Volksbanken Raiffeisenbanken
Cooperative Financial Network

The Sustainable Bond market regains momentum

After a promising start in 2024 the Sustainable Bond market is warming up for new records

For a long time, it appeared that 2023 would be the second consecutive year in which the Sustainable Bond market experienced a decline in new issuance volume. Ongoing geopolitical uncertainties, macroeconomic headwind, increased cost of capital, a volatile overall market and challenges relating to sustainable finance regulation were among the factors that led to the postponement or even cancellation of sustainable projects, a slowdown in sustainable lending by financial institutions as well as a slowdown in sustainable funding activities.

However, the year ended on a conciliatory note, with the new issuance volume growing by around 14% to just under USD 866bn. The Sustainable Bonds' share of total market new issuance increased from 18.5% in 2022 to 19.8% in 2023.

The positive trend continues in 2024. After a strong first quarter, the market looks set to pass the USD 1 trillion mark, warming up for new records in 2025 and beyond.

Content

Dear reader,

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

For 2024, we forecast that both the absolute new issuance volume of Sustainable Bonds and their share of the total market will continue to rise. We are seeing a similar trend for sustainable promissory note loans ("Schuldscheindarlehen").

Project categories for Green Bonds are becoming increasingly diverse. In his guest contribution, Arnim Emrich, Head of Treasury at the State of Baden-Württemberg, explains how the state has incorporated the topic of biodiversity into its own Green Bond programme and why SSA issuers are leading the way in this area.

Investors are also at the heart of this edition: Union Investment has adopted a climate strategy that will exclude any major issuer that refuses to formulate and pursue comprehensive climate targets from 2025. The future of the SFDR and its potential impact on investors is also discussed by Union Investment in a separate article.

Enjoy reading!

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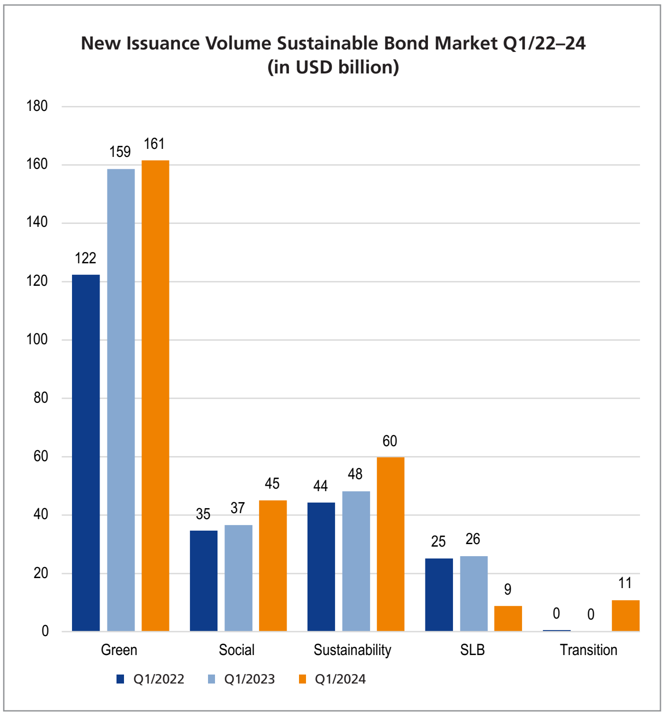
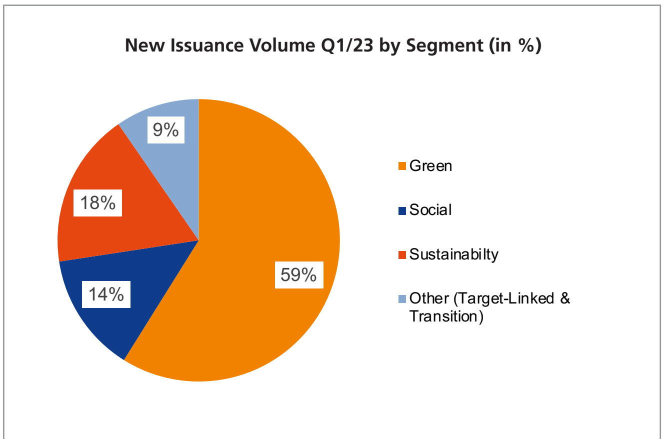
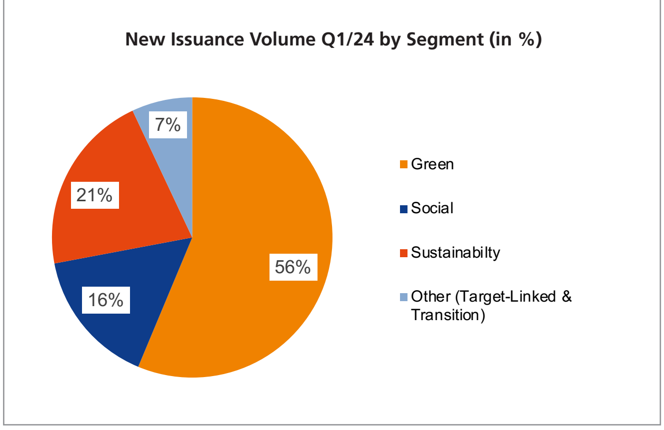
DZ BANK

