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FINANCIAL INSTITUTIONS

Bank Pulse: Sustainable supply fails to keep pace with higher bank bond supply

Despite the covered bond-led increase in bank bond supply this year, sustainable issuance by credit institutions is not growing compared to last year. The persistent dominance of green supply does appear to narrow the range of sustainable development goals supported by sustainable bank bonds

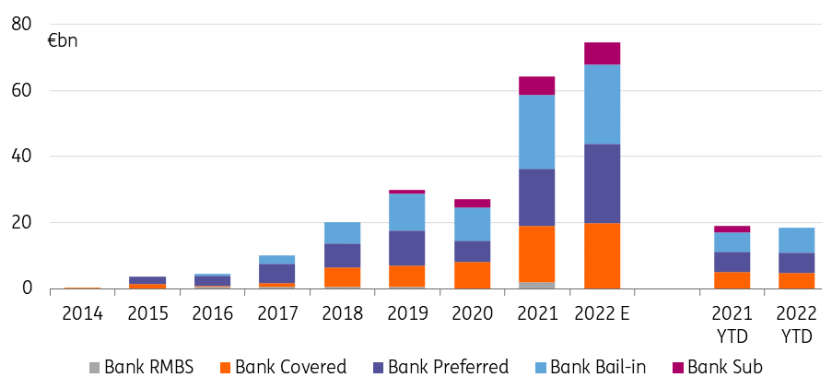


Source: ING

Sustainable bank bond supply just ahead of last year

Banks have issued €19bn in EUR sustainable bonds this year, matching the sustainable supply over a similar period of time last year. The sustainable supply reading is exactly flat on last year's year-to-date equivalent for covered bonds and preferred senior paper. Further down the liability structure, a rise in sustainable supply in bail-in senior has compensated for the lower sustainable issuance activity in bank subordinated paper.

Sustainable bank bond supply by type of bond issued



Source: ING

For covered bonds, the stable sustainable supply compared to last year is probably most at odds with this year's general issuance trend. In our [Bank Pulse](#) of 1 April 2022, we wrote about the surge in bank bond supply during the first quarter of this year, mainly on the back of a significant €55bn increase in covered bond supply. In contrast, supply in non-covered bank bonds in 1Q22 merely ran parallel to last year. Therefore, a similar sustainable issuance pattern for non-covered bank bonds is understandable. However, the primary flow in covered bonds would have suggested a higher sustainable reading in this segment.

In our view, the supply picture is so different that even the more obvious spread advantage of sustainable bonds in the unsecured market cannot fully explain it. True, sustainable issuance in covered bonds has the disadvantage that issuers would ideally allocate their bond proceeds to sustainable assets that also meet the cover pool eligibility criteria. This constraint does not apply to the unsecured market, meaning that this market is more suitable for proceeds to be allocated to sustainable assets that would not be eligible for inclusion in covered bond collateral pools.

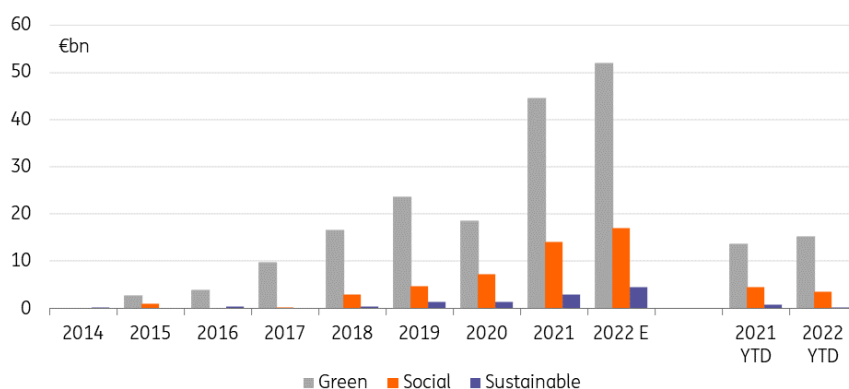
However, when looking at the most recent allocation reports available, various existing sustainable portfolios do appear to offer scope for more sustainable issuance, and in covered bonds, too. Besides, there is still a broad range of banks that, in their green, social or sustainability bond frameworks, do provide for the option to issue a sustainable bond in the covered bond format, but that have up until today never done so.

