Green FINgers | Financials gear up for ESG risks

Desk Strategy | Credit – Financials

13 October 2021

Banks and insurers must prepare for ESG risks

With thanks to our FI Sustainable Finance colleagues.

In our previous ESG note we looked at the role of bank supervisors to prevent "greenwashing" with stress tests.

In this note we look at **potential new rules on banks and insurers to help them prepare for climate related risks**. We also revisit our relative value metrics like green bond premium monitors for senior and sub financials and we note the continued entrenchment of "greeniums" for most bonds.

Banks – potential capital buffers for climate change risks

- We have seen articles suggesting that banks could face climate-related capital requirements. In an interview with Bloomberg, Pilar Gutierrez of the EBA regulator suggested that **once banks report climate related disclosures, they are more likely to be encouraged to build capital buffers against ESG related risks**. As we highlighted in our previous Green FINgers note, ESG minimum disclosure requirements such as the Green Asset Ratio are expected to be part of bank Pillar 3 disclosures from **2022**. Although there is no clear timeline for this resulting in climate-related capital requirements for banks, Gutierrez suggests that the disclosures could be a catalyst for banks to get the ball rolling for better climate change risk management.
- Along with **reputational and operational risks** that bank face with climate change, the ECB will examine whether **banks' trading books** are exposed to ESG shocks such as losses on the debt of oil companies. ECB authors published a paper for the methodology of the climate stress test which said that the ECB will "*construct market-risk shocks driven by climate change dynamics that could be used to reprice corporate bonds*". The ECB said that "*an internal ECB model has been developed to approximate the **shock on credit spreads** from transition and physical risks under the three climate scenarios*". Ultimately, the ECB authors said that "*the impact of market risk is somewhat limited as compared with the credit-risk channel*" – as shown in graph 1 below, **portfolio losses for the vast majority of banks is below -1%** in both an "orderly transition" and "hot house" scenario.

Graph 1 continued on the next page…

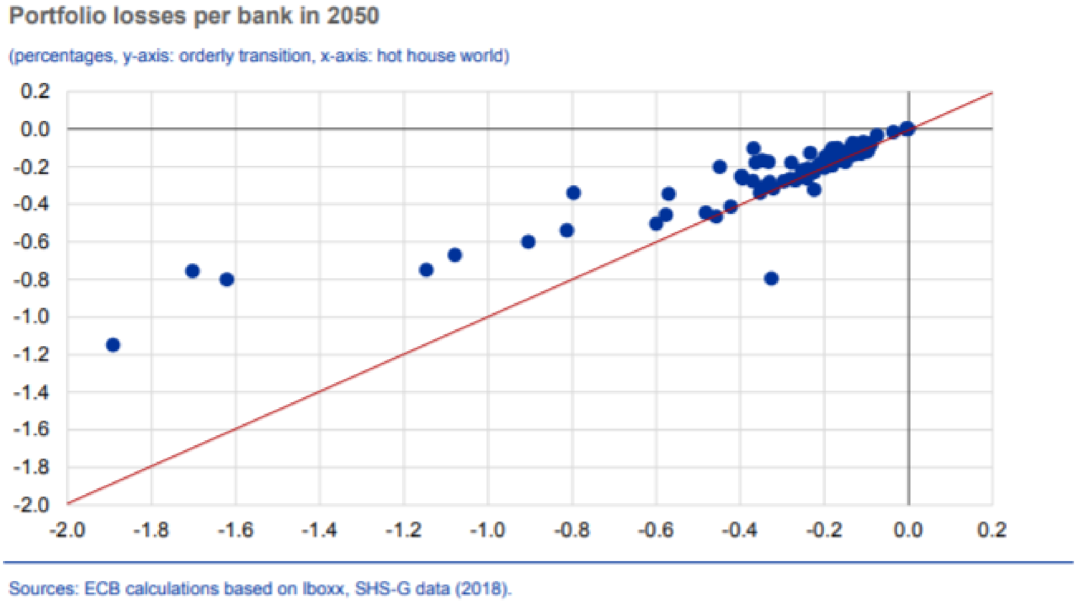
Strategists:

Financials Credit Trading Strategy
financialscredittradingstrategy@natwestmarkets.com

David Alam, CFA
Financials Credit Strategy
+44 20 7085 3242
david.alam@natwestmarkets.com

Desk Strategy India
Ankita Agarwal

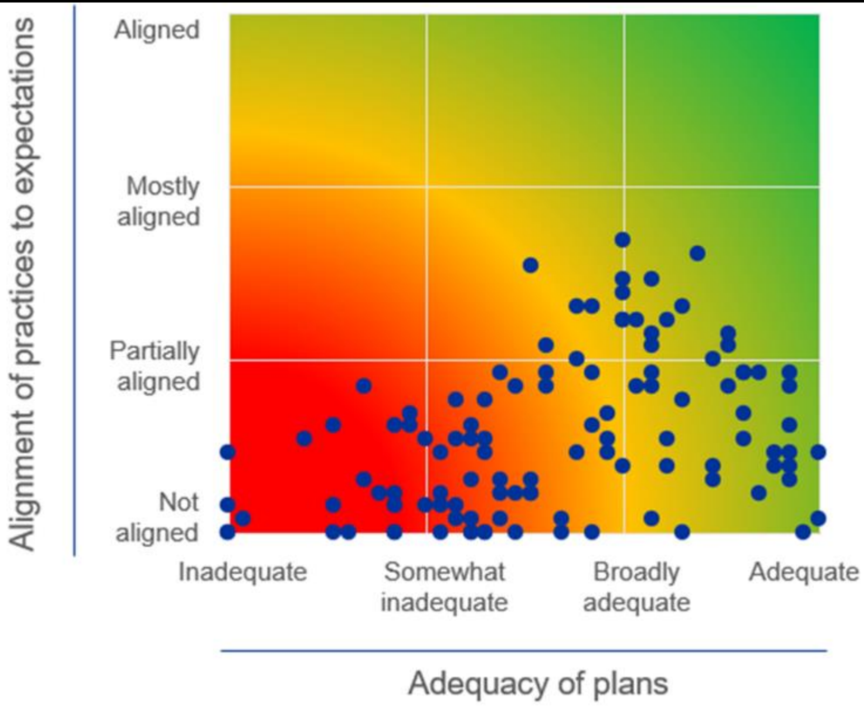
Graph 1: Market losses for banks' corporate bond portfolio