The new issuance volume after three months was higher than the same period last year for almost all labels. Overall, the total market grew by around 4.5% year-on-year to USD 282bn (Q1/23: USD 270bn). The mature Green Bond segment continued to be the largest contributor, accounting for around 57% of the new issuance volume.



Source: DZ BANK Sustainable Finance, CBI, Bloomberg (2024)





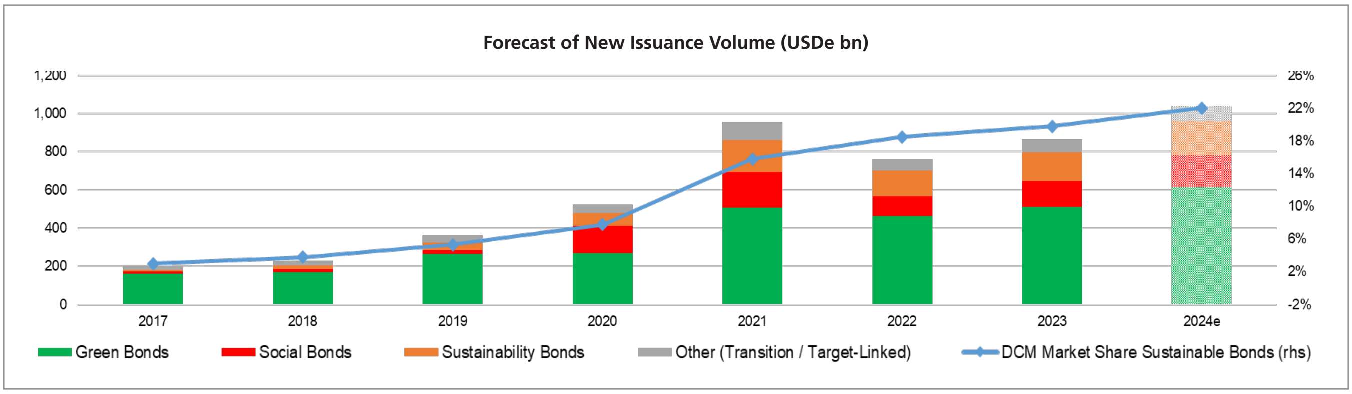
Source: DZ BANK Sustainable Finance, CBI, Bloomberg (2024)

However, the new issuance volume of Sustainability-Linked Bonds experienced a decline of approximately 70%. Target-linked structures, particulary outside the Schuldschein market, faced challenges as many investors criticized the lack of materiality in the selected KPIs and the level of ambition in the underlying sustainability targets. A report by the the Climate Bonds Initiative highlighted that currently 86% of the Sustainability-Linked Bond market is not alligned with international climate goals.

On the other hand, Use-of-proceeds Transition Bonds, which have struggled to gain traction in most parts of the world, reached a new milestone when Japan priced the world's first Sovereign Transition Bond in February.

We are confident that the upward trend in the Sustainable Bond market will persist in 2024 and forecast that the new issuance volume will increase by 20% to around USD 1,04trn. We anticipate market growth across all segments.

From 2025 onwards, we forecast accelerated and sustained growth.



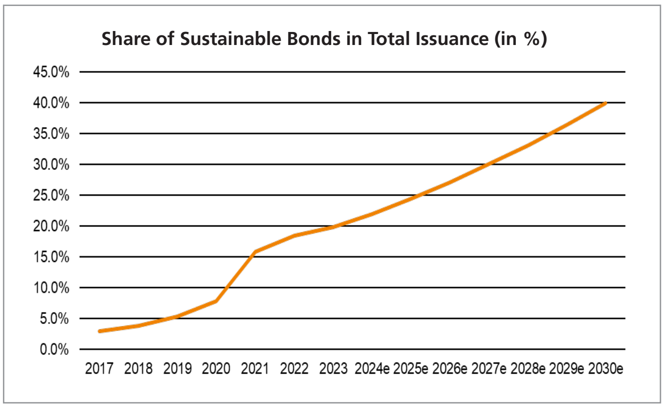
Source: DZ BANK Sustainable Finance, CBI, Bloomberg (2024)

COP28 has demonstrated that the fixed income market is a crucial component in financing the global sustainability agenda, offering significant potential for further expansion. This potential is underpinned by supportive policies, taxonomies and regulations worldwide that encourage the issuance of sustainable debt.

