European Banks – Quarterly ESG Update (3Q23)

- Record year for ESG issuance in 2023 still possible despite third quarter slump
- Primary market volumes of FIGs and SSAs underperformed due to market volatility but issuers still presented innovative structures to investors
- After some widening in secondary market spreads throughout 3Q23, indicative fourth quarter data suggests markets have firmed as risks receded and greeniums were partially restored
- Fixed income markets face new regulatory and disclosure requirements that will raise standards but also improve data quality and comparability of entities from an environmental perspective

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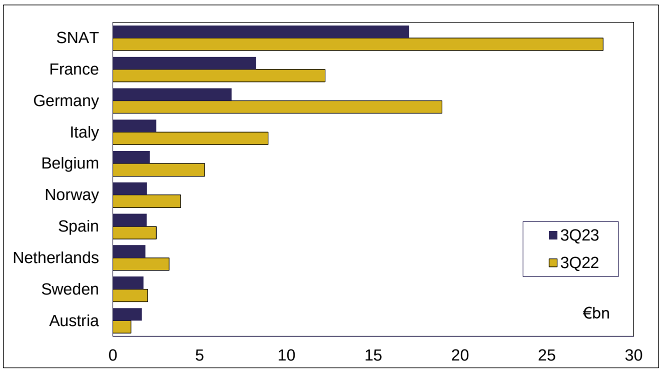
Overview: Record year for ESG issuance in 2023 still possible despite 3Q23 slump

In 3Q23, global ESG bond issuance across all sectors – comprising green, social, sustainable and SLB bonds – declined noticeably compared to last year. Issuance volumes in 3Q23 amounted to EUR180bn (3Q22: EUR230bn), down 21.7% yoy. This was the weakest quarterly performance in terms of ESG debt supply since 4Q20. Reductions were registered across all categories, with sustainability (-32.1% yoy), green (-23.3% yoy) and social bonds (-9.9% yoy) most affected. SLB bond volumes remained broadly flat (-0.9% yoy), however they only occupy an 8.5% share of the total quarterly volume. Despite the overall pullback in 3Q23 volumes, green and social bonds remain ahead of last year's figures on a 9M basis, by 7.6% and 1.2% respectively. Thus, 9M23 total issuance of EUR721bn remained up 2.1% yoy.

In Europe, ESG-linked bond sales from SSAs and FIGs reached EUR52bn in 3Q23 according to Bloomberg data, down 45.2% yoy. Of that total, green bond sales amounted to EUR21bn (-58.7% yoy), sustainable bond volumes stood at EUR19bn (-32.7% yoy) and social bonds accounted for EUR11bn (-21.3% yoy). Entities from France, Germany, Italy and Belgium led European ESG debt issuance in 3Q23 alongside Supranationals. ESG-themed bonds issued by European financial institutions fell by EUR9.1bn from a year earlier to EUR18.5bn (-33% yoy). The drop among SSAs was even more pronounced as volumes fell by EUR33.5bn to EUR33bn (-50.2% yoy).

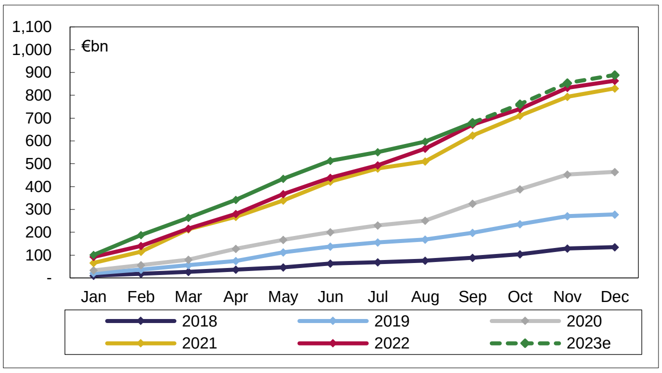
The reduction in sustainable bond volumes in 3Q23 was not just limited to this segment of the fixed income market. In fact, issuance across global bond markets declined for a variety of factors. Undoubtedly, falling issuance volumes and higher yields were a response to major central banks signalling their 'higher-for-longer' rate stance, despite pauses in their respective rate hike cycles. It also coincided with a general slowdown in economic activity in Europe and uncertain outlooks for 2024. Nevertheless, we remain cautiously optimistic for 4Q23 issuance activity as funding conditions have improved on the back of slowing inflation reads and possible monetary policy pivots in 2024. We also anticipate positive growth momentum for ESG debt stemming from the COP28 conference taking place in Dubai.

European ESG Bond Issuance by Country



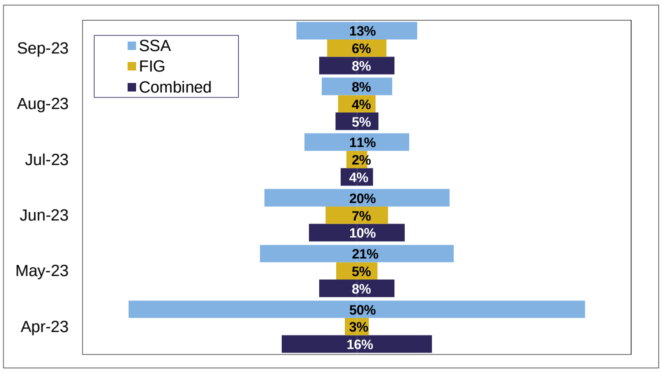
Source: Bloomberg; includes FIGs & SSAs; Daiwa Capital Markets Europe Ltd.