Source: ECB Occasional Paper Series No 281, September 2021

- Even if the ECB stress test next year does not result in immediate capital requirements for banks, it is clear from an ECB Supervision newsletter in August that **banks are still far from ready for ESG risks and that the regulators wants banks to do more**. The ECB newsletter says that "*very few banks have incorporated sound climate and environmental risk management processes… into their strategies or risk mitigation processes*". For example, graph 2 below shows that **only one-third of banks have plans in place that are at least broadly adequate** (in the right hand column) and that **a fifth of the banks have (somewhat) inadequate plans that will barely improve** (in the bottom left square).

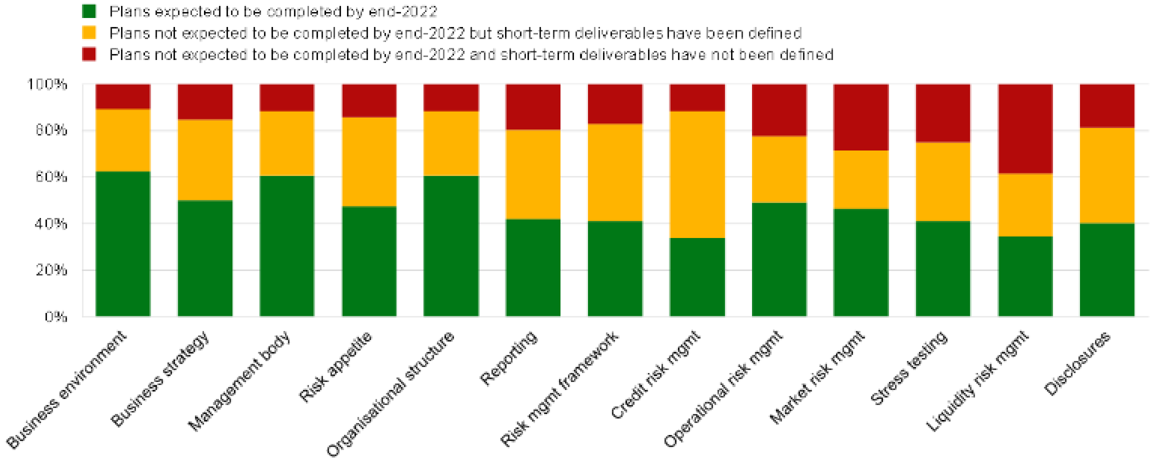
Graph 2: Alignment of banks' practices with expectations against the adequacy of plans



Source: ECB Supervision Newsletter, 18 August 2021

- The ECB Supervision newsletter also highlights that **banks need to speed up their efforts to adequately manage climate and environmental risks in a timely fashion**. In graph 3 below, **less than 35% of banks** expect their credit risk and liquidity risk management practices to be aligned by end-2022. The ECB also highlights that some banks will miss meeting end-2022 plans and also have not defined short-term deliverables to meet by end-2021 (the red bars in graph 3), which is particularly high for liquidity risk management at **nearly 40%**.

Graph 3: Banks' projections of the timing of plans and deliverables



Source: ECB Supervision Newsletter, 18 August 2021

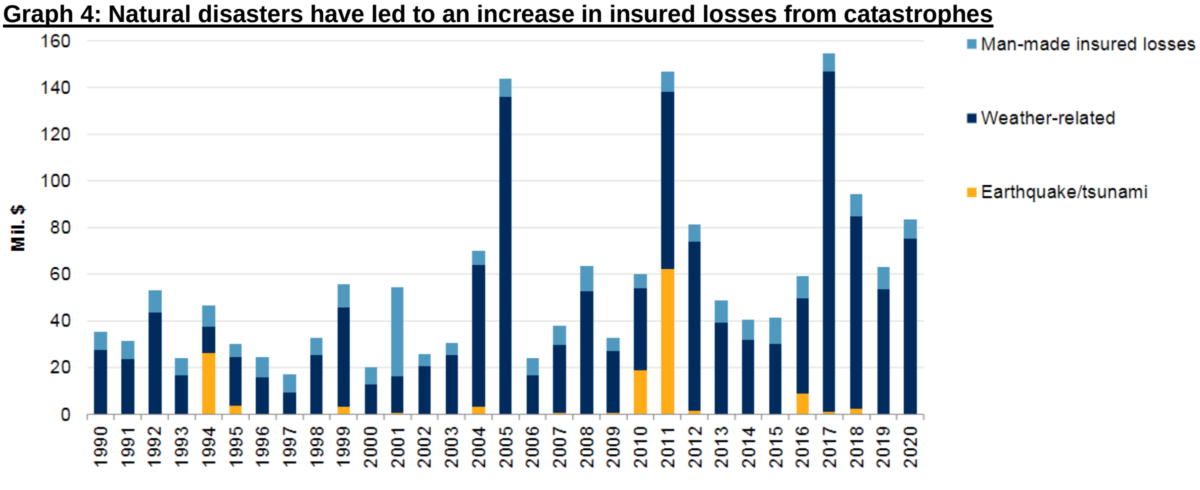
Insurers – EC wants climate risks to be better managed

- Last month, the European Commission proposed amendments to the Solvency II Directive and a new Insurance Recovery and Resolution Directive. As explained in a Q&A document, the European Commission said that it will be "***introducing a requirement for a long-term climate change scenario analysis** [which] will take into account climate change-related risks that may not always be captured when calculating capital requirements. In addition to this, **EIOPA will conduct centralised climate stress tests in the (re)insurance sector** and the Commission will launch a Climate Resilience Dialogue and explore ways to improve the collection of insured loss data.*" Mentions of stress tests and scenario analysis clearly indicate that insurers will be scrutinised more by regulators on their management of climate related risks.