As central banks are expected to begin to cut interest rates and more existing sustainable debt matures, we can expect an increase in issuance. If fiscal barriers, particularly in Europe, can be overcome, the growth could be even stronger.

Investors interest in Sustainable Bonds remains strong, as evidenced by continuous inflows into sustainable and responsible funds, further driving demand for these bonds. Hence, we expect further diversification by issuers, structure, and themes as we move throughout 2024 and beyond. Diversification in the Sustainable Bond market provides investors with more bespoke choices. That's important for investors when they're looking to build balanced portfolios.

We expect the share of Sustainable Bonds in total issuance to rise to approximately 22% in 2024 and to exceed a quarter within a few years.



Source: DZ BANK Sustainable Finance, CBI, Bloomberg (2024)

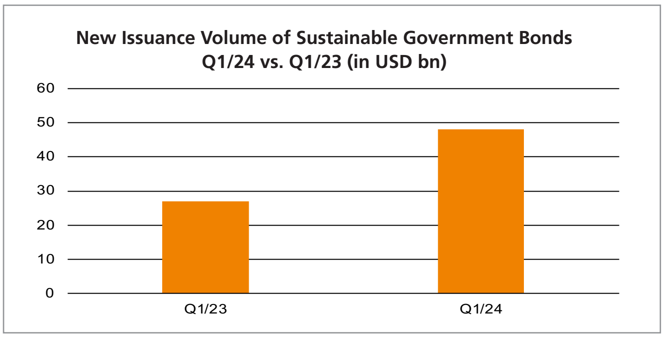
Green Bonds will continue to dominate the Sustainable Bond market in 2024 and beyond.

Among other things, we forecast Green Bond issuance by the EU, one of the largest Green Bond issuers, to accelerate in 2024 as well as a strong contribution from other Sovereigns.

The success story of Sovereign Sustainable Bonds continues

Without doubt, 2023 was a record year for Sovereign Sustainable Bonds issuance. The new issuance volume increased by around 49% to USD 156bn (2022: USD 105bn), hence surpassing the previous record volume of USD 117bn in 2021. At the end of 2023, 52 Sovereigns had issued Sustainable Bonds with a cumulative volume of more than USD 450bn.

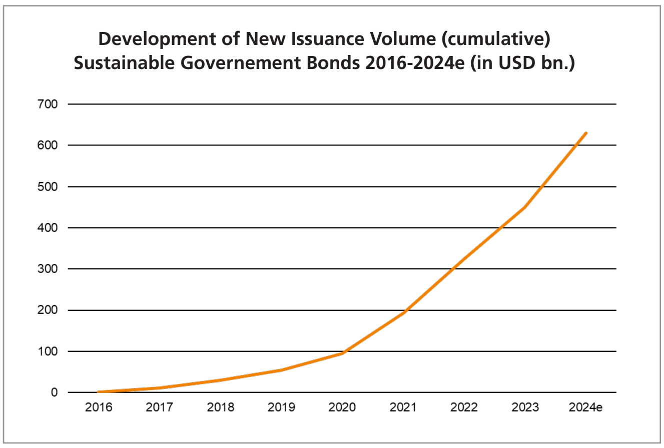
The success story of the Sovereign Sustainable Bonds will continue in 2024. In the first quarter of 2024, the new issuance was almost 80% higher than the same period the previous year, increasing from EUR 27bn to EUR 48bn. A number of maiden issuers, such as Iceland, Japan and Romania, made their debut in the Sustainable Bond market.



Source: DZ BANK Sustainable Finance, CBI, Bloomberg (2024)

As governments will start to prepare their next round of NDCs this year, Sovereign issuance of Sustainable Bonds will be one of the key triggers to accelerate market development in 2024 and subsequent years, leading to increased demand. In addition, we predict a further increase in sustainable debt issuance from emerging markets, as these markets actively seek ways to bridge the sustainable financing gap from both environmental and social perspectives.

With first-time issuers entering the market and established issuers expanding their sustainable finance activities, we expect a new issuance volume in the range of around USD 180bn in 2024. Around 70% of that volume is forecasted to originate from developed markets countries, with the remainder coming from emerging markets countries.