Cumulative annual sustainable debt transactions*



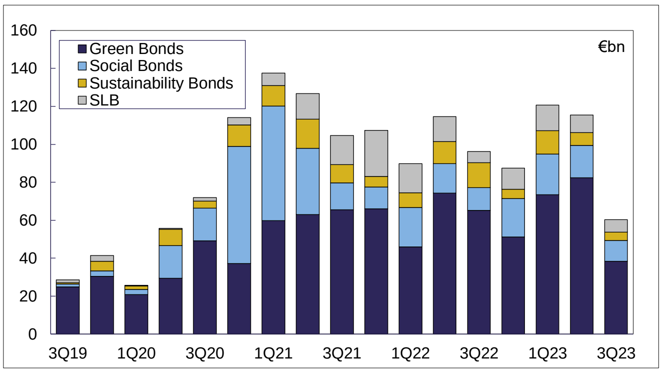
*Source: Bloomberg; FIG, SSA & Corporates; *excl. securitisations, green and sustainability-linked loans; Daiwa Capital Markets Europe Ltd.*

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.

Key regulation and disclosure highlights impacting the ESG landscape in 2024 and beyond

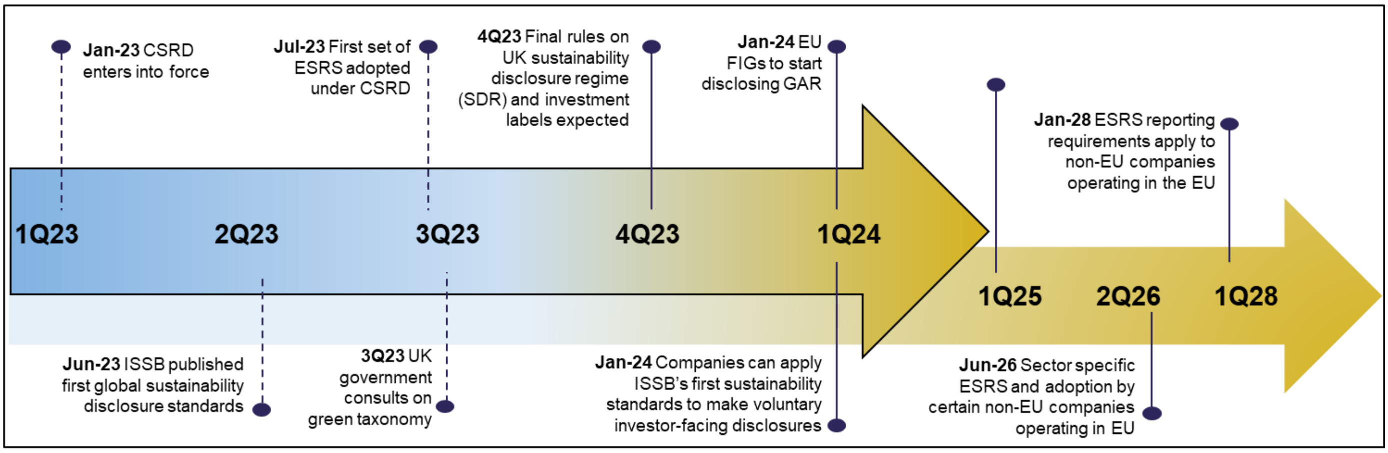
CSRD and Green Asset Ratio aim to enhance comparability

In Europe, 2023 has seen a host of key regulatory and disclosure standards agreed that will help advance data availability and the quality of the ESG landscape in 2024 and beyond. The Corporate Sustainability Reporting Directive (CSRD), which builds on the Non-Financial Reporting Directive (NFRD), is more encompassing than its precursor as it incorporates smaller companies and third-country entities in its reporting framework. It aims to improve the transparency of social and environmental information provided by companies in all sectors, requiring them to publish annual reports on sustainable policies. The European Commission delayed CSRD implementation to 2024, when entities in scope will have to disclose their taxonomy-alignment. Since 2022, financial institutions have only been required to disclose their share of taxonomy-eligible assets. But as of next year, financial institutions will also need to disclose their taxonomy-aligned activities. The differences in the application of eligibility calculations means these figures are often not comparable between institutions. For financial institutions, the introduction of the 'Green Asset Ratio' (GAR) in 2024 will harmonise and quantify in a single figure the share of taxonomy-aligned balance sheet exposures. Admittedly, in its current form, the ratio has limitations due to omissions and exclusions from its equation, thus reducing its usefulness when trying to analyse and compare a large number of FIGs with different business models and varying balance sheet compositions.