- According to a Fitch report on these Solvency II reforms, the rating agency thinks that lower capital charges for insurers investing in **longer-term assets** could boost the demand for **environmentally sustainable infrastructure and renewable energy projects**. However, Fitch notes that the impact could be "*gradual as it will take time for insurers to source investments they consider suitable*". We would welcome more involvement from regulators on developing insurers' **ESG related disclosures**, as was done by bank regulators with the Green Asset Ratio.

- Insurers have clear economic incentives to effectively manage risks, particularly losses from **natural catastrophes and weather related claims**. Given the increasing severity and frequency of extreme weather events, we note a recent S&P report which looked at how reinsurers are incorporating climate change risks. S&P said that "scenario analysis suggests that reinsurers' estimates of their **exposure to natural catastrophe risk could be underestimated by 33-50%**". The S&P report also says that "71% of reinsurers consider climate change in their pricing assumptions, but **only 35% include a specific component of the price allocated to climate change**". As such, the report suggests that reinsurers can do more to better protect their capital and earnings volatility from physical climate risks.

Graph 4: Natural disasters have led to an increase in insured losses from catastrophes



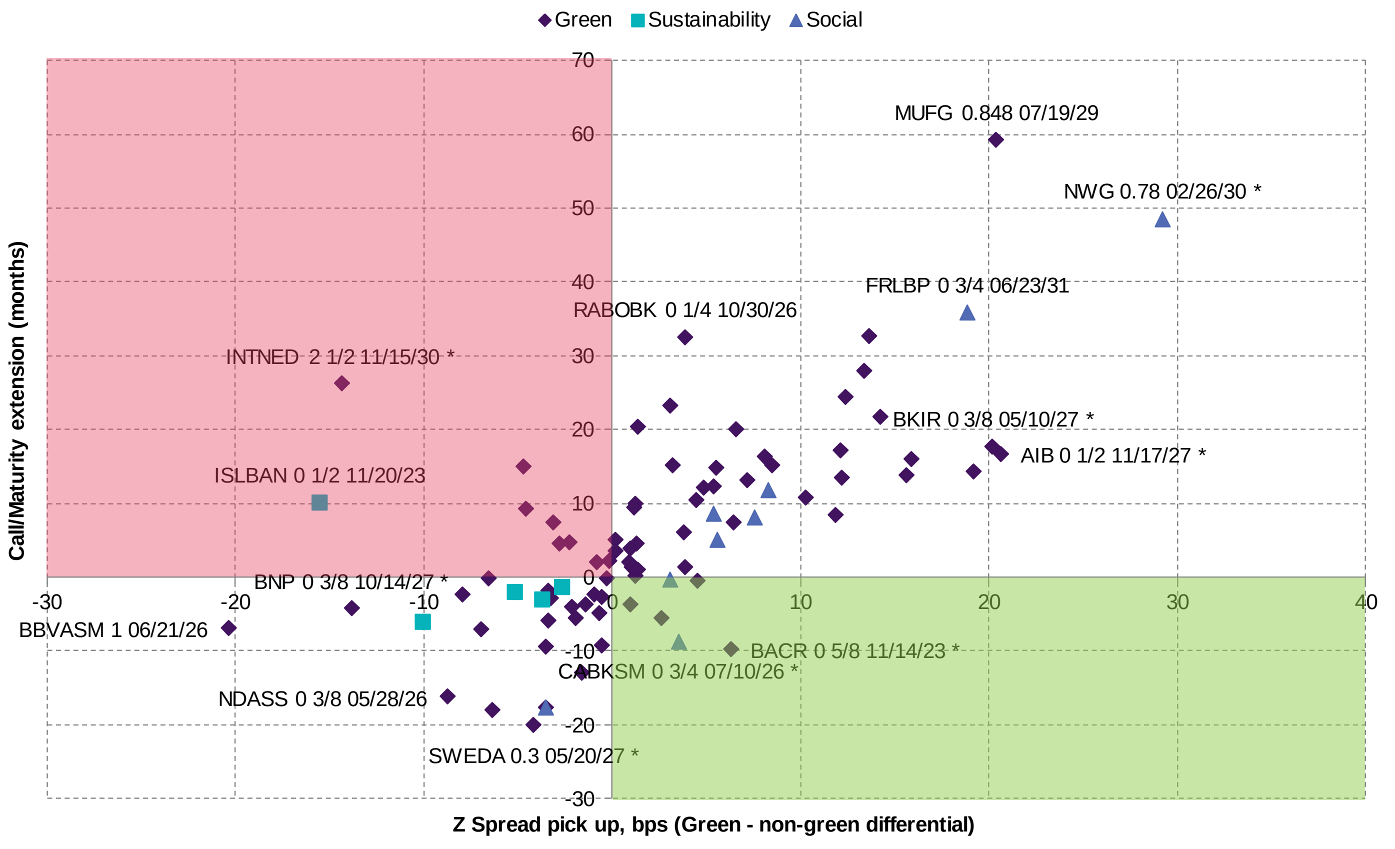
Amounts are at 2020 prices. Source: Swiss Re Institute.

