The Green Deal - 02/23 (EN) #responsiblebanking

February 7, 2023 14:13 CET

Strong start to the year 2023 for ESG bonds on both the primary and secondary markets. Additional tailwind is currently coming from the ECB, which is now considering and implementing further measures to "green" its own bond portfolio and at the same time encourages other market participants to follow suit. In total, the primary market share of ESG bonds increased significantly in 2023 — the role of corporate bonds seems to be outstanding here, where already more than 40% of the issues are ESG bonds. Also, two of the most exciting issues were (Italian) corporate bonds and one of them very successfully tapped a whole new investor base. All in all, it can be said that the ESG segment has obviously left behind their weak phase in 2022.

- EUR ESG primary market 2023 so far strong but "not yet" record-breaking
- In corporate bonds, however, the ESG share is at a record level
- ESG secondary market off to a good start in 2023
- ECB plans to "green" bond holdings and published new climate related statistical indicators
- This month's deals of the month are all about Italian SLB bonds — Retail SLB could contribute to funding diversification
- Climate Startup Climework removed carbon dioxide from the air as first ever

Primary market

The start of the year on the ESG market was strong but not record-breaking, as it was the case on the EUR bond market as a whole. Nevertheless, January 2023 represented the second strongest EUR ESG issuance month (after September 2021) in the history of the product class, with EUR 55 bn. Green bonds remain dominant with a share of 58%, followed by social bonds (20%) and sustainability bonds (13%). The potential "high-flyer" among the ESG bond products — sustainability-linked bonds — seem to be struggling on the market at the moment as many investors lack confidence in the product and the partly "weak" KPIs also contribute to this. We are sticking to our position: SLB bonds are a necessary key for a green transformation. ESG issuance in 2023 was led by the SSA segment (34%), closely followed by financial issuance at 31%. The utilities segment came in third with 18% of this year's EUR new issue volume. Geographically, France (28.9%) and Italy (9.8%) stood out — their share of issuance is well above the average of recent years. The share of supra issuers in the EUR ESG market has been significantly below average to date (6.1% ytd, 2022: 18%).

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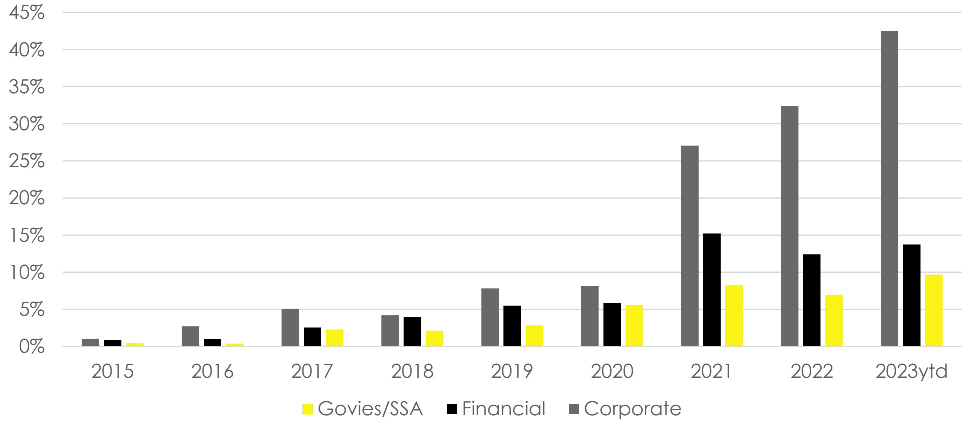
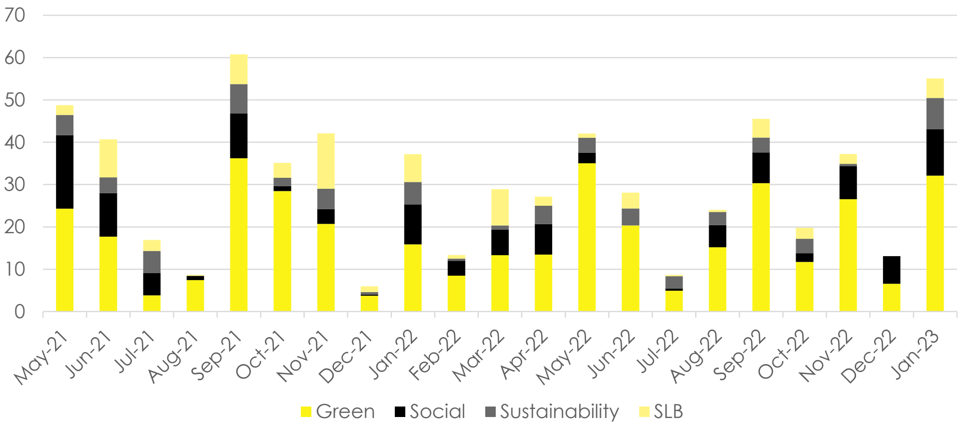
Chart 1 - Share of EUR ESG bonds per segment in %