Source: DZ BANK Sustainable Finance, CBI, Bloomberg (2024)

Looking at the numbers, the Sovereign Sustainable Bond market offers enormous potential here. With approximately 170 countries issuing sovereign debt, there are still many countries yet to enter the market. This includes three sovereign issuers with the largest outstanding volume (the US, Japan, and China), as well as many issuers from developing countries.

Following the success of Chile and Uruguay, it is likely that SLBs will attract issuers from beyond Latin America, such as Southeast Asia or Africa. SLBs are expected to become increasingly popular among sovereign issuers from emerging markets, as the flexibility in using the raised funds makes this type of debt attractive to smaller issuers that may not have an extensive pipeline of green or social projects that would qualify for Green or Social Bond proceeds.

The conversation in the fixed income market has matured from investing in green to investing in transition as well

COP28 has closed with an agreement that signals the "beginning of the end" of the fossil fuel era by laying the ground for a swift, just and equitable transition, underpinned by deep emissions cuts and scaled-up finance.

Against this background, no one should be excluded from sustainable funding. This applies in particular to the so-called hard to abate industries. The transition also requires collective action. No single corporate or sector can make this change alone.

Meeting these challenges is not just a question of financial capacity. The crux of the matter is to allocate that capital effectively. The good news is: We have the money. And we have the right instruments.

This is a major growth opportunity for the Sustainable Bond market as conversation in the fixed income market has matured from talking about investing in climate to investing in transition as well. One advantage of using the fixed income market to finance a just transition is that a wider range of actors can issue bonds compared to those who can issue equity.

And the good news is that we don't have to reinvent the wheel to finance the transition with the help of Sustainable Bonds. As transition is a process, it is too broad to reduce it to a label. Hence, it can be financed both through the use of proceeds structure and through target-linked instruments.

With a growing number of companies globally committing to a NetZero pathway, we also expect corporate Sustainable Bond issuance to accelerate. More and more corporates will venture into sustainable funding, particularly due to their transition needs. Against the backdrop of a broader investor and societal push for the financial sector to become more sustainable in the wake of COP28, it is also expected that sustainable loan books will experience better growth dynamics than less sustainable loan portfolios.

This is supported by new investor behavior. In the past, many sustainable and responsible investors focused on strategies such as exclusions or best-in-class approaches. Those who did not fit into the grid were sold. Today, investors look more at the transition potential of the real economy. They recognize that we will not achieve a more sustainable world if we only finance assets that are already green. And there are simply not enough assets available. The identification of "sustainable companies of tomorrow" is becoming increasingly important. Hence, they live the new credo "transform instead of divest". The investors are entering an active dialogue with the management of the companies to be transformed. The possibility of divestments always remains – but only as ultima ratio if the company leaves the promised, credible transition path.

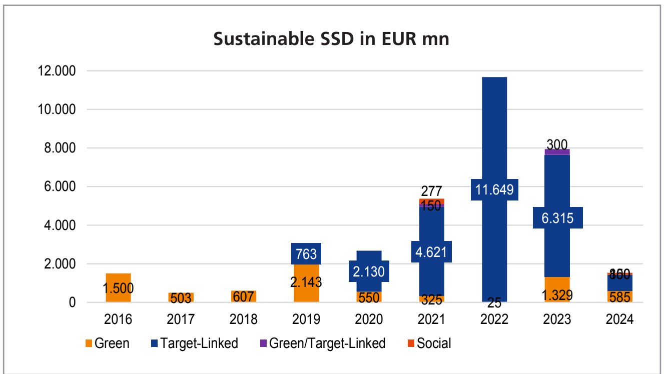
As Target-linked instruments play a key role in transition finance and the need for it to successfully implement the Paris Agreement, we expect market participants to rediscover their interest in target-linked structures. We are confident that issuers and arrangers can address the growing concerns of this instrument by focusing on material KPIs and ambitious SPTs to enhance the quality of target-linked financing via the fixed income market and, thus, its credibility.

The sustainable Schuldschein market – where is the journey heading?

Sustainable Schuldscheindarlehen (SSD) are now an integral part of the overall market. However, after an initial continuous increase, the volume has stagnated in recent years, albeit at a high level. On the other hand, we have recently observed a diversification of structures in the market. In the past, target-linked structured were predominantly chosen – i.e. structures where issuers are allowed to use the proceeds for general corporate purpose, but where the interest rate is dependent on selected sustainable performance targets. In the record year for sustainable SSDs in 2022, this structure was even chosen almost exclusively. How-ever, we are currently seeing a renewed increase in green SSDs, i.e. use-of-proceeds structures in which the proceeds are used for environmentally sustainable projects and expenditure. But what are the main drivers for the growth of use-of-proceeds structures? Why is the proportion of sustainable SSDs stagnating despite increasing regulatory requirements? And how do SSD investors assess the topic?

