Daiwa Capital Markets

European Banks – Quarterly ESG Update (3Q22)

- In Europe, ESG bond issuance volumes rose yoy in 3Q22 underscoring their resilience.
- High energy prices highlight important role for SSAs in funding the climate transition, while impact of high inflation also calls for continued flow of social bond issuance.
- ECB and BoE climate stress tests reveal qualitative and quantitative challenges for banks.
- Short-dated SSA issuance drives yoy primary market growth, while FIGs contend with fewer funding opportunities pushing new-issue premiums up. Secondary spreads remain volatile.

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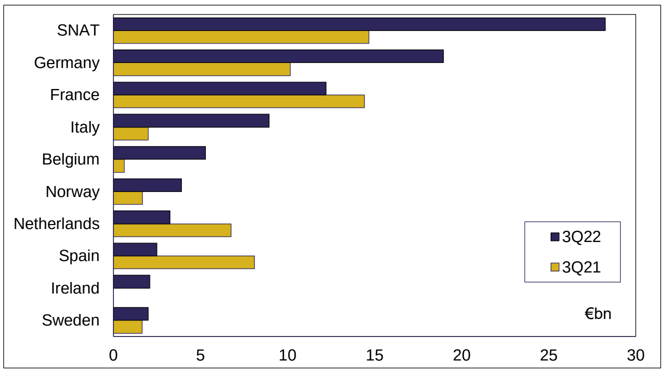
Overview: European ESG issuance volumes remain resilient in 3Q22

Issuance of ESG bonds – comprising green, social and sustainable bonds – grew again in 3Q22 compared to the previous quarter but once more lagged volumes compared to a year earlier. Global ESG bond issuance in 3Q22 amounted to EUR214bn (3Q21: EUR282bn), down 24% yoy. Recession expectations and risk-off market sentiment adversely affected the issuance of global sustainable debt, particularly social and sustainability-linked bonds (SLB). The decline was seen in green (-15.1% yoy), social (-46.8% yoy) and SLBs (-59.3% yoy), while sustainability bonds saw a minor increase (+1.2% yoy) due to higher issuance volumes from SSAs.

In Europe, ESG-linked bond sales from SSAs and FIGs reached EUR94bn in 3Q22 according to Bloomberg data, up 13.7% yoy. Of that total, green bond sales amounted to EUR52bn (+13.7% yoy), social bond volumes stood at EUR15bn (-3% yoy), and sustainable bonds accounted for EUR28bn (+25.1% yoy). Issuance volumes in European ESG bond markets have proven resilient, suggesting that they could see a swift rise in volumes should credit and market conditions improve. Entities from Germany, France and Italy led European ESG debt issuance in 3Q22 alongside Supra-nationals.

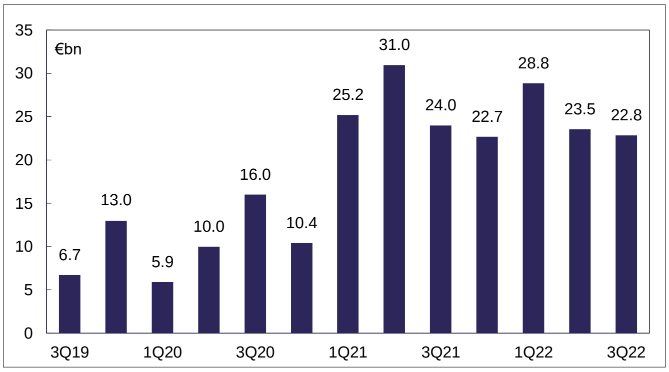
ESG-themed bonds issued by European financial institutions fell by EUR1.9bn from a year earlier to EUR27.7bn last quarter, while SSA volumes grew by EUR13.3bn to EUR66.7bn (+25% yoy). The latter benefitted from more market participation from sovereigns and higher issuance volumes. Within the euro-denominated space, ESG-themed debt issued by European entities as a share of total FIG and SSA issuance rose again, particularly towards the end of the quarter, following traditionally quiet summer months. Looking ahead, Europe's structural shift away from Russian energy, high energy prices and ongoing cost of living pressures call for an enhanced role for SSAs in funding the transitions to net zero and energy independence, as well as programmes aimed at mitigating the social impacts of economic events. Therefore, we expect a continued pickup in the number of SSA transactions over the foreseeable future.

European ESG Bond Issuance by Country



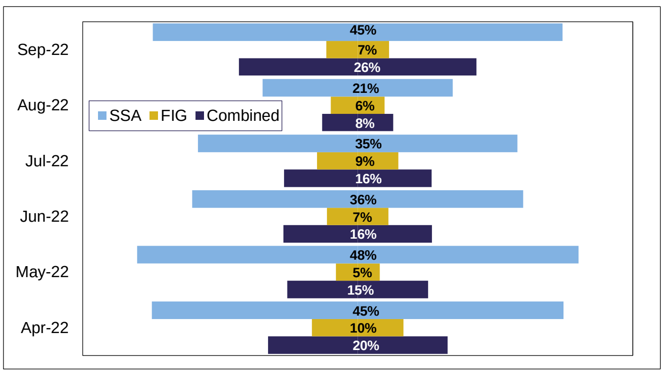
Source: Bloomberg; includes FIGs & SSAs; Daiwa Capital Markets Europe Ltd.

