Volksbanken Raiffeisenbanken
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DZ BANK Spotlight:

Sustainable Bond Market 2021 – Green Bonds will strike back!

Without doubt, 2020 was an exciting year for the Sustainable Bond market. In the blink of an eye, a pandemic has turned the world upside down. The Corona crisis had a firm grip on the Sustainable Bond market - with varying effects on the individual segments.

It gave Social and Sustainability Bonds, which already contributed to the diversification of the market with above-average growth in 2018 and 2019, additional tailwind. During the year, they have proved themselves a suitable financial instrument to raise funds for the fight against the COVID-19 outbreak and for mitigating its negative economic and social impact. The maiden issue of the EU SURE Social Bond was a milestone for the entire sustainable bond market. These developments are ultimately reflected in impressive growth figures. While the new issuance volume of Sustainability Bonds increased by almost 80% compared to the previous year, that of Social Bonds increased by more than 700%.

Content


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Dear Reader,

We are pleased to present the latest edition of our Sustainable Finance Bulletin.

2020 was a dynamic year in the Sustainable Bond market. COVID-19 gave Social and Sustainability Bonds additional tailwind. In contrast, things were more turbulent in the Green Bond segment. It experienced lows and highs during the year. The furious comeback of Green Bonds however, shows that „build back better" only works if we also consider the environmental dimension of sustainability. Hence, we are confident that the Green Bond segment will strike back in 2021 and beyond. In addition, new sustainable funding opportunities like Sustainability-Linked Bonds and Transition Bonds will help to further grow the market. Both provide a much stronger link between the sustainable issuance and the company as a whole and hence represent a logical and conclusive next step in the Sustainable Bond market.

Enjoy reading! Stay healthy!

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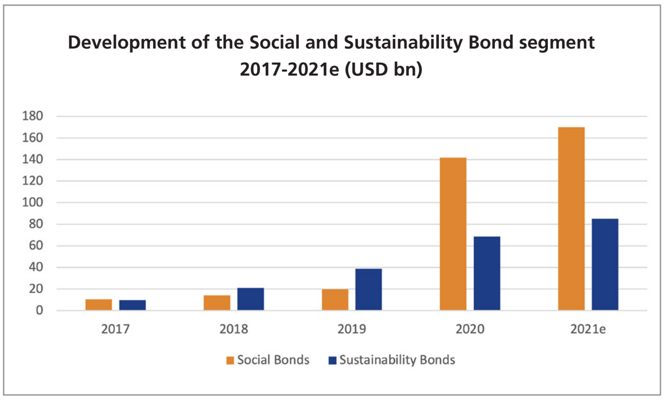
DZ BANK



Source: DZ BANK, CBI (2021)

In contrast, things were more turbulent in the Green Bond segment. It experienced lows and highs during the year.

In particular, at the beginning of the pandemic the Green Bond segment took a deep „breather". As an initial emergency response to COVID-19, many issuers – especially SSAs - that issue both Green Bonds and Social or Sustainability Bonds have focused on the latter. As a result, the new issuance volume in March 2020 amounted to only USD 5.4bn. This was the lowest monthly new issuance volume since December 2015.

Luckily, a recovery of the Green Bond segment began as early as in April. This recovery continued steadily in the following months taking the segment to new, unimagined heights. With a monthly new issuance volume of USD 36.8bn, the Green Bond segment set a new record in September.

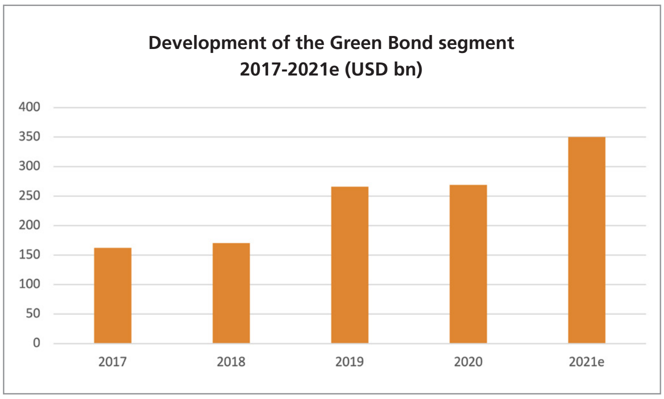
Ultimately, there was a conciliatory year-end for Green Bonds. With a new issuance volume of USD 269.0bn, the segment finally still managed a marginal growth of 1% compared to the previous year. And more importantly: In the fourth quarter, Green Bonds reached its most substantial milestone yet, surpassing USD 1 trillion in cumulative issuance since market inception in 2007.

