European Banks – Quarterly ESG Update (2Q23)

- ESG bond issuance volumes in 1H23 robust despite headwinds
- Lack of transition bond activity in Europe and dwindling SLB issuance activity may be halted by updated documentation published by ICMA and European Commission recommendation
- Primary market volumes of FIGs and SSAs generally performed well, particularly traditional green bonds. Sovereign and sub-sovereign issuers could support growth in the SSA and SLB space
- Secondary market spreads and greeniums recovered and stabilised in 2Q23 after mostly short-lived shocks.

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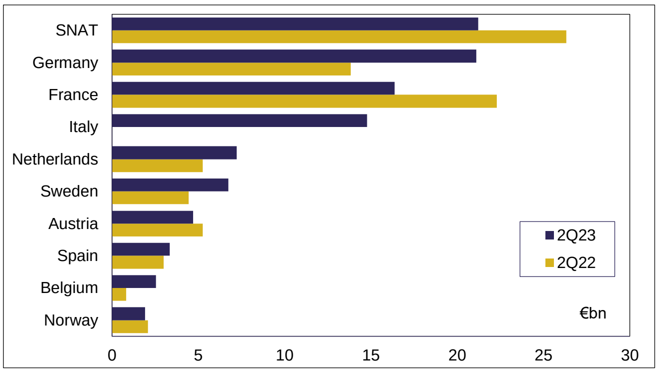
Overview: Sustainable finance markets robust amid headwinds

In 2Q23, global ESG bond issuance across all sectors – comprising green, social, sustainable and SLB bonds – rose again compared to last year. Issuance volumes in 2Q23 amounted to EUR262bn (2Q22: EUR236bn), up 10.8% yoy. This was the strongest recorded second quarter in terms of ESG debt supply, as increases were registered among sustainability (+29.1% yoy), social (+25.1% yoy) and green bonds (+10.9% yoy). The significant growth among sustainability bonds was aided by investments in emerging markets, where they are often focused. The above segments constituted a combined 95% share of total ESG issuance, and comfortably offset reductions among SLBs (-39.9% yoy) that continued their downward trend. Structural concerns persist over the adequacy of SLB coupon step-up features to adequately incentivise issuers from meeting their sustainability pledges. Equally, investors have raised concerns over the use of call options ahead of potential coupon step-up events that could result in allegations of greenwashing.

In Europe, ESG-linked bond sales from SSAs and FIGs reached EUR106bn in 2Q23 according to Bloomberg data, up 18.2% yoy. Of that total, green bond sales amounted to EUR66bn (+25.7% yoy), sustainable bond volumes stood at EUR21bn (+24.2% yoy) and social bonds accounted for EUR18bn (+6.3% yoy). Entities from Germany, France, Italy and the Netherlands led European ESG debt issuance in 2Q23 alongside Supranationals. ESG-themed bonds issued by European financial institutions rose by EUR5.8bn from a year earlier to EUR33bn (+21.5% yoy) last quarter. SSA volumes also contributed to the robust growth, rising EUR10.4bn to EUR72.5bn (+16.8% yoy).

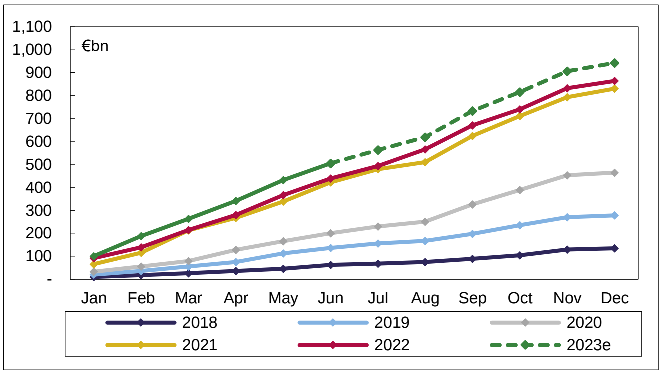
We maintain our 2023 outlook that foresees ESG bond volumes outpacing previous years, albeit with a greater reliance on the green bond component. In Europe alone, green bond issuance by FIGs (+35% yoy) and SSAs (+20% yoy) grew strongly during the second quarter. However, a drop-off in issuance activity from the real-estate sector, owing to higher interest rates and depreciating asset values, will likely present a headwind going into 2H23. Recent easing of inflationary pressures suggests that rates in Europe are approaching the peak, which may encourage near-term ESG supply.

European ESG Bond Issuance by Country



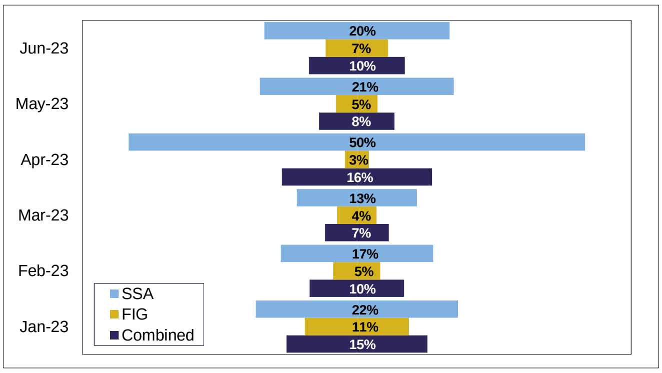
Source: Bloomberg; includes FIGs & SSAs; Daiwa Capital Markets Europe Ltd.