Quarterly ESG Bond Issuance: European FIGs*



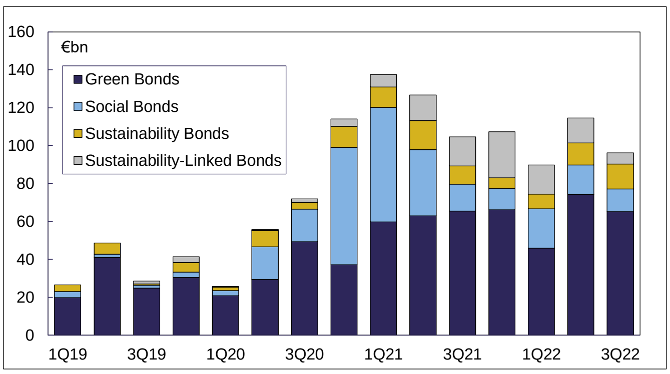
*Source: Bloomberg and Daiwa Capital Markets Europe Ltd.; *Green, social and sustainability labelled bonds >€250m.*

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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Landmark climate risk stress tests reveal challenges for banks

ECB exercise a learning experience for banks and supervisors

In July, the ECB published the results of its climate risk stress test (CST) on a representative sample of significant banking institutions. 104 banks participated in a test across three modules, providing information on: 1) their own climate stress-testing capabilities, 2) reliance on carbon-emitting sectors, and 3) performance under different scenarios over several time horizons. The stress test within the third module was limited to just 41 institutions directly supervised by the ECB to ensure proportionality towards smaller banks. Key findings were that most banks had not yet developed sufficiently capable risk-management practices to integrate climate risks, which in turn highlighted current data limitations. We expect banks to swiftly upgrade their capabilities in this regard to comply with the incoming Corporate Sustainability Reporting Directive (CSRD) and to meet the standards of the International Sustainability Standards Board (ISSB). Importantly, the ECB also concluded that the results of the CST would not directly influence Pillar 2 capital requirements as banks and supervisors are still at an early stage of understanding how climate risks affect the sector. The outcomes of the exercise will instead be incorporated into its annual SREP assessment in a qualitative manner. However, as the CST overcomes its data and methodological limitations over time, we expect quantitative adjustments to Pillar 2 requirements for banks that persistently display shortcomings. The ECB provided all participating institutions with specific feedback and recommendations to overcome current challenges and will publish a set of best practises in 4Q22.

BoE stress test less uniform but helps build entity level capabilities

The Biennial Exploratory Scenario (CBES) conducted by the Bank of England investigated climate risks faced by UK banks and insurers, gauging their resilience to physical and transition risks under a range of possible climate scenarios. On the surface, it appears that the overall costs to these firms from the transition to net zero should be bearable without substantial impacts on their respective capital positions. However, we note that the scope of the CBES understates the challenges faced by these entities, as it does not include trading portfolios and limits the counterparty-level analysis only to the largest banking (seven largest) and insurance groups (five life, five general and two international general insurers). The results currently lack nuance and individual loss estimates vary widely, which we consider a function of the BoE allowing banks to develop their own modelling approaches in this first exploratory exercise. The BoE also stated that poor data quality and availability meant that many climate risks could only partially be measured. However, we deem this non-prescriptive approach positive as it develops capabilities and encourages participants to liaise directly with counterparties on climate risks, helping expose data and modelling gaps. Unlike the ECB, the BoE appears to be more upfront with uncertainties and shortcomings of its loss projections, which are probably vastly understated.

Quantitative findings point towards shortcomings

The results of the ECB assessment also yielded interesting findings from a credit perspective as they informed on expected credit and market risk losses stemming from transition and physical risks. The 2022 CST was a bottom-up exercise, meaning that participating banks provided their own data submissions and stress test projections subject to a common methodology and common scenarios. Under the three-year short-term scenario, the stress test of 41 banks resulted in projected losses of EUR70bn. Broken down, these stem from a disorderly transition (EUR53bn) and from short-term physical risks such as drought and heat events or flood risk (EUR17bn). The ECB also found that 60% of banks do not yet sufficiently incorporate climate risk into their stress-testing frameworks and only 20% consider climate risk as a variable when granting loans. In contrast, the BoE projects GBP44bn in losses for the seven largest UK banking groups in the first five years of its most adverse scenario. The results appear more severe as losses are spread across a smaller sample of banks, albeit over a longer period. Overall, loss projections from the BoE vary across participants and scenarios but are equivalent to an annual drag on profits of around 10-15% on average. Furthermore, the ECB test highlighted significant data-shortcomings with regards to the use of actual counterparty data vs proxy data. For instance, only 20-30% of counterparty Scope 1, 2 and 3 greenhouse gas emissions (GHG) data was based on actual figures. This problem is compounded by the lack of harmonised legislation for Scope 3 disclosure requirements, hampering entities' ability to collect data. Scope 3 emissions importantly inform on all indirect emissions that occur in the value chain of the reporting company, and have been identified as the dominant driver of carbon intensity for banks.

