ING Research: The beach edition

Acting and singing 'legend', David Hasselhoff, makes a surprise appearance in our flagship global update this week; find out why. We swap Baywatch red for green in our in-depth analysis of sustainable finance. And that well-known former synchronised swimmer, Christine Lagarde, kept us all guessing at the ECB. Enjoy this week's summer reading list...

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The world in 2 minutes

From New York to Singapore, Hong Kong to Frankfurt, ING's global economists tell you what's going on in the world right now. Growth, inflation, Covid, the dollar... we've got it covered, all in two minutes

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Article | 10 June 2021

ECB: Avoiding taper talk - part two

After no changes to the official monetary policy decisions, all eyes were on the ECB press conference for any hints from Christine Lagarde on future...

Source: Shutterstock
ECB President Christine Lagarde in Brussels

The ECB's main mission today was to avoid any taper talk and not harm the still tentative economic recovery or allow bond yields to surge prematurely.

Even if the ECB slightly resembled my dog's strategy of pretending to be invisible when a bigger dog approaches, the ECB accomplished its mission: the ECB seems to have bought some time without starting the taper talk.

Highlights from the press conference

In the absence of shocking changes in the ECB's stance and macro assessment, here is what you should remember from today's meeting:

- As regards the official decisions, today's announcement was an almost verbatim copy of the April decisions. No changes in rates, no changes in asset purchases and no changes to the language that asset purchases will be conducted "at a significantly higher pace than during the first months of the year". Lagarde's comments during the Q&A session, however, suggested that not all ECB members supported sticking to this line.

- As regards financing conditions, Lagarde referred to increased market interest rates since March. According to Lagarde, "a sustained rise in market rates could translate into a tightening of wider financing conditions that are relevant for the entire economy. Such a tightening would be premature and would pose a risk to the ongoing economic recovery and the outlook for inflation." In our view, it is clear that the future line on higher market rates will be that increases will have to reflect improved economic prospects, otherwise the ECB will intervene.
- As regards the latest ECB staff projections, both growth and inflation forecasts were revised upwards for this year and 2022. GDP growth is now expected to come in at 4.6% in 2021, 4.7% in 2022 and 2.1% in 2023. Inflation is expected to come in at 1.9% this year, 1.5% in 2022 and 1.4% in 2023. This means that the ECB still sees the current inflation as being transitory. The reference to the slack in the eurozone economy as well as low core inflation projections support this point. More important than the pure numbers were the assessment of risks and core inflation expectations. According to the ECB, the risks surrounding the economic outlook were broadly balanced. With this, the ECB has gone through a gradual change of its risk assessment over the last months, from "risks tilted to the downside" to "medium-term risks more balanced" to now an outright "broadly balanced". At the same time, the fact core inflation is expected to come in at 1.4% in 2023, any taper in the coming months will be very soft and gradual.

Taper avoided but for how long?

The ECB is obviously buying time despite higher inflation prints and the prospects of accelerating inflation.

With hard data not yet matching the optimism reflected in strong soft indicators, the ECB would rather err to the downside than withdrawing monetary stimulus prematurely.

The ECB's strategy to avoid any taper talk simply followed the principle of the brutal force method: "we didn't discuss it", "it's premature" or "we will discuss it when the time has come". As much as we agree with the ECB that not every detail of the meeting should be shared with financial markets, it is hard to see that any central bank does not discuss future scenarios. In the end, monetary policy is supposed to be forward-looking.

Where will we go from here? Strictly taken, tapering is built into the current asset purchases as the PEPP will end in March 2022 if not extended. As soon as hard data start to catch up with strong soft indicators, confirming the view of a substantial rebound of the eurozone economy, support for asset purchases under the umbrella of pandemic-fighting will drop. The 9 September meeting could be the moment at which the ECB will at least start philosophising about tapering. However, as long as core inflation projections remain at their current low levels, tapering will rather be a rotation from one asset purchase programme to the other than a significant outright reduction of the purchases.

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Listen: ECB avoids taper talk but for how long?

The European Central Bank said it is still too soon to talk about unwinding monetary support, even as the Bank raised its forecasts for growth and...

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Sustainable finance: The search for 'greenium'

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The Manhattan skyline from Central Park

Issuing green bonds requires considerable effort. Does that cost really matter?

Going down the Green route requires considerable effort. A long logistical exercise is required all the way from identification of use of proceeds, to project evaluation, to the management of proceeds; all of which require efforts over and above what would be typical for issuance of a vanilla bond.