Cumulative annual sustainable debt transactions*



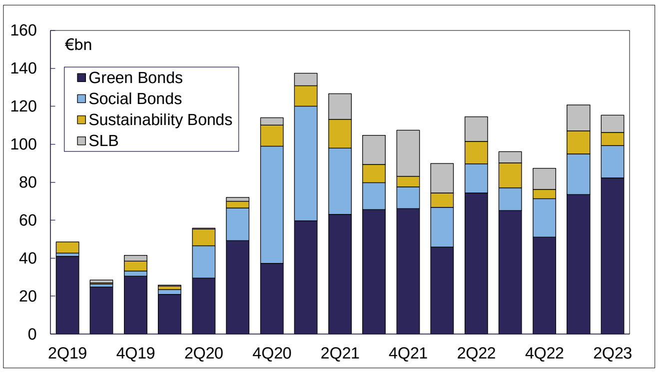
Source: Bloomberg; FIG, SSA & Corporates; *excl. securitisations, green loans and sustainability-linked loans; Daiwa Capital Markets Europe Ltd.

Proportion of ESG-themed debt to total issuance*



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

Quarterly European ESG Bond Issuance by Type



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

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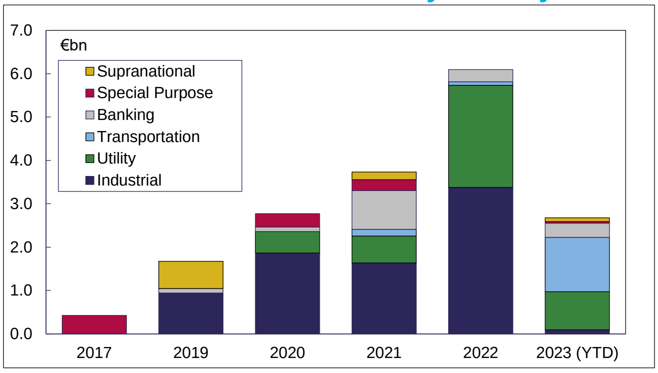
The state of transition finance in Europe

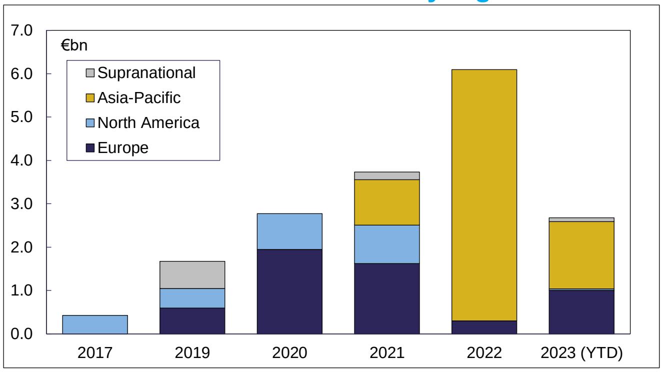
In Europe, the transition finance segment has experienced mixed fortunes in establishing itself alongside traditionally labelled debt instruments as enthusiasm for such bonds has ebbed and flowed. The sub-segment aims at transitioning high-carbon emitting industries and issuers to more environmentally friendly practices. However, Bloomberg data shows that so far in 2023 only 18 (self-labelled) transition bonds have been issued globally. 2022 issuance reached EUR6bn (YTD 2023: EUR2.7bn), which is relatively insignificant in a year when global ESG bond issuance totalled some EUR955bn. Of the EUR17.3bn in transition bonds issued since 2017, sector concentration remains geared towards Industrials (46% of total), Utilities (25%) and Banking (10%). This mixed picture can be attributed to a combination of factors such as a lack of established frameworks and definitions that raise market-participants' fears of greenwashing, as well as competition for transition finance from other issuance formats like sustainability-linked bonds. In contrast to Europe, investors in Asia (notably Japan and China) note the importance that their supportive policy and regulatory environments have played in facilitating issuance. Japan developed its own guidelines on transition finance in 2021, while the People's Bank of China worked on basic policies and market practices and also identified four sectors for transition finance standards (i.e. steel production, coal power, agriculture, and construction and related materials).

Global transition bond volumes by industry



Source: Bloomberg; Daiwa Capital Markets Europe Ltd.

Global transition bond volumes by region



Source: Bloomberg; Daiwa Capital Markets Europe Ltd.

In 2022, the number of transition bond transactions declined to just one in Europe, while the number of deals in Japan and China increased tenfold compared to the previous year to 50. In the two Asian countries, growth was largely driven by heavy industries and utilities and could soon be complemented by government issuances that are expected to further encourage private-sector deals. In Japan, the green transformation (GX) bond initiative is due to debut this year or early 2024 with the government aiming to raise an estimated JPY20tr over a 10-year period. This raises the question as to what direction the European transition finance landscape is taking as Asia gears up for further expansion in this field. To this end, two recent documents have the potential to reshape how transition labels are perceived in Europe: ICMA's updated 'Climate Transition Finance Handbook' and the European Commission's (EC) sustainable finance package (SFP).

