ESG supply by banks set to stay strong in 2024

ESG primary market activity by banks is set to remain strong in 2024, but isn't likely to be quite as prosperous as in 2023 due to slower lending growth

Following recent legislation from the European Council, issuers will officially be able to start marketing bonds as European Green Bonds towards the end of 2024 – but for now, it remains uncertain whether issuance will pick up significantly

Sustainable bank bond supply on track to reach new highs in 2023

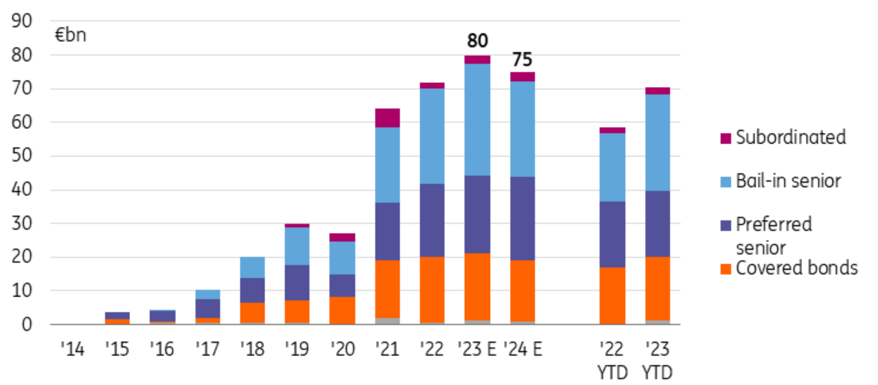
Banks remained very active in the sustainable bond market this year. By the end of October, credit institutions across the globe had issued over €70 billion in EUR sustainable bonds. This is more than €10bn ahead of the sustainable supply over the same period in 2022. We expect green, social and sustainability issuance of banks to reach €80bn this year, up €8bn versus 2022. While banks will still issue notable amounts of sustainable debt in 2024, slower lending growth will probably make it difficult for them to continue to issue at the same pace as this year. We expect to see slightly less sustainable supply next year, despite our forecasted modest rise in total bank supply.

€75bn

in ESG supply by banks in 2024

Banks issued €19bn in 2023 YTD (27%) in sustainable debt via the covered bond market, €19bn (28%) in preferred senior, €30bn (43%) in bail-in senior and €2bn (3%) in T2 bonds. This confirms the dominant focus of the ESG issuance on bail-in senior this year. This has been more than a reflection of the general supply dynamics alone. Banks printed 31% of their bail-in senior supply with a sustainable use of proceeds. This compares with much lower shares of 19% in preferred senior, 11% in covered bonds and 10% in T2 bonds. The better observable funding cost advantages of sustainable issuance further down the liability structure form one of the reasons. Besides, the broader investor base for sustainable bonds has supported banks in issuing bail-in senior deals against a backdrop of sometimes volatile market conditions.

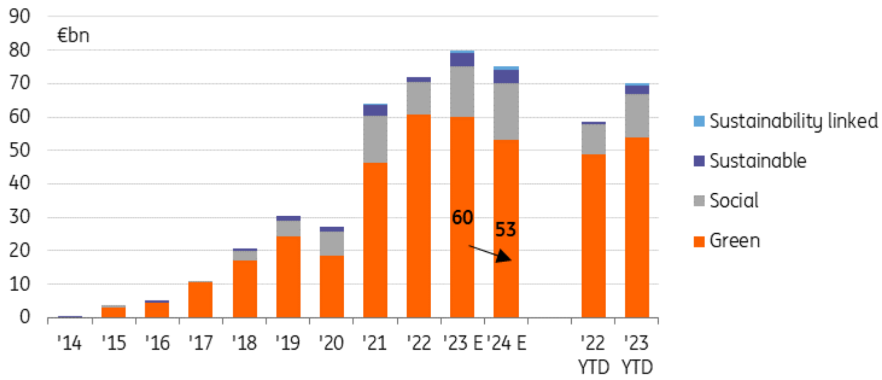
Sustainable issuance in bank bonds continues to rise



Source: ING | Only EUR bank bonds with a minimum size of €250m included

Green issuance continues to dominate, even though the pickup in social supply is probably more noteworthy. At €13bn YTD, social issuance is up €4bn versus last year year-on-year and on track to beat the peak year 2021 (€14bn in social bonds). The YTD rise in social issuance almost matches the €5bn rise in green supply, while green supply is in total four times as high as social issuance. The supply of bonds with proceed allocations to both green and social projects (i.e., sustainability supply) remains low at €2bn YTD.