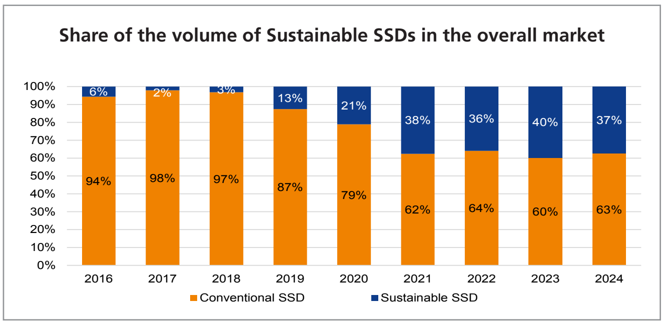
Market Overview

Taking acloser look at the market, we reached a new record in 2022 with a volume of almost EUR 12 billion in sustainable SSDs, more than doubling the previous year's volume. This record-breaking trend was not at risk of being surpassed in the following year. However, the start of 2024 does not currently indicate that we will achieve another record year in absolute terms.



Source: DZ BANK Sustainable Finance, CBI, Bloomberg (2024)

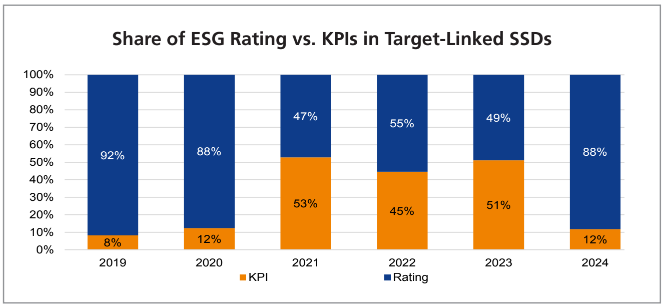
However, we must view these figures in an overall context. 2022 was an exceptionally strong year for Schuldschein, partly because the bond market was not favorable for some issuers due to geo-political and macroeconomic issues. Sustainable SSD issues also benefited from this, as a subset of the overall market. If we analyze the relative share of sustainable issues in the market, a different picture emerges. In fact, we observed an increase in the volume-weighted share of sustainable SSDs in the overall market, rising from 36% in 2022 to 40% in 2023. In 2024, we are currently between these two figures at 37%.



Source: DZ BANK Sustainable Finance, Bloomberg (2024)

Current driver

This means that more thanone-third of the raised funds in the SSD market are sustainable, and this has consistently been the case since 2021. But why are we not seeing an increase in this share? On the one hand, regula-tion is lagging somewhat behind. The Corporate Sustainability Reporting Directive (CSRD) will only become relevant for companies that already have to publish a non-financial report for the 2024 financial year, and only a year later for further smaller companies. Data quality has therefore not yet significantly improved for many companies. On the other hand, many resources in this area are tied up in preparing for the increased sustain-ability reporting requirements. In addition, many corporate and sustain-ability strategies are currently being revised against this background – these are all issues that currently tend to prevent companies from anchoring their sustainable strategy in an SSD issue. However, in the medium term, the CSRD has the potential to create conditions for sustainable financing and leverage synergies in the market. CSRD will have the potential to leverage synergies on the market, as the conditions for sustainable financing are created by these structures.



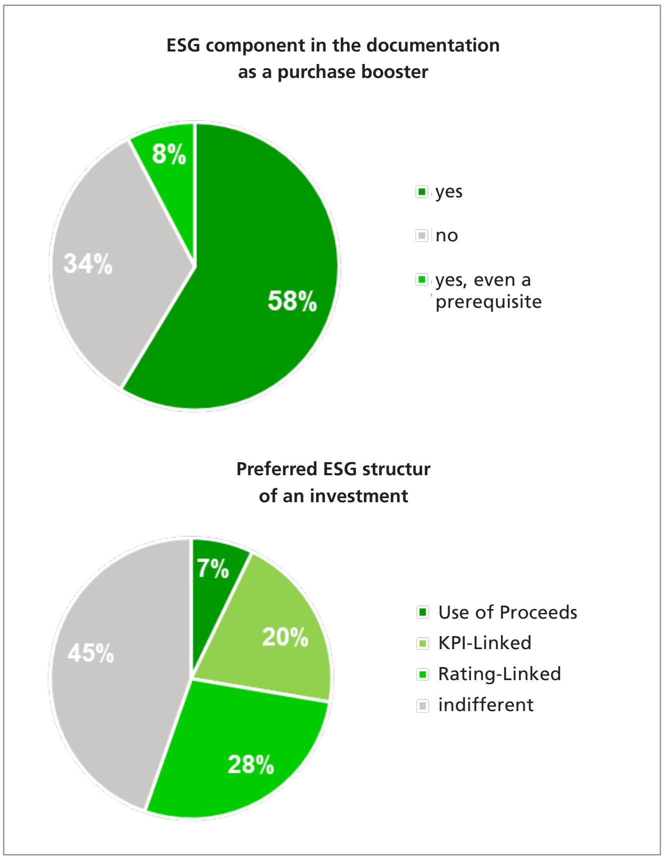
Source: DZ BANK Sustainable Finance, CBI, Bloomberg (2024)