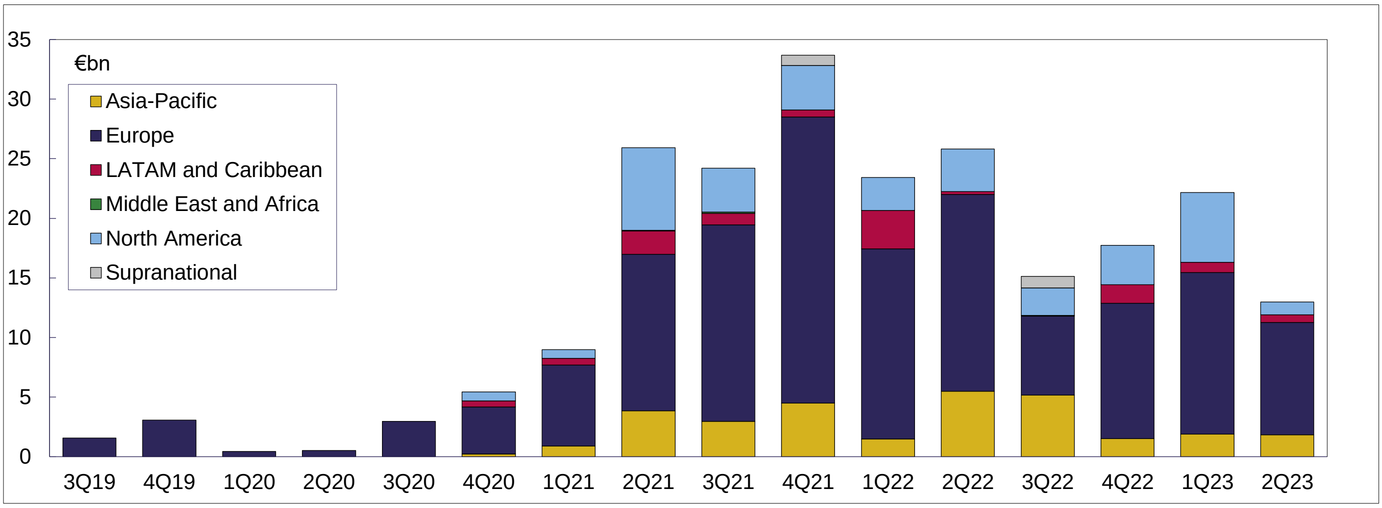
ICMA's revised transition finance handbook more granular but lacks dedicated label

When ICMA published the first iteration of its transition finance handbook in December 2020, it was no more than an eight-page pamphlet with basic guidance and common expectations for capital market participants on the practices, actions and disclosures to be made when raising funds in debt markets for climate transition-related purposes. The revised Climate Transition Finance Handbook (CTFH) from June updates its four key elements: 1) Issuer climate transition strategy and governance; 2) Business model environmental materiality; 3) Climate transition strategy use of science-based targets; and 4) Implementation transparency. The CTFH is also more explicit about the need for issuers to address scope 3 emissions (i.e. those emissions related to its value chain) in their reporting where these are material. Overall, the handbook remains focused on guiding transition finance through existing ESG bond labels rather than charting a route to a dedicated label. When presenting the CTFH at their annual conference, senior representatives at ICMA acknowledged demand for dedicated transition bonds in specific jurisdictions and market segments but generally saw them as a 'sub-label', similar to what blue bonds are to the green category or gender bonds are to the social category. For instance, 'green transition bonds' by the European Bank for Reconstruction and Development (EBRD) fit this 'sub-label' mould as they are aimed at facilitating transition activities but are issued under the bank's green bond framework.

ICMA's SLB-principles expanded to include (sub)-sovereigns

In addition to renewing its transition finance handbook, ICMA also provided a meaningful update to its 2023 Sustainability-Linked Bond Principles (SLBP). This includes revisions of the five core components to accommodate all types of issuers, including sovereigns and sub-sovereigns following the first such deals issued by the governments of Chile and Uruguay in 2022. These steps include new metrics for sovereigns and social issues in the KPI registry and will strengthen the format after sustained market criticism of the label over perceived weaknesses in the structures coming to market. SLBs are generally well suited to transpose transition information to investors. However, suitability is inextricably linked to sufficiently ambitious targets. Unlike use of proceed instruments, SLBs are based on environmental performance indicators defined by forecasts rather than specific projects and therefore lend themselves particularly to issuers on longer-term transition journeys. ICMA's broadening of the SLBPs to include sovereign and sub-sovereign entities, as well as Uruguay's innovative coupon step-down feature that built in a performance reward rather than just a penalty, could encourage European sovereigns to move in the direction of SLBs, attract a wider range of issuers and support modest growth over coming quarters. Since the beginning of 2022, the segment has been unable to maintain the momentum of previous years, not least as a result of volatile market conditions and increasing scrutiny with regards to greenwashing allegations. The SLB market experienced an almost nine-fold increase in 2021 against the previous year but endured a 11.5% decline by end-2022.

Sustainability-linked bond volumes continue to trend lower



Source: Bloomberg; Daiwa Capital Markets Europe Ltd.

European Commission gradually integrates transition activities into its frameworks

The other important document published in June was the Sustainable Finance Package (SFP), released by the European Commission (EC), containing a series of legislative and non-legislative announcements. These included transparency and integrity of ESG rating activities, updated Taxonomy criteria, a draft delegated act on European Reporting Sustainability Standards (ESRS), and lastly a much anticipated recommendation on transition finance. The EC's message, that transition finance will be essential for the EU to meet its sustainability targets, was clear and needed to be evaluated in the context of taxonomy usability. To this end the EC reported that 63% of companies included in the STOXX600 already reported some form of taxonomy eligibility and alignment within their 2022 annual reports. Upon closer inspection, the numbers reveal that only a small number are fully-aligned and vary for opex (24%), capex (23%) and revenues (17%). The numbers show us that companies in Europe are investing in taxonomy alignment but that revenues from these investments are lagging expenditure.

The report makes a series of recommendations to support market participants that wish to obtain or provide transition finance that the EC, for the purposes of its recommendation, defines as investments in portfolios tracking EU climate transition benchmarks, Paris aligned-benchmarks, and taxonomy-aligned activities among other things. The Commission expects that, over the short term, transition finance will often not result in improvements that meet green performance targets. However, over the long run, transition finance can be aligned with climate and environmental objectives of the EU and be considered either green or low-impact, thus removing any distinction. In order to access transition finance, entities should disclose credible transition plans with steps to reach climate neutrality by 2050.