Social issuance will continue to become more dominant



Source: ING | Only EUR bank bonds with a minimum size of €250m included

Factors driving sustainable bank bond supply in 2024

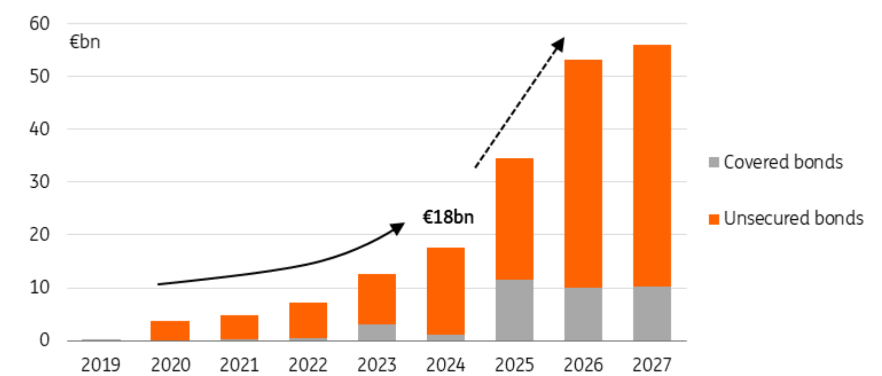
Slower lending growth (-)

Bank lending growth is stagnating against the backdrop of the rise in interest rate levels. This makes it difficult for banks to substantially grow their sustainable loan portfolios. That said, against the backdrop of the evolving ESG regulation and wider investor and societal push for companies and banks to become more sustainable, the sustainable loan books will still see better growth dynamics than the less sustainable loan portfolios.

Few sustainable bond repayments (-)

Redemption payments in the sustainable bank bond segment remain low, with only €18bn in EUR bonds maturing in 2024. This frees up little space for banks to refinance maturing bonds against the same pool of sustainable assets. Moreover, part of the sustainable loans that fall free may not be refinanced via new sustainable bonds. Either because issuers have strengthened their loan eligibility criteria, or because the loans do no longer fall within the look-back periods that issuers apply for new issuance.

Only €18bn in EUR sustainable bank bonds fall due in 2024

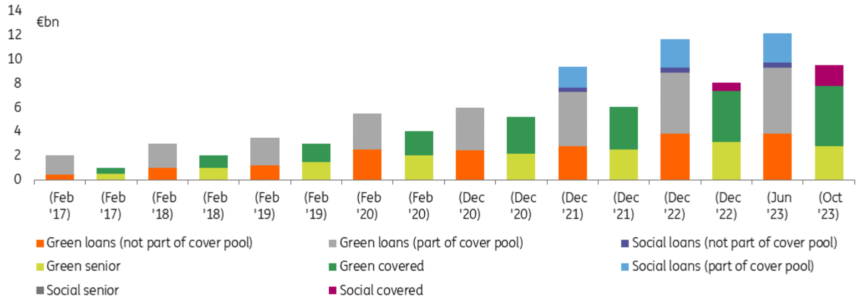


Source: ING | Only EUR bank bonds with a minimum size of €250m included

Identification of new assets (+)

There are also boundaries to the further growth potential via the identification of new sustainable assets or first-time issuers. Following the substantial issuance in previous years, more banks are reaching the limits of their available sustainable assets. Some banks also assign parts of their sustainable portfolios to deposit or commercial paper alternatives. These loans are then unavailable for sustainable bond market funding. Nonetheless, we continue to see banks financing new sustainable loan types – including, for instance, via separately established social bond frameworks in addition to their existing green bond frameworks. This will remain supportive to sustainable issuance.