And even then the job is not done, as a reporting exercise is required in order to ensure compliance with prior project selection, and often external assurance firms are needed to confirm sustainability quality. Having the people and capability on board is clearly a requirement and a cost.

> *All types of large operations are knee-deep in miscellaneous logictical stuff; sustainable financing is just an add on*

The counterargument to the implied cost of engaging in green finance is that corporates are knee-deep with this kind of stuff to begin with. Every corporate will have accounting, legal, logistical, development and finance functions that together are in a constant state of reacting to regulatory requirements and changing circumstances.

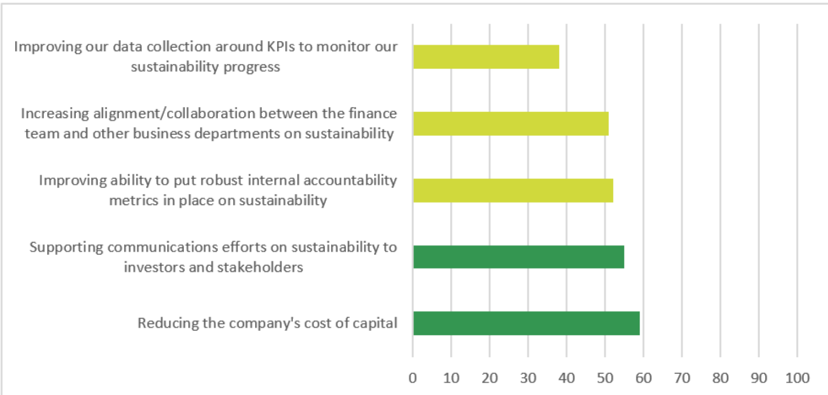
Our survey of corporates suggests that green issuance is a bigger ask of the Treasury team in terms of time and effort, but the implied benefits that come back dominate. Here, we're going to explore the actual costs and benefits through both quantitative and qualitative factors, with a particular focus on the financing aspect of sustainability.

Corporates have quite a holistic view on the benefits of sustainable financing. And the survey says ...

In the recent Longtitude/ING study, 'Now or never, a new bar for sustainability', some key questions were posed to corporates on funding through sustainable finance.

When asked about motivations for engaging in sustainable finance, the reduction in the cost of capital was a factor, but far from the only one.

To what extent did the use of sustainable finance deliver benefits? (out of 100%)



Source: Longitude/ING survey of corporates

Lower costs and positive benefits

Other factors such as sending a positive message to employees, support for sustainability communications to investors and stakeholders and help to improve Environment and Social Governance (ESG) ratings were equally high on the list of desirable outcomes.

59% of corporate respondents see a lower cost of capital from sustainable financing

When it comes to the actual effects of sustainable issuance, some 59% of respondents did see a reduction in the company's cost of capital, and some 55% viewed the exercise as supporting communications on sustainability to investors and other stakeholders.

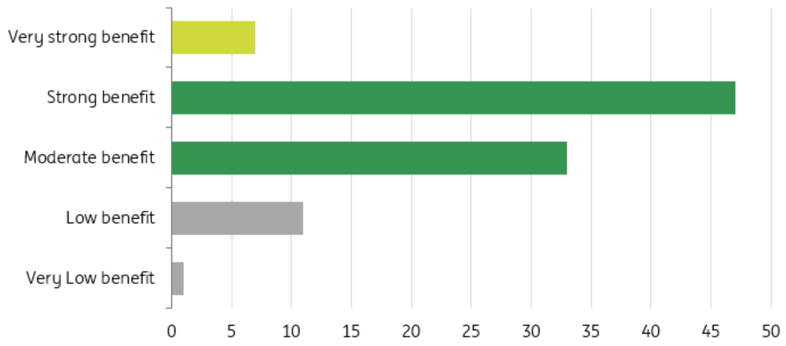
55% of corporate respondents viewed sustainable financing as a positive tilt for both investors and stakeholders.

Benefits were also gleaned from the collaboration between the finance team and other business departments on sustainability issues.

There were also corporates that did not see these as material benefits, but the lesson here is that green financing has ancillary benefits. Lower funding costs are on that list, but even if the funding costs were not lower, there were still other more qualitative benefits to be had.

To what extent did sustainable finance support communications on sustainability to stakeholders?

Sums to 100%



Source: Longitude/ING survey of corporates

Growing awareness across the board

One of the underlying circumstances at play here is the growth of awareness of ESG issues generally, from the stakeholder of all guises, whether that be shareholders, business partners or employees. In terms of the pure financing decision, there is no coercion coming from the official sector. Rather it is a bottom-up choice that has evolved as the right choice under the totality of circumstances.

