# B(ey)ond Green

## The Fixed Income team's quarterly newsletter

January 2025



An affiliate of NATIXIS INVESTMENT MANAGERS

## Our bond investment philosophy :

Green, social and sustainable bonds (GSSB)[1] are a highly effective means of providing transparency and ensuring our investments have an impact. When it comes to the sovereign, supranational and agency (SSA) segment, Mirova has opted to invest only in GSSBs since the extremely vast scope covered by the segment's conventional debt makes it complicated to assess the impact of funds invested in such debt. When it comes to investing in corporate bonds, meanwhile, the analysts in Mirova's ESG Research team are capable of analysing and assessing their impact. GSSBs are not a must-have for companies whose products and solutions make a significant contribution to at least one of the UN's Sustainable Development Goals (SDGs), but Mirova does prioritise them when financing the transition of companies with little positive impact.

# Key points worth noting

1 **2024 ranks second in terms of the amount of labelled debt[1] issued during the year, behind 2021.** Issuance increased by 8% over the year thanks to corporate interest in these formats, especially growing interest in the sustainable format[1]. The Utilities sector[2] is by far the biggest issuer of GSSBs and among the sectors best placed to issue bonds under the EuGBS [3] , the European Union standard for green bonds which came into effect on 21 December.

2 **2024 showed not only a tendency towards a steepening of the euro and dollar curves but also a widening dichotomy between the two currency zones.** The fall in euro short-term rates materialised whereas US bond yields again proved resilient. Investors will keep a close eye on US inflation in 2025 while showing more concern about growth in Europe… unless the total opposite happens, since Trump and his administration are an unpredictable lot and could deliver their share of surprises.

3 **Mirova chose to invest in certain Central and Eastern European banks in 2024.** This increased returns on our portfolios without compromising credit quality. There are plenty of opportunities to invest in the region's labelled debt, and indeed we estimate that 30% of CEE euro-denominated bank bonds were issued in GSSB format in 2024.

1. GSSB (Green Social Sustainable Bonds): a term covering Green Bonds, Social Bonds and Sustainable Bonds that generate both environmental and social benefits. We talk of labelled debt to refer to the GSSB universe plus Sustainability-Linked Bonds or SLBs (bonds whose features – particularly their interest rates – vary depending on whether or not the issuer meets certain ESG targets).
2. *Utilities:* organisation that produces or delivers electricity, natural gas, water and related services to the public.
3. EuGBS (European Union Green Bond Standard): new European standards for the green bond market.

# Sustainable bond investments : another year of growth for the GSSB market

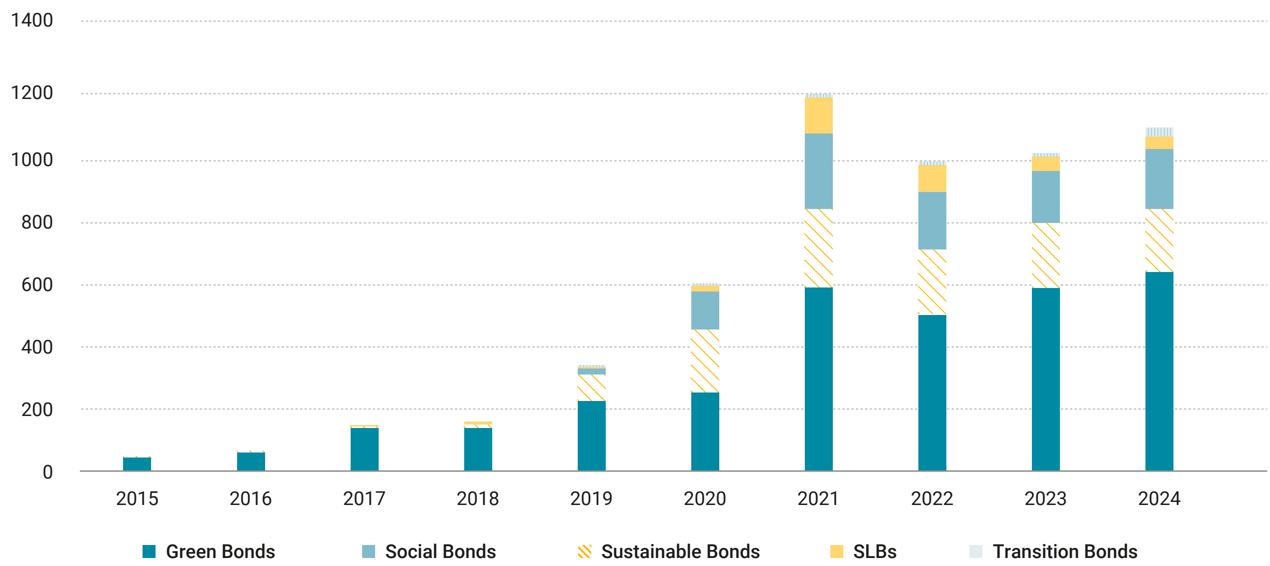
**Agathe Foussard, CFA**
*FI portfolio manager*
*Paris*

**Lucie Vannoye, CFA**
*Credit analyst*
*London*

2024 was a year of some uncertainty about trends in the labelled bond market. **The primary market remained stable in the first half of the year whereas the second half exceeded that of 2023, enabling the market to grow by 8% over the full year to $1,166 billion.** Excluding SLBs[4] (whose issuance volumes have plummeted by 65% since 2021), growth even works out at 12%.

**The momentum was exceptionally strong in the third quarter** when issuance totalled $300 billion, an amount equivalent to the record level reached in the third quarter of 2021 and one-third higher than in the previous year. All this pointed to a promising end to the year, but this scenario was undermined by the US election and Donald Trump's victory. The amount of labelled debt issued in November 2024 came to just $70 billion whereas the month's issuance usually averages $100 billion.

