utilised for lending to Social Housing Associations in the Netherlands, according to the issuer's SDG Housing Bond framework. With demand appearing particularly promising at the shorter end of the curve combined with attractive levels back to Euribor, the issuer decided to pursue a 3.5-year tenor. NWB's 2022 long-term funding requirements amount to EUR12bn-13bn and, similar to many of its peers, it is already well advanced with its plans, with issuance amounting to EUR6.5bn to date (37% ESG). Following this transaction, the market for offshore SSAs issuing benchmark-sized Kangaroo bonds was closed for three weeks following Russia's invasion of Ukraine and was only reopened when Nordic Investment Bank (NIB) launched its own 3.5-year Kangaroo bond for AUD350m.

The **European Union (EU)** issued EUR15bn in debt in 1Q22 with a further EUR6bn issued in April, bringing it close to half of its 1H22 funding target of EUR50bn across five transactions (2x NGEU, 2x EMTN, 1x SURE). A large amount of that supply came from a dual-tranche offering in late March for a combined EUR12bn. The 10-year, EUR10bn NGEU and the 15-year, EUR2bn SURE bond garnered total orders of EUR98bn. This was of interest, as issuers up until this point had been hesitant to offer longer maturities due to ongoing market volatility, which was amplified by the ECB signalling tighter monetary policy to come. However, interest in the deals was strong due to the spreads on offer. Euro spreads widened between swap-rates and Bund yields, in part due to the aforementioned 'flight to quality' that for a while pushed Bund yields markedly lower. Both EU deals priced some 49bps and 55bps above Bunds respectively, in part driving the high demand. The EU garnered even greater interest in April for its 20-year green bond, sized EUR6bn. The deal was 13x subscribed helping it price 2bps inside guidance.

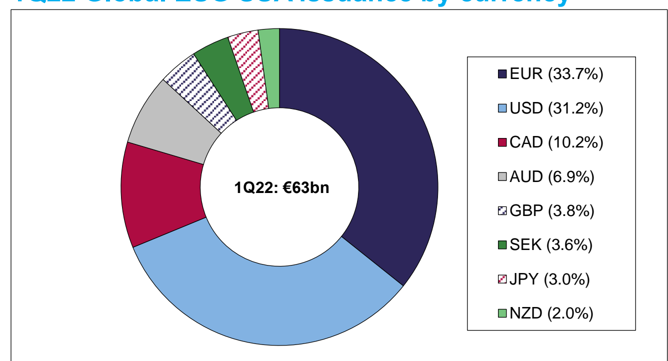
The war in Ukraine has painfully highlighted Europe's energy dependence on Russia, in turn raising the possibility of extra debt issuance to fund new spending on both energy infrastructure (under a new "REPowerEU" programme) and security/defence capacity. In late March, the European Commission was tasked by EU leaders to identify investment gaps and make proposals for new common policy initiatives in May 2022.

1Q22 European ESG SSA issuance by currency



Source: Bloomberg; 8 largest currencies Daiwa Capital Markets Europe Ltd.

1Q22 Global ESG SSA issuance by currency



Source: Bloomberg; 8 largest currencies Daiwa Capital Markets Europe Ltd.

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Total **FIG** ESG volumes in 1Q22 were strong despite market disruptions, with issuance reaching EUR36bn (+14.9% yoy). Issuance was front-loaded during the quarter with 45% of the total reaching markets in January, 34% in February and 21% in March. Issuers were keen to place their transactions early, as persistent inflation saw central banks accelerate their plans to normalise monetary policy. The prevailing 'risk-off' sentiment was heightened by the war in Ukraine, resulting in fewer transactions from lenders and issuance concentrated on those most removed from the conflict. However, the preference for secured transactions from high quality, core-European entities soon gave way to increasingly junior transactions and non-core issuers accessed markets again towards the end of the quarter. Notable issuers and transactions in 1Q22 included:

FIG - Top 10 European ESG Issuers 1Q22

Issuers	Total Issued (€m)*	Average Tenor (years)
Vonovia	2,500	6.7
Helaba	1,949	7.9
Deutsche Bank	1,776	10.0
DNB Bank	1,570	4.5
Segro Capital	1,150	6.0
CaixaBank	1,000	6.0
Nordea	1,000	5.0
VGP NV	1,000	6.5
DZ Hyp	1,000	7.7
SEB	1,000	5.5