Source: S&P, 23 September 2021

"Greenium" in seniors – green bond premiums remain entrenched for most

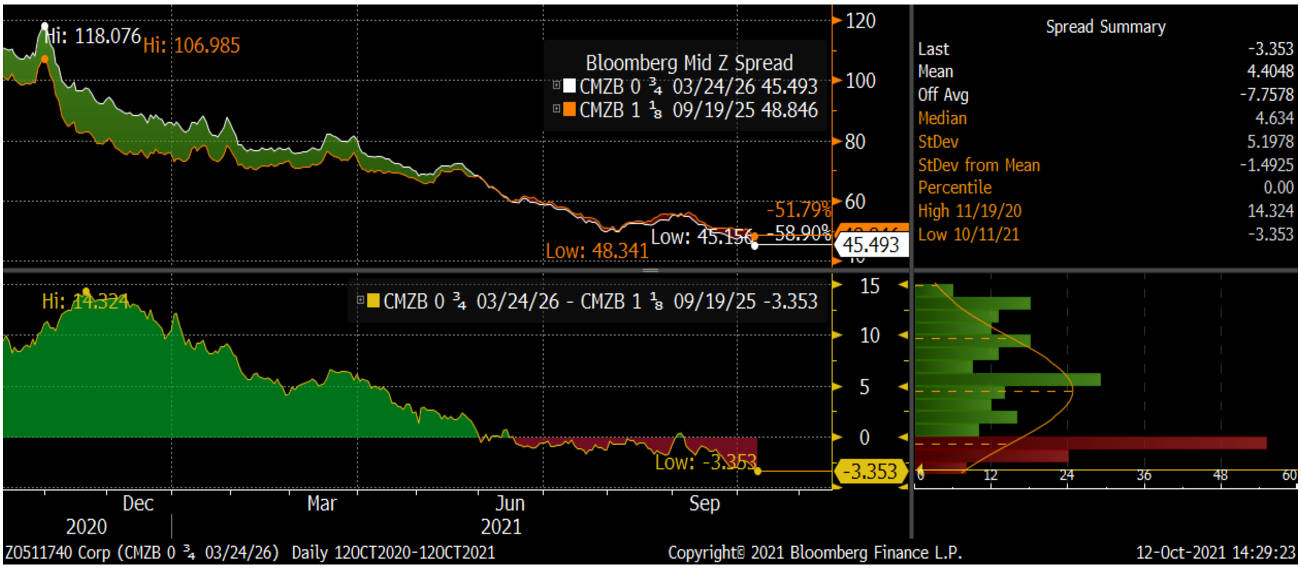
- Like our previous Green FINgers ESG notes, below we highlight our "**greenium**" monitor for seniors. In graph 5 below we track the difference in maturity/call date between a GSS and non-GSS bond compared to the Z spread pick-up. If a bond is in the green bottom-right quadrant of our chart, this would indicate that the GSS bond is attractive in the pair, as the GSS bond offers both a Z spread pick-up and a shorter duration than the non-GSS bond.
- In our previous Green FINgers note we noted that "*GSS bonds have held onto their green bond premiums and therefore not reversed earlier outperformance over non-GSS bonds*". **Such entrenchment of "greeniums" has generally held true in recent months, despite the sell-off**. For example in our June Green FINgers note, we had highlighted how the green CMZB 0.75% 26-25 SNP had outperformed and compressed flat on spread to the non-green CMZB 1.125% 25s counterpart. This **green bond outperformance has continued in Q3** so that the **green CMZB now trades 3bps tighter than the non-green equivalent**, as per graph 6 below.
- As can be seen in graph 7 below, hardly any GSS bonds offer a pick-up over a non-GSS equivalent for almost all the pairs, with the exception of **Irish seniors** we which had already identified in June. Here we can see than the **green AIB and BKIR seniors still offer ~20bps pick-ups over their respective non-green equivalent**, albeit for a maturity extension too.
- We note one exception is **SHBASS SNP where the green bond has underperformed the non-green**. As seen in graph 8 below, the spread differential has nearly doubled in Q3 and now the green SHBASS 0.01% 27s offers an **all-time high pick up of 9bps** over the non-green.

Graph 5: GSS bond Z spread pick-up vs duration extension, compared to non-GSS



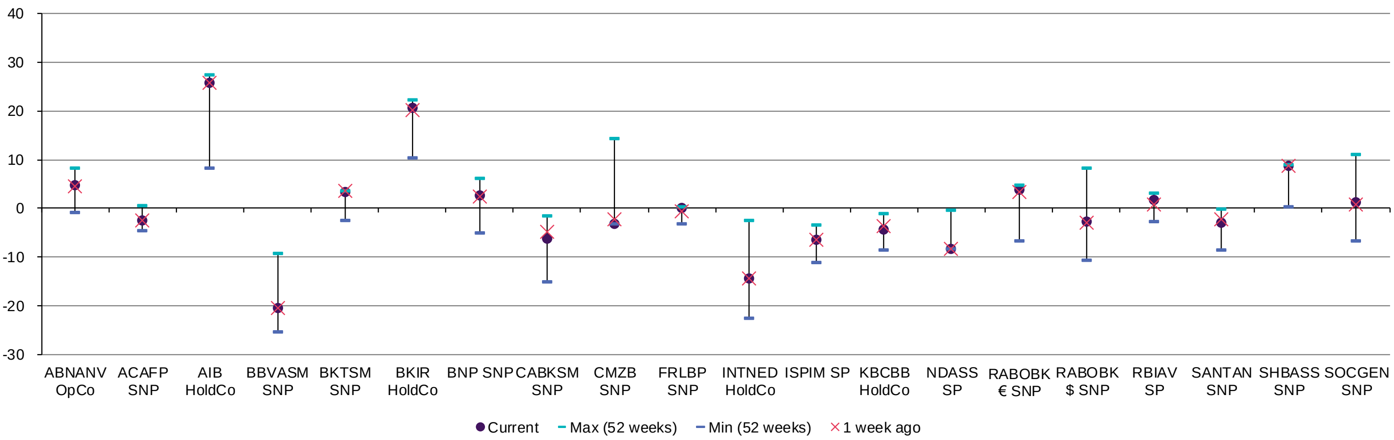
*(Source: Bloomberg, NatWest. * denotes callable. Underlying bonds listed in appendix at the end)*

Graph 6: CMZB 0.75% 26-25c green SNP vs CMZB 1.125% 25s non-green SNP, Z spread bps



(Source: Bloomberg)

Graph 7: Selected € GSS senior bond Z spread pick-up vs non-GSS, 12 month range



(Source: Bloomberg, NatWest. Underlying bonds listed in appendix at the end. SP = senior preferred. SNP = senior non-preferred)