Source: Refinitiv, RBI/Raiffeisen Research

Overall, the share of ESG issues since the beginning of the year is significantly higher than in previous years, currently 15.3% (2022: 10.4%). This is particularly remarkable because covered bonds in particular dominated the primary market in the first weeks of the year - and ESG issues are clearly underrepresented in this bond class (keyword pricing advantage and placeability). While financial issues clearly dilute the share of ESG issues in the EUR primary market, the level in the SSA segment is already above last year's value, albeit still at a low level (this could change soon thanks to the ECB focus). The ESG issues in the corporate bond segment currently represents 43% of new EUR issuance in 2023 which is an all-time high.

Chart 2 - Monthly Issuance Volume - EUR ESG Market (EUR bn)



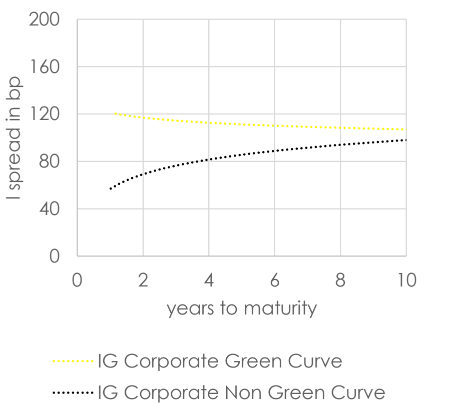
Source: Refinitiv, RBI/Raiffeisen Research

Secondary market

2022 ended with global IG ESG bonds in total returning -17% slightly underperforming global IG bonds with -16%. In contrast, 2023 started well in the positive territory. With treasury and bund yields trading substantially lower and credit spreads tightening, the total return for global IG ESG bonds has been 4% sofar ytd (see Chart 6). The lower assessment of credit risk is also evident when looking at our IG BBB index, however, green bonds remain at a risk premium pickup vs traditional bonds due to the real estate exposure. Yet, the positive moment could see some headwinds going forward. The recently improved economic sentiment in the Euro zone (ZEW, PMIs, consumer sentiment) in combination with more hawkish comments by the ECB as of late, potentially puts more upside risk to the currently priced interest rate path and could lead to a repricing for bund yields. Anyhow, with the higher interest rate environment, we would not expect the greenium distortion stemming from the real estate sector to vanish in the near future.

Excluding the real estate exposure from our curves we would still end up with a greenium across the curve of 1-8bp.