LABELLED BOND ISSUANCE BY YEAR IN $BN



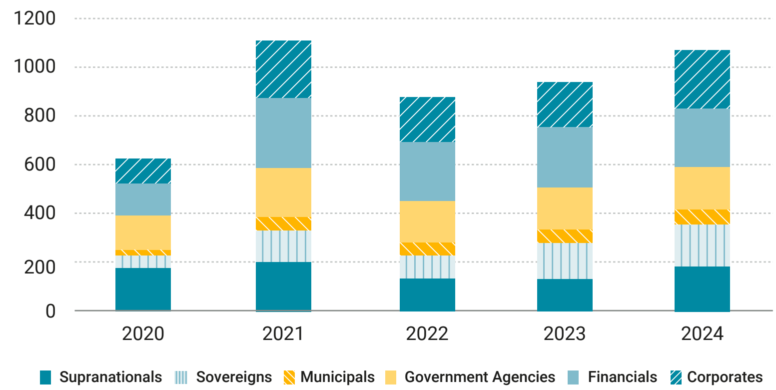

*Sources : Bloomberg, Mirova, at 31/12/2024*

4. SLBs (*Sustainability-Linked Bonds*) : bonds whose characteristics – primarily their interest rates – vary depending on whether or not the issuer meets certain ESG targets.

## 2024 in the rear view mirror

- **For the first time since 2021, companies made greater use of GSSBs to finance themselves than financial institutions did.** These two types of issuers are almost neck and neck, accounting for respectively 24% and 21% of issuance, but we believe this trend could continue.

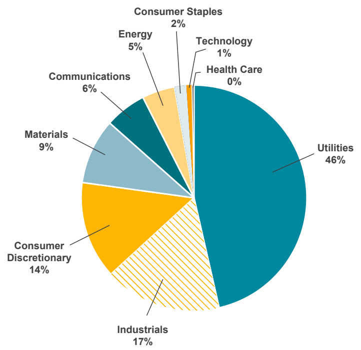
BREAKDOWN OF GSSB ISSUANCE IN 2024 BY ISSUER TYPE



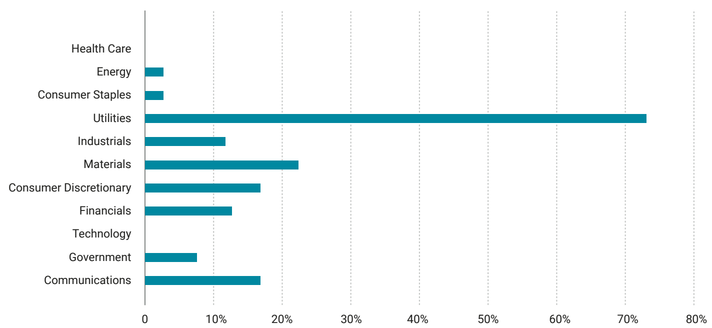

*Sources : Bloomberg, Mirova au 31/12/2024*

- **The sustainable format had an excellent year,** hitting its record of 2021 and accounting for 20% of the labelled market. Supranational agencies continue to appreciate this format and accounted for about 50% of the market, while companies plus financial institutions increased their issuance by 60% over the year to account for almost 25% of the total market in 2024.
- **The labelled market once again drew in few companies in the United States this year, resulting in a 70% drop in their emissions over three years.** This is not, however, reflected in the dollar amounts of labelled debt issuance as the dollar is the preferred currency of emerging market issuers. Two-thirds of labelled debt issuance in 2024 came from the APAC and EMEA regions. Conversely, **the yuan does not enjoy the same support and recorded an 18% year-on-year decrease in labelled bond financing** in 2024, impacted by a significant 50% drop in issuance by financial institutions. This trend could reverse next year as China's economy responds to the stimulus measures brought in by its government.
- **The Utilities sector, already a major player in the GSSB market, has continued its momentum and generates over 70% of its issuances in euros in this market.** The ranking of the top three sectors has remained unchanged ever since the market emerged, with industrials in second place this year and the consumer discretionary sector in third place.

BREAKDOWN OF GSSB ISSUANCE BY CREDIT SECTOR IN 2024




PENETRATION RATE OF EURO DENOMINATED GSSB ISSUANCE IN 2024




*Sources : Bloomberg, Mirova at 31/12/2024*

## What's new on the issuer side?

One industrial player issued its first ever green bond in the autumn of 2024: **Knorr Bremse**, a world leading supplier of braking systems for trains and commercial vehicles. Our research department assessed this green programme as having a **High Positive Impact**, with most of the proceeds contributing to the development of rail transport.

After two tough years, gross issuance levels in the conventional high yield bond market were decent again in 2024 and almost double the previous year's. Although the trend toward refinancing on the lending and private debt markets continues, this has not prevented new issuers from moving in. The bond market thus welcomed OEG Finance, Applus and Roquette Frères in the second half of 2024. **SIG Plc's refinancing was particularly well received by our research team[5], which assigned it a High Positive Impact rating** for its activities but also its practices. SIG Plc generates 65% of its sales from the distribution of insulation solutions and invests through its subsidiaries in the development of biobased insulation solutions as alternatives to glass and rock wool. The company has also implemented a solid decarbonisation plan that has been validated by the SBTi[6]. And it is actively involved in waste management and reduction, which is a crucial issue for biodiversity in the construction sector.

*Sources Mirova at 31/08/2024*


5. For more information about our methodologies, please refer to Mirova's website: www.mirova.com/en/research..
6. SBTi (The Science Based Targets initiative): a corporate climate action organization that aims to support companies in reducing greenhouse gas (GHG) emissions, aligning with the targets established by the Paris Agreement.