Europe consolidates sustainability reporting with ESRS

Another reporting milestone was reached in 3Q23 in relation to the adoption of the European Sustainability Reporting Standards (ESRS). The standards will harmonise and consolidate the sustainability reporting processes, which should lead to better comparability between companies on their standalone environmental impact performance. The CSRD sets the legislative framework mandating sustainability reporting, defining its scope, while the ESRS in turn provides the practical methodology for how to report on sustainability. A key feature for reporting under these regulations is the double materiality principle, where firms have to consider how their business is impacted by environmental or social issues, as well as how their activities impact society and the environment. The Commission has tried to ensure a high degree of alignment between ESRS and the standards set by the independent standard-setting body, the International Sustainability Standards Board (ISSB). The CSRD will be applied from January 2024, with first reporting expected in 1Q25.

Select ESG regulatory milestones



Source: Daiwa Capital Markets Europe Ltd; (CSRD) = Corporate Sustainability Reporting Directive; (ISSB) = International Sustainability Standards Board; (ESRS) = European Sustainability Reporting Standards; (SDR) = Sustainability Disclosure Regime; (GAR) = Green Asset Ratio; (GBS) = Green Bond Standard

Green bond standard finalised but initial uptake will likely be limited

Following an initial political agreement in February, the voluntary EU green bond standard (GBS), which foresees project alignment with the EU-taxonomy, was finally approved and adopted in October. Once the text has been published in the EU's Official Journal, it should then apply within 12 months, thus potentially becoming effective sometime in late 2024 or early 2025 and allowing then for issuers to officially market EU-GBS bonds. Initially we expect the GBS to be used by EU institutions and other dedicated ESG issuers. Broader adoption could be limited by concerns surrounding the current usability of the taxonomy, particularly surrounding the 'Do No Significant Harm' (DNSH) and 'Minimum Safeguards' requirements. Furthermore, the reliance on European legislation and criteria means it will be more challenging to assess projects outside of the EU. The limited stock of eligible assets under the taxonomy and the rather modest 15% flexibility pocket, which allows for the inclusion of activities not yet covered by taxonomy, will likely be an impediment to wider adoption of the standard, for now at least. Despite these headwinds, we do believe that there will be an early adopter advantage for issuers that take on the challenges that the label presents. The stricter requirements will set any EU-GBS bonds apart from 'regular' green bonds and could command a larger greenium to what we currently see.

EBA prepares environmental and social considerations for capital requirements

When the European Banking Authority (EBA) published its environmental statement at the 2023 United Nations Climate Change Conference (COP28), it reiterated its efforts to integrate sustainability aspects in many areas of its work, including risk management, disclosures, supervisory practices, climate stress testing and the Pillar 1 framework. The latter would represent a world first as it aims to set industrywide capital requirements for eurozone banks, incorporating environmental and social risks. The EBA recommended this approach in favour of introducing environmentally supporting or penalising adjustment factors in its Pillar 1 assessment. In a report published in October, it identified some 'short-term actions' (over next three years) as part of the implementation of the revised Capital Requirements Regulation (CRR3) and Capital Requirements Directive (CRD6). Near-term recommendations contain among other things i) the inclusion of environmental risks as part of the stress testing program; ii) incentives for environmental and social factors to be part of external credit assessments by agencies; and iii) the development of environment-related concentration risk metrics as part of supervisory reporting. Over the 'medium-long term' the report also presents possible revisions to the Pillar 1 framework, reflecting the growing importance of environmental and social risks, most notably considering the role transition plans can play in the future as part of the development of further risk-based enhancements to the Pillar 1 framework. The EBA's plan will not introduce additional capital requirements any time soon or drive imminent rating actions. However, the greater recognition of the aforementioned risk factors will influence the risk profile of the European banking landscape and traditional risk categories.

Daiwa Capital Markets Conference 2023: ESG Panel

Each November, Daiwa Securities hosts its annual Capital Markets Conference (DCMC) in Tokyo, bringing together issuers and investors to discuss key market developments. An SDG-related panel discussion at this year's DCMC, which can be viewed here, brought together a diverse group of SSA issuers to explore the future of ESG debt markets and recent developments within the green, social and transitional finance spaces.

Globally, public and private sector entities are developing increasingly ambitious climate change mitigation and adaptation strategies while investing in more sustainable technologies with potential to be transformative for communities and whole economies. The panel explored how to meaningfully assess these developments and ensure that they are not only economically successful but also conducted in a socially and responsible way.

DCMC 2023: SDG Panel Members

Panellist	Role	Institution
Masahiro Ito	Director, Capital Markets and Funding Division, Treasury Department	Japan Bank for International Cooperation (JBIC)
Karoliina Kajova	Senior Manager, Funding	Municipal Finance pls (Munifin)
Isabelle Laurent	Deputy Treasurer and Head of Funding	The European Bank for Reconstruction and Development (EBRD)
Junko Takahashi	Senior Director of the Treasury, Finance and Accounting Department	Japan International Cooperation Agency (JICA)
Novi Puspita Wardani	Deputy Director for Portfolio Management in the Directorate of Government Debt Securities	Ministry of Finance, Indonesia
William Hahn (Moderator)	Senior Credit & ESG Analyst Europe	Daiwa Capital Markets Europe (DCME)

Key talking points and take-aways from the session included the following:

- **Taxonomy developments:** Ongoing green taxonomy developments are not only shaping financial products but also help develop incentive and disincentive polices in the public sector. In Europe, taxonomy alignment under the GBS is still considered a challenge for the market due to prevailing data gaps and the upskilling required. Meeting DNSH and minimum safeguards represents a hurdle, which should be considered at project implementation phase rather than later on in the process to ensure necessary conditions are met and green financing is secured. Separately, recognising the need for transitional energy technologies such as natural gas under the EU taxonomy was also considered to be important as they can not only substantially reduce the output of carbon emissions compared with oil or coal use, but also reduce pollution.