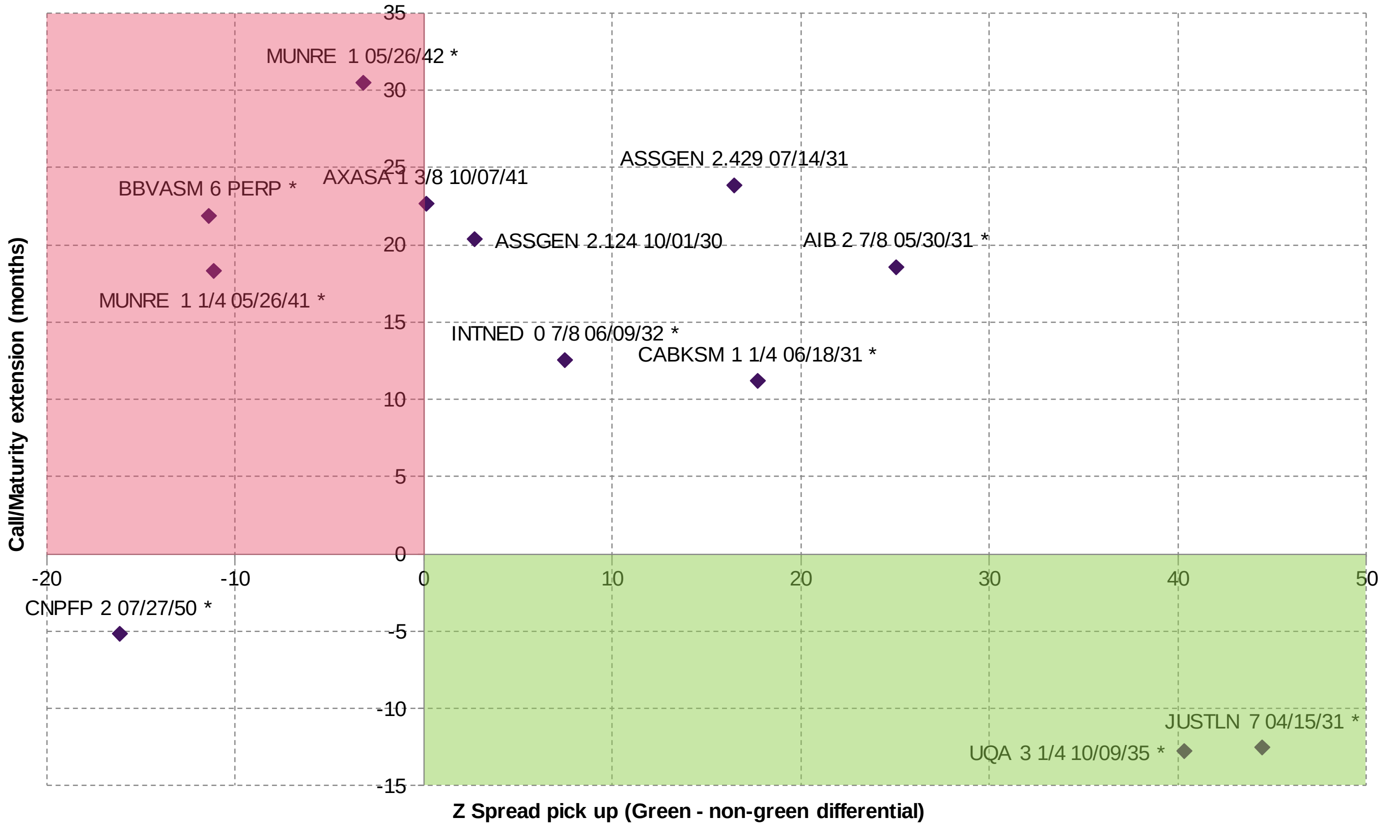
Graph 8: SHBASS 0.01% 27s green SNP vs SHBASS 0.05% 26s non-green SNP, Z spread bps

(Source: Bloomberg)

"Greenium" in sub debt – AT1 and Tier 2 greeniums moved oppositely

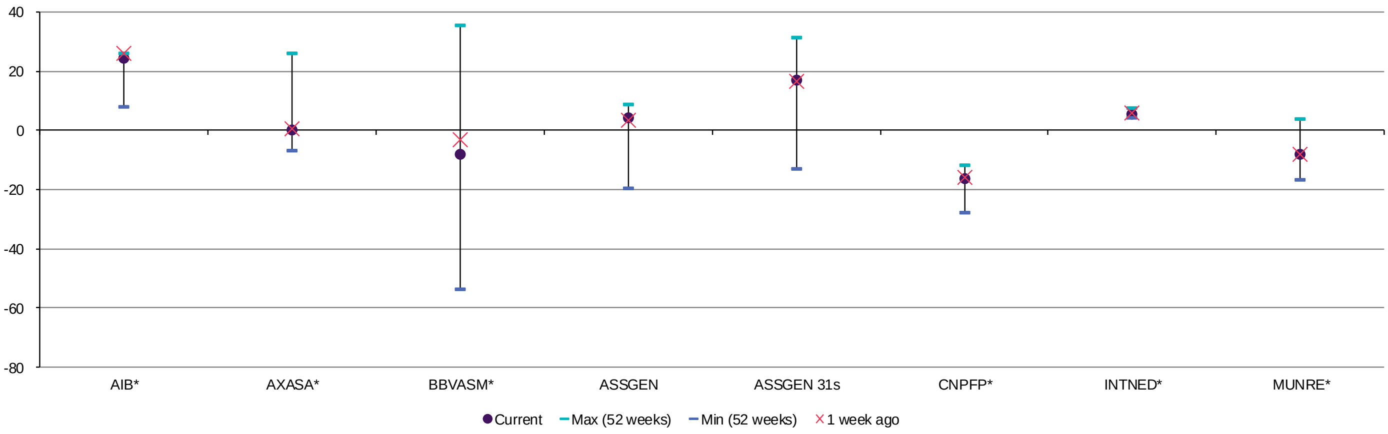
- Similar to seniors, graph 9 below is another quadrant chart to track if the green bond premium for subordinated debt is related to duration. We again note that the apparent green bond pick-ups and shorter maturities available in the green quadrant for the JUSTLN and UQA insurance Tier 2s are not drawn from perfect like-for-like comparisons.
- As shown in graph 11, the **green BBVA AT1 used to trade up to ~30bps wider** than the non-green BBVA AT1 during the summer which likely reflected the credit curve steepness from a 2024 call to 2026 call. However in the recent sell-off, we can see that the **green BBVA AT1 has outperformed** so that it now trades ~10bps tighter. We recognise that the green BBVA 6% 26c AT1 has a **higher reset level** (+6.456%) than the comparable non green BBVA 6% 24c (+6.039%), which is also a strong reason for its recent relative outperformance. This is a theme we discussed in our AT1 Alert publication, and so we caveat that the **relative resilience of this green BBVA AT1 should not be attributed all to its green bond status**.
- In contrast to the outperformance of spreads for BBVA's green bank capital, we have seen **green bank T2 such as AIB 2.875% 2031-26c underperform in Q3**. As seen in graph 12 below, the **green AIB T2 underperformed the non-green AIB T2 to reach an all-time high differential of ~26bps**. We caveat that some of this increase will be from curve steepening due to the higher duration of the AIB green bond.