# Euro and dollar rates: a dichotomy that remains... and may be widening

**Bertrand Rocher**
*Co-head of Fixed Income*
*Paris*

What an end to the year! **Some thought 2024 would be "the year of the bond". And although this still seemed plausible in the run-up to the fourth quarter, major market movements towards the end of the year put paid to such a scenario.** Donald Trump's election will, of course, have fuelled this volatility even though it had already been partly factored in by the markets. His statements about the need to raise tariff barriers and restrict migration flows into the United States initially revived concerns about inflation making a comeback; but such apprehension eased after he adopted a more moderate tone and, ultimately, we can see that the country's macroeconomic statistics remain as promising as ever.

Here in Europe, Italy, Spain and Ireland have continued to reassure the markets as all three countries remain on solid trajectories. **But the political and economic situations in France and Germany are eroding enthusiasm for the eurozone as the euro has naturally lost ground against the dollar.** Moreover, Europe's domestic automotive industry is in the midst of a major crisis that is actually worsening: sales volumes remain low and the chances of the industry sustaining the very comfortable operating margins it has enjoyed since 2020 are now nil. The United Kingdom, meanwhile, continues to publish sharply contrasting data. Here too, the backdrop is that of a fragile government under Keir Starmer.

As for China, the country has finally managed to offer the markets some reassurance about its prospects after bringing in a whole series of economic stimulus plans (the initial batch struck many as inadequate).

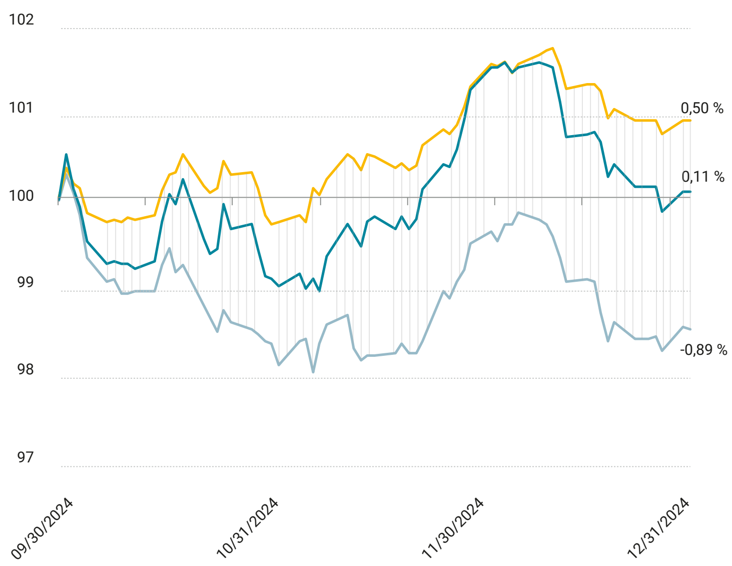
Needless to say, central banks have continued to cut their interest rates. But they have toned down their narrative somewhat as upcoming political contests call for caution and there are very small - but very real - signs of inflation proving stubborn.

**2024 will therefore have kept at least one of its promises: that of a growing dichotomy between the US and European economies, a trend that had already taken root since 2008 and that has widened significantly.**

## To summarise the main trends in the bond market over the year 2024 :

- Interest rates kicked off the year by strongly retracing their late-2023 decline, and the bond markets remained volatile with a succession of upward and downward phases varying from one month to the next. **At the end of the year, it was short-term interest rates that proved most resilient, especially euro interest rates.**
- The two-year Schatz narrowed by 21bp over the year to 2.19%, whereas its US counterpart ended the year 5bp higher at 4.29%. Longer-term interest rates had a rough ride: the ten-year Bund widened by 45bp to 2.47% in 2024 and the ten-year Treasury yield rose by 80bp to 4.68%. **This led to a sharp steepening of yield curves across all currency zones.**
- **The credit market continued to perform well thanks to economic resilience and the prospect of quantitative easing.** Thus, the LECPOAS[7] spread against sovereign debt narrowed by 36bp, a compression also fuelled by the performance of swap spreads. Having peaked in 2022, spreads between the eurozone's sovereign market and swap market are now looking tight: the ECB has begun to scale back its support for the bond market, and sovereign bonds are suffering all the more as investors are increasingly wary about growing deficits. Corporate bonds benefit from their attractive yields and lower refinancing needs.
- **The high yield bond segment was the top performer in the bond universe**, turning in an absolute annual return of over 8%.

KEY INDICES OVER THE Q4




*Sources : Bloomberg, Mirova, at 31/12/2024*

### Who were the top performers in Q4 2024?

- Credit outperformed the other fixed income asset classes thanks to its tightening credit spreads and lower duration.
- The Global Aggregate index underperformed its Euro Aggregate sub-index, penalised by its exposure to US interest rates.

7. Spread LECPOAS: benchmark used to track the evolution of credit spreads within a Euro Aggregate universe.

# Our outlook?

**David Belloc, CFA**

*Portfolio manager / Strategist*
*Paris*

**Global economic growth in 2024 came out in line with its potential rate of around 3%. But this figure conceals major disparities between different regions.** As expected, the United States is clearly outperforming other developed countries thanks to its productivity gains, particularly through strong spending and earlier fiscal stimulus measures, which together propelled growth to 2.8%. The eurozone struggled, however, with growth reaching just 0.8%. Political uncertainty, especially in France, and structural constraints have taken a heavy toll on the region's economic recovery. Germany is in the midst of a prolonged industrial decline, underlining the vulnerability of its export-oriented economic model. Fortunately, the Southern European countries, led by Spain, are doing better, often showing a real momentum.

China, meanwhile, has benefited from the massive recovery plan it launched towards the end of the year aimed at stabilising its financial system and reviving its struggling property sector, and is set to report around 5% growth in 2024. Additional stimulus measures are expected to follow in 2025, but the country still faces major structural challenges that are bound to intensify in the coming years.