Within the document there was still no mention of an extension of the EU taxonomy to include so-called 'amber' activities that reference standalone transitional activities and no steps were outlined for the creation of a transition bond standard. The idea for such an amber category was floated in 2022 by the EC's expert group, the Platform on Sustainable Finance (PSF), to explore the role of transition activities within an extended environmental taxonomy. Such an extension of the framework with a traffic light system would move past the dichotomy of green and non-green activities. However, we believe that it would likely have been intensely contested as evidenced by the protracted debate surrounding the inclusion of natural gas and nuclear energy into the EU taxonomy as transitional activities. The lack of sufficient green assets in the European economy necessitates the further adoption of transition finance. But from a policy perspective we don't anticipate any further significant impulses from the Commission ahead of next year's European Parliament elections in June and the appointment of a new Commission that may change the political climate in the EU.

European primary markets in 2Q23

SSA ESG issuance volumes in 2Q23 reached EUR73bn, flat compared to last quarter, of which 53% had a green bond indicator, 28% were sustainable bonds and 19% were labelled social bonds. Green bonds recorded strong gains (+54% qoq) during the quarter, helped by sizeable transactions from sovereigns (Germany, Italy and Austria) as well as frequent issuers such as KfW or NWB. At its annual meeting in June, ICMA released several updates to its set of principles, including SLB and social bond principles. These changes were announced alongside ICMA's inclusion of a 'just transition' into its guidance. This is expected to support the development of transition finance projects under a social guise. Updates to SLB principles now include key performance indicators (KPIs) related to national sustainable development policies that are relevant to sovereign issuers. This gradual broadening of principles and guidance may encourage modest volume growth in upcoming quarters.

SSA - Top 10 European ESG Issuers 1H23

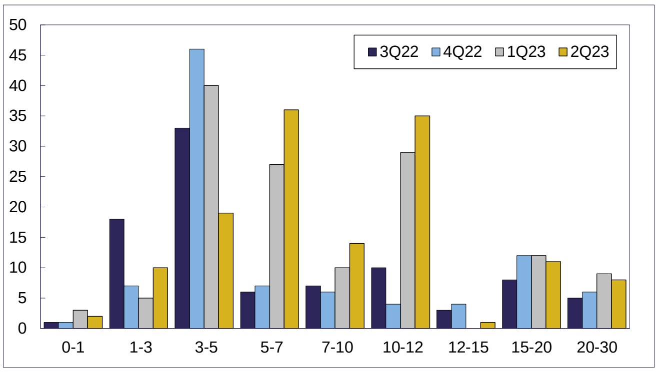
Issuers	Total Issued (€m)*	Average Tenor (years)
IBRD	23,995	8.2
CADES	18,459	5.8
EIB	12,353	8.3
Italy	10,000	8.5
Germany	9,750	20.0
KfW	6,622	5.2
AIIB	6,113	6.8
IADB	3,669	7.3
Ireland	3,500	20.8
BNG Bank	3,342	9.9

*Source: Bloomberg; *Cumulative issuance 1H23*

SSA green bond volumes rose considerably during the quarter to EUR39bn (+54% qoq) as issuers continued to front-load their annual funding needs during mostly benign funding conditions. The strong growth among green bonds compensated for declines among sustainability-linked bonds (-33% qoq) to EUR53m, sustainability bonds (-31% qoq) to EUR20bn, and social bonds (-25% qoq) to EUR13.5bn. The overall number of SSA transactions remained almost flat at 136 compared to the previous quarter and the average amount issued per transaction was also almost unchanged at EUR533m (-0.5% qoq). 2Q23 SSA supply was focussed on the middle segment of the curve with the majority of deals carrying a 5-7-year tenor (27%) followed by 10-12 years (26%) and 3-5 years (14%).

So far in 2023, local authorities or sub-sovereign SSAs have been one of the drivers of SSA issuance growth. According to Bloomberg data, during the first six months of 2023 the segment surged by 68% yoy, to more than EUR16.5bn. This is likely linked to the general trend we've observed among local government issuers increasing their share of bond issuance, especially among German states, despite their generally balanced budgets. Within this category, German development banks are poised to see their share of ESG labelled debt grow as they play an increasingly important role in facilitating the country's energy transition. The sector is split by 17 regional banks, of which NRW Bank is the largest, which. They implement development policies on behalf of their respective federal states and at the federal level, KfW and Rentenbank similarly enact policies on behalf of the central government.

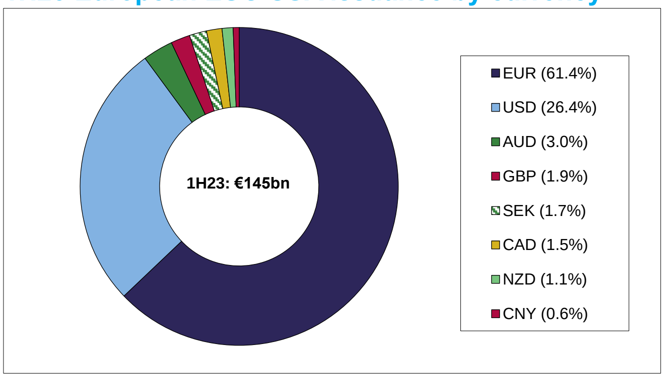
Number of SSA transactions per tenor bucket



Source: Bloomberg; Daiwa Capital Markets Europe Ltd.