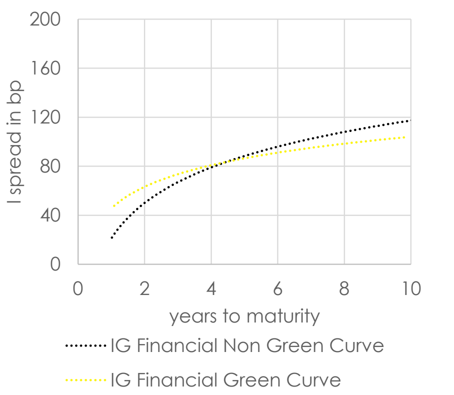
Chart 3 - Corporate Green vs Non Green*



**EUR denom.; > EUR 250 mn; > 1y to maturity; Plain vanilla fixed coupon*

Source: Refinitiv, RBI/Raiffeisen Research

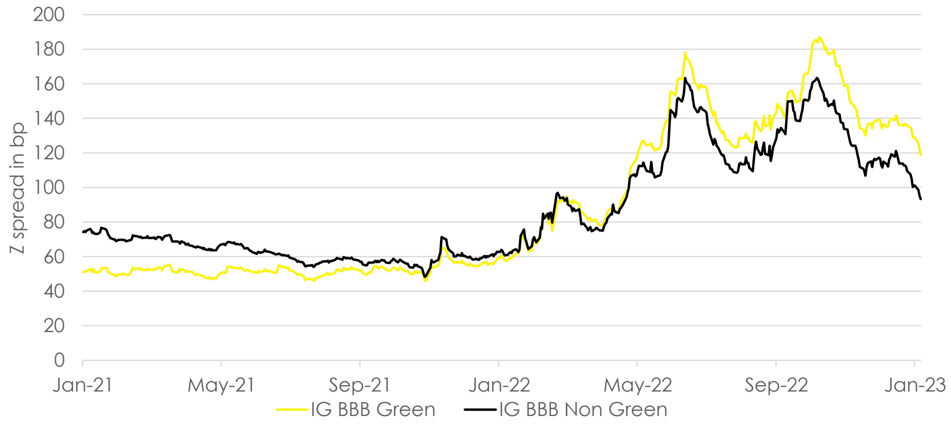
Chart 4 - Financials Green vs Non Green*



**EUR denom.; > EUR 250 mn; > 1y to maturity; Plain vanilla fixed coupon*

Source: Refinitiv, RBI/Raiffeisen Research

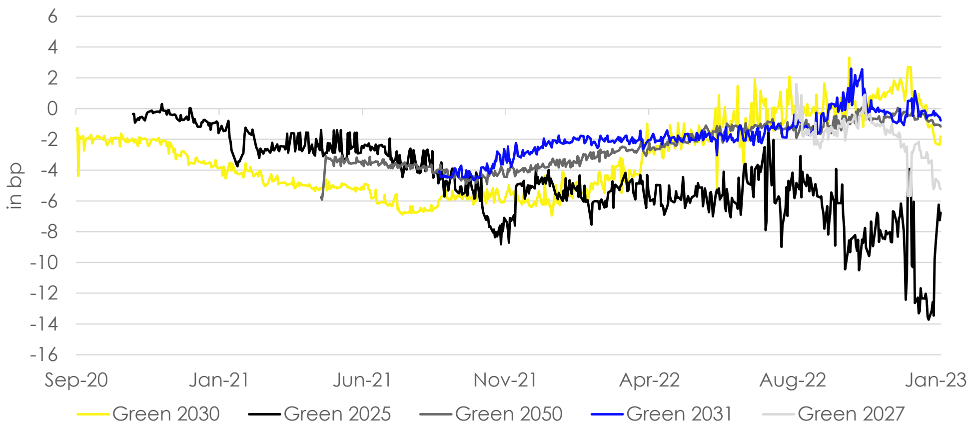
Chart 5 - Corporate green vs non green index spread development*