Overall, 2024 painted the picture of an uneven and sometimes fragile recovery. **There are some pockets of economic vigour, such as in the USA, which have sparked optimism. But stubborn structural challenges and geopolitical uncertainties have highlighted vulnerabilities in the global economic system.**

Given all the uncertainty surrounding the magnitude, timing and prioritisation of the Trump administration's policies, it is difficult at this stage to fully assess their potential impact. **But our baseline scenario for 2025 still assumes that US policy will manage to keep inflation in check while promoting growth thanks to a more pragmatic than ideological approach; that said, we believe it will be essential to remain flexible and take an active approach to asset management throughout the year.**

Trump's agenda consists essentially of trade protectionism, deregulation, restrictions on immigration and an extension of the tax cuts introduced in 2017. Some of these measures should boost economic activity in the short term, especially the fiscal and regulatory measures. This means that US growth could remain robust in 2025 thanks to strong consumer spending and business investment, and we see the country's GDP growth exceeding 2.5%. At the same time, US inflation could ease in the coming quarters,

8. Headline inflation is the total inflation rate that includes all items in the consumer price index (CPI), reflecting the overall change in prices consumers experience, including food and energy.

with headline[8] inflation settling at just above 2.5% the back of softer energy prices, slowing rent inflation and declining unit labour costs driven by productivity gains. Inflation factors will remain, nonetheless, in the form of rising tariff costs and labour market strains created by immigration restrictions. These factors could have a more significant impact in 2026 and undermine US and global economic growth at a time when the international landscape is going to have to cope with increased volatility due to US protectionism.

Given these circumstances, the Fed is likely to maintain a cautious stance at first and hold back from lowering interest rates any further in the coming months, even if it then has to quietly resume its monetary easing cycle at a later stage. In general, record levels of government debt are preventing central banks from considering allowing their countries' real interest rates to exceed their potential growth rates for any length of time. **We forecast a terminal rate of around 4% in the USA, within a 12 to 18-month horizon, implying two further cuts from its current level.** As regards the long end of the curve, the equilibrium nominal interest rate for the medium term could hover around 4.5% to 5%. (i.e. at least 2% real potential growth, which has increased in recent years, to which we need to add 2.5% inflation as well as a term premium). Similarly, the USA's savings/investment imbalance has widened since 2020 - with a current account deficit of 3.5% of GDP in Q3 2024 vs an average of 2% during the period 2010-2019 -, while its investment needs have risen due to the energy transition, greater spending on military equipment and infrastructure, an increased need to invest in tech and AI, while the country's long-standing creditors, particularly China and Japan, are now less accommodating. There seems to be rather little prospect of bond yields declining. **We maintain a neutral or even slightly negative duration position on US 10Y bond yields and expect the two-year to ten-year yield curve to continue steepening.**

Growth in the eurozone is set to remain modest in 2025 (at between 0.8% and 1%), reflecting persistent structural weaknesses. Fiscal consolidation across the region is likely to undermine growth, while the region's dependence on exports makes it vulnerable to global trade tensions and uncertainties. Headline inflation is expected to settle at around 2% at the end of 2025. Core inflation is high but should adjust downwards as wage growth slows and thus returns to normal following the significant wage increases of recent years. All this should give the ECB headroom to continue easing its monetary policy. **We forecast a terminal rate of around 2 or even 1.75% in Europe within a 12 to 18-month horizon, implying another four to five cuts from its current level.**

Where bond yields are concerned, the eurozone's equilibrium real rate is naturally below the USA's

as Europe's potential growth rate is much lower and its current account is in surplus (vs a deficit in the USA). The equilibrium nominal interest rate for the medium term could average about 2.5% for the eurozone and 2% for the Bund. Current levels are higher for various reasons: the influence of US rates on European rates, the ECB's relatively cautious approach to inflation, and exogenous factors that could prove positive over the months ahead (a peace agreement in Ukraine, Germany's elections in February paving the way for fiscal reforms, an improvement in China's macroeconomic situation, a less detrimental US tariffs policy than expected), all of which could create upward momentum. At the same time, consumers are likely to continue enjoying real wage growth and reducing their savings rates to increase their spending. **For all these reasons, we maintain a neutral duration position on the ten-year bund and expect the two to ten-year yield curve to continue steepening.**

**We also remain overweight credit. The asset class still offers an attractive risk/reward trade-off as the outlook for credit remains robust under a whole variety of macroeconomic scenarios.** As regards valuation, we have a preference for European corporate bonds over their US counterparts. We also remain positive on the European high yield, financial subordinated debt and corporate hybrid segments. Yields in these segments seem decent, while technical factors remain favourable due to the supply/demand imbalance and less available supply to the benefit of private debt funds and bank loans.

## Find out more here

➜ Outlook 2025 - Listed assets

## Market news by Felipe Gordillo,

### Lead Impact & ESG Specialist on GSS Bonds

**The EuGBS (European Union Green Bond Standard) is the result of long and painstaking work carried out under the EU Sustainable Finance Framework.** After extensive negotiations between the European Commission, European Council and European Parliament, the standard was officially adopted and **brought into effect on 21 December 2024.** The framework seeks to improve the transparency and integrity of green bonds, combat greenwashing, and steer investments toward positive environmental impact projects.

### 1. How might the EuGBS affect Europe's GSSBs bond market?

With the introduction of the EuGBS, we expect the green bond market to become more segmented and split into three distinct levels:

• **"Gold Standard" :** this level includes green bonds whose use of proceeds (UoP) is at least 85% aligned with European taxonomy criteria. These bonds will offer greater transparency and a significant environmental impact.