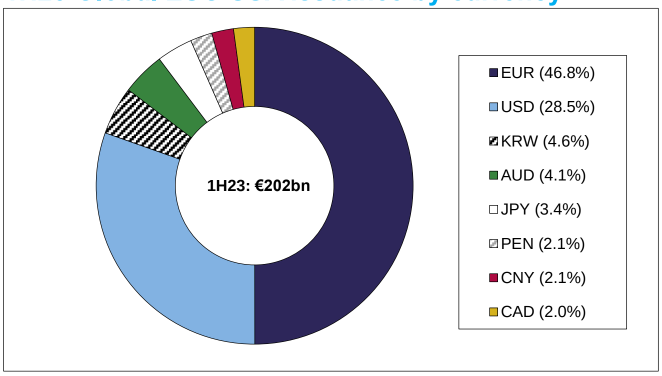
Since the pandemic, grants, loans and guarantees by German development banks have risen significantly, peaking at EUR153bn in 2020 (2022: EUR117bn) compared with pre-Covid averages of EUR73bn. The Association of German Public Banks stated that areas of growth in 2022 related to housing and urban development (EUR22bn), which doubled compared to the previous year, reaching historic highs. Growth was driven by measures aimed at improving household energy efficiency as well as the creation of new homeownership, and construction aid for flood victims. Development banks are expected to provide about 25% more funding this year than in 2022 due to heightened refinancing needs and lower budget surpluses. Additionally, innovative sustainability concepts, such as L-Bank's sustainability bonus, should further facilitate growth. This issuer offers interest rate reductions on loans to companies that develop a climate strategy, including CO2 assessments or defining emission reduction targets with associated implementation measures.

1H23 European ESG SSA issuance by currency



Source: Bloomberg; Daiwa Capital Markets Europe Ltd.

1H23 Global ESG SSA issuance by currency



Source: Bloomberg; Daiwa Capital Markets Europe Ltd.

Total **FIG ESG** volumes in 2Q23 reached EUR33bn (+21.5% yoy). Primary market activity was skewed toward the latter part of the quarter with May (41% of all deals) and June (37%) accounting for the bulk, while April (22%) was likely impacted by the U.S. and Swiss banking sector fallout. Towards the end of the last quarter and into 2Q23, capital market activity was greatly reduced in the weeks following the collapse of certain U.S. regional banks and the failure of Swiss behemoth Credit Suisse. Risk indicators and CDS prices remained at elevated levels, well into May, dampening capital market activity. Ultimately, spill-over effects and sector contagion didn't materialise, which led to a pick-up in activity. 2Q23 issuance saw the market taking on more duration as the proportion of bonds with medium tenors increased. Although senior bonds with shorter tenors continued to account for the majority of issuance medium-maturity trades were in increasing supply. Average bond maturities were mostly concentrated in the 3-5 year maturity bucket (36% of total), followed by 5-7 years (32%) and 1-3 years (16%). Of note was also the increase in themed subordinated debt supply, counting five trades, up from just one in the previous quarter.

FIG - Top 10 European ESG Issuers 1H23

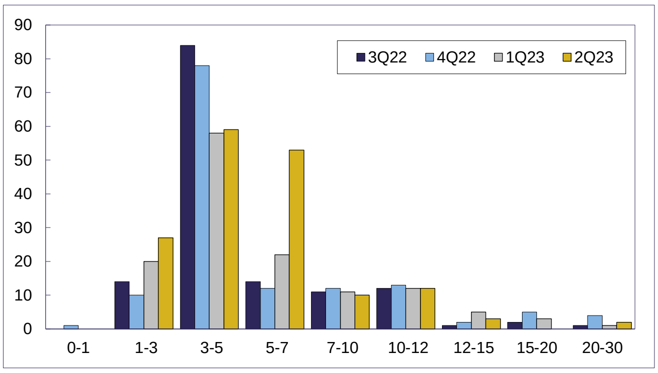
Issuers	Total Issued (€m)*	Average Tenor (years)
Intesa	6,054	6.8
ABN Amro	3,243	4.2
Danske Bank	2,225	5.2
DNB Bank	2,144	5.0
BNP Paribas	2,000	7.0
Berlin Hyp	1,916	7.7
Stadshypotek AB	1,763	5.0
Banco BPM	1,500	4.5
Swedbank	1,374	5.5
La Banq. Post. SFH	1,250	8.0

*Source: Bloomberg; *Cumulative issuance 1H23*

Subordinated debt issuance, including ESG-themed notes, remained curtailed for an extended period following the write-down of Credit Suisse AT1s in March. But Banco Santander reopened the conventional sub-debt market in mid-May, opting to launch the first Tier 2 bond since the Credit Suisse fallout. The issuer's high-quality status and solid credit profile allowed spreads to tighten during pricing, resulting in a new issue premium (NIP) of 20-25bps. This was comparable to that of some senior trades at the time, which was seen as an excellent result considering the preceding market volatility. This positive outcome laid the groundwork for the first sizeable financial institution to place an ESG labelled Tier 2.

Just one week after the positive reception towards Banco Santander's Tier 2 opener, **BPCE**, one of France's largest banks, issued the first social themed Tier 2 bond since August 2022. It was the issuer inaugural ESG Tier 2 and proceeds were aimed at granting clients with loans that contribute to local economic development, particularly in low income areas. The bank raised EUR500m with a maturity of 10NC5. Due to pent up demand for high yielding debt from high quality issuers, demand for the issue was strong, attracting EUR4.6bn in orders. This resulted in a significant reduction of the spread by 35bps to MS+265bps. Ultimately, the deal was 9.2x subscribed, making it the most oversubscribed ESG bank bond so far in 2023. The resulting NIP of 10-15bps was a very strong result considering the higher premiums charged on senior trades during that period.

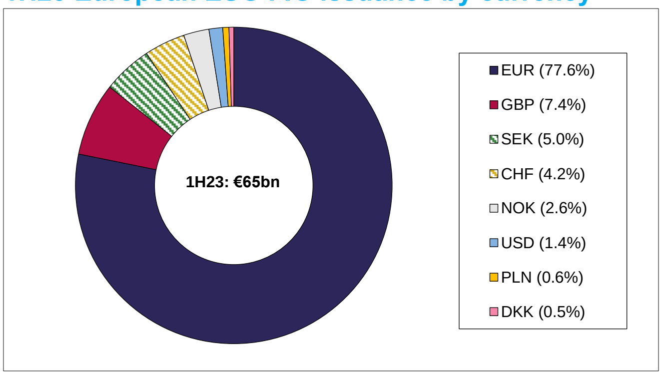
Number of FIG transactions per tenor bucket



Source: Bloomberg; Daiwa Capital Markets Europe Ltd.