The furious comeback of the Green Bond segment in 2H/20 shows that „build back better" only works if we also consider the environmental dimension of sustainability. The European Commission for example intends to raise 30% of its EUR 750bn Next Generation EU recovery fund through the issuance of Green Bonds, hence becoming one of the largest issuers in the segment globally.

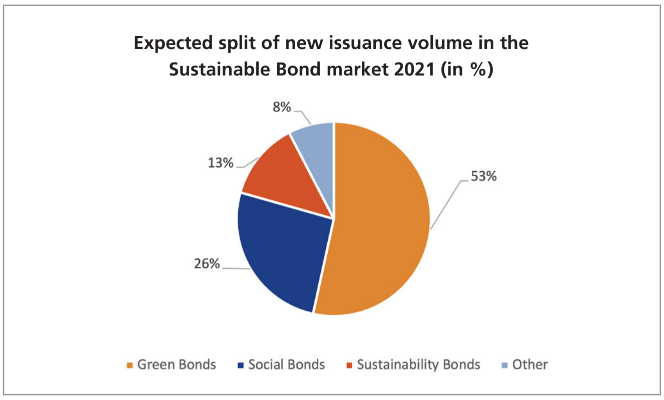
Given the prominent role environmental topics will play on the recovery agenda, we are confident that the Green Bond segment will strike back in 2021 and beyond.

In addition, there are promising news from various corners of the world, which will support the growth of the Green Bond segment: More than 15 sovereign governments across the globe are waiting in the wings to issue Sovereign Sustainable Bonds in the future. We expect the majority to choose the colour green for their first appearance in the market. We also expect accelerating growth of China's and Japan's Green Bond market. China's aim to go carbon neutral by 2060 and its push to bring its domestic Green Bond standards closer to the international ones will also be a driver for more issuance. Japan's aim to go carbon-neutral by 2050 and the public announcement that responding to climate change is no longer a constraint on economic growth will require more funds and this could definitely boost Green Bond issuance. Across the big pond, Joe Biden is turning words into action. A significant part of projects mentioned in his election programme that directly or indirectly promote climate protection could be financed through Green Bonds. This is the historic opportunity to make "America green again". Last but not least, there are also signs that more and more central banks – giving their role as anchor investors – are warming up to the idea of buying Green Bonds.

Hence, we forecast that the new issuance volume of Green Bonds will increase by 30% to USD 350.0bn in 2021. Green Bonds are expected to account for more than 50% of the new issuance volume in the Sustainable Bond market in 2021. In a few year's time, the annual new issuance volume should approach the USD 1 trillion mark.

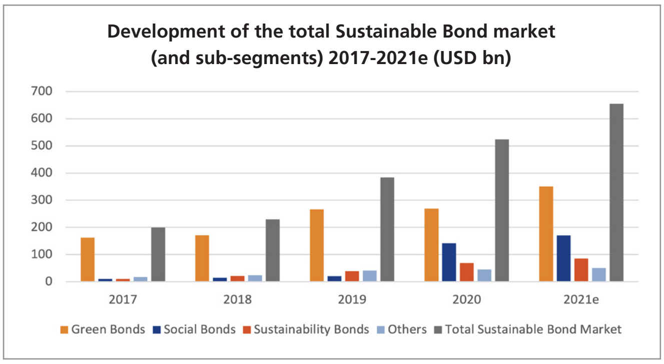


Source: DZ BANK, CBI (2021)



Source: DZ BANK (2021)

The "S" will remain a crucial element of the sustainable transformation and recovery in 2021 and beyond. We expect growth in the Social Bond segment and Sustainability segment to continue in 2021, though to a smaller degree than in 2020. We forecast new issuance volume in the Social Bond segment to increase by 20% to USD 170bn and new issuance volume in the Sustainability Bond segment to increase by 25% to USD 85bn.