Income dependence on carbon-intensive sectors

The ECB report suggested that financial institutions derived a median 65.2% of their interest income from 22 carbon-intensive sectors. Together these sectors represent 54% of the EU economy in terms of gross value added. These findings highlight the predicament banks face when it comes to aligning the need to decarbonise their balance sheets whilst not leaving borrowers from high-emitting sectors behind and supporting them on their transition journeys. The BoE report also assessed the impact of corporate exposures, noting that some of the most carbon-intensive industrial sectors disproportionately accounted for projected corporate credit losses. Under the transition scenario, the sectors most affected by transition risks accounted for some 30% of banks' provisions despite only accounting for 14% of banks total corporate exposures. Ultimately, EU and UK banks will need to be more selective to whom they lend in order to satisfy their own sustainability targets and avoid potentially higher capital requirements in the future. The tests only represent individual initiatives amongst a host of policy actions that require ongoing development and coordination in order to culminate in a harmonised and meaningful framework.

Primary markets in 3Q22

SSA - Top 10 European ESG Issuers 9M22		
Issuers	Total Issued (€m)*	Average Tenor (years)
CADES	27,458	8.3
IBRD	24,299	7.6
EIB	14,395	6.4
European Union	13,170	20.5
KfW	7,969	3.3
IDA	6,339	15.1
Italy	6,000	12.6
IADB	5,975	7.4
BNG Bank	5,275	9.7
Germany	5,000	5.1

*Source: Bloomberg, *Cumulative issuances 9M22*

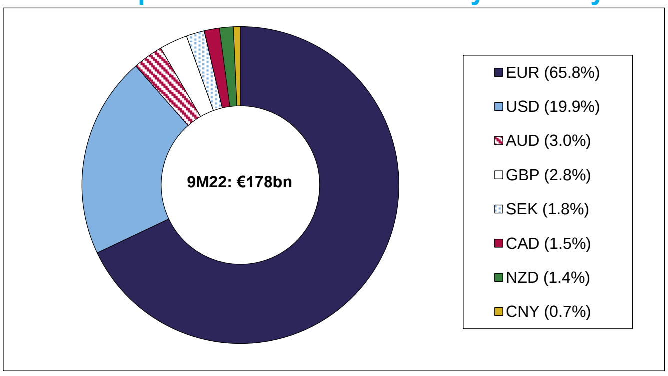
SSA ESG issuance volumes in 3Q22 reached EUR67bn (+7.5% qoq) of which 41% had a sustainable bond indicator, 40% were green and 19% were labelled social bonds. Sustainable bond volumes in particular experienced significant growth (+77.3% qoq) mainly from Supras, as the number of deals rose to 52 (+48.6% qoq) and average deal size increased to EUR530m (+19.3% qoq). However, green bond volumes (-17.7%) and social bonds (-11.6%) experienced noticeable declines. Compared to the same period last year, growth was more pronounced, with total issuance volumes up 25%, driven by increased sustainable debt from Supras as well as more syndicated ESG issuance from sovereigns. The end of the ECB's PEPP programme in 2Q22 has seemingly not had a limiting impact on sovereign ESG debt issuance so far but may lead to conservative sovereign budget planning for 2023. In 3Q22, SSA supply remained focussed on the front end of the curve with the majority of deals carrying a 3-5 year tenor (36%) followed by 1-3 years (20%) and 10-12 years (11%).

Sovereign issuers continued their presence in the ESG space after being absent earlier in the year. In 3Q22, they placed EUR15.5bn of themed debt in capital markets across three transactions, thus exceeding the EUR10.8bn in supply placed during the first six months of the year. **Belgium's** government issued its second syndicated green deal, alongside deals from **Germany** and **Italy** in September. The EUR4.5bn April-2039 bond priced with a spread of OLO+6bps, tightening 2bps from IPT on the back of book orders in excess of EUR31bn. The issuer only paid a 2.5bps new issue premium (NIP) on the trade, compared to a potential 4bps for an equivalent conventional deal. The issuer thus effectively benefitted from a 1.5bps greenium as the ESG label arguably attracted a wider investor base. The October investor presentation of Belgium's debt agency shows total 2022 funding requirements increased to EUR48bn, up 18.7% against last year's requirements. The new green bond adds to the outstanding EUR10.6bn in green debt and is aligned with the issuer's updated green bond framework to which all future green OLOs have to adhere from July 2022 onwards.