- **Transition finance:** In order to meet targets under the Paris agreement, transitional activities are essential. Renewable energy development, for instance, is still strongly interlinked with industries that require significant decarbonisation drives (e.g. steel, chemicals, concrete), so 'lock-in' of old technologies for future renewable energy development needs to be avoided. And if robust and substantial, interim technologies can mitigate otherwise negative and harmful practices. Thus, in the context of the taxonomy, transition finance should be not seen as separate from green finance as long as it is robust, substantial and avoids 'lock-in'.

- **Project evaluation and transparency:** Comprehensive and meaningful project evaluation relies on well-defined and innovative metrics and access to good quality data. The latter can be a challenge, especially when there is reliance on collecting reliable data from third parties. Standard guidelines and harmonised frameworks for impact reporting can help in this regard at the project level. Understanding what is considered core information by key institutions significantly improves comparability across projects. However, contextualising information is just as relevant as assessing numerical impact metrics. Context can be provided by using innovative data collection methods, such as satellite imagery when tracking progress on reforestation or electrification projects.

- **Capacity building:** A big focus of MDBs is capacity building, using the knowledge of experts to help understand what aspects of transition plans are relevant for a particular sector or entities. This transfer of knowledge provides benefits and co-benefits and helps assess whether a project is sufficiently ambitious. In this context, taxonomies are helpful as they provide a common language and a general understanding of what can and should be considered ambitious enough.

- **'Just transition' and climate change adaptation:** Many green bonds already incorporate social aspects and it is considered a natural progression to place increasing emphasis on these factors given the rapid and large-scale transformations underway across many sectors. The social co-benefits of green bonds need to revolve around enabling a 'just transition' for people affected by these significant changes. Additionally, challenges for social bond markets emerge from the fact that their assessments are more qualitative and not as easily quantifiable, an area that needs to see improvement. Considerations around climate change adaptation for investors are increasingly coming to the forefront as we are already seeing the adverse consequences of climate change around us. Therefore, adaptation strategies need to be considered now, alongside mitigation efforts as the Paris agreement also mentions climate resilience as one of its objectives.

Key ESG Transactions 3Q23

Bank	Rank	Amount	Maturity	IPT (bps)	Final Spread (bps)	Book Orders
SSA						
CADES	Sr. Unsecured (Social)	USD4bn	3Y	SOFR MS + 37	SOFR MS + 34	>USD11bn
IBRD	Sr. Unsecured (SDB)	GBP850m	7Y	G + 39	G + 39	>GBP1bn
IBRD	Sr. Unsecured (SDB)	EUR2.5bn	15Y	MS + 30	MS + 29	>EUR4.8bn
IBRD	Sr. Unsecured (SDB)	USD3.5bn	5Y	SOFR MS + 35	SOFR MS + 34	>USD5.25bn
IBRD	Sr. Unsecured (SDB)	USD3bn	7Y	SOFR MS + 44	SOFR MS + 43	>USD4.25bn
Flemish Community	Sr. Unsecured (Sustainability)	EUR1.5bn	19Y	OLO + 35	OLO + 30	>EUR12.7bn
BNG Bank	Sr. Unsecured (Social)	EUR1bn	10Y	MS + 12	MS + 11	>EUR1.5bn
BNG Bank	Sr. Unsecured (Social)	EUR500m	15Y	MS + 34	MS + 33	>EUR790m
Rentenbank	Sr. Unsecured (Green)	EUR1bn	10Y	MS + 2	MS + 1	>EUR1.75bn
Land Hesse	Sr. Unsecured (Green)	EUR1bn	10Y	MS + 2	MS - 1	>EUR2.4bn
IFC	Sr. Unsecured (Green)	CAD1bn	3Y	CORRA + 15	CORRA + 14	>CAD1.3bn
KfW	Sr. Unsecured (Green Tap)	NOK1bn	Jan-2029	n.a.	N + 15	n.a.
KfW	Sr. Unsecured (Green)	CAD500m	5Y	CORRA + 25	CORRA + 25	>CAD725m
ICO	Sr. Unsecured (Social)	EUR500m	5Y	SPGB + 20	SPGB + 15	>EUR2.3bn
AFD	Sr. Unsecured (Sustainability)	EUR500m	15Y	OAT + 43	OAT + 39	EUR6.1bn
IBB	Sr. Unsecured (Social)	EUR500m	5Y	MS – 1	MS – 1	>EUR830m
Kommuninvest	Sr. Unsecured (Green)	EUR500m	4Y	MS – 6	MS - 8	>EUR1.3bn
FIG (Senior)						
Société Générale	SNP (Green)	EUR1bn	6NC5	MS + 175	MS + 150	>EUR1.9bn
DNB Bank	SNP (Green)	EUR1bn	5NC4	MS + 125	MS + 100	>EUR2.1bn
Bank of Ireland	Sr. HoldCo (Green)	EUR750m	8NC7	MS + 225	MS + 205	>EUR1.5bn
BFCM	SP (Social)	EUR750m	7Y	MS + 130	MS + 100	>EUR2.7bn
Commerzbank	SNP (Green)	EUR600m	5.5NC4.5	NS + 225	MS + 195	>EUR5bn
Crelan	SNP (Green)	EUR600m	6NC5	MS + 300	MS + 285	>EUR1.15bn
Grenke	Senior Unsecured (Green)	EUR500m	3Y	8.00%	8.00%	>EUR650m
Mediobanca	SNP (Sustainable)	EUR500m	4NC3	MS + 170	MS + 145	>EUR2bn
Credito Emiliano	SNP (Social)	EUR500m	6.5NC5.5	MS + 185	MS + 160	>EUR1bn
Swedbank	SNP (Social)	EUR500m	7Y	MS + 150	MS + 135	>EUR885m
Banca Pop. Sondrio	SP (Green)	EUR500m	5NC4	MS + 225	MS + 210	>EUR670m
NordLB	SP (Green)	EUR500m	5Y	MS + 175	MS + 160	>EUR775m
Sparebank 1 SR	SNP (Green)	EUR500m	5Y	MS + 165/170	MS + 150	>EUR725m
BPCE	SP (Social)	EUR500m	5Y	MS + 120	MS + 97	>EUR2.3bn
FIG (Subordinated)						
Generali	Tier 2 (Green)	EUR500m	10Y	MS + 250	MS + 210	>EUR1.1bn