The fact that there is a cost of funding improvement to boot is an added benefit; but more of a welcome outcome than a driver. The real test would be where the funding advantage disappeared completely or is even inverted. There would likely be a point where issuance plans would revert towards vanilla if the price point were severe enough. But that would likely require near-ubiquity in ESG bonds, and we are quite some way away from that.

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Article | 9 June 2021 **Financial Institutions** | **Sustainability**

The corporate premium in green finance

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Frankfurt's skyline behind a field housing an art installation

The market for sustainable financing features a premium on ESG bonds; a reflection of long term aspirational change

Environment, Social & Governance (ESG) as a concept has been elevated in importance on both sides of the financing fence – the issuer and the investor. It's reflected in the deployment of product by issuers that prefer to pursue an ESG objective, alongside investors that want to be seen embracing the same. Green issuance trades at a premium; that's a clear measure of tilt towards greenness.

As a consequence of an excess of demand over supply of ESG bonds, a so-called "greenium" is in play, where ESG bonds trade at a higher price than vanilla ones (thus commanding a lower yield). In consequence, issuance in ESG bonds is cheaper for the issuer, and the buyer accepts a lower running yield.

Sustainability reduces existential risk, the ultimate default ...

Why? It's not just because embracing ESG is seen to be the right thing to do, it is also seen as a sensible long-term investment practice; to be in things that are seen to be sustainable. The ultra buy-and-hold strategy must embrace this, as holding on for the long term requires sustainability, by definition. At the extreme, sustainability reduces existential risk (the ultimate default).

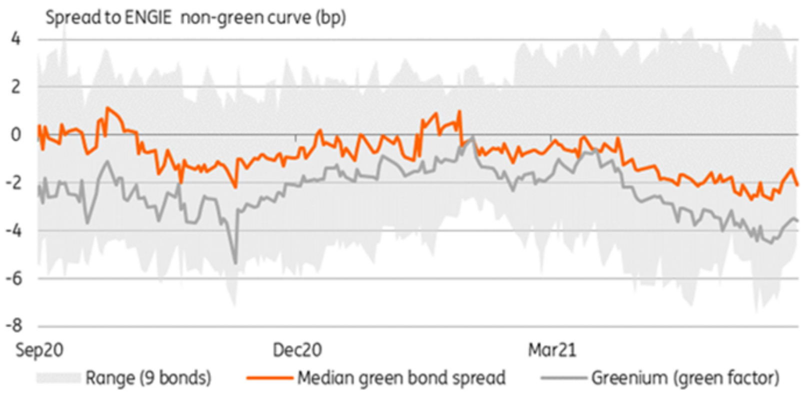
Changing times

The lower yield on Green issuance has not always been the norm. A number of years back it was the reverse, where Green issuance meant higher funding costs for issuers. Back then, issuing in the Green space meant making a statement that issuers were willing to pay a bit more to be more Green. Now it's investors making the statement that they are willing to sacrifice (a bit of) yield to help build their Green credentials (both for the investor, and the intermediary).

And this has occurred alongside a dramatic build in ESG issuance. It is clear though that there is demand for more.

Example of recent evolution of the greenium and its deviations for different bonds from the same issuer

EUR Enegie, bp



Source: Refinitiv, ING estimates

Our calculations show a Greenium of some 1bp to 3bp in EUR versus a higher greenium of 5bp to 8bp in USD

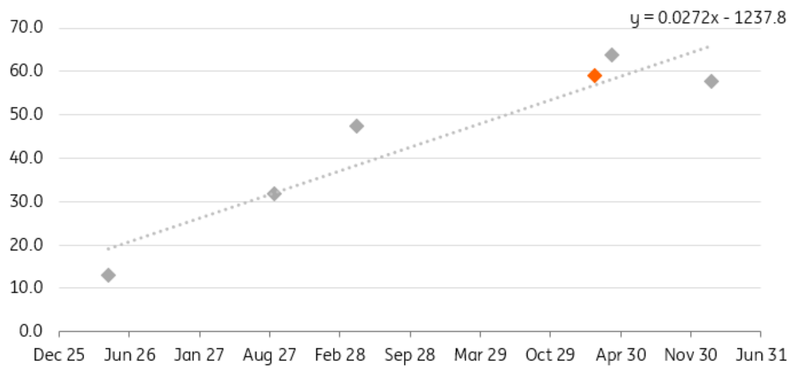
We've done an updated holistic analysis of where the greenium is. We base it off EUR and USD issuance completed in 2020 and 2021 to date, from mostly European - and US-based corporates. For EUR issues we find a median greenium of 2bp, but can be much higher depending on circumstances. Our credit strategy team has looked at the greenium specifically in EUR investment-grade corporates and has concluded that it is now in the 1bp area, and has fallen in the past number of quarters, mostly on account of more Green issuance. This illustrates considerable variability in the size of the greenium, but also some evidence that is not as large as it was (some 6bp a year ago).