As at 9M22, the **International Bank for Reconstruction and Development (IBRD)** ranks second in our ESG issuance table, having issued 29 themed bonds in 3Q22 alone, totalling EUR10.8bn. The IBRD forms the largest part of the World Bank Group, providing loans to governments of middle-income and creditworthy low-income countries, as well as promoting sustainable economic development. A large portion of 3Q22 supply came from the IBRD's sustainable development bond (SDB) dual-tranche offering for a combined USD4.5bn. The shorter 4-year FRN was sized at USD1.5bn while the longer 7-year note was USD3bn. The bonds were launched into a particularly challenging market environment following the release of elevated US CPI data, which may explain the more restrained investor response as subscription levels were just 1.2x and 1.3x respectively. We observed spread tightening on the shorter leg by 1bps while the other remained unchanged from IPT. The IBRD has a track record of developing innovative bond structures, tailored to pressing global challenges. For instance, its catastrophe bonds (CAT bonds) allow entities exposed to natural disaster risk to transfer a portion of that risk to bond investors, while more recent Rhino bond structures form the first outcome-based wildlife conservation bonds worldwide.

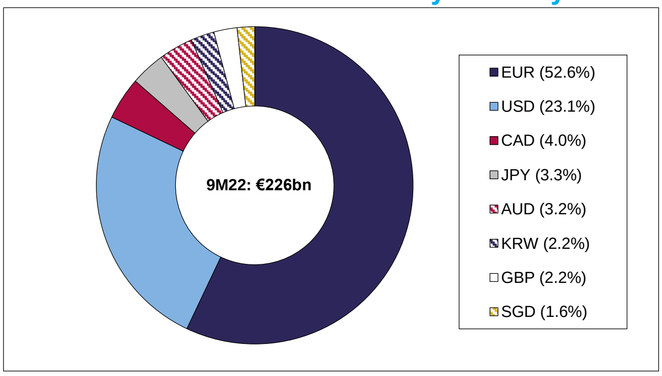
Within the space of multilateral development banks (MDBs) the case for innovation, greater capital use and expanded issuer mandates has increasingly been made. A G20 working group report from July substantiated this position and reviewed the capital adequacy frameworks of MDBs, such as the IBRD's. Indeed, due to complexities deriving from credit rating agency assessments and capital treatment it can be argued that MDBs have lending headroom that is currently unutilised. While unique features such as their preferred creditor status generally lead sovereign borrowers to prioritise payments to MDBs, it also makes it more difficult to evaluate them from capital adequacy standpoint. The often countercyclical nature of MDB development mandates paired with the challenging environment of rising borrowing costs and slow economic growth call for a prudent assessment of the G20 working group recommendations in our view.

9M22 European ESG SSA issuance by currency



Source: Bloomberg; Daiwa Capital Markets Europe Ltd.

9M22 Global ESG SSA issuance by currency



Source: Bloomberg; Daiwa Capital Markets Europe Ltd.

Total **FIG ESG** volumes in 3Q22 reached EUR27.7bn (-6.5% yoy). Primary market activity was somewhat back-loaded during the quarter with 48% of all deals taking place in September, 22% in August and 30% in July. Market conditions were choppy throughout and displayed heightened sensitivity to monetary policy announcements and key data releases. Unsurprisingly, issuers continued to opt for mostly senior trades with shorter tenors. Average bond maturities were largely concentrated in the 3-5 year maturity bucket (60% of total), followed by 1-3 years (10%) and 5-7 years (10%). Accommodative funding windows for sub-debt or lower-tier issuers were limited and access to those segments often came at a steep premium. However, from a credit perspective, issuer fundamentals remained largely robust and are expected to remain so as FIGs are expected to reap the near-term benefits of sharp interest rate rises. However, over the medium term, deteriorating consensus views on macroeconomic growth imply pressure on banks' asset quality and higher provisioning levels. Gains from new lending activities could quickly be eroded by a combination of low growth, higher customer deposit rates and rising cost pressures.

FIG - Top 10 European ESG Issuers 9M22

Issuers	Total Issued (€m)*	Average Tenor (years)
Helaba	4,719	6.6
DNB Bank	3,099	4.4
Vonovia	2,622	5.4
Berlin Hyp	2,551	5.0
ING Group	2,500	7.5
Deutsche Bank	2,372	6.1
CaixaBank	2,000	6.5
LBBW	1,912	6.6
AIB Group	1,750	5.0
SBAB Bank	1,576	3.9