Graph 9: GSS sub bond Z spread pick-up vs duration extension, compared to non-GSS



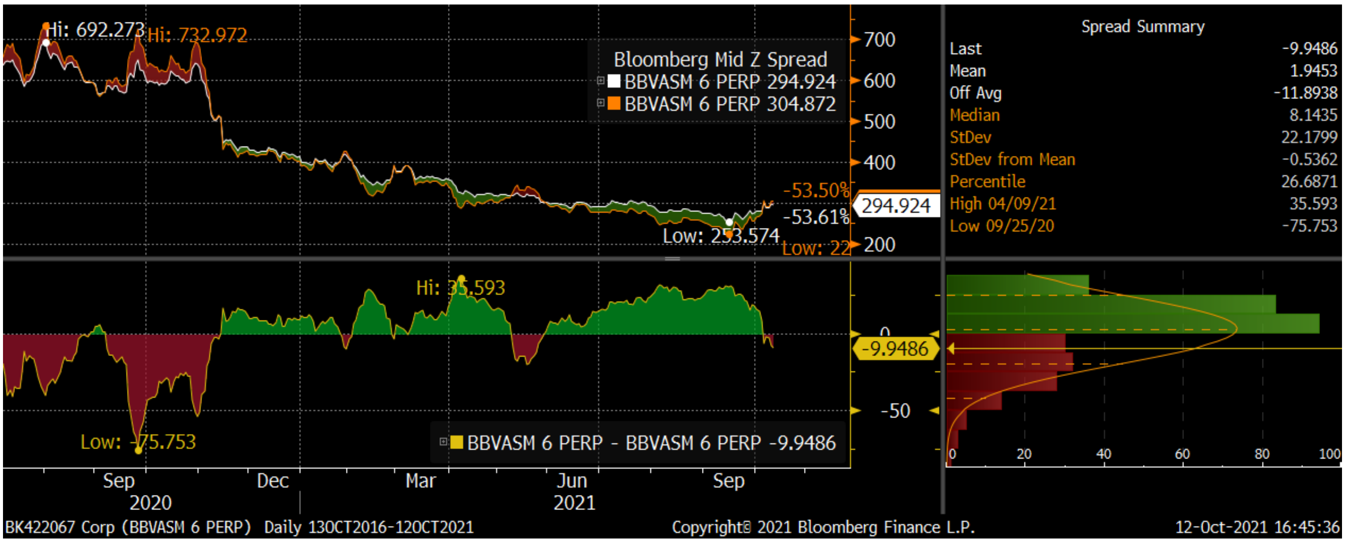
(Source: Bloomberg, NatWest. Underlying bonds listed in appendix at the end)

Graph 10: GSS sub bond Z spread pick-up vs non-GSS, 12 month range



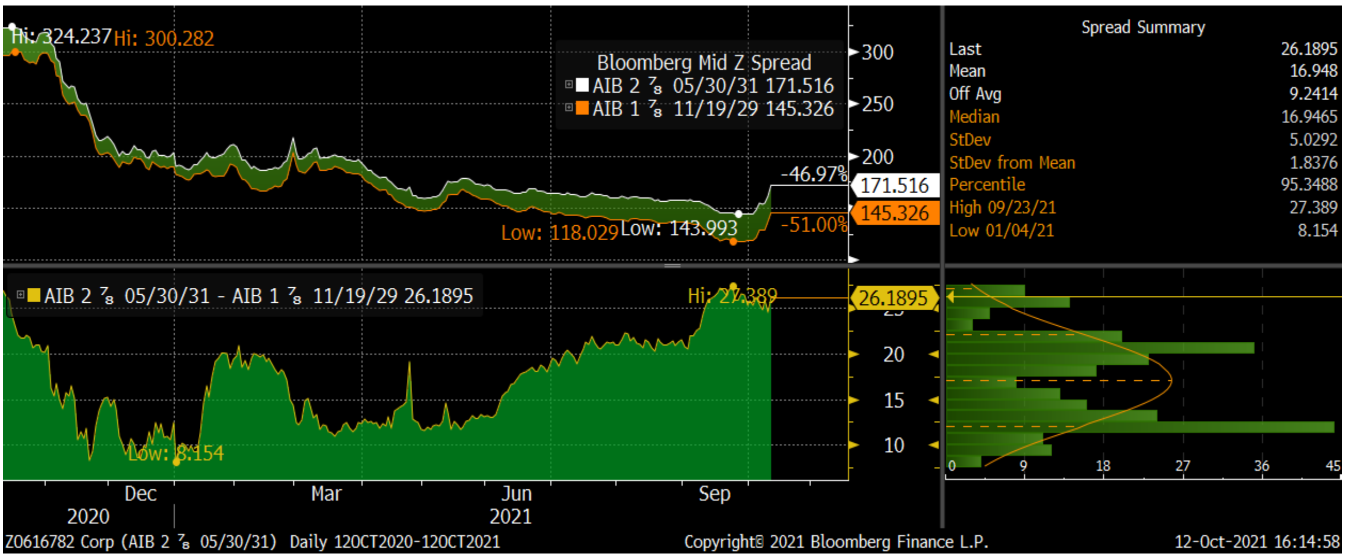
(Source: Bloomberg, NatWest. Underlying bonds listed in appendix at the end)