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

European primary markets in 3Q23

SSA ESG issuance volumes in 3Q23 reached EUR33bn, down 52% on the previous year, of which 52% had a sustainability bond indicator, 25% were social bonds and 23% were labelled green bonds. Green bond issuance declined significantly during the quarter (-81% qoq to EUR7.5bn) as traditionally sizeable transactions from European sovereign issuers were in comparatively short supply due to adverse yield developments. Sovereign bond yields rose sharply from the beginning of 3Q23, particularly in longer maturities, reflecting investor expectations that major central banks will keep monetary policy restrictive for longer. Higher rates have the potential to continue driving additional market volatility and curtail issuance activity, but the more recent downtrend in inflation in Europe and the U.S. has raised the possibility of rate cuts coming sooner rather than later. SSA issuers raised EUR181bn in 9M23, down 14% from a year ago. The average deal size almost halved to EUR370m during 3Q23 while the overall number of registered trades was broadly unchanged.

SSA - Top 10 European ESG Issuers 9M23

Issuers	Total Issued (€m)*	Average Tenor (years)
IBRD	36,059	8.1
CADES	22,203	5.3
EIB	12,353	8.3
Italy	10,000	8.5
Germany	9,750	20.0
KfW	8,253	4.8
AIIB	8,039	6.2
BNG Bank	5,181	11.9
Austria	4,376	0.2
IADB	4,252	7.8

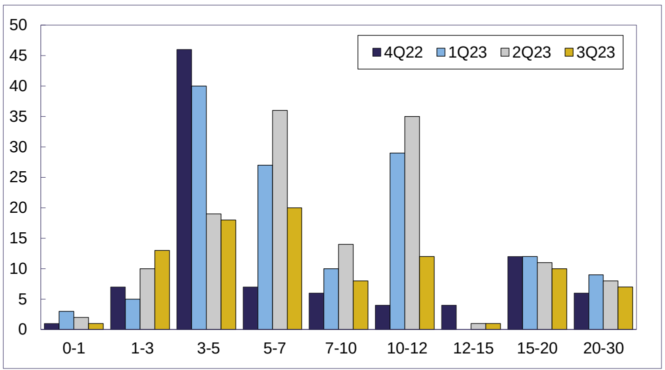
*Source: Bloomberg; *Cumulative issuance 9M23*

While the strongest declines were registered among green labelled debt, themed SSA bond issuance volumes fell across the board. Issuance of sustainable bonds, accounting for the largest share of SSA issuance in 3Q23, also receded, albeit to a lesser extent (-13% qoq to EUR17.5bn). Social bond issuance also fell below the levels of previous quarters (-39% qoq to EUR8.2bn). 3Q23 SSA supply was focussed on the early and middle segment of the curve with the majority of deals carrying a 5-7-year tenor (22%) followed by 3-5 years (20%) and 1-3 years (14%). Looking at 4Q23, despite solid activity recorded in October, indicative data suggests that volumes were trailing 36% yoy as at end-November, mainly due to a slump in euro benchmark SSA volumes. At this rate, we do not expect SSA volumes to catch up to last year's volumes and performance at the end of this year and into next year will in part depend on sovereign yield developments. Euro area government bond yields have recently declined. If they now stabilise, positive impulses emerging from COP28 could encourage further issuance before year end.