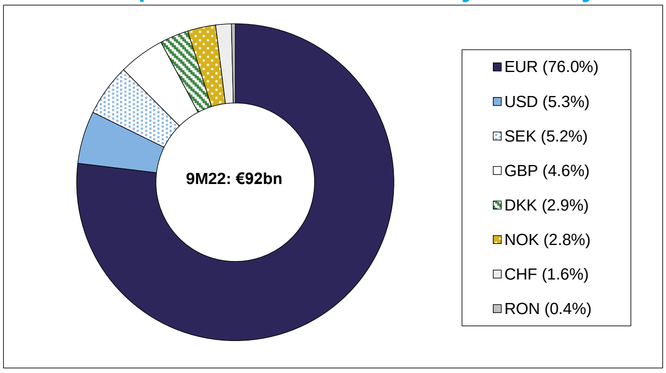
*Source: Bloomberg, *Cumulative issuances 9M22*

Access to primary markets for peripheral lenders from Italy, Spain, Portugal and Greece was at times limited to national champions during the past quarter. Their combined issuance volume was just EUR4.4bn in 3Q22, down 18% yoy and accounted for just 16% of the quarterly FIG total. By country, Italy (50% of total) and Spain (45%) accounted for the bulk of volume but pressure on BTP spreads over Bunds throughout the quarter arguably dampened market access for lower-tier issuers. There were some exceptions to this, as evidenced by the deals of Banco BPM and Abanca, showing that lower-quality peripheral lenders could place senior MREL deals, albeit at a price. The maturity of **Banco BPM's** EUR500m green SNP deal was similar to that of most senior deals on offer at that time. Despite the ESG label and relatively short tenor, the spread was still high at MS+385bps. When compared to Intesa's green SNP that landed just one week earlier, the final spread was 135bps wider despite carrying a one-year shorter maturity. Banco BPM's new issue premium at launch is considered to have been around 60bps compared to the ~25bps paid by Intesa.

Meanwhile, **Abanca** from Spain also launched an ESG bond. The EUR500m SP note carried a green label, opening it up to a broader investor base. 2.4x book orders helped lower the spread to MS+305bps (-20bps from IPT) for the 6NC5 deal. The new issue premium is believed to have been around 50bps. Looking ahead, sustained demand for labelled debt and upward revisions of sustainable financing targets lead us to expect a healthy pipeline for debt issuance, especially from peripheral lenders that have been lagging. **BBVA** for instance recently announced that it raised its sustainable financing target to EUR300bn for the period between 2018 and 2025. BBVA had originally targeted financing of EU100bn back in 2018, before doubling its target in July 2021. As of 1H22, the Spanish lender has already reached a total of EU112bn in sustainable finance. By business segment, 65% comes from the corporate and investment banking operations for large clients, followed by companies (18%) and retail financing (17%).

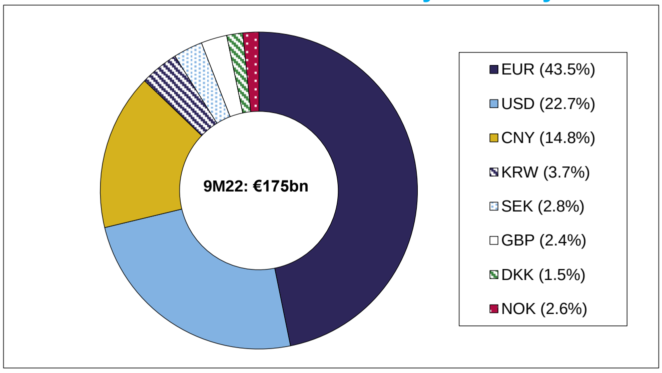
Issuance of themed subordinated bonds rose to EUR3.1bn in the quarter, outpacing 2Q22 levels (+80% qoq) as well as those seen during the same time last year (+56% yoy). In part, we put this down to catch-up effects after issuers put off issuing riskier bail-in debt earlier in the year. It was mostly higher-quality, investment grade issuers that tapped markets. One of them was **Société Générale** that launched a self-led EUR500m social Tier 2 with a tenor of 10NC5. It is SocGen's only labelled Tier 2 bond and forms part of its EUR4-4.5bn 2022 sub-debt funding target. The spread on the deal tightened to MS+310bps (-15/20bps from IPT), resulting in a new issue premium of some 20bps. **ING Groep** launched the largest themed subordinated deal of the quarter. The EUR1bn green Tier 2 with an 11NC6 tenor generated book orders of EUR2.6bn that helped push initial price thoughts of MS+275bps down by 25bps. The resulting spread reportedly offered investors a 5bps new issue concession. The concession on offer, compared to that of similarly rated SocGen, highlights the importance of targeting accommodative funding windows in the current environment.

9M22 European ESG FIG issuance by currency



Source: Bloomberg; Daiwa Capital Markets Europe Ltd.

9M22 Global ESG FIG issuance by currency



Source: Bloomberg; Daiwa Capital Markets Europe Ltd.