Our calculations confirm a definite greenium, and currently larger in USD vs EUR

When we look at the USD numbers we find evidence that the greenium is currently larger (versus EUR). Our USD debt capital markets team spends its days looking at new issues and identifies a spread of anywhere between 1bp to 10bp as the greenium currently for the bulk of bonds that have been issued so far in 2021. We've done a separate exercise looking at secondary market levels and have found that the average greenium is in the area of 5bp to 8bp, and in some extreme cases, the greenium can be in excess of 20bp (albeit callable/coupon size impacted). There has been a clear build in issuance from US corporates, and the greenium on USD issuance commands a demand for more.

Example where vanilla bonds sit alongside a relatively new green bond

USD, Toyota, bp



Source: Refinitiv, ING estimates

There are various ways to do this exercise, depending on whether we fit a curve or simply look at comparison versus immediate adjacents, and we provide a summary of the detailed outcomes in the illustrations below.

Table of greenium calculations for EUR and USD

Negative means green yield below vanilla equivalent

	USD Greenium	EUR Greenium
Mean	-8	-3
Median	-6	-1
High	-33	-18
Low	11	6

Source: Refinitiv, ING estimates

Lets take a middle ground, say a 5bp greenium. For a $1bn bond, that comes to a cost saving of $500,000. Or for a $10bn bond portfolio that is then a $5m cost saving. Maybe not determinative, but also not nothing.

Driving towards a sustainable future

Does this make a difference to the overall drive for a more sustainable future? As a stand-alone, probably not. Even the brownest of operators can identify green aspects to what they do and look then to embrace them by highlighting and ring-fencing them from a financing perspective. The financing decision is part of a bespoke set of processes that as a collective characterises where any corporate is on the spectrum of greenness.

The bigger lifting in terms of making a real difference comes from how businesses are run, what they produce, how they produce, where it's done and what efforts are made to actually make a difference. That still likely requires some carrot and stick. But the pleasing aspect is that Green finance is increasingly positioned to partake in this, and indeed as an aid to lubricating the bigger effort, and that's important in itself.

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London's Canary Wharf financial district

The theory behind the greenium

One of the peculiarities of ESG (aka “Green”) issuance is the capability to trade at a premium versus regular (aka “Vanilla") bonds. There is no theoretical reason that this should be the case. Green bonds are just as likely to be repaid as Vanilla bonds, or in other words there is no greater or lesser default risk attached to them (from the same issuer, and without subordination).

> *Green bonds are just as likely to default as Vanilla bonds are, so why the premium in green?*

So if Green bonds command a premium, it must reflect a prevalence of demand over supply. The issuance of Green bonds has soared in recent years, but demand has outstripped it. The so-called “greenium” reflects this through a lower yield being attached to Green relative to Vanilla bond issuance.

But also there is a longevity rationale. Sustainability should mean avoidance of existential risk, and to that extent we could or should expect to see a premium being attached to such product.

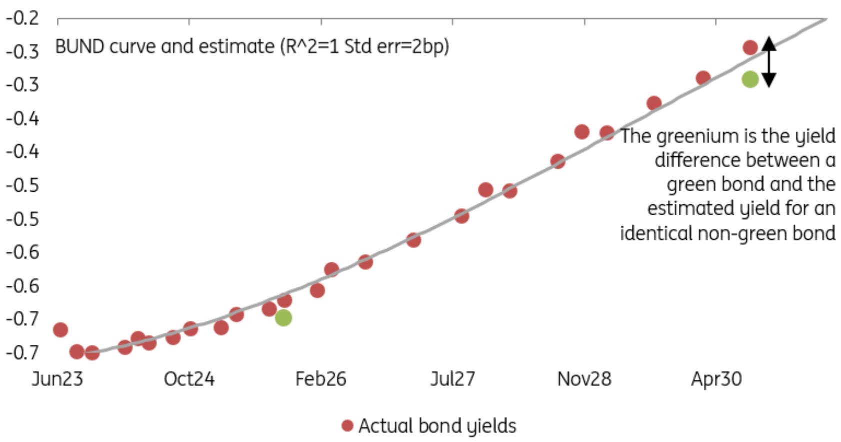
What is a Greenium, our methodology in a nutshell

We have quantified the pricing difference between green and non-green bonds (the greenium in its purest sense, as a price differential). There is more than one way to approach this issue. There is rarely a green and non-green bond sharing exactly the same characteristics (coupon, maturity, size, issue date, currency, sector, etc.) so direct comparison is almost never an option.