**BBB rating bucket; EUR denom.; > EUR 250 mn; > 1y to maturity; Plain vanilla fixed coupon*

Source: Refinitiv, RBI/Raiffeisen Research

Chart 6 - Greenium German twin bonds



Source: Refinitiv, RBI/Raiffeisen Research

Chart 7 - Global ESG Market Total Return 2022 vs 2023 ytd

Source: Bloomberg Finance L.P., RBI/Raiffeisen Research

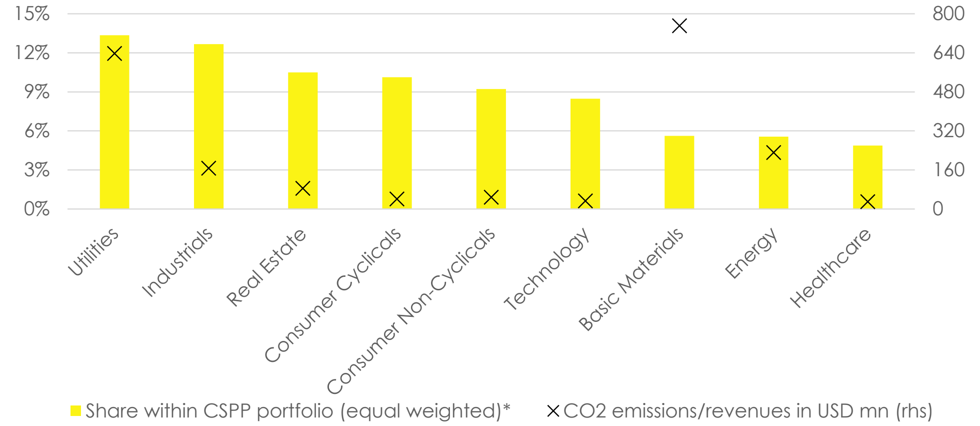
Hot Topic: ECB plans to green bond holdings

You had my curiosity, now you have my attention. After specifying in September last year how the ECB will tilt their corporate bond portfolio towards issuer with better climate scores through reinvestments, a speech by ECB board member Isabel Schnabel earlier in January received attention by markets.

We outlined the details on how the tilting of the CSPP (corporate sector purchase program) will take place in our October 2022 version of the Green Deal. That is through the ECBs own climate score which will tilt reinvestments within the CSPP. However, as the ECB is only reinvesting rather than actively conduction net purchase as they aim to reduce their balance sheet, the effect of such measures is limited. In addition, the decarbonization of the CSPP depends in part also on the respective issuers reducing their carbon intensity and not only on the tilting factor. Further, reinvestments under the APP are set to phase out after February 2023 and under the PEPP potentially after the end of 2024. Once reinvestments are ended, the decarbonization is out of the ECBs hand.

Therefore, Isabel Schnabel stated in her speech that a stock-based rather than flow-based tilting approach would be required, meaning **active reshuffling of the portfolio towards greener issuers**. At the same time she said that the ECB, however, should not completely divest (initially at least) from companies that are particular important in the green transition (implying high carbon footprint companies) but rather foster incentives. Nevertheless, an **active reshuffling implies active selling of bonds** which would affect investors (through losses/diminished returns on their investments) and borrowers (through higher yields/refinancing costs on their debt) alike. The current sector distribution within the CSPP holdings shows that companies within the Utilities, Industrials, Basic Materials and Energy Industry (TRBC) would be most exposed to such a reshuffling as they demonstrate the highest CO_2 intensity on average. Utilities and Industrials also demonstrate the highest share (not volume weighted) with in the CSPP holdings at around 13% each, while Basic Materials and Energy only account for 6% each (see Chart 8 below).

Chart 8 - CSPP sector exposure and CO2 intensity



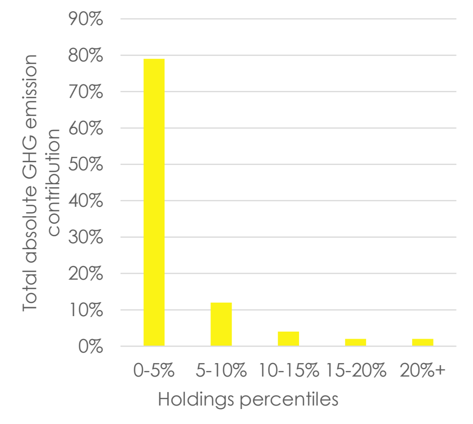
**as of 20 January 2023*

Source: ECB, Refinitiv, RBI/Raiffeisen Research

At the recent policy meeting on 2nd of February, the ECB provided further details. **Primary market purchases** for the **private sector** programmes (ABSPP, CBPP3, CSPP) will be **phased out** once the partial reinvestment phase starts in March, meaning only secondary market purchases will be conducted. However, to tilt the bond portfolio towards green issuers, the ECB will continue to purchase securities on the primary market from corporate issuers with a better climate performance (based on the ECB´s climate score) as well as green corporate bonds.