*Source: Bloomberg, *Cumulative issuances 1Q22*

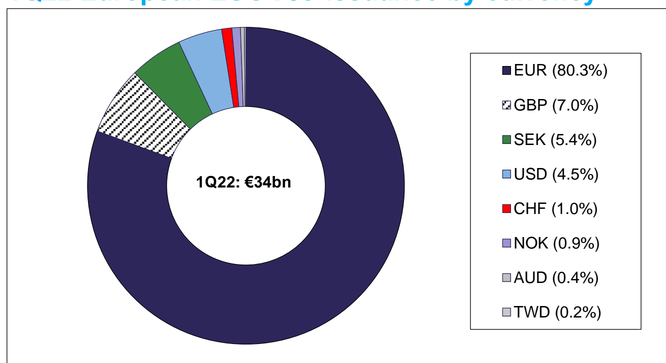
- German FIG issuers accounted for 30% of the sector's ESG issuance in 1Q22, featuring four of the top ten entities in our ranking. Among them were several Pfandbrief issuers as well as deals from **Vonovia** as well as Deutsche Bank. German housing company Vonovia become Europe's largest residential real estate group in 2021 having merged with fellow German real estate group Deutsche Wohnen in what was the biggest merger in Europe last year. In March, it issued a triple-tranche transaction of senior unsecured bonds, each EUR850m in size. It offered the unusual combination of a green bond paired with two debut social bonds, giving the issuer the opportunity to expand its investor base. The shorter-dated social bonds adhere to Vonovia's sustainable finance framework from February 2022, which in turn is aligned with ICMA's principles.

- The bonds will finance social housing for low-income households as well as offer affordable access to housing to privately financed flats, with rental fees at least 15% below the officially determined average local reference rent. According to the issuer, the 10-year green bond is the first offered by a property company that fully adheres to the EU taxonomy regulation. For this purpose, Vonovia adjusted its sustainable financing framework to the new EU standards, adding social components. **Deutsche Bank** provided further themed bond supply by a German issuer with its sizeable EUR1.25bn green SNP. The issuer found an opportune window to launch the deal, which tightened 17bps to MS+138bps as book orders reached EUR3bn. The 10bps new issue premium was broadly in line with what we have observed in the market thus far in 2022.

- Spanish banks were among those least affected by the war in Ukraine due to relatively low exposures to the region. Therefore, it wasn't surprising that they were among the first peripheral lenders to access senior capital markets after Russia's invasion. In mid-March, **Sabadell** issued the first senior bond from a peripheral borrower, a green SNP for EUR750m. The 4NC3 transaction garnered strong demand with order books at 5.6x deal size. This helped the issuer tighten the spread by 30bps from IPT to MS+220bps. In January, **CaixaBank** added to Spanish ESG bond supply with the first socially labelled FIG bond of the year. The EUR1bn SP transaction carried a maturity of 6NC5 and eventually priced at MS+62bps, paying a 5bps new issue premium. It was the second time since July 2020 that Caixa issued a bond with a social theme. Caixa's SDG bond framework, developed in 2019, permits the issuance of green, social and sustainability bonds. Its 2021 total ESG issuance amounted to EUR3.6bn across three green and one social bond accounting for 38% of overall Spanish FIG themed bonds. Turbulent market conditions throughout 1Q22 have raised concerns that ESG bond volumes from peripheral lender may be muted in 2022. However, Spanish banks have already issued EUR2.37bn, which is up slightly on last year (+3% yoy).

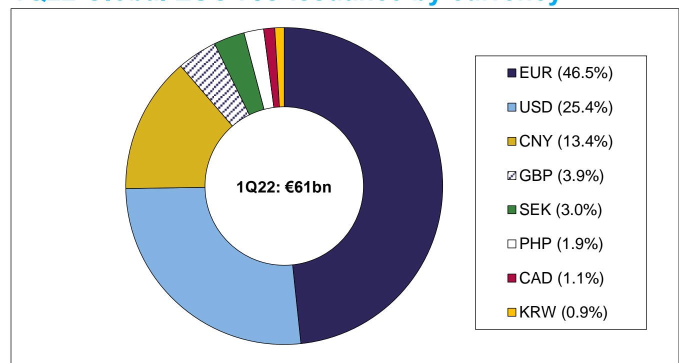
- The currency distribution of European FIG themed debt remained broadly similar to the same period last year. The greatest variations occurred among EUR (+676bps yoy) and USD (-342bps yoy) while globally, the largest variations were observed among CNY (+1,146bps yoy) and KRW (-480bps yoy).

1Q22 European ESG FIG issuance by currency



Source: Bloomberg; 8 largest currencies Daiwa Capital Markets Europe Ltd.

1Q22 Global ESG FIG issuance by currency



Source: Bloomberg; 8 largest currencies Daiwa Capital Markets Europe Ltd.