Source: DZ BANK, CBI (2021)

DZ BANK Spotlight:

The ICMA Climate Transition Finance Handbook – A Milestone for Transition in the Sustainable Finance Market

Public capital alone is not enough to comply with the Paris Climate Agreement and the associated limitation of global warming to as close as possible to 1.5°, and to achieve climate neutrality within the EU by 2050. The goal is also to channel private funds in environmentally-sustainable directions and to get all market participants on board – this includes emission-intensive economic sectors as well. For some manufacturing companies, it will not be possible in the short and medium term to go „green" right away. Many companies are at the beginning of a transition to a more sustainable, lower-emission business model and are considering refinancing via the capital market, for example in the form of Sustainable Bonds such as Green Bonds.

On 9 December 2020, the ICMA published the Climate Transition Finance Handbook. This is a voluntary framework for issuers of Use-of-Proceeds and/or Target-Linked structures. The target group is mainly companies that are not able to convert their business model to a fully sustainable one within a short period of time, belonging to the so-called hard-to-abate sectors. The recommendations on disclosure and transparency contained in the document are to be applied if the issuer of a Sustainable Bond wants to transparently communicate the underlying climate and decarbonisation strategy. The recommendations are based on four key elements according to which issuers can structure their reporting: (1) Issuer's climate transition strategy and governance, (2) Business model environmental materiality, (3) Climate-transition strategy to be science-based including targets and pathways, and (4) Implementation transparency.

(1) Issuer's climate transition strategy and governance

This element should show how the refinancing purpose enables the issuer's own transition and sustainability strategy. For this purpose, the issuer can follow established standards in the market, such as the Task Force on Climate-Related Financial Disclosures (TCFD). It can be reported on the company's long-term goals (such as compliance with the Paris Climate Agreement) and the associated intermediate steps. The decarbonisation or sustainability strategy to be implemented as part of governance should also take a broader sustainability approach and address not only the Paris Climate Agreement but also the UN Sustainable Development Goals. External verification of the strategy against the backdrop of the defined goals also increases the issuer's credibility.

(2) Business model environmental materiality

The planned strategic direction of the transition pathway should be environmentally material to the issuer's core business model and instrumental to its success. Within this key element, the issuer should also report on the impact of the business on the environment and society. Different international standards such as SASB or IASB can be used to determine materiality. Possible future scenarios that may directly influence the business model should be taken into account, such as the consideration of technological, disruptive developments or the introduction of CO2 pricing. The type of disclosure used here can be based on the provisions of the TCFD, as described in key element 1.

(3) Climate-transition strategy to be science-based including targets and pathways

The issuer's transition strategy shall be based on quantitatively measurable, scientific variables and scenarios. Furthermore, it should be consistent with other science-based trajectories and be made publicly accessible (incl. possible interim milestones). In this way, it can be shown that the short-, medium- and long-term targets for greenhouse gas reduction are scientifically aligned with the Paris Climate Agreement. The emission savings calculations should cover Scope 1, 2 and 3 and include different scenario methodologies (such as from ACT or SBTi). Technical external verification is recommended.

(4) Implementation transparency

The last key element is aimed at investments and how these are communicated transparently. Here, the issuer should report on the investment programmes that underpin the transition strategy. In addition to CapEx and OpEx, this also includes R+D-related capital expenses that exceed mere „business as usual". Reporting should include qualitative and quantitative information and explain how the investment programmes enable the issuer's strategy. This can be done in table or text form and can be implemented in existing reports (Sustainability Report, Annual Report, on the website, etc.). For example, the percentage of expenditure underlying the issuer's objectives described in Element 1 may be reported. Alternatively, reporting may include a strategy-related CapEx roll-out plan.

The Climate Transition Finance Handbook is not intended to constitute a set of Transition Bond Principles to be put in place in parallel with the existing ICMA Principles. Rather, it is a guideline for issuers of Sustainable Bonds (regardless of whether their structures are use-of-proceeds or target-linked) that can be used in addition to the existing principles. Against this background, it is not a definition or listing of „transition activities", but rather a transparency and disclosure guideline to communicate the issuer's transition strategy. It is up to the issuer to decide whether the respective bonds are classified as „Transition Bonds". Companies from hard-to-abate sectors in particular may find it more difficult to issue pure Green Bonds. This may be because of a lack of assets, but also due to the fear that the issuance of such a bond (or similar bonds) could lead to accusations of „greenwashing". By referring to this handbook, these companies can transparently communicate to market participants how the issuance programme contributes to the transition strategy and how this strategy is structured.