• **Intermediate :** this level applies to issuers with an alignment percentage of less than 85% but that adopt the EU's green bond reporting templates. These templates offer an opportunity for continuous improvement and commitment to more sustainable practices, as well as a significant step towards taxonomy alignment.

• **Traditional green bonds:** these bonds comply with the framework established by the Green Bond Principles developed by the International Capital Market Association (ICMA). However, issuers are not required to conduct a taxonomy alignment assessment.

The first two levels, Gold Standard and Intermediate, are becoming essential to our bond portfolios as they will contribute to the taxonomy alignment assessments performed for these funds. The volumes and amounts allocated to each category will depend on market dynamics and issuer perceptions of any legal and reputational risks that may arise from the regulations and supervisory framework governing the EuGBS market.

### 2. Which sectors may be best prepared to issue EuGBS bonds?

The sectors most likely to issue EuGBS bonds are those that already have experience of the green bond market and that have the capacity to carry out a full taxonomy alignment assessment, in particular with regard to the **DNSH**[9] (Do No Significant Harm) principle.

Although these standards may be adopted only gradually, we believe there are some sectors, such as railways and power utilities, that are already well placed to meet DNSH requirements. Such firms could thus take advantage of the opportunities offered by a new market while contributing to a sustainable energy transition.

9. DNSH ("Do No Significant Harm"): a principle in sustainable finance ensuring that an investment or project does not significantly harm any environmental objectives while contributing positively to sustainability.

## 3. What are our expectations as a responsible investor?

As an investor subject to the Sustainable Finance Disclosure Regulation (SFDR), Mirova is required to disclose the alignment levels of each of its portfolios with the EU Green Taxonomy. Incorporating EuGBS Gold Standard and Intermediate bonds provides a solid basis with which to improve these levels.

The EuGBS and ICMA frameworks will exist side by side in the near term. The ICMA framework is currently applied in 100% of green bond-labelled transactions and will remain an essential reference, especially for the 55% of these issues carried out in foreign currencies in 2023[10]. Moreover, the European Union itself has announced that it does not intend to apply "Gold Standard" rules to its NextGenerationEU green bond programme. Last of all, there is a lack of economic incentives for issuers seeking to align their business models with the taxonomy. EuGBS benchmarks are therefore unlikely to develop all that rapidly and the size of the market will thus remain constrained.

Mirova's view is that the establishment of a European regulatory framework for green bonds marks an important step forward for the market. It will help the market become more transparent and tackle greenwashing more effectively. As responsible investors, we therefore have an opportunity to play a key role in this transition by selecting assets that will support a sustainable and resilient economy and improve the taxonomy alignment of our bond portfolios. The EU authorities will also have to be attentive to the needs of market participants, take the time to assess the EuGBS framework, and adjust it if necessary in order to maximise its effectiveness and impact.

10. https://www.climatebonds.net/files/reports/cbi_sotm23_02h.pdf

# Banks
# Look further East

**Felipe Gordillo**

*- Lead Impact & ESG Specialist on GSS Bonds*

*Paris*

**Andreea Playoust, CFA**

*Credit analyst*

*Paris*

*This section refers to our monthly "MirovAlpha – Creating Sustainable Value" publication from October 2024. Find out more here : https://www.mirova.com/fr/idees/mirova-creating-sustainable-value-octobre-2024*

**The narrowing of spreads between banks in peripheral Europe[11] and core countries[12] has presented investors with a challenge in finding new investment opportunities with a strong credit story and potential for spread compression. One such opportunity is to increase portfolio yield without compromising overall credit quality or increasing volatility by investing in bonds issued by Central and Eastern European (CEE) banks, as Mirova indeed does.**

We limit the investment space for CEE banks to the 11 EU member countries in the region, which translates into around 30 banks that have issued liquid bonds in euros[13]. These issues are mostly concentrated in the Czech Republic, Poland and Hungary, followed by Romania, Slovenia, Slovakia and Estonia.

## Eastern Europe: the new periphery?

The banking sector in CEE represented approximately 5%[14] of total European Union (EU) banking assets at the end of June 2024, with Poland and the Czech Republic being the largest contributors to this proportion. **Our view is that CEE banks present an appealing opportunity for investment in growing European emerging economies that benefit from EU membership and its institutional framework.**

After a period of slowed growth momentum, economic activity in most CEE countries bounced back in 2024 and this is set to continue into 2025. **The region is expected to grow twice as fast as the EU average**, with some exceptions such as Estonia which the consensus still expects to remain in slight recession (-0.7%)[15]. EU funding and development programmes will continue to play a crucial role in spurring economic activity, contributing to the bloc's digital, green energy and social ambitions. CEE banks will benefit indirectly from this growth and directly as intermediaries for EU funds to local recipients. In addition, lower interest rates and increasing banking penetration in the region should also boost volumes.

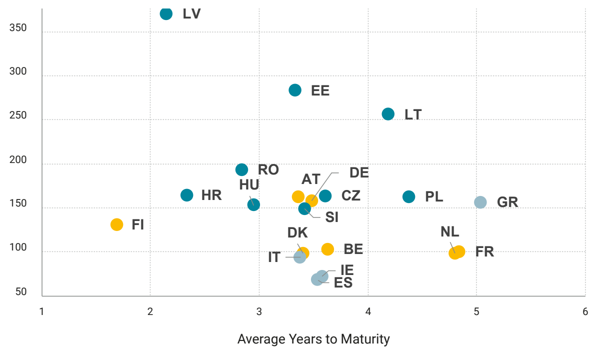
**CEE banking systems are profitable and well capitalised, and their asset quality is broadly in line**

11. Peripheral European countries refer here mainly to Spain, Italy, Ireland and Portugal
12. Core European countries refer here mainly to Germany, Belgium, France, the Netherlands, and the Nordic countries.
13/14/15. Source : Bloomberg