Which structures are selected?

The fact that regulatory requirements on sustainability can leverage synergies for the corresponding financing is supported by another observation: the proportion of green SSDs increased in both 2023 and 2024, although they still represent a small account for a small proportion overall. In 2023, for example, just under 21% of transactions were green, compared to less than one percent in 2022 and 9% in 2021. While the volume in 2024 is not yet representative, the trend is evident, with 38% of the proceeds from sustainable SSDs this year being used for sustainable projects. The EU taxonomy supports some issuers in this regard, provding orientation on which activities can be considered sustainable based on clearly defined criteria. Although many companies will not fall under the reporting obligation until the CSRD is applied, companies that are already required to publish a non-financial report today are obliged to report. To this end, the taxonomy offers a good orientation as to which activities can be considered sustainable due to clearly defined criteria. However, it remains to be seen whether the proportion of use-of-proceeds structures can maintain or even increase its current level.

On the other hand, 2024 also showed that ESG ratings have not yet peaked. After a relatively balanced proportion between individual Key Performance Indicators (KPIs) and an ESG rating since 2021, the majority of companies once again relied on an ESG rating in their target-linked transactions in 2024. „Keep it simple“ seems to be the motto. One reason could be that the scarcity value of KPI structures, which are often more complex to set up, has decreased. However, reporting in accordance with CSRD should leverage synergies for companies and significantly improve data quality for environmental KPIs. We therefore assume that the proportion of KPIs will increase again in the medium term.

Our DZ BANK SSD investor survey, with participation from more than 100 institutional investors, supports the high importance of sustainable components in financing: more than half of the investors surveyed consider an ESG component in financing to be a purchase enhancer, while for 8% it is even a prerequisite. When it comes to the type of structuring, slightly less than half of investors are indifferent, but more than a quarter prefer ESG ratings. This preference can be attributed to many investors managing their portfolio based on external ESG ratings. It is difficult to predict whether this trend will continue in the medium term, but the Sustainable Finance Disclosure Regulation (SFDR) encourages investors to collect more individual and granular data and the EU is also working on the regulation of ESG ratings, which could increase their credibility.



Source: DZ BANK Sustainable Finance (2024)

Where is the journey heading?

The last three years have been relatively constant for sustainable SSD: the relative share has been stable at a high level, favoring target-linked variants, with ESG ratings and KPIs balancing each other out. In 2024, there seems to be a little more movement in the market. Although the relative share is at a similar level to previous years, there is a certain reluctance, particularly with target-linked variants. Issuers are increasingly focusing on ESG ratings again – thanks to the lower costs involved. However, we are convinced that the CSRD will soon bring about a turnaround here. The proportion of green SSDs will continue to represent a higher level in the future, and the taxonomy could provide support in this regard. However, it is still too early to expect a significant increase given the current limitations in inclusiveness and administrative processes. Nevertheless, we believe that the current high level of 38% could at least be maintained. Overall, however, it is still too early for 2024 to estimate precisely how the journey will unfold in 2024.. In any case, sustainable SSDs will continue to be highly relevant and are here to stay. A certain degree of diversification and development in the structures is therefore welcome in any case.

Interview:

Green Bonds and biodiversity – SSA issuers leading the way for greater importance for sustainable issuers

Arnim Emrich is head of treasury for the State of Baden-Württemberg. Under his management the state has established a yearly Green Bond issuance program that refinances green expenditure of the sub-sovereign entity

Author: Arnim Emrich

The Indian social and environmental activist Vandana Shiva's once said: **„In nature's economy, the currency is not money; it is life."**

One could conclude that the financial market is not the right place to deal with nature and biodiversity. On a second glance, just as is the case with climate change, sustainable finance might be one way to bridge the gap between the money-world and nature, between an extraction-oriented economy and nature-positivity.