About half a year after the publication of the Sustainability-Linked Bond Principles, the ICMA has now turned its attention to the topic of Climate Transition Finance in the form of a handbook. It remains to be seen how players in the sustainable finance market will follow these guidelines and to what extent they will promote the issuance of Transition Bonds. One thing is clear: emissions-intensive companies play a key role in mitigating climate change. The publication of the Handbook provides them with an aid to enter the Sustainable Bond market and contribute to the fight against climate change.

https://www.icmagroup.org/assets/documents/Regulatory/Green-Bonds/Climate-Transition-Finance-Handbook-December-2020-091220.pdf

Guest Commentary:

Union Investment – Innovations in the Sustainable Bond Market

Johannes Böhm,
ESG Analyst
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In light of an ever-increasing public awareness and acceptance surrounding sustainability related topics, capital markets, too, are playing an increasingly important role in achieving corresponding goals in the real economy. The market for Green Bonds in particular has in recent years fostered the dialogue between issuers and investors and thereby helped to raise awareness regarding environmental and climate protection issues among capital market participants. Green Bonds have recorded strong growth over recent years, and Social Bonds have benefitted from a boost in issuances over the course of the COVID-19 pandemic.

Meanwhile, Sustainable Bonds in a more traditional sense usually refer to specific assets that can be attributed to a firm's sustainable activities and hence only to a part of its business. The issuance may then be accompanied by a separate corporate strategy towards a more sustainable business model, but not necessarily. Against this background, the International Capital Market Association (ICMA) has published two new guideline documents in 2020 – the Sustainability-Linked Bond Principles (SLBPs) and the Climate Transition Finance Handbook (CTF). Both provide a much stronger link between the sustainable issuance and the company as a whole and hence represent a logical and conclusive next step in the Sustainable Bond market.

Specifically, Sustainability-Linked Bonds (SLBs) are financial instruments whose financial characteristics depend on the issuer's achievement of pre-defined sustainability targets. The instrument is therefore based on a company's commitment to improve relevant sustainability aspects within a defined period of time and with the entire business model in mind. Another important differentiating feature is that SLBs are not „Use of Proceeds" type of bonds, as in the case of a more traditional Green Bonds, but rather „General Corporate Purposes" type of instruments. As a result, the capital raised can be used for a wide range of economic activities, provided there is a connection to the company's overarching and material sustainability goals.

Credible Transformation

Climate Transition Finance instruments can be seen in a similar context. However, as the name suggests, there is a stronger focus on climate, and thus on companies whose business models are particularly relevant for mitigating climate change. In particular, the so-called „hard-to-abate" sectors, such as steel, aluminium and cement, are being called upon to make a significant contribution to the reduction of greenhouse gas emissions. Sustainable transformation in these sectors partly requires a fundamental rethinking of value creation processes and thereby substantial investments in innovative climate-friendly technologies. This in turn creates significant financing needs in the medium term. With this rationale in mind, Climate Transition Finance aims to complement the financing side of those companies that can and must contribute significantly to mitigating climate change through their sustainable business transformation. The guidelines then support companies in issuing credible debt instruments by making clear reference to an integrated business and climate strategy, to the firm's relevant investment activity and its governance oversight with which the issuer can signal its willingness to transform its business model towards more sustainability.

Because although companies from (currently) brown sectors have a critical role to play in creating a low-carbon economy, these companies have largely remained absent from the Sustainable Bond market. For example, a consultation commissioned by the Climate Transition Finance Working Group showed that issuers from the hard-to-abate sectors do, in principle, see Sustainable Bonds as a suitable instrument for addressing investors. However, the design of existing market standards, such as the Green Bond Principles, was considered insufficient to be able to issue a credible green instrument. More specifically, there were reservations due to reputational risks associated with issuances marked as ‚sustainable' from sectors that are traditionally considered unsustainable. Moreover, in some cases the pool of assets that would be eligible for green transactions was simply not sizable enough.