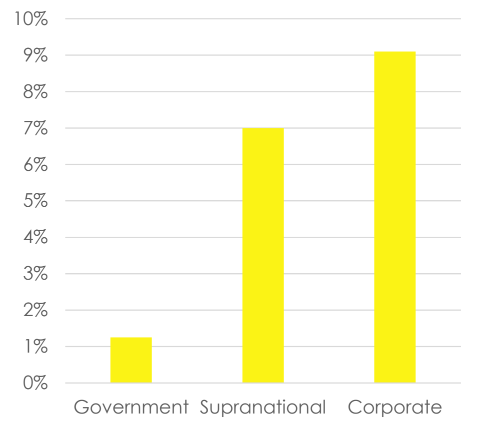
Regarding the **public sector holdings**, the ECB is considering two options. Either to increase the share of bonds issued by supranationals and agencies as those two asset classes have a higher share of green bonds already compared to sovereigns, and/or to continuously reshuffle the sovereign bond portfolio from traditional bonds of an issuer to green bonds as more and more green bonds come to the market. In our view this will likely result in the **greenium for sovereign bonds to become even more evident** as demand for green bonds will exceed those for traditional ones.

Chart 9 - Distribution of GHG emissions by % of corporate bond holdings



Source: ECB, RBI/Raiffeisen Research

Chart 10 - Share of green bonds in universe by asset class



Source: Bloomberg Finance L.P., ECB, RBI/Raiffeisen Research

Finally, through limiting the share of assets issued by entities with a higher carbon footprint that can be used as collateral for the purpose of borrowing from the Eurosystem, the ECB will also **green** the **lending operations**. This also includes hair cuts for corporate bonds based on climate related risks. It could also mean that future expansionary monetary policy cycles could include lending out based on green factors.

In addition, the ECB published new **climate related statistical indicators** in January. The indicators aim to assess the impact of climate related risk on the financial sector and to monitor the sustainable finance market and are as such a first step to narrow the climate data gap. The indicators are either experimental or analytical — meaning that, especially for analytical indicators, the quality could be limited. Going forward, the ECB and national central banks will work to improve the methodology and data used. Overall there are three types of indicators:

- **Experimental indicators** that provide an **overview of ESG debt instruments**, that is Green, Social, Sustainability or Sustainability-linked instruments issued or held in the euro area. It's important to note that also self-labelled instruments are currently considered under this framework amid lack of a universal standard.

- **Analytical indicators of carbon emissions financed by financial institutions.** Those provide information on the carbon intensity of loan portfolios of financial institutions. The data suggests that investment funds finance the majority of Scope 1 & 2 emissions.

- **Analytical indicators on climate-related physical risks**. Those analyze the impact of climate change (e.g. floods, storms, wildfires) on the performance of loans, bonds and equities. Physical risks are besides transition- and technological risks one of the most important factors to consider. Especially P&C insurer could be exposed as wildfires, floods, earthquakes or storms could result in a rise of insurance claims. The data shows that most of the financial institutions portfolios are exposed to water stress with close to 100%, ahead of wildfires with close to 90% and subsidence closely behind. However, the exposure does not consider the likelihood of such events actually occurring. Therefore, a risk score that takes that into account was published as well. Out of the three mentioned, the score suggests that only water stress exposure demonstrates a relatively high "high" and "medium" risk exposure, while wildfires are mostly low risk.

Deals of the month

- **Pirelli** issued the first benchmark size **SLB** within the tyre industry globally. The deal was met with strong demand, as the order book was almost 6x the size of the final amount of EUR 600 mn. The final pricing was tightened to 145bp over mid swaps vs IPTs of ms+190/200bp for the 5y term — equivalent to a coupon of 4.25%. The bonds interest payments are linked to Pirelli´s CO_2 targets in 2025. Scope 1 & 2 are targeted to be 42% lower (vs 2015), while Scope 3 should be reduced by 9% vs a 2018 baseline. The step-up amounts to 25bp per KPI. Therefore, in total three coupon payments could amount to 4.75% each. We consider the KPI not to be very ambitious given that it's an absolute target and that Pirelli reduced Scope 1 & 2 already by 31% vs 2015 and Scope 3 by 6% vs 2018 in 2021. Nevertheless, the target is aligned with the SBTi 1.5 degree scenario. (Georg Zaccaria)