Evolution of the green and social portfolio versus supply of Germany's largest issuer of sustainable bonds



Source: Berlin Hyp, ING | Outside green loans in the cover pool the June '23 portfolio is plotted stable vs end 2022

Financing of other environmental objectives (+)

Green bank bonds continue to (re)finance mostly loans for the purpose of climate change mitigation. However, they could also more often start funding other environmental objectives, such as climate change adaptation. Think of loans related to the implementation of physical and non-physical solutions to reduce physical climate risks as identified through climate risk and vulnerability assessments (CRVA).

In June 2023, the European Commission also published the Environmental Delegated Act. This sets the technical screening criteria for the remaining four environmental objectives of the EU Taxonomy, i.e., sustainable use and protection of water and marine resources, the transition to a circular economy, pollution prevention and control, and the protection and restoration of biodiversity and ecosystems. This may open further opportunities for the issuance of green bonds.

Sustainability-linked issuance (+)

Sustainability-linked bond supply is still more a corporates than a financials phenomenon. In 2023, one of the major Nordic banks issued its first EUR use of proceeds bond financing a portfolio of sustainability-linked loans (SLL) to companies with sufficiently ambitious climate change mitigation goals. Apart from that, there was no sustainability-linked issuance directly via sustainability-linked bonds (SLB), nor indirectly through the use of proceeds instruments financing sustainability-linked loans.

Use of proceeds SLL bonds have the advantage in that they do not have coupon step-up features linked to any sustainability KPIs at the level of the bond. These KPIs and interest rate step-up/step-down features are set at the level of the sustainability-linked loans financed by the bonds. There are therefore no coupon characteristics at the level of the bond that could be seen as an incentive for early redemption. The latter has made it difficult for banks to issue senior or subordinated bonds in SLB format eligible for a bank's minimum requirement for own funds and eligible liabilities (MREL).

We believe that sustainability-linked issuance could develop more in the bank bond segment. Particularly against the backdrop of the Corporate Sustainability Reporting Directive (CSRD) and Corporate Sustainability Due Diligence Directive (CSDD) requiring (non-)financial companies to disclose their transition plans.

What to expect from the European Green Bond Standard

On 23 October, the European Council adopted the European Green Bond legislation, eight months after the EU reached a political agreement on the standard in February. The regulation will be signed and published in the EU's Official Journal and will enter into force 20 days after publication in the Official Journal. The European green bond regulation should then apply 12 months after entry into force, so likely from November to December 2024 onwards. This means that towards the end of next year, issuers can officially start marketing bonds as European Green Bonds.

The European Green Bond Standard – the requirements in a nutshell
The proceeds of bonds marketed as European Green Bonds should be allocated before the maturity of the bond conforms to the requirements from the EU Taxonomy.

Issuers may apply a **portfolio approach**. They can allocate the proceeds of multiple green bonds to a portfolio of taxonomy-aligned assets. When the bond proceeds are allocated to financial assets such as loans, the loans should in principle not be created later than five years after issuance of the European green bond, unless the portfolio approach is used.

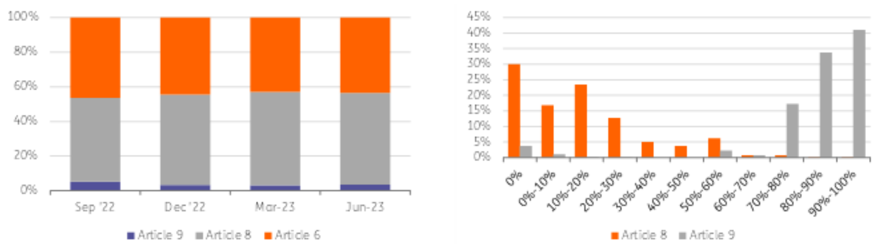
The European green bond regulation provides for a so-called **flexibility pocket**. Up to 15% of the proceeds can be allocated to economic activities that comply with the EU taxonomy apart from the technical screening criteria, for instance because these criteria have not entered into force yet. The activities funded should still contribute substantially to one of the taxonomy's environmental objectives. The relevant generic 'do no significant harm' provisions should also be met.

Importantly, if the **technical screening criteria** are **amended** before the maturity of the European green bond, the bond will keep its European green bond status if the proceeds were allocated based upon the old technical screening criteria. Only the unallocated proceeds and proceeds covered by a CapEx plan assuring their forthcoming taxonomy alignment will have to be allocated to conform to the new technical screening criteria within seven years. When a portfolio approach is applied, the assets not meeting the amended technical screening criteria can stay part of the green portfolio for seven years at most.