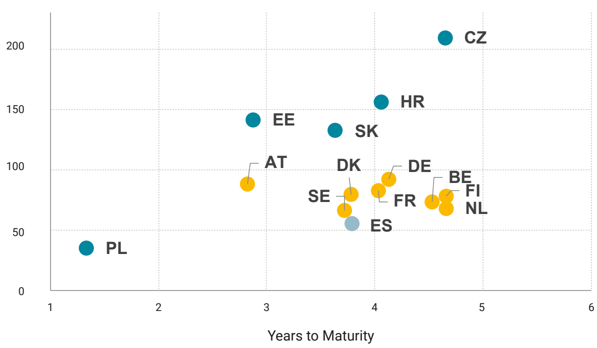
**with that of European peripheral banks.** They also have stable domestic deposits as a funding source. However, there are specific downside risks to consider, such as political instability in some countries and geopolitical risks, particularly for the Baltics. In certain countries like Poland and Hungary, a high degree of government interventionism has led to measures aimed at supporting borrowers, thus putting pressure on banks' profitability. Nevertheless, the vast majority of banks have managed to absorb these measures and remain profitable.

**Credit ratings for CEE banks range from BBB- to A-**, which is generally lower than those of other EU banks averaging around A-. Moreover, CEE banks are largely owned by Western European banks, which are attracted by the high risk-return potential and solid growth prospects in the region as opposed to their home countries where they have less headroom and already enjoy dominant positions. Austrian banks, such as Raiffeisen Bank International SA and Erste Group Bank AG, are particularly active in the CEE market, leveraging their geographical proximity. Belgium's KBC Group NV, which generated more than 40% of its revenue in CEE countries in the first half of 2024, also has an extensive footprint in the region. Other institutions, including ING Groep N.V., UniCredit SpA and Intesa Sanpaolo SpA, are also working to grow their presence in the region.

Z-SPREAD (BP) BY COUNTRY, 'BBB' RATED SENIOR BONDS



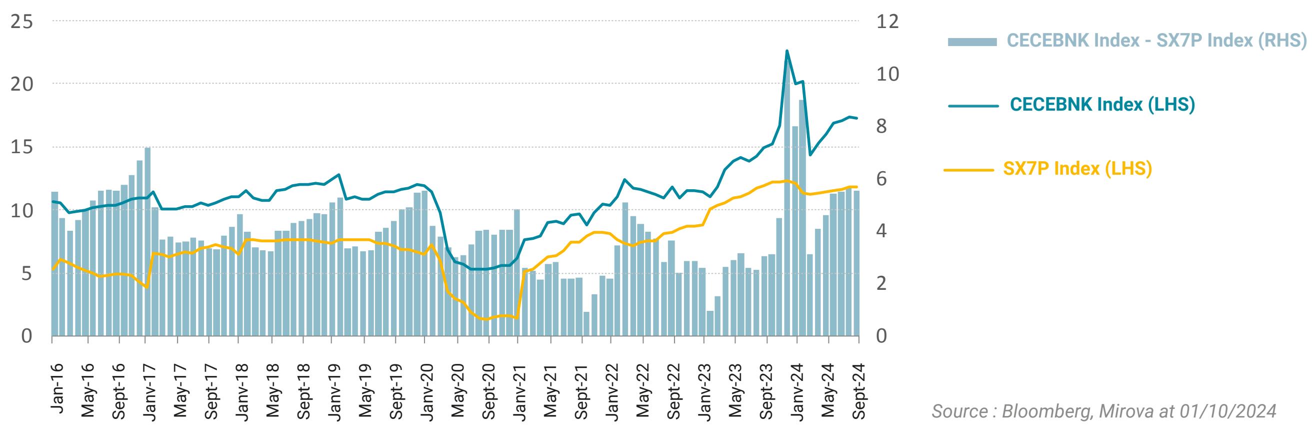

Z-SPREAD (BP) BY COUNTRY, 'A' RATED SENIOR BONDS




NB : AT : Austria, BE : Belgium, BG : Bulgaria, CZ: Czech Republic, DE : Germany, DK: Denmark, EE: Estonia, ES :Spain, IE: Ireland, IT : Italy, FI: Finland, FR: France, GR: Greece, HR: Croatia, HU: Hungary, LV : Latvia, LT : Lithuania, NL : Netherlands, PL: Poland, PT: Portugal, SE: Sweden, RO: Romania, SK : Slovakia, SI : Slovenia, EU : European Union.

*Source : Bloomberg, Mirova at 01/10/2024*

RETURN ON EQUITY (%) CEE BANKS VS. BANKS IN THE STOXX EUROPE 600 BANK INDEX




*Source : Bloomberg, Mirova at 01/10/2024*

## CEE countries: similar but not the same.

Though economic trends are similar across the whole CEE region, there are significant discrepancies in wealth levels and the ways in which banking sectors are organised.

**Banks in the Czech Republic and Slovenia benefit from a strong record of economic performance, with among the highest levels of GDP per capita within the CEE region** estimated at about $30,000 and $34,000, respectively, in 2024, according to the IMF. These countries also have healthy public fiscal positions and concentrated banking sectors, which ensures strong pricing power for the dominant banks such as Česká Spořitelna AS and Raiffeisenbank AS.

**The Czech Republic has the second-largest banking sector in the region, after Poland, but accounts for only 1% of EU banking assets**[16]**.** It boasts the highest level of financial intermediation in the region, as measured by its ratio of financial system assets/GDP which stood at 163% at the end of 2022 (yet lagging the eurozone average of 516%). Its banking sector is sound, supported by a good record of macroeconomic performance and reliable institutions, with 90% of its banks being foreign owned. The ratings of Czech banks are not influenced by those of their sovereign state, which is rated Aa3 by Moody's and AA- by S&P, at par with France.