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(Table 1) Key ESG Transactions 1Q22

Bank	Rank	Amount	Maturity	Final Spread (bps)	IPT (bps)	Book Orders
SSA						
NWB	Sr. Unsecured (SDG)	AUD650m	3.5Y	ASW + 26	ASW + 24/26	>EUR3.1bn
NWB	Sr. Unsecured (SDG)	EUR1.75bn	10Y	MS - 5	MS - 3	>EUR2.6bn
European Union (SURE)	Sr. Unsecured (Social)	EUR2.17bn	15Y	MS - 8	MS - 6	>EUR35bn
CADES	Sr. Unsecured (Social)	EUR6bn	10Y	OAT + 18	OAT + 20	>EUR26.5bn
CADES	Sr. Unsecured (Social)	USD3bn	10Y	SOFR MS + 48	SOFR MS + 50	>USD4.25bn
CADES	Sr. Unsecured (Social)	EUR2bn	7Y	OAT + 18	OAT + 19	>EUR2.4bn
BNG Bank	Sr. Unsecured (Sustainable)	EUR1.75bn	10Y	MS - 3	MS - 1	>EUR5bn
BNG Bank	Sr. Unsecured (Social)	EUR1bn	15Y	MS + 3	MS + 5	>EUR1.5bn
IDA	Sr. Unsecured (SDGI)	EUR2bn	20Y	MS + 14	MS + 15	>EUR3.1bn
NIB	Sr. Unsecured (Green)	EUR500m	7Y	MS - 18	MS - 16	>EUR1.45bn
FIG (Senior)						
Vonovia	Sr. Unsecured (Social)	EUR850m	3.85Y	MS + 85	MS + 125	>EUR3.2bn
Vonovia	Sr. Unsecured (Social)	EUR850m	6.25Y	MS + 115	MS + 150/155	>EUR2.8bn
Vonovia	Sr. Unsecured (Green)	EUR850m	10Y	MS + 140	MS + 180	>EUR5bn
DNB Bank	SP (Green)	EUR1bn	6NC5	MS + 32	MS + 50	>EUR1.3bn
Deutsche Bank	SNP (Green)	EUR1.25bn	6NC5	MS + 138	MS + 155	>EUR3bn
CaixaBank	SP (Social)	EUR1bn	6NC5	MS + 62	MS + 80	>EUR1.3bn
Nordea	SNP (Green)	EUR1bn	5Y	MS + 60	MS + 80/85	>EUR3.1bn
SEB	SNP (Green)	EUR1bn	5.5Y	MS + 53	MS + 70/75	>EUR2bn
Sabadell	SNP (Green)	EUR750m	4NC3	MS + 220	MS + 250	>EUR4.2bn
Danske	SNP (Green)	EUR750m	5NC4	MS + 85	MS + 100	>EUR1.35bn
BPCE	SNP (Green)	EUR750m	6NC5	MS + 60	MS + 80	>EUR1.8bn

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

Secondary markets in 1Q22

Throughout most of the first quarter of 2022 issuers experienced headline-driven volatility, resulting in deteriorating CDS price indices on European senior and subordinated financials as well as higher new issue premiums and wider secondary market spreads. Central bank actions in response to rising inflation were one of the drivers. In Europe, the ECB's Governing Council responded to the marked deterioration in the near-term inflation outlook by announcing a more abrupt slowdown of net asset purchases in the second quarter than previously planned. While it also acknowledged a weaker economic outlook, it reaffirmed expectations of an end to net purchases in 3Q22, thus making room for a rate hike before the end of the year while insisting that any adjustments to interest rates will take place "some time after the end of the net purchases and will be gradual". Meanwhile, the Bank of England's (BoE) Monetary Policy Committee (MPC) tightened monetary policy for the third successive meeting in March, with the increase of 25bps taking Bank Rate back to its pre-pandemic level and post-financial crisis peak of 0.75%. The MPC moderated slightly its forward guidance from February, stating that "some further modest tightening in monetary policy might be appropriate in the coming months", rather than "is likely to be appropriate". Across the pond, the Fed also delivered its first rate hike for four years, of 25bps lifting the target range to 0.25-0.50%. And as it sought to catch up with market pricing, it signalled a series of further increases for the remainder of the year as well as the likely agreement of plans quantitative tightening in May.

Are greeniums evaporating for good?