Key ESG Transactions 3Q22

Bank	Rank	Amount	Maturity	Final Spread (bps)	IPT (bps)	Book Orders
SSA						
ADB	Sr. Unsecured (Gender)	CAD700m	3Y	MS - 11	MS - 10	>CAD1bn
AFD	Sr. Unsecured (Sustainable)	USD1.25bn	5Y	SOFR MS + 61	SOFR MS + 62	>USD1.8bn
AfDB	Sr. Unsecured (Social)	EUR1.25bn	7Y	MS -3	MS - 2	>EUR2.3bn
AIIB	Sr. Unsecured (SDB)	USD2bn	5Y	SOFR MS + 63	SOFR MS + 64	>USD2.4bn
ALS	Sr. Unsecured (Sustainable)	EUR750m	15Y	OAT + 53	OAT + 53	>EUR770m
Belgium	Sr. Unsecured (Green)	EUR4.5bn	Apr-39	OLO + 6	OLO + 8	>EUR31.5bn
BNG Bank	Sr. Unsecured (Sustainable)	EUR750m	Jul-32	MS - 1	MS - 1	>EUR1bn
CADES	Sr. Unsecured (Social)	EUR3bn	5Y	OAT + 37	OAT + 38	>EUR5.5bn
CADES	Sr. Unsecured (Social)	EUR5bn	10Y	OAT + 35	OAT + 36	>EUR11.5bn
CDP	Sr. Unsecured (Sustainable)	EUR750m	5Y	BTP + 45	BTP + 50	>EUR1.2bn
DBJ	Sr. Unsecured (Sustainable)	EUR600m	4Y	MS + 20	MS + 22	>EUR2bn
DBJ	Sr. Unsecured (Sustainable)	USD600m	3Y	SOFR MS + 71	SOFR MS + 73	>USD2.4bn
EIB	Sr. Unsecured (SAB)	USD4bn	5Y	SOFR MS + 38	SOFR MS + 40	>EUR13bn
EIB	Sr. Unsecured (CAB)	EUR4bn	7Y	MS - 17	MS - 15	>EUR27bn
Ferrovie dello Stato Italiane	Sr. Unsecured (Green)	EUR1.1bn	4Y	BTP + 87	BTP + 100	>EUR2.1bn
Germany	Sr. Unsecured (Green)	EUR5bn	5Y	OBL - 1.25	OBL - 1	>EUR14bn
IADB	Sr. Unsecured (SDB)	USD3bn	7Y	SOFR MS + 46	SOFR MS + 48	>USD3.7bn
IBRD	Sr. Unsecured (SDB)	USD1.5bn	4Y	SOFR + 31	SOFR + 32	>USD1.8bn
IBRD	Sr. Unsecured (SDB)	USD3bn	7Y	SOFR MS + 46	SOFR MS + 46	>USD3.9bn
ICO	Sr. Unsecured (Social)	EUR500m	5Y	SPGB + 14	SPGB + 16	>EUR1.1bn
IDA	Sr. Unsecured (SDB)	EUR2bn	15Y	MS + 10	MS + 10	>EUR2.9bn
Italy	Sr. Unsecured (Green)	EUR6bn	Apr-35	BTP + 5	BTP + 7	>EUR40bn
NRW Bank	Sr. Unsecured (Green)	EUR1bn	10Y	MS – 7	MS – 7	>EUR3.8bn
NRW Bank	Sr. Unsecured (Social)	EUR1bn	15Y	MS + 6	MS + 8	>EUR3.7bn
Ville de Paris	Sr. Unsecured (Sustainable)	EUR300m	20Y	OAT + 36	OAT + 38	>EUR845m
FIG (Senior)						
Abanca	SP (Green)	EUR500m	6NC5	MS + 305	MS + 325	>EUR1.2bn
AIB Group	Sr. HoldCo (Green)	EUR750m	4NC3	MS + 200	MS + 220	>EUR1.2bn
Banco BPM	SNP (Green)	EUR500m	4Y	MS + 385	MS + 400	>EUR900m
Bank of Ireland	Sr. Unsecured (Green)	USD1bn	4NC3	T + 265	T + 285	n.a.
BCC	SP (Social)	EUR500m	4NC3	8.00%	8.13%	>EUR975m
Caixabank	SP (Green)	EUR1bn	7Y	MS + 155	MS + 175	>EUR1.4bn
Citigroup	Sr. HoldCo (Green)	EUR1bn	6NC5	MS + 125	MS + 145	>EUR2.4bn
DNB Bank	SP (Green)	EUR1.25bn	5NC4	MS + 77	MS + 100	>EUR2.3bn
Helaba	SNP (Green)	EUR650m	5Y	MS + 100	MS + 115	>EUR800m
Intesa	SNP (Green)	EUR1bn	5Y	MS + 250	MS + 270/275	>EUR2bn
Mizuho	Sr. Unsecured (Green)	EUR800m	5Y	MS + 123	MS + 145	>EUR950m
NatWest	Sr. Unsecured (Green)	EUR1bn	6NC5	MS + 185	MS + 210	>EUR1.9bn
RBI	SP (Green)	EUR500m	3Y	MS + 200	MS + 230	>EUR1.7bn
Sparebank 1 SMN	SP (Green)	EUR500m	3.25Y	MS + 72	MS + 90	>EUR650m
SR-Bank	SP (Green)	EUR500m	3Y	MS + 70	MS + 90	>EUR850m
Svenska	SP (Green)	EUR750m	7Y	MS + 65	MS + 85	>EUR2.3bn
FIG (Subordinated)						
Bank of Ireland	Tier 2 (Green)	GBP300m	10.25NC5.25	G + 470	G + 480	>GBP600m
Credito Emiliano	Tier 2 (Social)	EUR200m	10.25NC5.25	7.63%	7.88%	>EUR450m
Generali	Tier 2 (Green)	EUR500m	10Y	5.80%	6.00%	>EUR1.25bn
ING Groep	Tier 2 (Green)	EUR1bn	11NC6	MS + 250	MS + 275	>EUR2.6bn
NN Group	Tier 2 (Green)	EUR500m	20.5NC10.5	MS + 320	MS + 320	>EUR640m
SocGen	Tier 2 (Social)	EUR500m	10NC5	MS + 310	MS + 325/330	>EUR1.1bn