**Banks in Romania and Hungary operate in more volatile political environments and with weaker public finances but exhibit sound structural fundamentals.** The high degree of foreign ownership, the involvement of the EBRD[17] as a long-term investor, and an EU-aligned regulatory framework should help banking systems in both countries to remain stable. Romania and Hungary are among the fastest-growing economies in the EU, and low private sector debt will provide structural support for earnings growth at these countries' banks. In Romania, the consolidation of the banking sector is expected to be beneficial for cost efficiency and profitability, further supporting already high levels. Additionally, Romania has a large proportion of underbanked households, providing significant growth opportunities for banks in the country. Banca Transilvania SA in Romania has played an important role in consolidating the sector.

**Poland, with a population of 37 million, has by far the largest economy and banking sector in CEE, accounting for 2%**[18] **of EU banking assets.** Its banking sector is more fragmented and includes a mix of foreign and domestically owned commercial banks (e.g. Bank Polska Kasa Opieki SA (Bank Pekao) and Bank Millennium SA), cooperative banks and credit unions. However, the five largest banks hold a dominant share of the market. The country's political and economic environment shares similarities with those of Romania and Hungary, characterised by a polarised political landscape, tense relations with the EU and a wide public deficit. Despite these challenges, Poland's banking sector has shown good profitability and cost efficiency, supported by strong digital capabilities, promising growth prospects, adequate funding and liquidity, and a sound level of solvency. A high degree of government interventionism, including in the country's two largest banks, raises governance issues and can impact profits. Thanks to adequate profitability, banks should be able to absorb the remaining legal costs from their legacy Swiss franc mortgage loans.

### KEY FIGURES OF THE BANKING SECTOR BY COUNTRY

| (%) | Bulgaria | Croatia | Czechia | Estonia | Hungary | Latvia | Lithuania | Poland | Romania | Slovakia | Slovenia | UE |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Banking sector concentration* | 78 | 82 | 65 | 90 | 60 | 88 | 90 | 58 | 63 | 77 | 74 | 69 |
| Return on equity | 12,0 | 18,9 | 14,9 | 16,4 | 21,8 | 20,2 | 20,5 | 17,9 | 21,8 | 12,0 | 17,5 | 10,9 |
| Return on assets | 0,9 | 2,2 | 1,0 | 1,9 | 2,4 | 2,3 | 1,4 | 1,8 | 1,9 | 1,0 | 2,1 | 0,7 |
| Cost/Income | 54,8 | 38,4 | 49,8 | 39,5 | 50,0 | 39,6 | 47,6 | 38,5 | 47,8 | 41,2 | 49,0 | 53,2 |
| Stage 3 loans | 2,4 | 2,1 | 1,1 | 1,0 | 3,2 | 0,5 | 1,0 | 3,7 | 3,3 | 1,9 | 2,0 | 2,2 |
| Coverage ratio of Stage 3 loans | 62,5 | 69,4 | 50,6 | 27,6 | 63,3 | 40,6 | 41,7 | 58,3 | 68,6 | 54,8 | 59,7 | 43,1 |
| Common Equity Tier 1 (fully loaded) | 18,5 | 69,4 | 50,6 | 27,6 | 63,3 | 40,6 | 41,7 | 58,3 | 68,6 | 54,8 | 59,7 | 43,1 |
| Loans/Deposits | 104 | 69 | 84 | 101 | 78 | 74 | 44 | 72 | 57 | 108 | 69 | 106 |
| Liquidity Coverage Ratio | 187 | 210 | 165 | 197 | 198 | 157 | 397 | 236 | 274 | 188 | 313 | 163 |
| Net Stable Funding Ratio | 131 | 169 | NA | 148 | 147 | 125 | 197 | 159 | 212 | 137 | 175 | 128 |