Graph 11: BBVASM 6% 26c green AT1 vs BBVASM 6% 24c non-green AT1, Z Spread bps



(Source: Bloomberg)

Graph 12: AIB 2.875% 2031-26c green vs AIB 1.875% 2029-24 non-green, Z Spread bps



(Source: Bloomberg)

Appendix

Graph 5. * denotes callables

Seniors				
GSS	Non-GSS		GSS	Non-GSS
ABNANV 0 1/2 04/15/26	ABNANV 1 04/16/25		ISPIM 0 3/4 12/04/24	ISPIM 1 07/04/24
ABNANV 0 1/2 09/23/29	ABNANV 0.6 01/15/27		ISPIM 0 7/8 06/27/22	ISPIM 1 1/8 03/04/22
ABNANV 0 5/8 05/31/22	ABNANV 4 1/8 03/28/22		ISPIM 1 1/2 04/10/24	ISPIM 1 07/04/24
ABNANV 0 7/8 04/22/25	ABNANV 1 04/16/25		JYBC 0.05 09/02/26	JYBC 0 3/8 10/15/25
ACAFP 0 1/2 09/21/29 *	ACAFP 0 3/8 04/20/28		KBCBB 0 3/8 06/16/27 *	KBCBB 0 1/8 09/10/26 *
ACAFP 0 1/8 12/09/27	ACAFP 1 7/8 12/20/26		KBCBB 0 7/8 06/27/23	KBCBB 0 3/4 10/18/23
ACAFP 0 3/4 12/05/23	ACAFP 2 3/8 05/20/24		LANBNN 0 3/8 05/23/25	LANBNN 0 1/2 05/20/24
ACAFP 0 3/8 10/21/25	ACAFP 1 3/8 03/13/25		MIZUHO 0.214 10/07/25	MIZUHO 0.118 09/06/24
AIB 0 1/2 11/17/27 *	AIB 2 1/4 07/03/25		MIZUHO 0.956 10/16/24	MIZUHO 0.118 09/06/24
ARION 0 3/8 07/14/25	ARION 0 5/8 05/27/24		MUFG 0.68 01/26/23	MUFG 0.339 07/19/24
BACR 0 5/8 11/14/23 *	BACR 1 1/2 09/03/23		MUFG 0.848 07/19/29	MUFG 0.872 09/07/24
BACRED 1 09/08/27	BACRED 0 7/8 01/15/26		MUFG 0.978 06/09/24	MUFG 0.339 07/19/24
BBVASM 0 3/4 06/04/25	BBVASM 0 3/8 11/15/26		MUFG 0.98 10/09/23	MUFG 0.339 07/19/24
BBVASM 0 3/4 06/04/25	BBVASM 0 3/8 11/15/26		NAB 0 5/8 08/30/23	NAB 0 5/8 11/10/23
BBVASM 1 06/21/26	BBVASM 0 1/2 01/14/27		NAB 0.35 09/07/22	NAB 2 3/4 08/08/22
BBVASM 1 3/8 05/14/25	BBVASM 0 3/8 10/02/24		NDASS 0 3/8 05/28/26	NDASS 1 1/8 09/27/27
BFCM 0 1/4 06/29/28	BFCM 1 3/8 07/16/28		NDASS 0.3 06/30/22	NDASS 3 1/4 07/05/22
BFCM 0.1 10/08/27	BFCM 1 1/4 05/26/27		NIBCAP 0 1/4 09/09/26	NIBCAP 0 7/8 07/08/25
BKIR 0 3/8 05/10/27 *	BKIR 1 11/25/25 *		NWG 0 3/4 11/15/25 *	NWG 2 03/04/25 *
BKTSM 0 5/8 10/06/27	BKTSM 0 7/8 07/08/26		NWG 0.78 02/26/30 *	NWG 1 3/4 03/02/26 *
BNP 0 1/2 06/01/22	BNP 2 7/8 10/24/22		OPBANK 0 3/8 02/26/24	OPBANK 0 3/8 08/29/23
BNP 0 1/2 06/04/26 *	BNP 1 1/2 11/17/25		PBBGR 0.1 02/02/26	PBBGR 0 1/8 09/05/24
BNP 0 3/8 10/14/27 *	BNP 0 1/2 02/19/28 *		RABOBK 0 1/4 10/30/26	RABOBK 0 5/8 02/27/24
BNP 1 04/17/24	BNP 1 06/27/24		RABOBK 1.106 02/24/27 *	RABOBK 1.339 06/24/26
BNP 1 1/8 08/28/24	BNP 1 06/27/24		RBIAV 0 3/8 09/25/26	RBIAV 0 1/4 01/22/25
BPCEGP 0 1/8 12/04/24	BPCEGP 1 07/15/24		RY 0 1/4 05/02/24	RY 0 1/8 07/23/24
BPCEGP 0 5/8 09/26/23	BPCEGP 0 3/8 10/05/23		SABSM 1 1/8 03/11/27 *	SABSM 0 5/8 11/07/25 *
BPCEGP 1 1/8 12/14/22	BPCEGP 4 1/4 02/06/23		SANTAN 0 5/8 06/24/29	SANTAN 1 1/8 06/23/27
CABKSM 0 3/4 07/10/26 *	CABKSM 1 1/8 03/27/26		SANTAN 0.3 10/04/26	SANTAN 0 1/4 06/19/24
CABKSM 0 3/8 11/18/26 *	CABKSM 1 3/8 06/19/26		SANTAN 1 1/8 06/23/27	SANTAN 0 1/2 02/04/27
CABKSM 0 5/8 10/01/24	CABKSM 2 3/8 02/01/24		SBAB 0 1/2 05/13/25	SBAB 0 3/4 06/14/23
CCBGBB 0 3/8 06/08/27	CCBGBB 0 3/8 02/13/26		SEB 0.3 02/17/22	SEB 0 1/2 03/13/23
CMZB 0 3/4 03/24/26 *	CMZB 1 1/8 09/19/25		SHBASS 0 3/8 07/03/23	SHBASS 0 1/2 03/21/23
CMZB 1 1/4 10/23/23	CMZB 0 1/2 09/13/23		SHBASS 0.01 12/02/27	SHBASS 0.05 09/03/26
DANBNK 1 5/8 03/15/24	DANBNK 0 7/8 05/22/23		SOCGEN 0 7/8 09/22/28 *	SOCGEN 1 3/8 01/13/28
DB 1 3/8 06/10/26 *	DB 1 1/8 08/30/23		STANLN 0.9 07/02/27 *	STANLN 1 5/8 10/03/27 *
DEVOBA 0.01 09/16/24	DEVOBA 0 3/4 06/25/23		STANLN 1.214 03/23/25 *	STANLN 3.785 05/21/25 *
ERSTBK 0 1/8 05/17/28	ERSTBK 0.1 11/16/28		SUMIBK 0.465 05/30/24	SUMIBK 0.819 07/23/23
ERSTBK 0 1/8 05/17/28	ERSTBK 0.1 11/16/28		SUMIBK 0.934 10/11/24	SUMIBK 0.819 07/23/23
FRLBP 0 3/4 06/23/31	FRLBP 2 07/13/28		SWEDA 0 1/4 11/07/22	SWEDA 0.3 09/06/22
FRLBP 1 3/8 04/24/29	FRLBP 2 07/13/28		SWEDA 0.3 05/20/27 *	SWEDA 0.2 01/12/28
HSBC 1 1/2 12/04/24 *	HSBC 0 7/8 09/06/24		UCGIM 0.8 07/05/29 *	UCGIM 0.85 01/19/31
INTNED 2 1/2 11/15/30 *	INTNED 2 09/20/28		WSTP 0 5/8 11/22/24	WSTP 0 3/4 10/17/23
ISLBAN 0 1/2 11/20/23	ISLBAN 1 1/8 01/19/24 *		WSTP 0.3 06/25/24	WSTP 0 3/4 10/17/23
ISPIM 0 3/4 03/16/28	ISPIM 1 3/4 03/20/28			