As such, we remain confident about the further growth potential of the sustainable bond market this year, including in covered bonds. Particularly in the event that covered bond spreads widen further, sustainable issuance may become more appealing to issuers from a greenium perspective. Also, once the net purchases under the CBPP3 have ended and reinvestments of redemptions become less dominant, covered bond issuers may feel more inclined to target the generally broader investor base for sustainable bonds.

Green issuance remains in the lead

When looking at the composition of the YTD sustainable bond issuance by banks, green issuance remains clearly in the lead. In fact, on aggregate, green bond supply by banks is even slightly (€1.5bn) ahead of last year's YTD equivalent. The combination of social and sustainability issuance by banks, meanwhile, is €1.5bn lower than last year.

Sustainable bank bond supply by green, social and sustainable segment



Source: ING

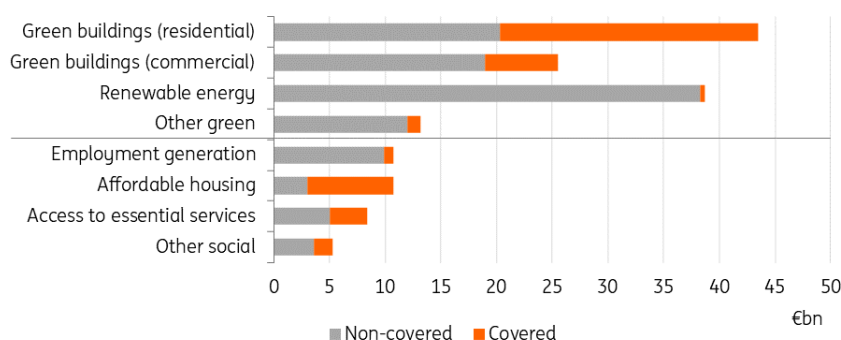
The biggest discrepancy between non-covered and covered bond sustainable issuance remains visible in the green segment. In covered bonds, green issuance only adds up to €3.3bn (67%) this year with social issuance at €1.6bn (33%). For uncovered bank bonds, green issuance is 3.5 times as high as for the covered bond market, at €11.5bn (83%), whereas social issuance is comparable to covered bonds at €2bn (15%). The remaining €0.3bn (2%) in sustainable unsecured issuance represents sustainability supply that combines a green and social use of proceeds.

Proceed allocations do differ for covered and non-covered bank bonds

An overview of the proceed allocations for sustainable non-covered and covered bank bonds immediately shows where the biggest discrepancies lie. For instance, as covered bonds are mostly secured by high-quality mortgage loans, green covered bond proceeds are generally allocated to green residential or commercial building loans. Proceed allocations for non-covered bank bonds are predominantly directed towards renewable energy loans. The graphic also confirms that a notable part of the unsecured bond proceeds is allocated towards green buildings. One could argue that this, in a way, does cannibalise the green issuance potential in the covered bond format.

When it comes to social bond issuance, a similar pattern emerges. Unsurprisingly, the proceeds of social covered bonds are mostly allocated to affordable housing, which fits with the typical nature of covered bond collateral pools (ie comprised predominantly of mortgage loans). Non-covered bonds issued in a social format mostly allocate proceeds towards employment generation (including SME financing). After the Covid-19 crisis, quite a number of social bonds were issued to finance loans alleviating the social and economic impacts of the crisis, including for SMEs.

Use of proceeds by core green and social categories



Source: ING

What about the support for different sustainable development goals?

Equally interesting is the question of how the different sustainable bank bond products promote the United Nation's sustainable development goals (SDGs) for 2030. In the chart below, we aim to give an overview of the SDGs supported by sustainable bank bonds. The chart covers 88% of the circa €155bn in EUR denominated sustainable bank bonds outstanding (non-covered and covered with a minimum issue size of €250m).