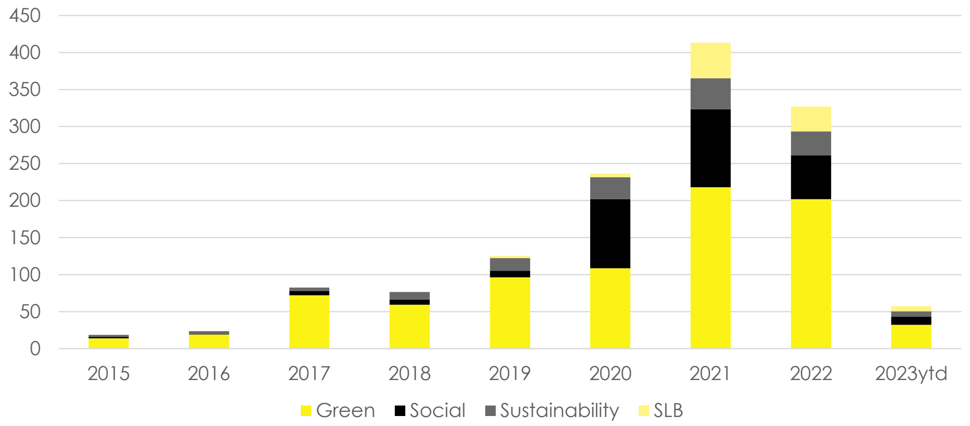
- We remain in Italy. What started with bank bonds is continuing with corporate bonds. What was uninteresting for a long time, especially from an investor's point of view due to the low interest rate environment, is becoming more interesting again due to the current market environment — for both sides. We are talking about retail bonds. These allow investors to lock in “attractive” coupons while issuers refinance themselves more cheaply or diversify their refinancing compared to the institutional bond market. European banks have already reactivated this instrument in 2022, and now it is spilling over into the corporate bond market, and what would be more appropriate than to offer retail customers a bond that contains a sustainable element. **Eni** was once again **a pioneer** in this area (as it had been in the SLB sector) and **placed the first retail sustainability-linked bond (5y) very successfully**. The target volume was between EUR 1 – 2 bn. However, it quickly became clear that the upper limit would be exhausted due to the high demand. The annual interest payment was fixed at the previously set floor of 4.3%. The issue was so successful that the originally planned 3-week sales period was shortened to five days. Already on day 1 of the selling period the maximum target volume of EUR 2 bn was exceeded and after five days the order volume exceeded the EUR 10 bn threshold. This could also be a d**oor opener for Austrian retail (ESG) corporate bonds**, as Austria is one of the markets where retail corporate bonds were already well established in the past (e.g. Wienerberger, Egger, S IMMO, OMV, Verbund, Borealis). (**Jörg Bayer**)

Good to know

Climeworks AG — a start up with focus on fighting climate change — said it has managed to pull carbon dioxide from the air and store it underground. The DAC+S process (**direct air capture and storage**) was confirmed by an independent third party for the first time in January and basically works like a tree (with the advantage of requiring less space than a forest). The Swiss Startup — which collected CHF 600 mn from several investors in their latest equity round in 2022 — operates the only such commercial direct-air-capture facility globally. The plant, which is located in Iceland has a capacity of 4 ths tons a year — equivalent to the emissions of around 800 passenger cars, which shows the need for further capacity in order to achieve a meaningful scale. Climeworks builds a second facility in Iceland with an annual capacity of 36 ths tons (start of operation expected for 2024) and plans on having a megaton capacity by 2030 and a gigaton capacity by 2050 (which compares to about 2 bn tons of carbon dioxide being removed from the atmosphere each year mainly by forests currently). It´s technology could therefore make a substantial contribution to the 2050 net zero target. On the one hand, it helps companies to offset their emissions (the business model is based on customers (e.g. Microsoft) paying Climeworks per ton of removed CO_2), but at the same time it can reduce the existing stock of carbon dioxide emissions, which is also essential to fight climate change.