The European green bond regulation also subjects issuers of European green bonds to stricter **transparency requirements** by requiring the publication of a (pre-issuance) green bond factsheet and a (post-issuance) allocation and impact reports. To facilitate comparability, public disclosure templates will be established for other environmentally sustainable bonds and sustainability-linked bonds, including on the taxonomy alignment. For this purpose, the European Commission will establish guidelines for voluntary pre-issuance disclosure and a delegated act for periodic disclosures, in line with the European green bond factsheet and allocation report.

Bonds marketed as European Green Bonds do count as 100% taxonomy aligned for the Taxonomy KPI disclosures of asset managers and banks. The bonds should also be eligible for inclusion in Article 9 funds (sustainable investments). Investors may therefore prefer bonds with a European green bond designation. That said, other green bonds also contribute to the Taxonomy KPIs of investors to the extent that the bond proceeds are used to finance Taxonomy-aligned activities. Moreover, against the backdrop of the ESMA's clarification in 2022 that SFDR Article 9 funds should be comprised of 100% of sustainable investments, most funds remain classified as Article 8 (promoting environmental or social characteristics). Data from Morningstar Direct confirm that most Article 8 funds do not require more than 30% of the investments to be sustainable. This means green bonds that are not 100% taxonomy compliant will still be met with a notable investor appetite.

Most of the assets under management are Article 8 with only few of the Article 8 funds requiring >50% sustainable investments



Source: ING, Morningstar Direct

Against this backdrop, it remains yet to be seen whether the issuance of European green bonds will pick up significantly by the end of next year – particularly as some issuers may still feel reluctant to market their green bonds as 100% taxonomy compliant. Ensuring 100% taxonomy compliance means banks not only have to be sure that loans in their green portfolios meet the EU taxonomy criteria for substantial contribution but also that the applicable do no significant harm criteria and minimum safeguards are met.

Bonds financing energy-efficient residential real estate assets may still be well suited to be marketed as European green bonds. These bonds would only have to meet the 'do no significant harm' provisions for climate change adaptation as per the relevant climate change mitigation criteria for the acquisition and ownership of buildings. To our understanding, this also applies to loans that finance the acquisition of houses built after December 2020. These provisions solely come down to the performance of a climate risk and vulnerability assessment (CRVA) to identify physical climate risks such as floods, and to the development of an adaptation solutions plan to reduce these risks if material.

The applicable do no significant harm criteria per real estate activity

Climate change mitigation	1	2	3	4	5	6
Construction of new buildings		✓	✓	✓	✓	✓
Renovation existing building		✓	✓	✓	✓	
Energy-efficiency equipment		✓			✓	
Charging stations		✓				
Devices for the regulation of energy performance		✓				
Renewable energy technologies		✓				
Acquisition and ownership of buildings		✓				

Source: Climate Delegated Act, ING

1 refers to the climate change mitigation object, 2 to the climate change adaptation objective, 3 to the sustainable use and protection of water and marine resources, 4 to the transition to a circular economy, 5 to the pollution prevention and control and protection and 6 to the restoration of biodiversity and ecosystems.

In the final report on the minimum safeguards of October 2022, the Platform on Sustainable Finance also clarified that households are not considered to be covered by the minimum safeguards under the EU taxonomy. Hence, the minimum safeguard provisions would not apply to mortgages granted to households for house purchases.

In summary

We expect banks to issue €75bn in sustainable EUR debt in 2024, €5bn less than our full-year estimate for 2023. We believe slower lending growth will make it difficult for banks to continue to issue sustainable bonds at the same pace as this year, particularly with an increasing number of issuers reaching the boundaries of their issuance capacity against the existing portfolios of sustainable assets.

That said, sustainable supply will continue to be lively in our view, as banks will remain resourceful in the identification of new assets suitable for ESG issuance. Against this backdrop, we expect a modest further rise in social issuance (€17bn), even though green supply is set to decline (€53bn). Meanwhile, banks will continue to prepare for the first issuance under European green bond regulation. Such issuance, however, will not take place before the end of 2024.

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