16. Source : Bloomberg
17. EBRD: European Bank for Reconstruction and Development.
18. Source : Bloomberg

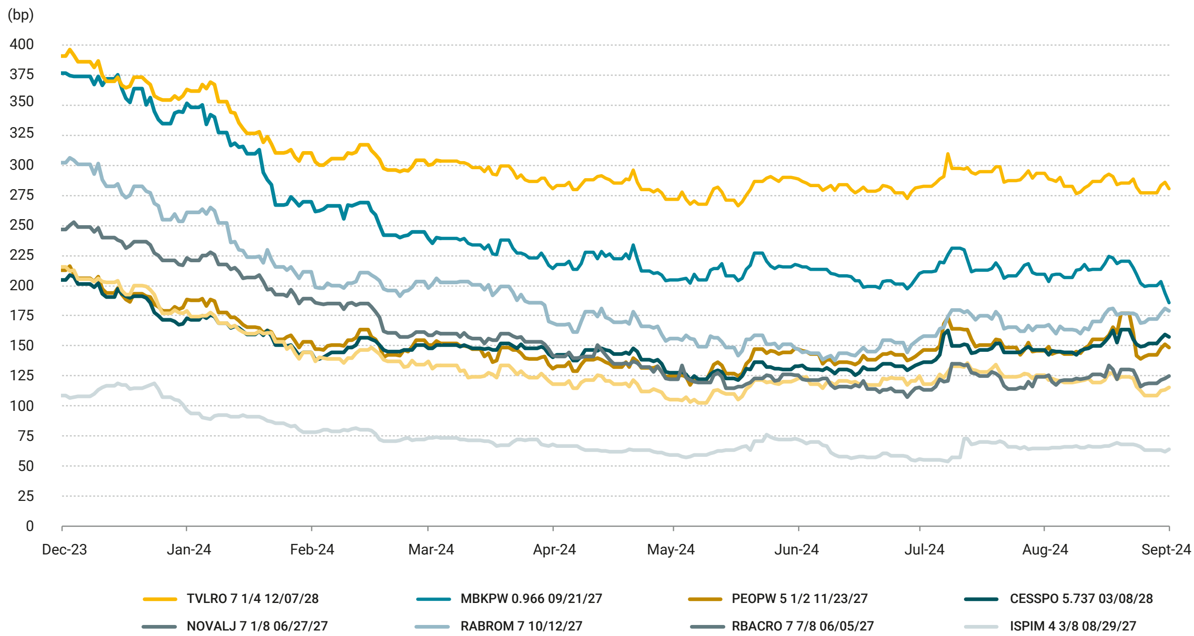
## Premium versus European peripherals

We find it interesting to note the spread differentials for senior bonds issued by CEE banks compared with those from Italy and Spain. The average spread premium is about 70 basis points[19] for BBB-rated CEE bank senior bonds, excluding the Baltics, relative to Italian senior bonds of the same category, and about 95 basis points relative to their Spanish equivalents[20]. The Baltic banks offer the largest premium, reflecting the geopolitical risk in the region and the fact that most Western investors lack extensive knowledge of the sector.

**Between the end of 2023 and the end of September 2024, BBB-rated CEE senior bonds outperformed their equivalents in Western Europe, with spreads contracting by an average of about 100 basis points compared to a contraction of about 36 basis points for their Western European equivalents. We argue that there is still room for further spread tightening.**

This is especially true as the primary market in recent years has been largely fuelled by banks issuing senior preferred (SP) and non-preferred (SNP)[21] instruments in order to comply with EU regulations, particularly the Minimum Requirement for Own Funds and Eligible Liabilities (MREL). However, these needs have now largely been met, which should limit supply in the short or even medium term and boost the secondary market. This positive effect could be diluted by specific rules in certain countries, such as Poland where banks will now need to issue long-term debt in order to comply with new financing regulations[22].

EVOLUTION OF Z-SPREAD FOR CEE BANKS SENIOR BONDS




**NB: The senior preferred debt issued by Intesa Sanpaolo (ISPIM 4 3/8 08/29/27) is presented in the graph as an example showing the trend for CEE bank senior bonds relative to an equivalent issued by a peer from a European peripheral country.**

*Source : Bloomberg, Mirova*

19. Data as of 1 October 2024, reference rating used: Bloomberg Index Rating
20. Source : Bloomberg
21. Senior preferred (SP) bond: a type of bond issued by a bank that takes precedence over other claims in the event of liquidation. Senior non-preferred (SNP) bond: a type of bond that ranks below senior preferred bonds in the event of liquidation
22. Long-term financing regulations in Poland require banks to fund 40% of their residential mortgage loans to individuals with long-term funding sources having a maturity of more than one year. Banks should favour the issuance of covered bonds.

## How can we invest in this sector responsibly?

Like Europe's financial sector, where the penetration rate of euro-denominated labelled debt issuance reached 14% in 2024, **the CEE region's financial sector issued around 30% of these bonds in a sustainable format this year, the highest level since the sector first started issuing sustainable bonds back in 2021.**

Our ESG research team estimates that approximately 45% of the sector's labelled debt met our GSSB standards. This figure of 45% is acceptable but below the average eligibility rate of 75% for all the banks in our database. There are two primary reasons for this eligibility gap: CEE banks often lack robust decarbonisation strategies including specific targets for carbon emissions reductions within their loan portfolios. However, this gap is narrowing as several CEE financial institutions have recently begun to adopt criteria from the EU Green Taxonomy which aims to maximise the impact of projects and assets backed by green bonds.

Two of the issuers whose green bonds are eligible are Polish banks: Bank Millenium (which entered the green bond market this year) and Bank Pekao. Romanian bank Banca Transilvania, meanwhile, remains one of the few issuers of sustainable bonds in the sector. The programme was rated Low Positive Impact by our ESG research team[23].

*Sources Mirova at 01/10/2024*

### ▶ A focus on Banca Transilvania's 2023 Sustainable Notes programme

The 2022 impact report emphasises the bank's interest in sustainable bonds and notes that 90% of funds invested in these bonds are to be allocated to social projects. **These funds support micro, small and medium-sized enterprises (MSMEs) and improve access to healthcare and education among targeted population groups.**

For example, the category funding MSMEs seeks to create jobs in order to prevent and/or alleviate unemployment arising from socioeconomic crises and also to fund energy transition and/or just transition projects. To be eligible, these MSMEs must meet one of the following criteria:

- be located in underprivileged socioeconomic areas with a GDP per capita below the national average or a GDP below 75% of the EU 27 average
- be owned by women
- be owned by young people aged below 30
- fund independent farmers, including those working in areas exposed to drought and/or flooding in underprivileged socioeconomic areas.

These criteria are used to target a specific population and thus adhere to the ICMA's recommendations.

23. For more information about our methodologies, please refer to Mirova's website: www.mirova.com/en/research.

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Investing in sustainability

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** Reference to a label is not an indicator of the future performance of the funds or of its fund managers*


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Portfolio Management Company - Anonymous Company RCS Paris No.394 648 216
AMF Accreditation No. GP 02-014
59, Avenue Pierre Mendes France 75013 Paris Mirova is an affiliate of Natixis Investment Managers.
Website – LinkedIn

**NATIXIS INVESTMENT MANAGERS**
French Public Limited liability company
RCS Paris n°453 952 681
Registered Office: 59, avenue Pierre Mendès- France 75013 Paris
Natixis Investment Managers is a subsidiary of Natixis.

**MIROVA US**
888 Boylston Street, Boston, MA 02199; Tel: 857- 305- 6333
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Riverside Square, 10th Floor, Riverside Drive,
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