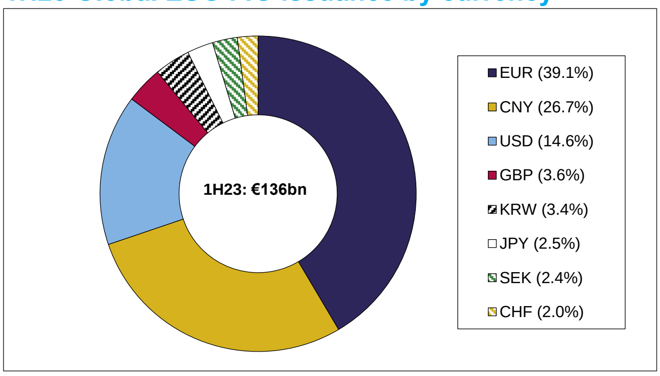
Italian banks, alongside French and Swedish entities issued the most labelled debt during the quarter. **Intesa** alone issued the equivalent of EUR3.1bn across three ESG deals in euro and sterling, solidifying its top position in our FIG ESG issuer ranking. A green SP dual-tranche transaction supplied EUR2.25bn into the market in mid-May and was complemented by Intesa's inaugural sterling social SP bond just one week on. The latter was the longest senior FIG transaction in sterling so far this year as it carried a 10-year tenor. The duration on offer for the GBP750m bond was met with 2.1x demand, helping spreads tighten to G+265bps (-20bps from IPT). Funding in sterling appears more attractive for the Italian bank in this segment of the curve when compared to the euro equivalent as the 5-year and 10-year segment in euros is relatively steep. NIP on the deal is thought to have been between 20-25bps.

1H23 European ESG FIG issuance by currency



Source: Bloomberg; Daiwa Capital Markets Europe Ltd.

1H23 Global ESG FIG issuance by currency



Source: Bloomberg; Daiwa Capital Markets Europe Ltd.

Key ESG Transactions 2Q23

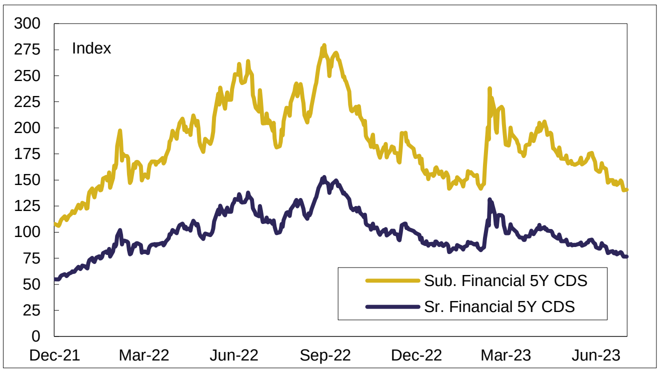
Bank	Rank	Amount	Maturity	IPT (bps)	Final Spread (bps)	Book Orders
SSA						
Italy	Sr. Unsecured (Green)	EUR10bn	8Y	BTPS + 10	BTPS + 8	>EUR52.9bn
Germany	Sr. Unsecured (Green)	EUR5.25bn	10Y	B +/- 0	B – 0.5	>EUR14.8bn
Germany	Sr. Unsecured (Green)	EUR4.5bn	30Y	B +/- 0	B – 0.5	>EUR29bn
IBRD	Sr. Unsecured (SDB)	USD5bn	5Y	SOFR MS + 39	SOFR MS + 37	n.a.
IBRD	Sr. Unsecured (SDB)	EUR2bn	15Y	MS + 26	MS + 25	>EUR2.6bn
IBRD	Sr. Unsecured (SDB Tap)	AUD500m	Apr-2033	ASW + 51	ASW + 51	n.a.
IBRD	Sr. Unsecured (SDB)	NZD950m	3Y	MS + 15	MS + 15	n.a.
CADES	Sr. Unsecured (Social)	USD3bn	5Y	SOFR MS + 47	SOFR MS + 45	>USD4.5bn
CADES	Sr. Unsecured (Social)	EUR3bn	8Y	FRTR + 28	FRTR + 26	>EUR11bn
Austria	Sr. Unsecured (Green)	EUR3bn	6Y	MS – 15	MS -17	>EUR6.8bn
KfW	Sr. Unsecured (Green)	EUR3bn	7Y	MS – 11	MS - 13	>EUR6.4bn
Land NRW	Sr. Unsecured (Sustainable)	EUR2bn	10Y	MS + 6	MS + 3	>EUR13bn
NWB Bank	Sr. Unsecured (Water)	EUR1.5bn	10Y	MS + 13	MS + 11	>EUR3.8bn
NWB Bank	Sr. Unsecured (Social)	USD1bn	5Y	SOFR MS + 47	SOFR MS + 45	>USD1.8bn
BNG Bank	Sr. Unsecured (Social)	USD1.5bn	5Y	SOFR MS + 488	SOFR MS + 45	>USD1.8bn
SNCF	Sr. Unsecured (Green)	EUR1.25bn	10Y	OAT + 53	OAT + 50	>EUR3.2bn
Bpifrance	Sr. Unsecured (Green)	EUR1bn	10Y	OAT + 34	OAT + 29	>EUR17.8bn
SGP	Sr. Unsecured (Green)	EUR1bn	30Y	OAT + 53	OAT + 52	>EUR1.8bn
NRW Bank	Sr. Unsecured (Green)	EUR1bn	7Y	MS +/- 0	MS - 2	>EUR1.7bn
NRW Bank	Sr. Unsecured (Social)	EUR1bn	10Y	MS + 3	MS + 3	>EUR1.25bn
CEB	Sr. Unsecured (Social)	EUR1bn	7Y	MS - 1	MS - 3	>EUR1.9bn
EIB	Sr. Unsecured (Sustainable)	GBP750m	5Y	G + 52	G + 51	>GBP1.15bn
Region Wallonne	Sr. Unsecured (Green)	EUR700m	15Y	BGB + 45	BGB + 44	>EUR1bn
Auto. Comm. Madrid	Sr. Unsecured (Green)	EUR600m	5Y	SPGB + 26	SPGB + 21	>EUR2.6bn
FIG (Senior)						
Intesa	SP (Green)	EUR1.25bn	3Y	MS + 115	MS + 90	>EUR1.9bn
Intesa	SP (Green)	EUR1bn	7Y	MS + 220	MS + 195	>EUR2.8bn
Intesa	SP (Social)	GBP750m	10Y	G + 285	G + 265	>GBP2.1bn
Danske	SNP (Green)	EUR1bn	7NC6	MS + 195	MS + 170	>EUR2bn
SEB	SP (Green)	EUR1bn	4Y	MS + 100	MS + 80	>EUR1.65bn
CaixaBank	SNP (Social)	EUR1bn	4NC3	MS + 170	MS + 150	>EUR1.5bn
BNP Paribas	SNP (Green)	EUR1bn	8NC7	MS + 160	MS + 137	>EUR1.85bn
ABN Amro	SP (Green)	GBP750m	3Y	G + 175	G + 160	>GBP1.25bn
Banco BPM	SNP (Green)	EUR750m	5NC4	MS + 300	MS + 280	>EUR1.15bn
Sabadell	SP (Green)	EUR750m	6NC5	MS + 230	MS + 200	>EUR1.8bn
Belfius	SP (Green)	EUR750m	5Y	MS + 110/115	MS + 90	>EUR1.95bn
KBC Group	Sr. HoldCo (Social)	EUR750m	8.5Y	MS + 165	MS + 145	>EUR1.5bn
BayernLB	Sr. HoldCo (Green)	EUR750m	5.5NC4.5	MS + 205	MS + 245	>EUR5bn
Credito Emiliano	SNP (Green)	EUR400m	6NC5	MS + 275	MS + 250	>EUR2.2bn
deVolksbank	SNP (Green)	EUR500m	4.5Y	MS + 180	MS + 170	>EUR625m
Crédit Mutuel Arkéa	SP (Social)	EUR500m	5Y	MS + 120/125	MS + 103	>EUR1.5bn
Swedbank	SNP (Green)	GBP400m	6NC5	G + 240	G + 230	>GBP615m
FIG (Subordinated)						
NN Group	Tier 2 (Green)	EUR1bn	20.5NC10.5	MS + 340	MS + 300	>EUR2.6bn
BPCE	Tier 2 (Social)	EUR500m	10NC5	MS + 300	MS + 265	>EUR4.6bn
Generali	Tier 2 (Green)	EUR500m	10Y	MS + 285	MS + 240	>EUR3.4bn