Our approach on allocations towards the 17 SDGs

The chart can only be read as indicative, as very few banks report their actual proceed allocations to dedicated SDGs. Instead, proceed allocations are generally provided along the lines of the use of proceeds categories identified in the green bond principles (GBP) and/or social bond principles (SBP), as summarised in the previous paragraph. However, most green, social or sustainability bond frameworks do give an overview of the sustainable development goals promoted by each use of the proceeds category. As such, where such an indication was given, we assumed an equal distribution of the proceed allocations within a specific green or social category towards the sustainable

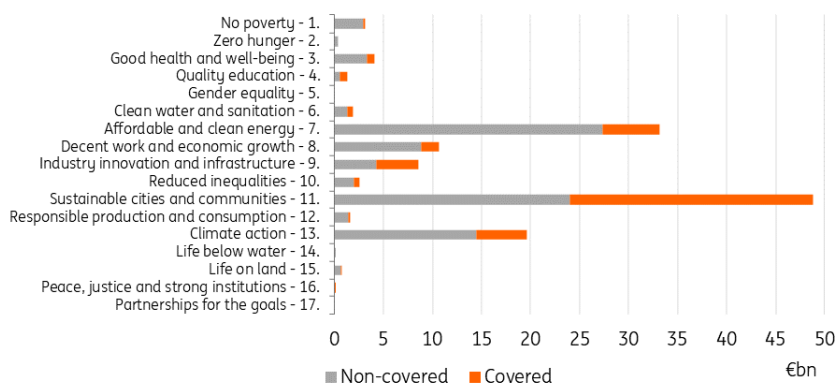
development goals identified for that category.

We do realise this approach is far from perfect, as even within a use of proceeds category, the support for one of the identified SDGs may be stronger than for others. Besides, when gathering the data for our analysis, we also came across an example where the communicated support for two SDGs within a use of proceeds category, reflected two times the full amount of the proceeds instead of half of the proceeds within the category being assigned to both of the SDGs.

Furthermore, which SDGs are actually promoted by the different use of proceeds categories is open to debate. Some second party opinion (SPO) providers, such as Sustainalytics and ISS ESG, give an indication of the SDGs they consider to be promoted by the use of proceeds categories specified in the green, social or sustainability bonds frameworks they review. There are multiple examples where these SPO providers came to somewhat different conclusions than the issuer itself in its respective green, social or sustainability bond framework. It is also likely that if these two SPO providers had analysed the same framework against the different SDGs, these would have come to slightly different conclusions.

For this reason, where possible, we tried to take the SDGs per use of proceeds category identified in the green, social and sustainability bond frameworks of the issuer as a reference. Only where the framework or related investor presentation did not give such an indication did we use the opinion of the relevant SPO provider as a reference. In all cases, we used the most recently available reports as input.

SDG-11 most supported by sustainable bank bond supply



Source: ING

Despite its indicative nature, the graphic does provide some interesting insights. The SDGs most supported by the sustainable bonds issued by banks are SDG-7, Affordable and clean energy, SDG-11, Sustainable cities and communities and SDG-13, Climate action. This is a reflection of the fact that green bond issuance clearly dominates the sustainable bond supply of banks. For similar reasons, the chart shows that SDG-7, Affordable and clean energy, is best supported by non-covered bank bonds, whereas SDG-11, Sustainable cities and communities is the dominant SDG category for covered bonds. This mirrors the fact that renewable energy loans are the most important use of proceeds category for non-covered bank bonds, whereas green buildings and social housing are the dominant use of proceeds categories for covered bonds.

Interestingly, of the broad sample of bank bonds we looked at, no proceeds had been allocated in support of SDG-5, Gender equality. The same holds for SDG-17, Partnership for the goals. SDG-2, Zero hunger, SDG-14, Life below water, and SDG-16 Peace, justice and strong institutions are also scarcely supported by sustainable bank bond supply.

Conclusion

Considering the surge in covered bond supply in the first months of this year, the sustainable issuance in this segment is clearly lagging. Green issuance, in particular, continues to be dominated by non-covered bank bonds. This can, in part, be explained by the wider use of proceeds possibilities of non-covered bank bonds, as well as by the more obvious greenium of sustainable bonds further down the liability structure. That said, we continue to believe in the further growth potential of the green bank bond market this year, including in covered bonds. The end of the CBPP3's net buying activity could be one factor supporting sustainable supply in covered bonds later this year.

Meanwhile, the overall dominance of green bank bond supply over social issuance also has noteworthy implications for the sustainable development goals (SDGs) promoted by sustainable bank bond issuance. These do have a stronger environmental focus. That said, while the relative share of social bonds is higher in covered bonds, the distribution of proceeds across the different SDGs is probably broader for non-covered bank bonds. The main explanation is that covered bonds do allocate proceeds primarily to categories that are aligned with the asset types collateralising the bonds. As these are predominantly housing loans (ie green buildings or affordable housing), SDG-11 appears to be most meaningfully supported by sustainable covered bonds.

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