> *We calculate the greenium using a curve model. Its agnostic to circumstances and fair.*

One approach is not to try to correct for these factors at all and just compare the average yield between green and non-green bonds. The advantage of this method is that it doesn't rely on any model, but the greenium estimate is liable to be drowned out by other factors (eg, maturity). At the other end of the spectrum, one can resort to a curve model and estimate the greenium for each issuer in order to avoid the measure being 'polluted' by other factors. This is our approach.

The greenium is the spread of a green bonds to the issuer's non-green curve



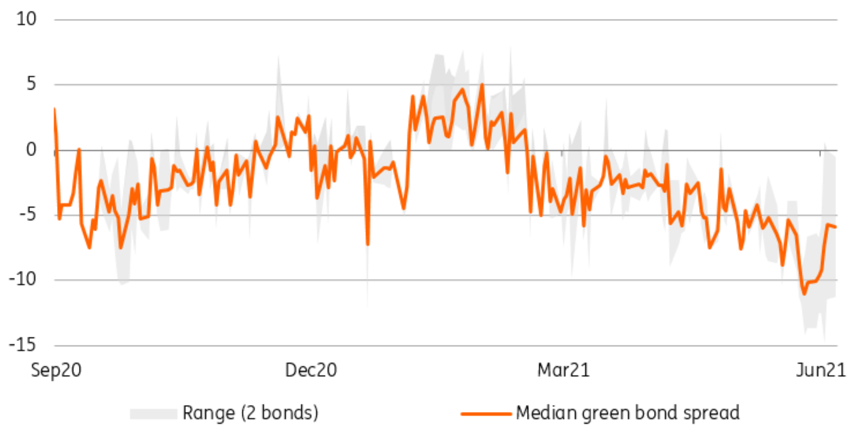
Source: Refinitiv, ING

To achieve this, we build two curve models for each issuer with a sufficient number of green and non-green bonds (3 and 10 respectively): one with a green factor, and one without. In the first case, the value of this green factor is simply our greenium estimate. In the second, the median model residual of all existing green bonds is our estimate. The two approaches are very similar but the second tends to be more robust for curves with only a small number of bonds, so we use both.

Below are some examples of greenium calculations.

Example of generic greenium in Verizon USD

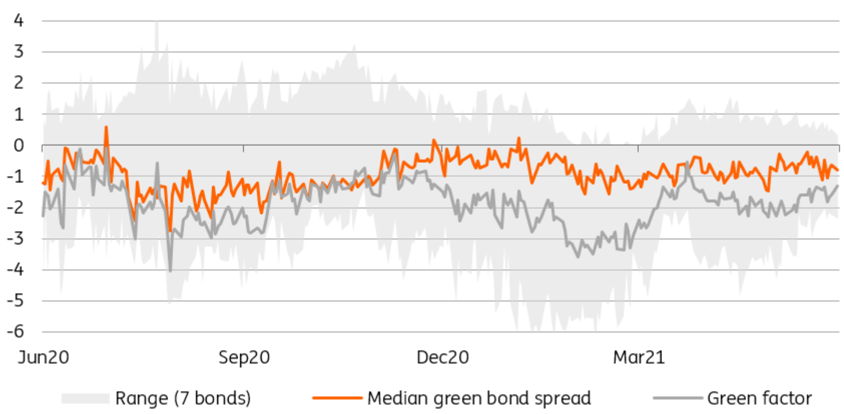
Spread to VZ non-green curve (bp)



Source: Refinitiv/ING estimates

Example of generic greenium in e.on

Spread to EONGI non-green curve (bp)



Source: Refinitiv/ING estimates

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The President of the European Investment Bank, Werner Hoyer