Opportunities for Sustainable Investors

But also from an investor's perspective the consultation concluded that companies from currently unsustainable sectors have to exhibit certain sustainability characteristics in order to be able to success-fully bring a sustainable financing instrument to the market and to be able to credibly signal their intention to transform their own business model. After all, the innovations in the Sustainable Bond market should also be seen in the broader context of an advancing market for Sustainable Investments. In the more recent past, the market has started to gradually move away from more traditional exclusionary approaches when constructing sustainable portfolios and is now increasingly moving towards accompanying and supporting companies lagging behind in transforming their business models, e.g. by integrating considerations of climate change mitigation. The buzzword „transition" can in this context be seen as a new building block in the sustainable investment toolkit. This is because the positive impact that can be reaped is much greater for those companies that are not yet among the best, but strive to catch up with the ESG leaders. Sustainable investors should therefore actively seek to identify those companies that need to significantly improve their sustainability credentials, but have not done so yet, e.g. because the company belongs to one of those industries that, by definition, have a challenging path ahead.

The emerging capital market innovations discussed here are particularly relevant for the field of Sustainable Investing: On the one hand, they foster a new dialogue between issuers and investors regarding the transformation of entire business models. On the other hand, they increase transparency and thus companies' credibility with regard to their willingness to change, and thus offer sustainable investors the opportunity not only to have a positive impact, but also to obtain a more comprehensive understanding of the path towards sustainability that the issuer is taking. Above all, however, the capital market innovations outlined enable investors to gain deeper insights into the business strategy of issuers, and thus to make a better judgement of how seriously, proactively and thus credibly sustainability is considered and promoted at the company level.

Sustainable investors can thus benefit from a more complete understanding regarding the extent to which sustainable issuances fit in the overall context of the issuer's sustainability strategy. After all, the ultimate goal is to make better and more integrated investment decisions and to preserve and enhance long term value. The new instruments are therefore not only relevant for fixed-income investors, but also contain additional information for those investors that are already pursuing a transformation strategy in the investment process. This is yet another reason why the innovations in the market for Sustainable Bonds constitute a logical addition to the existing range of instruments, as they will help to meet more complex requirements regarding transformation strategies on the investor side going forward.

DZ BANK Spotlight:

Flight to Liquidity – Sustainable and Conventional Bonds in the Secondary Market

One of the many reasons for issuing a Sustainable Bond is to increase investor diversification and thus broaden the investor base, especially to reach Socially Responsible Investment (SRI) investors. Many of these investors are so-called „buy-and-hold" investors, i.e. they usually hold the bonds until maturity. Since many SRI investors are represented among the bondholders of Sustainable Bonds, it can be assumed that this should also have an impact on the liquidity and thus also on the spread development of Sustainable Bonds in the secondary market.

In order to analyse this assumption, in the following we have created a simplified, unweighted index for both Sustainable Bonds and Conventional Bonds for the different sectors, namely SSAs („Sovereigns, Supranationals & Agencies"), banks and corporates[1]. We have deliberately decided against including Green Bond indices that already exist in the market. Although they reflect the performance of Green Bonds very well, they are only suitable to a limited extent for a comparison with a Conventional Bond index (e.g. due to the differences in the issuers included, the issue volume or the residual term of the bonds). For our indices, we have always formed bond pairs from the same issuer, i.e. each Sustainable Bond of an issuer was compared with a conventional bond with a similar maturity and similar volume from the same issuer.

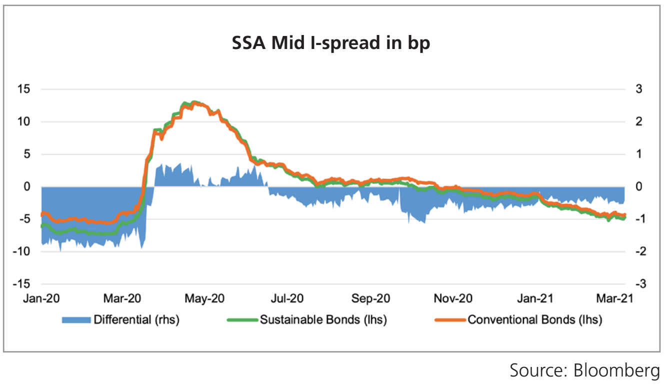
As demonstrated in the table on the next page, the bonds within the sectors are similar, especially in terms of the remaining time to maturity. Only in terms of volume we observed material discrepancies, in particular in the SSA segment where Sustainable Bonds tend to be signifi-cantly smaller than their conventional peers.