Sovereign greeniums are shrinking

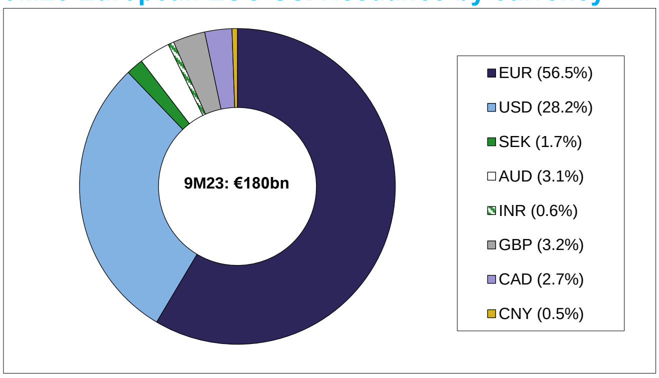
As the list of sovereign green bond issuers grew in recent years, so too did the expectation that additional expenses associated with eligible project selection, structuring and reporting should be rewarded with a greenium at launch. Twin bond structures are most suited to track pricing differences between labelled and vanilla bonds. Most recently, Denmark launched its first syndicated twin-bond that raised DKK7.75bn with a 10-year maturity. The green leg priced 1.5bps inside of its conventional twin, carrying a 2.25% coupon, a sharp drop from the 5bps achieved during Denmark's green bond auction in 2022. Some of the difference may stem from the differing investor bases as the auction targeted domestic buyers, while the syndication was aimed at attracting an international audience, facilitated by a lower greenium. Despite the issuer's strong ESG credentials and alignment with the EU taxonomy, the narrower greenium follows a trend we have observed in comparable twin-Bund structures. The spread between these bonds has been generally narrowing and most recently stood at 2bps. In secondary trading, Denmark's spread differential between the green and conventional bonds also widened to just over 2bps at end-November.

Number of SSA transactions per tenor bucket



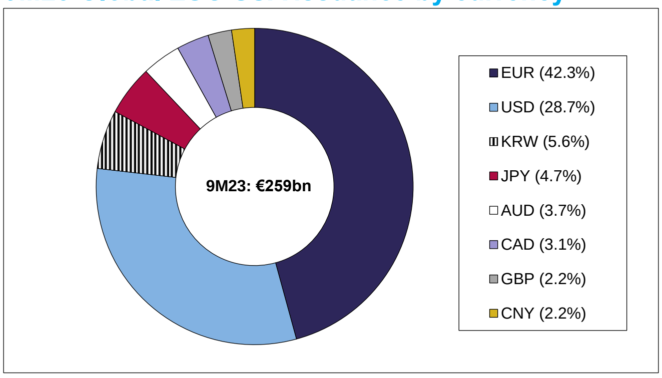
Source: Bloomberg; Daiwa Capital Markets Europe Ltd.

9M23 European ESG SSA issuance by currency



Source: Bloomberg; Daiwa Capital Markets Europe Ltd.

9M23 Global ESG SSA issuance by currency



Source: Bloomberg; Daiwa Capital Markets Europe Ltd.

Total **FIG ESG** volumes in 3Q23 reached EUR18.5bn (-33% yoy). Primary market activity was skewed toward the latter part of the quarter with September (58% of all deals) accounting for the bulk, while July (23%) and August (19%) were less active trading months due to the traditional summer lull. Additionally, market conditions were choppy throughout and displayed heightened sensitivity to monetary policy announcements and key data releases, leading issuers to mostly place senior bonds while avoiding duration trades. Average bond maturities were concentrated in the 5-7 year maturity bucket (36% of total), followed by 3-5 years (28%) and 1-3 years (22%). Accommodative funding windows for sub-debt or lower-tier issuers were limited and, when accessed, were mostly unlabelled in nature. Bloomberg data shows that ESG sub-debt issuance was limited to just a single Tier 2 trade during the quarter. Nevertheless, from a credit perspective, issuer fundamentals remained mostly strong during in 3Q23 as top-line revenues and profit margins continued to benefit from the current rates environment. However, in some core European markets, this benefit has already peaked and is now facing headwinds from rising deposit betas, declining lending volumes and general economic uncertainty.

FIG - Top 10 European ESG Issuers 9M23

Issuers	Total Issued (€m)*	Average Tenor (years)
Intesa	6,054	6.8
ABN Amro	3,243	4.2
DNB Bank	3,144	5.0
Berlin Hyp	2,416	7.2
Danske Bank	2,225	5.2
BNP Paribas	2,000	7.0
Swedbank	1,874	5.9
DZ Hyp	1,770	4.7
Stadshypotek AB	1,763	5.0
Banco BPM	1,500	4.5

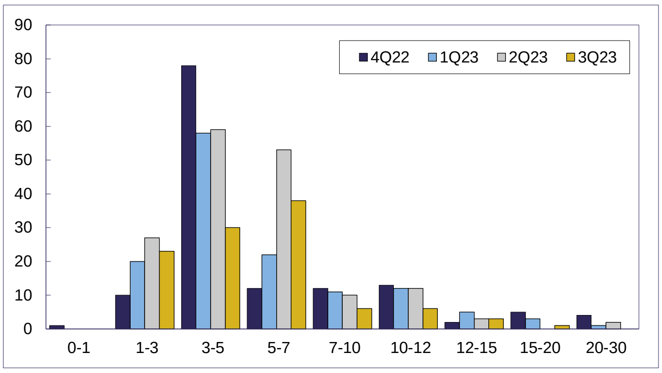
*Source: Bloomberg; *Cumulative issuance 9M23*

Sustainable debt issuance among financial institutions remained lively throughout 9M23 at EUR82bn, but ultimately trailed 9M22 levels of EUR90bn. However, indicative 4Q23 activity is promising as funding conditions have been more benign and volumes have already matched 3Q23 total issuance, leading us to anticipate a narrowing of full-year volumes to levels we observed last year (EUR116bn). In 2024 FIGs will likely further slow issuance due to lower bank lending, which will be a headwind to ESG debt supply. If interest rates remain 'higher for longer', banks' ability to grow their sustainable loan portfolios might be stunted. Additionally, upcoming ESG debt maturities next year amount to just EUR28bn, implying only limited refinancing requirements.