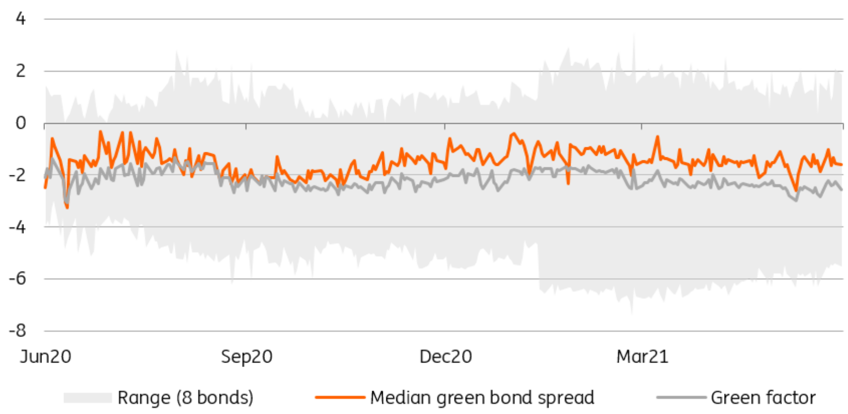
Sovereign and SSAs: a small but clear funding advantage (at least in EUR)

Sovereigns and SSAs (sub-sovereign, supranational and agencies) have been one of the most prolific green bond issuers for years, and they typically have liquid non-green curves to compare them to. Here we find a relatively well-defined tendency for green bonds to carry lower interest than their peer, ie, a positive greenium. But even there, it is hard to make broad-brush statements.

SSAs present our best chance to accurately measure the greenium as they tend to issue a greater number of green bonds than other types of borrowers. We find that among these issuers, the greenium on EUR curves is more clearly defined than in other currencies, although in most cases it oscillates between 0bp and 5bp. Take for example the European Investment Bank (EIB), an early and enthusiastic issuer of green bonds. Its EUR curve displays a clear and well defined greenium worth around 2bp, while its USD curve suggests no clear funding cost advantage in issuing green bonds.

EIB greenium in EUR is stable and clearly defined

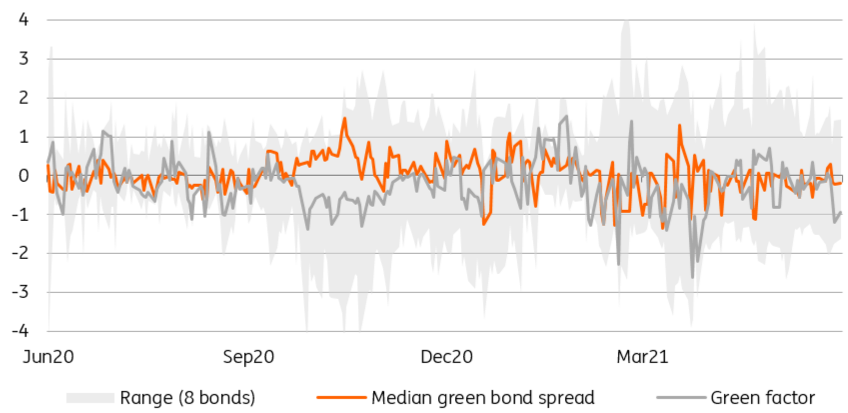
Spread to EIB non-green curve (bp)



Source: Refinitiv/ING

The same cannot be said of its USD greenium

Spread to EIB non-green curve (bp)



Source: Refinitiv/ING

The 'sovereign' approach

In contrast, the approach retained by most sovereigns is to issue a small number of large green bonds. This means that for each one of the - mostly European - countries, our greenium estimate is a one or two bonds estimate. The result is not statistically significant for each issuer but we do observe greeniums in the range of 0.3bp (Ireland) to 5.0bp (Italy) across the six eurozone sovereigns that have issued green bonds, the median being 2.4bp.

So we feel more confident in talking about the existence of a greenium in the official sector for EUR-denominated debt. This is a slightly different conclusion than for corporate issuers above but it should be said that discrepancies from one borrower to the other are significant. It may be also that as USD green bonds from sovereigns and SSAs gain in popularity, so will their greenium.

As USD green bonds from sovereigns and SSAs gain in popularity, so will their greenium

As with corporates, there are indeed other benefits for the official sector to issuing green securities. For one thing, we believe the initiative taken by SSA borrowers in launching the first green bonds should at least share some of the credit for their popularity. By the same token, the UK Debt Management Office's recent decision to issue green gilts should turbocharge the growth of the sterling green bond market.

Secondly, a more observable 'greenium' on the more liquid sovereign and SSA curve, albeit modest, adds to the case for green issuance for other borrowers where the funding benefit should be larger.

Finally, the practice of regularly issuing green bonds acts as a form of political commitment to green projects even through electoral cycles.

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