Source: BondRadar, Bloomberg; SDB=Sustainable Development Bond; Daiwa Capital Markets Europe Ltd.

Secondary markets in 2Q23

CDS prices resumed their downward trend following a brief period of turbulence related to bank failures in the U.S. and Europe. Mostly easing inflationary pressure and less hawkish central bank stances have improved market sentiment, animating primary market activity, while generally reducing spreads in secondary markets. However, some supply-side concentration in shorter dated maturities has put pressure on those spreads while we expect to see increased duration premiums in the second half of the year, particularly at the longer end of the curve due to prevailing economic uncertainties. This view is echoed by the still elevated level of new issue premiums compared to fair value, a benchmark for investors. Credit fundamentals remain robust so far in part helped by mostly better than expected 2Q23 FIG earnings reports.

iTraxx Financials Index

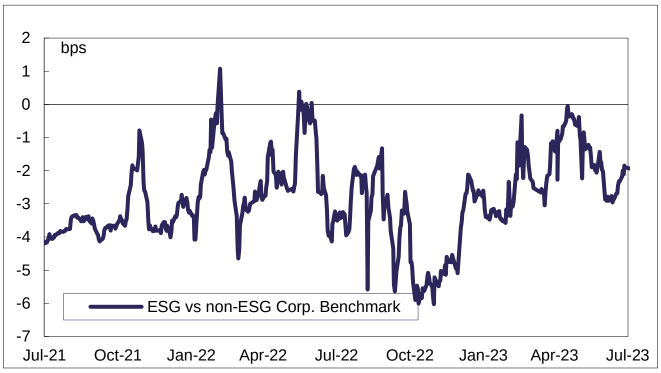


Source: Bloomberg; Data until 31.07.2023; Daiwa Capital Markets Europe Ltd.

ESG bond spreads recover from short-lived shocks

Supply of sustainable debt, particularly in Europe, increased compared to the same period last year, while short-lived periods of volatility in April and May saw the option-adjusted spread (OAS) between the ESG and non-ESG themed indices narrow temporarily before easing somewhat towards the end of the quarter and into July. The median negative OAS differential between the ESG and non-ESG benchmark indices was -1.32bps, from -2.9bps in 1Q23 and -2.32bps in 2Q22. Increased supply of ESG-labelled debt and the recovery of the greenium appear to have made at least one line of reasoning for the persistence of greenium appear less valid now. The rationale was that the greenium started to exists due to supply and demand imbalances. However, as supply has caught up with demand in a maturing market with more pricing experience for these types of bonds, the basis for lower spreads on labelled debt should disappear. So far at least, this does not entirely appear to be the case.