Nordic bank drives innovation in SLL

Nordic entities were among the most prominent in the FIG space during 3Q23, arguably attracting greater investor interest during risk-off periods. Their combined issuance volume accounted for 25% of the total and provided the market with some innovative structures. In August, Nordea from Finland issued its inaugural euro denominated bond backed by a portfolio of sustainability-linked loans (SLLs) targeted at firms with strong climate change mitigation targets. The bond was raised under the issuer's SLL funding framework and, unlike an SLB, does not feature a coupon step-up/down feature tied to sustainability KPIs at the bond level. Instead, it is set at the loan level and therefore does not provide the issuer with an incentive for early redemption at the bond level.

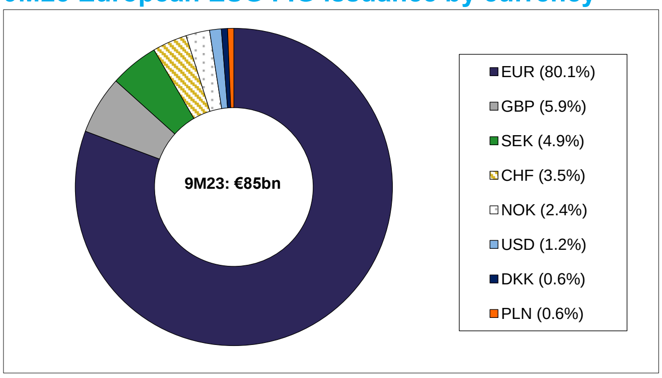
Number of FIG transactions per tenor bucket



Source: Bloomberg; Daiwa Capital Markets Europe Ltd.

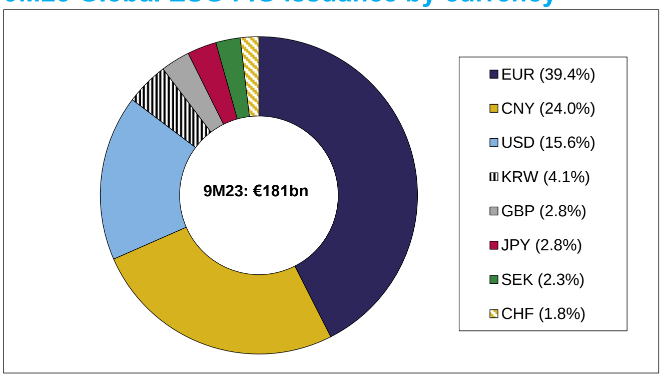
The lack of coupon characteristics at the bond level is relevant from a regulatory perspective, as these features are one reason why most banks have opted not to issue in the SLB format. Back in June 2021, the EBA stated that it does not view 'favourably' links being established between payments on regulatory debt instruments and performance targets. This stance by the EBA has discouraged issuers to consider SLBs for MREL purposes. In this case, however, the novelty of Nordea's bail-inable EUR1bn SNP note with a 3NC2 maturity was reflected in a sizeable order book of almost EUR2bn. The bond spread of MS+68bps meant the issuer priced with a low concession of 6-8bps. Although this format and framework will not be easily replicated, it may inspire others to pursue a similar approach.

9M23 European ESG FIG issuance by currency



Source: Bloomberg; Daiwa Capital Markets Europe Ltd.

9M23 Global ESG FIG issuance by currency

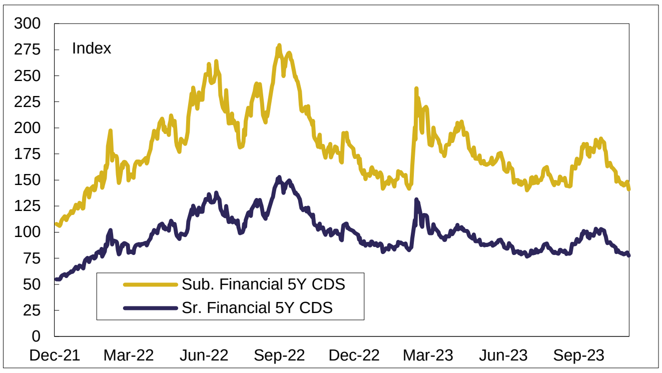


Source: Bloomberg; Daiwa Capital Markets Europe Ltd.