Graph 7 * denotes callables

Seniors	
GSS	**Non-GSS**
ABNANV 0 1/2 04/15/26	ABNANV 1 04/16/25
ACAFP 0 3/8 10/21/25	ACAFP 1 3/8 03/13/25
AIB 0 1/2 11/17/27 *	AIB 2 1/4 07/03/25
BBVASM 1 06/21/26	BBVASM 0 1/2 01/14/27
BKTSM 0 5/8 10/06/27	BKTSM 0 7/8 07/08/26
BKIR 0 3/8 05/10/27 *	BKIR 1 11/25/25 *
BNP 0 1/2 06/04/26 *	BNP 1 1/2 11/17/25
CABKSM 0 3/8 11/18/26 *	CABKSM 1 3/8 06/19/26
CMZB 0 3/4 03/24/26 *	CMZB 1 1/8 09/19/25
FRLBP 1 3/8 04/24/29	FRLBP 2 07/13/28
INTNED 2 1/2 11/15/30	INTNED 2 09/20/28
ISPIM 0 3/4 03/16/28	ISPIM 1 3/4 03/20/28
KBCBB 0 3/8 06/16/27	KBCBB 0 1/8 09/10/26
NDASS 0 3/8 05/28/26	NDASS 1 1/8 09/27/27
RABOBK 0.25 10/30/26	RABOBK 0.625 02/27/24
RABOBK 1.106 02/24/27 *	RABOBK 1.004 09/24/26 *
RBIAV 0 3/8 09/25/26	RBIAV 0 1/4 01/22/25
SANTAN 1 1/8 06/23/27	SANTAN 0 1/2 02/04/27
SHBASS 0.01 12/02/27	SHBASS 0.05 09/03/26
SOCGEN 0 7/8 09/22/28 *	SOCGEN 1 3/8 01/13/28

Graph 9 * denotes callables

Subs	
GSS	**Non-GSS**
AIB 2 7/8 05/30/31 *	AIB 1 7/8 11/19/29 *
ASSGEN 2.124 10/01/30	ASSGEN 3 7/8 01/29/29
ASSGEN 2.429 07/14/31	ASSGEN 3 7/8 01/29/29
AXASA 1 3/8 10/07/41	AXASA 3 1/4 05/28/49
BBVASM 6 PERP *	BBVASM 6 PERP *
CABKSM 1 1/4 06/18/31 *	CABKSM 2 1/4 04/17/30 *
CNPFP 2 07/27/50 *	CNPFP 2 1/2 06/30/51 *
INTNED 0 7/8 06/09/32 *	INTNED 2 1/8 05/26/31 *
JUSTLN 7 04/15/31 *	JUSTLN 9 10/26/26 *
MUNRE 1 1/4 05/26/41 *	MUNRE 3 1/4 05/26/49 *
MUNRE 1 05/26/42 *	MUNRE 3 1/4 05/26/49 *
UQA 3 1/4 10/09/35 *	UQA 6 07/27/46 *

Graph 10 * denotes callables

Subs	
GSS	**Non-GSS**
AIB 2 7/8 05/30/31 *	AIB 1 7/8 11/19/29 *
AXASA 1 3/8 10/07/41 *	AXASA 3 1/4 05/28/49 *
BBVASM 6 PERP *	BBVASM 6 PERP *
ASSGEN 2.124 10/01/30	ASSGEN 3 7/8 01/29/29
ASSGEN 2.429 07/14/31 *	ASSGEN 3 7/8 01/29/29
CNPFP 2 07/27/50 *	CNPFP 2 1/2 06/30/51 *
INTNED 0 7/8 06/09/32 *	INTNED 2 1/8 05/26/31 *
MUNRE 1 1/4 05/26/41 *	MUNRE 3 1/4 05/26/49 *