Heightened uncertainty throughout most of 1Q22 resulted in significant spread movements between the option-adjusted spreads (OAS) for ESG and non-ESG themed indices. In the first quarter, the median negative OAS differential between the Barclays MSCI Euro-Corporate ESG Index and Barclays Pan-European Aggregate Corporate Index was just -2.83bps compared to -4.85bps one year prior. In early March, we even observed an inversion of the greenium (+1.08bps) which was probably the result of significant volatility in bond markets. Market liquidity was adversely affected by plans to tighten monetary policy to curb inflation in addition to the escalating geopolitical situation in Ukraine. Liquidity concerns for themed bonds were likely heightened by their narrower investor base, and lower trading volumes in turn may explain the sudden spread reversal. Longer average tenors and lower liquidity represents elevated risks for bondholders that tend to manifest themselves during credit risk sell-offs. This was observable during the last two major sell-offs where the ESG index underperformed compared to the broader market. We believe that the observable volatility under duress will add to the understanding of ESG bond pricing and likely contribute to further narrowing of the greenium over the medium term. We also note however, that the greenium for liquid sovereigns such as German Bunds remains in place compared to their conventional curves, although the aforementioned narrowing and spread reversal is also observable here. On two trading days shortly after the Russian invasion of Ukraine, the Z-spread differential turned positive before eventually reverting back to a narrower greenium compared to previous quarters. The 1Q22 median spread differential was -4.55bps compared to the 2021 median of -5.51bps (4Q21: -5.51bps; 3Q21: -6.38bps; 2Q21: -5.24bps; 1Q21: -4.20bps).

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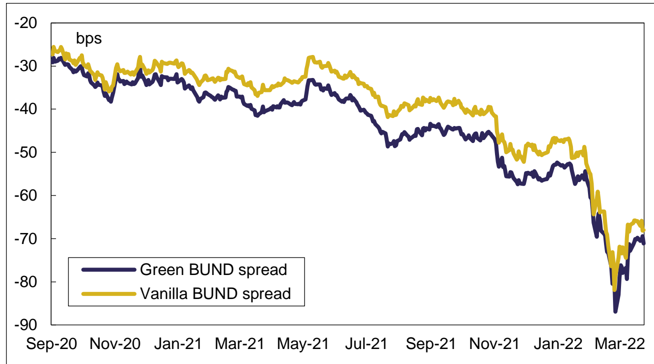
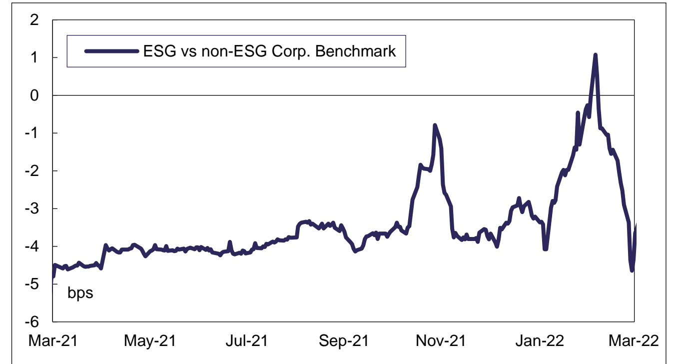
Obtaining greeniums at issue has often been a baseline assumption for many ESG borrowers and historical data indeed show the favourable pricing achieved. Despite heightened volatility and narrowing greeniums in the secondary market, we still expect greeniums at issue to persist going forward. In particular, themed bonds that will be aligned with the EU's Green Bond Standard (GBS) – once it has been finalised by EU legislators – are expected to display greeniums as they will adhere to the most stringent green bond criteria. Their status as fully taxonomy-compliant fixed income products and initial low availability will set them apart from 'regular' green bonds that do not necessarily meet the taxonomy criteria. Reportedly, less than 50% of sovereign bonds and only 18% of corporate bonds currently comply with the GBS at end-2021. The EU is currently undertaking further steps to implement the GBS, and in April the EU Council agreed its negotiation position on the GBS which should enable it to reach a final agreement with the EU Parliament on a final text.

Green vs Vanilla BUND Z-spreads



Source: Bloomberg; Daiwa Capital Markets Europe Ltd.

Spreads (OAS) of ESG vs non-ESG benchmarks



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

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- For derivative and margin transactions etc., our company may require collateral or margin requirements in accordance with an agreement made beforehand with you. Ordinarily in such cases, the amount of the transaction will be in excess of the required collateral or margin requirements**.
- There is a risk that you will incur losses on your transactions due to changes in the market price of financial instruments based on fluctuations in interest rates, exchange rates, stock prices, real estate prices, commodity prices, and others. In addition, depending on the content of the transaction, the loss could exceed the amount of the collateral or margin requirements.
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- Before engaging in any trading, please thoroughly confirm accounting and tax treatments regarding your trading in financial instruments with such experts as certified public accountants.

* The amount of the trading commission cannot be stated here in advance because it will be determined between our company and you based on current market conditions and the content of each transaction etc.
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