Green Bond financing is one of the tools that could achieve this, as it creates transparency about investment in environmental objectives for investors and awareness within the organization of the issuer.

Global call for action

The Kunming-Montreal Global Biodiversity Framework was passed in the end of 2022. It is the first global commitment on biodiversity and is often compared to the Paris Agreement on climate change. It addresses biodiversity loss and has the ambition to restore ecosystems and protect indigenous rights.

The call of action in the words of the United Nations Environment Programme:

„The stakes could not be higher: [The planet] is experiencing its largest loss of life since the dinosaurs. One million plant and animal species are now threatened with extinction, many within decades."

The reaction in the Sustainable Finance market?: According to figures provided by the DZ BANK Sustainable Finance-Team, around 13% of all Green Bonds issued list „Terrestrial and aquatic biodiversity conservation" as part of their Eligible Green Project Categories in the respective Frameworks.

Land Baden-Württemberg with focus on biodiversity in Green Bond

Baden-Württemberg's Green Bonds have allocated relevant shares to biodiversity each year since the inaugural bond in 2021. The Land Baden-Württemberg will issue its fourth Green Bond in 2024 and its second bond that will have benchmark size (≥ EUR 500 million). Our Framework was based on all six environmental objectives of the EU Taxonomy from the start. 15% of the EUR 1.25 billion outstanding have since been used to refinance expenditure that improves biodiversity.

The measures include conservation measures, biodiversity funding for non-state actors and the acquisition of land. Impact is measured and reported with respect to the area of newly protected land or enhanced protected zones. Other measures focus on awareness building and cannot directly be linked to impact - one such measure is the mapping of biotopes. The examples show that - although possible – measurement is specific to each activity and there are more output (e.g. area protected) than outcome indicators (e.g. increase of number of species in protected area).

Lack of investor sensibility and accepted metrics

We could not help but notice that there was a difference in market perception, rigour of analysis and appreciation between our green projects. Investors are mostly looking for a summary of key performance indicators, ideally for greenhouse gas emission reduction. However, biodiversity does not fit into that metric.

But it is not only investors that are taking a narrow view on our sustainability challenges. Even the sustainability agencies that provide second party opinions have a skewed focus. While they question every aspect of energy efficiency measures and have standards they verify in the area of circular economy or pollution prevention, the toolbox to assess biodiversity measures seems much more limited.

In the meantime, there are more and more initiatives that provide frameworks for companies to report on biodiversity or – more broadly - nature-related risk. The Taskforce on Nature-related Financial Disclosures (TNFD) is the most global approach and issued its recommendations in September 2023. Within the EU, the Delegated Act for biodiversity for the EU Taxonomy provides some guidance, but it remains much broader and has less quantitative metrics than the delegated act on climate protection.

Conclusion: Biodiversity needs more attention in green finance

If the science is right on biodiversity and its potential to severely affect the functioning of our food networks and endanger the world as we know it, then green finance needs to step up and develop methodologies that put it on par with climate change objectives.

As a single issuer we try to do our part by financing biodiversity expenditure with a relevant share of our Green Bonds and providing coverage of the impact via our external impact analysis by Wuppertal Institute, an independent research institution. We hope it can serve as a starting point for other issuers to define their own strategies to address the problem of biodiversity.

Baden-Württemberg
MINISTERIUM FÜR FINANZEN

Interview:

Union Investment's climate strategy: engagement to keep companies investable

Author: Jakob Haerle

As part of Union Investment's climate strategy, any major issuer that refuses to formulate and pursue comprehensive climate targets will be excluded from 2025. Intensive engagement should ensure that as many companies as possible remain investable until then.

Two years ago, Union Investment adopted its own climate strategy with the aim of achieving climate neutrality for both its own carbon footprint and its assets under management by 2050. Since mid-2023, Union Investment has therefore been in dialogue with the 50 largest issuers to explain the climate strategy, its objectives, and consequences, and to promote understanding for this approach.

From January 2025 onwards, issuers that refuse to commit to climate neutrality and show no ambition to set themselves a full neutrality target (Scopes 1, 2 and 3) are to be excluded across Union Investment. Scope 1 relates to a company's own direct emissions, Scope 2 to the indirect emissions from energy suppliers. Scope 3 covers all other indirect emissions along the value chain, i.e. at customers and suppliers.

The escalation phase has started

Due to the impending exclusions, the escalation phase began in January 2024, in addition to the company dialogues that have been ongoing since 2023. This leaves one year for further active engagement to keep all issuers investable where possible. For international companies, escalation begins with a non-public letter to affected issuers ahead of the AGM season. If there is no response, the next step is not to approve the actions of the Board of Directors and the Supervisory Board at the AGM, accompanied by a public letter explaining this step. In the case of German issuers, the option is also used to create further pressure for action by means of a speech at the AGM. A final decision on exclusions and exceptions will then be made by Union Investment in the fourth quarter of 2024.