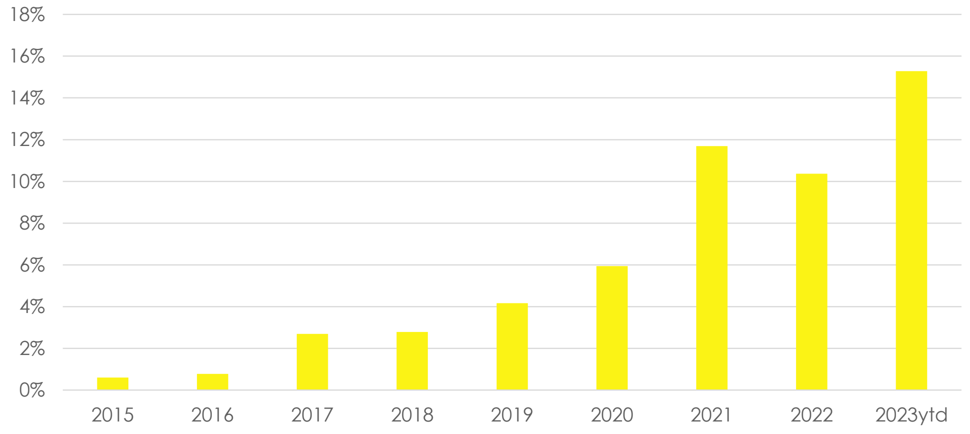
Appendix

Chart 11 - Yearly Issuance Volume - EUR ESG Market (EUR bn)



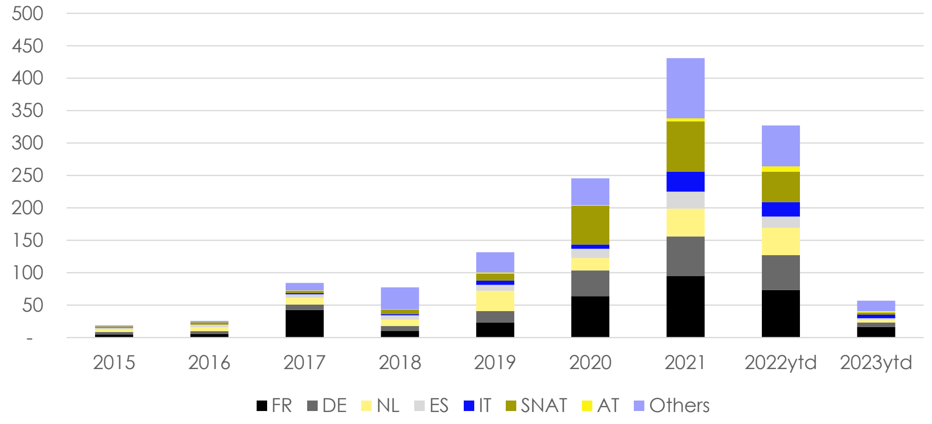
Source: Refinitiv, RBI/Raiffeisen Resarch

Chart 12 - Share of ESG bonds in the EUR primary market



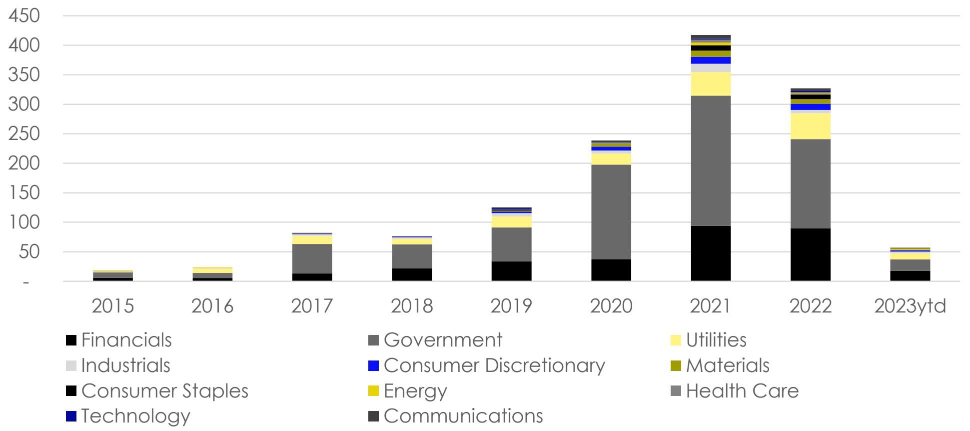
Source: Source: Refinitiv, RBI/Raiffeisen Research