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

Secondary markets in 3Q22

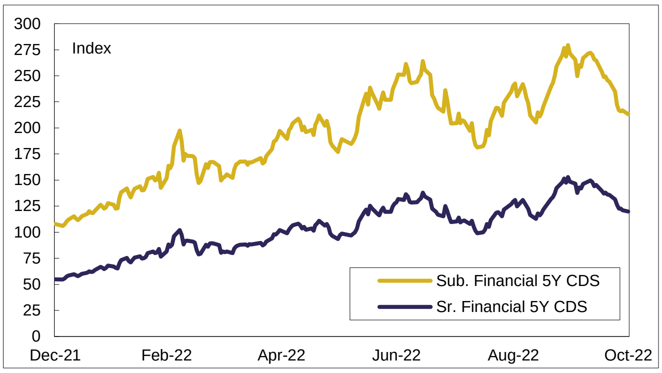
Market volatility carried through into the third quarter of 2022. CDS price indices of European senior and subordinated financials have recently retreated from 52-week highs but remain at elevated levels. Consistently high inflation across Europe will likely continue to evoke tightening monetary policy responses over the near future. As expected, the ECB's Governing Council decided to raise all of its key interest rates by 75bps at its October meeting, most notably doubling the deposit rate to 1.50% and taking the cumulative tightening since July to 200bps. It also took steps towards monetary policy normalisation, announcing measures to address excess liquidity in the euro area, by amending the conditions of the TLTRI-iii loans among other things. Terms for the EUR2.1tr outstanding TLTRO will change from 23 November, effectively removing the arbitrage opportunity for European banks from borrowing at negative rates and depositing excess reserves at higher rates with the ECB. Banks with actual funding needs will find that cost of the TLTRO tranches indexed at the deposit rate for the remainder of their duration will still compare favourably to yields demanded in capital markets. Other financial intuitions that focused more on taking advantage of the scheme for arbitrage purposes will likely make use of the additional repayment opportunities provided to settle outstanding amounts.

Looking ahead, the ECB seems warier of recession risks, leading Daiwa economists to expect a slower pace of policy tightening over coming meetings, forecasting a 50bps hike in December. The upcoming BoE Monetary Policy Committee (MPC) meeting is expected to result in another rate rise of 75bps to 3.0% amidst ongoing concerns about domestically generated inflation fuelled by a tight labour market. However, a stronger economic contraction in 3Q22 than previously expected by the BoE and further contractions in the quarters ahead should help inflation fall back in due course. In the US, meanwhile, the Federal Open Market Committee (FOMC) will likely implement a 75bps rate hike in the Fed Funds Rate at its 2 November meeting. This will take the target range to 3.75-4.0%. While Daiwa economists do not expect a deviation from the recent pattern of tightening, there may be a slight pivot on guidance. Chair Powell has noted in the past that the Fed will at some point slow the pace of adjustment. This could lead to deceleration to 50bps in December and possibly a pause in early 2023.

Widening ESG and non-ESG bond spreads qoq

Market volatility caused by an uncertain macroeconomic outlook, ongoing geopolitical tensions and persistent inflationary pressures continue to have adverse effects on funding conditions and spread developments. Nevertheless, sustainable bond issuers continued to attract sizeable book orders from a growing investor base. This is in part driven by greater transparency and disclosure requirements under the EU's Sustainable Finance Disclosure Regulation (SFDR), entrenching sustainability awareness and considerations within the investor landscape as well as enhancing liquidity. Greater demand and the increased scope for spread tightening at issue somewhat mitigate current adverse market conditions. We see this reflected in the spread development of the option-adjusted spreads (OAS) for ESG and non-ESG themed indices. In the third quarter, the median negative OAS differential between the Barclays MSCI Euro-Corporate ESG Index and Barclays Pan-European Aggregate Corporate Index was -2.70bps (from -3.88bps in 3Q21). Despite the narrowing of the differential against last year's figures, we also saw the first widening on a quarterly basis since 2Q20.

iTraxx Financials Index YTD 2022



Source: Bloomberg; Daiwa Capital Markets Europe Ltd.