1) All bonds were equally weighted, i.e. no different weighting according to volume etc.

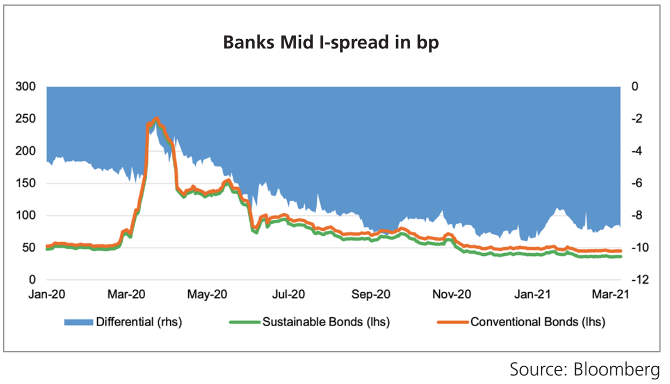
Overview of the bonds included in the indices [2)]

	SSA		Banks		Corporates	
	Sustainable	Conventional	Sustainable	Conventional	Sustainable	Conventional
# Bonds	11	11	12	12	13	13
Ø Years to Maturity	6,9 years	7,2 years	4,1 years	4,2 years	5,6 years	5,2 years
Ø Volume	€ 1.300m	€ 1.989m	€ 729m	€ 938m	€ 781m	€ 827m

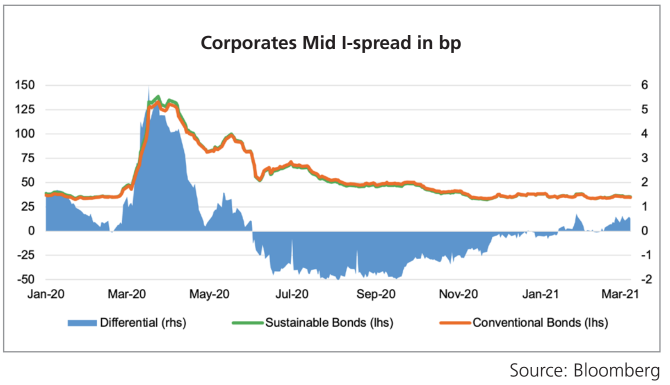
It should be noted when looking at the spread development that the spread differential in the charts cannot necessarily be evaluated as a „greenium", since only bonds with similar maturities are compared here without carrying out an extrapolation that takes the maturity differences into account, among other things.



Source: Bloomberg



Source: Bloomberg



Source: Bloomberg

The charts show that Sustainable Bonds tended to perform slightly worse across different sectors than conventional bonds during the height of the COVID-19 crisis and the related significant spread widening in the secondary market.

Based on the assumption that comparatively more investors pursue a buy-and-hold strategy in Sustainable Bonds than in conventional bonds, a countervailing development would have been expected. However, this very factor can have the opposite effect. In times of high volatility and widening spreads, many investors tend to invest in financial instruments with the highest possible liquidity. This would then support a preference for conventional bonds over Sustainable Bonds between February and April 2020. This effect is reinforced in particular in the analysis of bonds in the SSA segment due to the greater differences in issue volumes. Furthermore, the increased share of buy-and-hold investors in Sustainable Bonds means that fewer of these instruments are traded in the secondary market and that correspondingly few small orders can lead to significantly larger spread movements.

It is also possible that this movement of widening spreads is further reinforced by the intermediaries (i.e. banks, market makers): traders try to avoid taking illiquid bonds onto their own books in times of crisis, for fear of being stuck with the item due to illiquidity.

From mid-April onwards, as market conditions improved and the secondary market spreads narrowed, it became apparent that the spread differences decreased again and headed towards pre-crisis levels.

2) „Sustainable" refers to the sustainable bond indices and „Conventional" to the conventional bond indices

LEGAL REFERENCES