Chart 13 - Country Overview - EUR ESG Market (EUR bn)



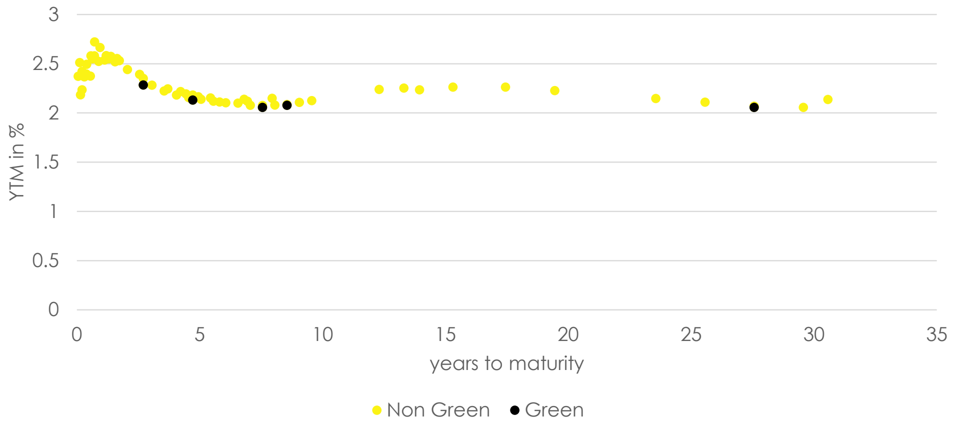
Source: Source: Refinitiv, RBI/Raiffeisen Research

Chart 14 - Industry overview - EUR ESG primary market (EUR bn)



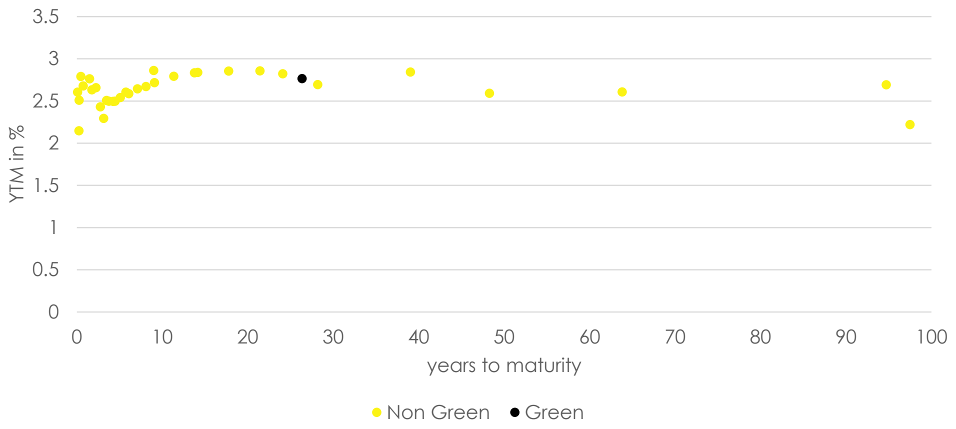
Source: Refinitiv, RBI/Raiffeisen Research

Chart 15 - Yields of German government bonds*



**EUR denom.; > EUR 250 mn; Plain vanilla fixed coupon*
Source: Refinitiv, RBI/Raiffeisen Research

Chart 16 - Yields of Austrian government bonds*



**EUR denom.; > EUR 250 mn; Plain vanilla fixed coupon*
Source: Refinitiv, RBI/Raiffeisen Research

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