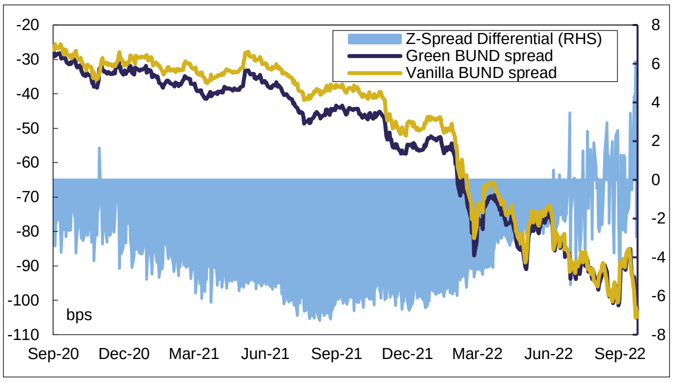
Smaller greeniums partially a function of issuer behaviour and market conditions

Average NIPs for ESG and non-ESG bonds continued to rise in line with the gradual decrease of cover levels for deals. 3Q22 average NIPs for themed SSA bonds remained below those of conventional SSA trades at 4bps vs 4.9bps respectively. The pricing benefit at issue for labelled debt was in part also driven by their shorter average tenors, which were over half a year shorter than regular SSA bonds. For FIGs we saw average NIPs of ESG bonds rise to 22.6bps, above the 16bps for conventional bonds (2Q22: 11.3bps and 10.5bps respectively). Tenors of labelled FIG bonds on average were less than a year shorter than non-ESG bonds. We also note a considerable acceleration in the rise of NIPs of ESG-labelled debt compared to conventional bonds across asset classes. On a quarterly basis, themed debt for SSAs and FIGs saw average NIPs rise 35% and 100% in 3Q22, compared to -19% and 52% for conventional bonds. These strong increases could stem from the historically lower nominal starting point. We also deem it likely that in the increasingly uncertain operating environment, investors place greater emphasis on fundamental credit concerns leading to an alignment of spreads at issue. Another possible reason for the spike in spreads for ESG bonds, particularly on the FIG side, is that several lower tier and less frequent issuers used ESG labels to support the placement of their MREL debt from a pricing perspective. In addition to green label for instance, they often opted for short maturities, high seniority and small-medium deal sizes to reduce spreads at issue.

Tighter liquidity and higher volatility pressure sovereign greeniums

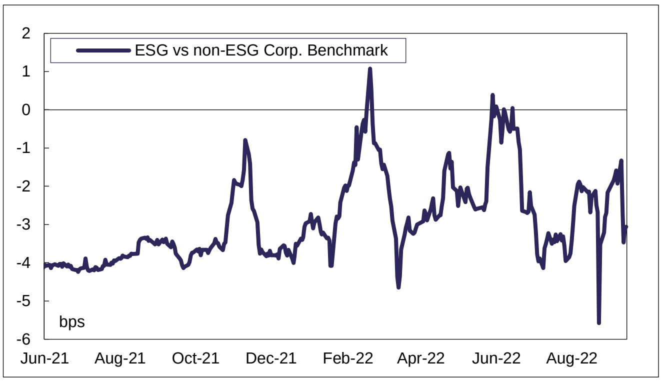
The average greenium for liquid sovereigns such as German Bunds continued the trend towards spread equivalence. Greater volatility due to market sell-offs have caused the spread differential to oscillate indiscriminately between positive and negative territory throughout the quarter. The 3Q22 median spread differential was -0.70bps compared to -6.38bps one year prior. (2Q22: -2.45bps; 1Q22: -5.06bps; 4Q21: -5.55bps; 3Q21: -6.02bps; 2Q21: -5.24bps; 1Q21: -4.39bps). More broadly, adverse trading conditions brought on by macroeconomic uncertainties, the ending of QE programmes and in some cases tightening of conditions led to worsening market liquidity. Liquidity appears to be the key driver of rising spread volatility between green and non-green bonds, as trading volumes of safe-haven assets have been curtailed by sizeable central bank and institutional investor holdings. Therefore, narrower sovereign greeniums are not necessarily a function of less liquidity of a particular green bond but tighter conditions in general. While central banks are currently scaling back their holdings, the need for decarbonisation of purchasing programmes is expected to drive future ESG bond growth. This was recently articulated by the ECB and could be emulated by other major central banks. Although details remain few, the ECB's corporate bond holdings and the collateral framework will form the cornerstones of this new approach, supporting future demand for sustainable credit.

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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