Spreads (OAS) of ESG vs non-ESG benchmarks

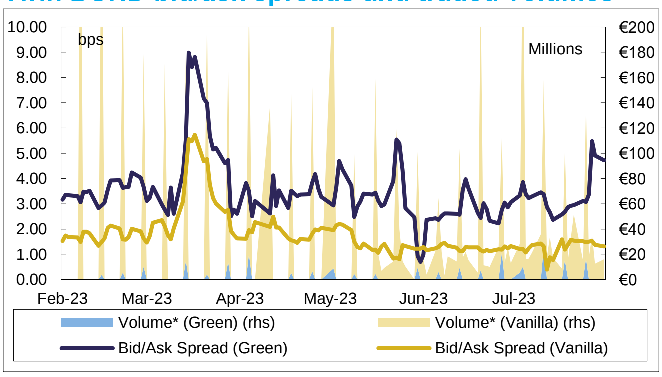


Source: Bloomberg; Barclays MSCI Euro-Corporate ESG Index vs Barclay Pan-European Aggregate Corporate Index; Data until 31.07.2023; Daiwa Capital Markets Europe Ltd.

Greenium stability for Bunds

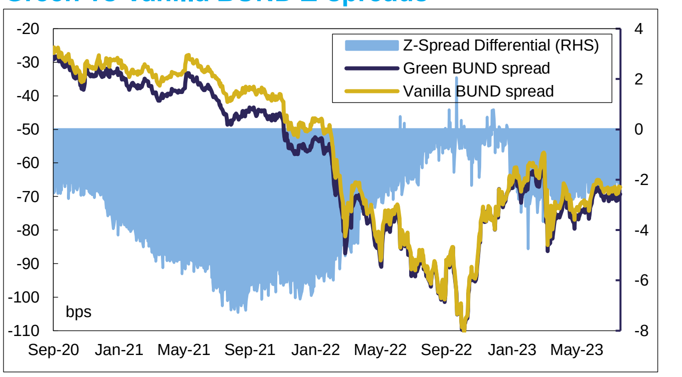
Average greeniums for liquid sovereigns such as German Bunds held firm over the past quarter, maintaining a stable buffer over the equilibrium. The 2Q23 median spread differential of the German Twin Bunds was -2.54bps compared to -2.45bps one year prior. On a quarterly basis, spreads also remained stable (1Q23: -2.49bps; 4Q22: -0.50bps; 3Q22: -0.76; 2Q22: -2.45bps), a reflection of the overall more benign market conditions in 2023. This has helped the greenium recover compared to last year following a series of exogenous shocks. Improvements can be seen in higher and more frequent traded volumes of both green and non-green Bunds, albeit still heavily skewed to the more liquid vanilla Bunds. Looking at the bid-ask spreads of the twin Bunds, we still find the green bond consistently wider. Based on Bloomberg data, we calculate that the 3-day rolling average spread over the past three months was 3.12bps for the green (previous reading: 3.93bps) and 1.31bps (2.29bps) for the conventional bond. The green bond in particular still displayed more erratic swings owed to its lower market liquidity.

Twin BUND bid/ask spreads and traded volumes



Source: Bloomberg; until 31.07.2023; Daiwa Capital Markets Europe Ltd.

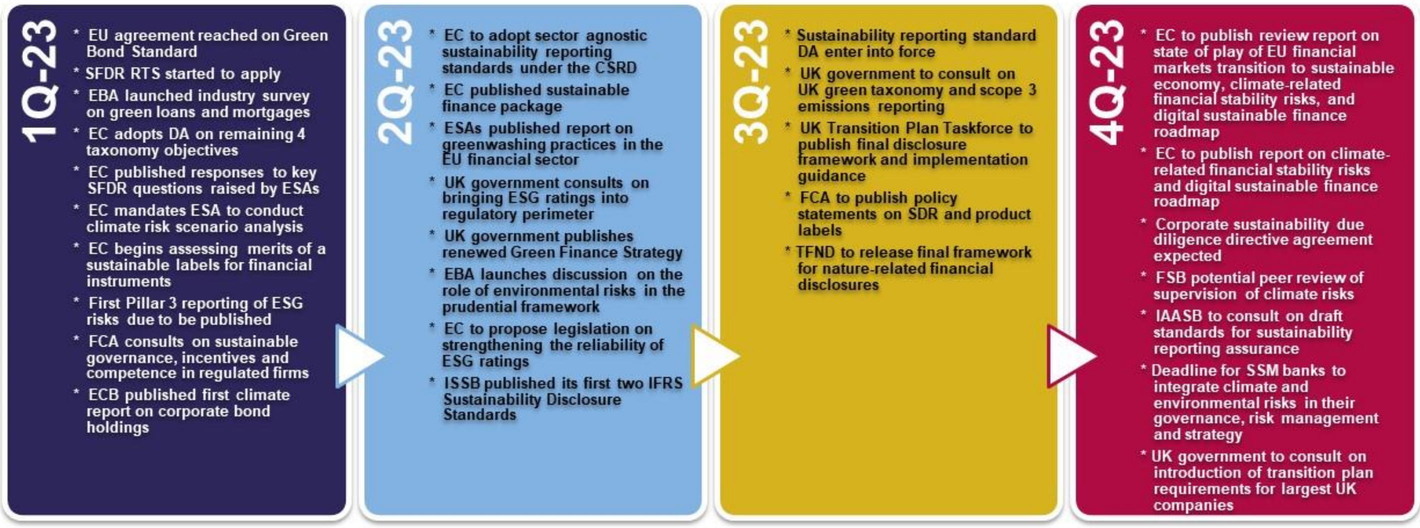
Green vs Vanilla BUND Z-spreads



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

Appendix:

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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