Secondary markets in 3Q23

As of end-November, CDS prices eased back to levels last seen in March, after a brief period of turbulence in October and November. 'Higher for longer' monetary policy stances arguably dampened the economic outlook for Europe and resulted in higher bond yields and CDS prices. Part of the subsequent CDS price tightening observed through November not only reflects receding inflation but also a gradual easing of concerns surrounding bank balance sheets going into 2024, helped by healthy 3Q23 earnings results. The sub financials CDS index tightened by 49bps from its October peak while senior prices also firmed up by 26bps during that period. Since the second quarter, the difference between the subordinated and senior indices has averaged some 72bps. This is close to the five-year average, implying no fundamental price dislocation across debt classes so far in 2H23.

iTraxx Financials Index

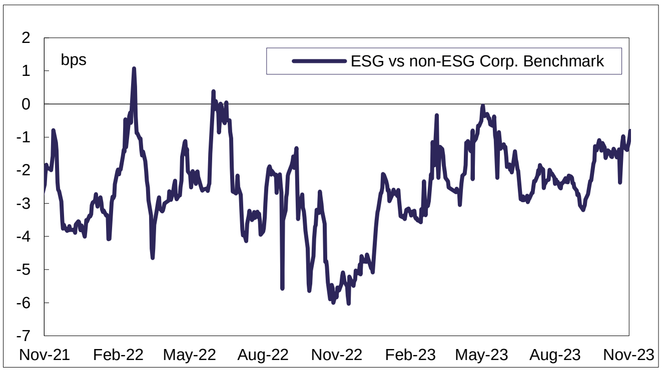


Source: Bloomberg; Data until 29.11.2023; Daiwa Capital Markets Europe Ltd.

FIGs benefitting from tighter ESG bond spreads

Supply of sustainable debt, particularly in Europe, decreased compared to the same period last year, while short-lived periods of volatility in October and November saw the option-adjusted spread (OAS) between the ESG and non-ESG themed indices narrow from its most recent low-point in September. The median negative OAS differential between the ESG and non-ESG benchmark indices was -2.4bps, from -1.3bps in 2Q23 and -2.67bps in 3Q22. Smaller greeniums from new trades are carried over into secondary trading, particularly in the SSA space, where the average greenium of 3-4bps a few years ago has fallen to 1-2.5bps. In the FIG space, spread compression from initial guidance for ESG-labelled bonds has been higher on average than that of conventional bonds. This was true across debt classes with the benefit ranging mostly between 2.5-5bps.

Spreads (OAS) of ESG vs non-ESG benchmarks

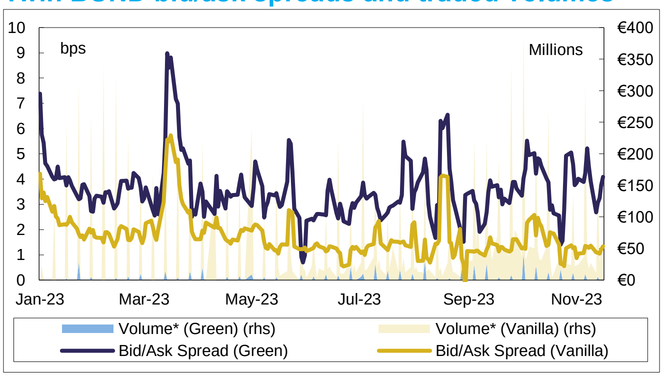


Source: Bloomberg; Barclays MSCI Euro-Corporate ESG Index vs Barclay Pan-European Aggregate Corporate Index; Data until 29.11.2023; Daiwa Capital Markets Europe Ltd.

Bund greenium waning in secondaries

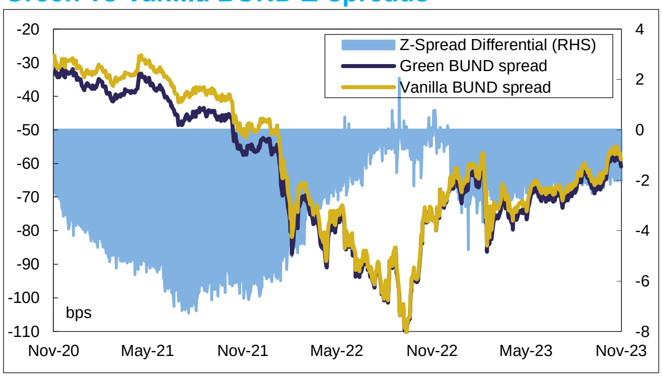
Average greeniums for liquid sovereigns such as German Bunds gave up some ground over the past quarter, but still retained a buffer over the equilibrium. The 3Q23 median spread differential of the German Twin Bunds was -2.09bps compared to -0.76bps one year prior, the latter influenced by higher volatility and less liquidity at the time. On a quarterly basis, spreads remained relatively stable (2Q23: -2.54; 1Q23: -2.49bps; 4Q22: -0.50bps; 3Q22: -0.76;), however indicative fourth quarter data as at end-November shows a renewed narrowing of the spread differential to -1.2bps. 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 3.66bps for the green (previous reading: 3.11bps) and 1.46bps (1.37bps) for the conventional bond. The green bond bid/ask spread continues to display more erratic swings owing to its lower market liquidity, which tends to diminish the longer the bonds are outstanding.

Twin BUND bid/ask spreads and traded volumes



Source: Bloomberg; until 17.11.2023; Daiwa Capital Markets Europe Ltd.

Green vs Vanilla BUND Z-spreads



Source: Bloomberg; until 29.11.2023; Germany Aug-2030 Twin; Daiwa Capital Markets Europe Ltd.

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