Scope 3: The companies' own initiative is required

Persistence pays off. Scope 1 and 2 emissions are no longer a major issue. The dialogue is almost exclusively about Scope 3, which is a particularly difficult topic for many companies. Of the 50 companies in the climate engagement process, around two-thirds are now well on track for Scope 3 and either have full climate targets or are credibly working towards them. The remaining third, which is at risk of potential exclusion, can be divided into three parts. A third are companies that would have to change their business model to meet the requirements. They mainly come from oil & gas and metals & mining. For the second third, the reasons appear to be more diffuse and management related - the carbon footprint does not appear to be a priority in corporate management. The last third need even more time to work on their targets. It is for the latter that continued dialogue seems most promising to prevent exclusion.

The good news is that even if they do not manage to set comprehensive climate targets as part of their climate strategy in time, they can still be re-included in the investable universe at a later stage again if they continue their efforts. Union Investment will therefore continue its engagement beyond 2025, supporting companies on their path to climate neutrality. This also applies to companies that currently appear unlikely to be able or willing to meet the targets required by Union Investment.

Interview:

The Sustainable Finance regulatory edifice: refurbish or build from scratch?

Autor: Fabian Niestert

No election posters have been put up yet, no polling stations have been opened and no votes have been counted: However, several EU institutions in Brussels are already focusing on the tasks and priorities of a new composed EU Parliament and a new EU Commission after the European elections. This also has implications for financial market regulation in sustainable finance.

Most of the work here should have been completed in the last legislature. Guided by the goal of redirecting private capital towards the sustainable transformation of the economy, regulation has evolved significantly in recent years. The Taxonomy Regulation now defines environmentally sustainable economic activities in Europe. The Corporate Sustainability Reporting Directive (CSRD) will require European companies to publish sustainability data in their annual reports starting in 2025. The MiFID reforms require that consumers be asked about their sustainability preferences when advised. And the Sustainable Finance Disclosure Regulation (SFDR) obliges financial market participants to make the sustainable characteristics of their financial products transparent. On the face of it, this appears to have been successful, with more than half of all European fund assets held in funds that qualify as sustainable under the SFDR.

However, despite this success, enthusiasm for the Disclosure Regulation in particular is limited. The definitions of negative indicators such as Principal Adverse Impacts (PAI) or the classification of funds according to Articles 6, 8 and 9 have caused a lot of headaches in the financial sector. The first measures for the reconstruction of the painstakingly built regulatory edifice are now on the agenda. So far, the SFDR has caused a lot of trouble, but the hoped-for transparency and comprehensibility of sustainable products has failed to materialize. Few can explain the differences between the various disclosure categories. And the EU Commission is also dissatisfied, as it believes that the categories with the numbers 6, 8 and 9 are misused in the market as product labels for the sustainability of funds. These should only describe the level of transparency to be achieved and not define the sustainable characteristics of a financial product.

In the autumn of 2023, the architects of the EU regulation went back to the drawing board and asked in a consultation what the "refurbishing" measures for an SFDR 2.0 might look like. The pertaining proposal is to develop the existing categories into product labels. This would mean that funds in a given category would have to meet minimum criteria for PAI or investments declared as sustainable. The pure transparency requirements of the Disclosure Regulation would be transformed into a catalogue of criteria.

The alternative to this is the „build from scratch" draft. The EU Commission's proposal to introduce product categories for sustainable investments is currently the subject of lively debate. Funds could then be given labels such as „sustainability solutions", „exclusion of negative impact" or „transformation" and new requirements for the investment processes. This is intended to make it easier for clients to understand the characteristics of a sustainable product. The proposal is based on the approach taken in the UK, where similar fund categories have already been introduced.

Feedback on these two proposals was mixed. The consensus seems to be that there is a need for change. Opinions vary widely on what these changes should look like. The next step will be for a new EU Commission to put the issue back on the agenda after the European elections. According to reports from Brussels, a proposal will be presented in 2025.

As with all construction sites, the question is how neighbors will be affected. At the same time, the European Securities and Markets Authority (ESMA) wants to define minimum criteria for sustainable fund names in a so-called Naming Directive. And both the EU Taxonomy and the CSRD are based on terminology and concepts that have their origins in the SFDR.

Whether it's a refurbishment or a new edifice, Brussels needs skilled craftsmen to get to work on the disclosure regulation in the next legislative term of the EU Parliament.

Union Investment