Banks and sustainability in 2021: The next steps on the bumpy road to climate neutrality

Sustainability is a theme that has attracted great attention, with the Covid-19 pandemic only underscoring its importance. But sustainability will remain a key topic for banks in so many different ways in 2021

Environmental protesters burn a globe in front of the ECB's headquarters in Frankfurt

European green deal - Moving on from the sustainable finance action plan

The regulatory developments reflecting Europe's climate ambitions have clearly accelerated in the past few years after the European Commission published its ambitious action plan on financing sustainable growth in March 2018. This action plan identified ten individual actions with the purpose of, among others, redirecting capital flows to sustainable investments which led to a flood of new regulatory proposals.

One of the most important regulatory outcomes of the action plan on sustainable finance is the taxonomy regulation that came into force on 12 July 2020. The taxonomy regulation provides a unified classification system for sustainable activities and one of the key requirements of the regulation is that companies must include in their non-financial statement information about the extent their activities are environmentally sustainable. The taxonomy regulation is also the backbone to establishing EU green bond standard (GBS). After all, eligible green projects that are financed by an EU green bond should contribute to environmental objectives as identified by the taxonomy.

> *The European green deal is seen as an integral part of the Commission's strategy to implement the UN's 2030 agenda*

On 11 December 2019, the European Commission presented the European green deal, which resets the Commission's commitment to tackle climate and environmental-related challenges. The European green deal is seen as an integral part of the Commission's strategy to implement the UN's 2030 agenda and the sustainable development goals. The initial roadmap of the key policies to achieve the European green deal among other things aims to increase the EU's climate ambition for 2030 and 2050.

To this purpose, the European Commission published its proposals for a European climate law on 4 March 2020, which sets an EU-wide legal target for climate neutrality by 2050 binding to all EU institutions and national governments. To ensure consistency with the climate-neutrality objective, the climate law proposals reiterate the European green deal's commitment to exploring the options to increase the EU's greenhouse gas emission reduction target for 2030 to a new target of at least 50% and towards 55% emissions reduction compared to the 1990 levels. This new ambition was also taken into consideration by the Technical Expert Group (TEG) in establishing the updated thresholds for the taxonomy technical screening criteria published in March 2020. As such, it is also of relevance for the development of the thresholds for loans originated by banks or bonds issued by banks that are marketed as green.

However, in September 2020 the Commission changed its greenhouse gas emissions reduction target to at least 55% by 2030. On 7 October 2020 in a vote on the European climate law, the European Parliament lifted the emission reduction bar even further to 60% by 2030, urging the Commission to also set an interim target for 2040 following an impact assessment.

> *All this, in our view, raises the question - to what extent will these emission reduction ambitions result in stricter technical screening thresholds for green assets*

The latter should ensure that the EU remains on track to reach the 2050 climate neutrality target. Besides, the European Parliament stressed that not only the EU but also all member states individually should become climate-neutral by 2050, and should walk a path of negative emissions thereafter. More recently on 23 October 2020, the European Council took a partial position on the climate law, by not specifying yet an updated 2030 greenhouse gas emission target. The Council is of the view that further work is needed to reach an agreement on such a target among the member states. The Council also asked the Commission to propose an intermediate target for 2040.

All this, in our view, raises the question - to what extent will these emission reduction ambitions result in stricter technical screening thresholds for green assets and/or in even stricter technical screening criteria thresholds compared to those proposed by the Technical Expert Group in March 2020. The European Commission is anticipated to publish the draft regulation on climate change mitigation and adaptation soon and will adopt a delegated act on it later this year.

The renewed sustainable finance strategy and green bond standard

The European Commission has estimated that to achieve the 2030 climate and energy targets set by the green deal an additional amount of €260bn of annual investments is required. As the private sector is considered key to financing the green transition, the European Commission intends to adopt a renewed sustainable finance strategy before the end of 2020, which will build on the ten actions defined in March 2018.

This will keep familiar topics such as the integration of sustainability into corporate governance frameworks, the increased focus on long-term developments and sustainability aspects and the climate and environmental disclosures by companies and financial institutions high on the agenda. Also, the EU eco-label scheme for retail investment products and the EU green bond standard will be part of the renewed sustainable finance strategy discussion. The same holds for the information to be provided to green bond investors in the prospectus or the further assessment of the suitability of existing capital requirements for green assets.

On 8 April 2020, the European Commission released a consultation on the renewed sustainable finance strategy to collect views of interested parties for the purpose of the development of the strategy. The questions were mostly organised along the lines of the three main actions identified for the renewed sustainable finance strategy, involving a broad range of topics which were addressed in the March 2018 plan. The important thing is that the renewed strategy is focused on how financial institutions can contribute to a greener economy, it is not about "greening" the financial system.

> *The important issue is whether EU green bonds should maintain their green bond status until maturity.*

Separately, on 12 June 2020, the European Commission published a consultation addressing the possibility of a legislative initiative on the EU green bond standard, as suggested in the TEG's usability guide on the EU green bond standard. The consultation on the EU green bond standard touches upon issues such as whether the use of proceeds of green bonds should be 100% used to (re)finance green assets as defined by the taxonomy. Another important issue is whether an EU green bond should maintain its "green bond" status until maturity, knowing that the taxonomy's technical screening criteria will periodically be reviewed and could result in projects no longer being eligible under the recalibrated taxonomy technical screening criteria. The consultation also requests feedback on whether specific financial or alternative incentives would be necessary to support the uptake of EU green bonds, such as public guarantee schemes provided at an EU level, or alleviations from the prudential requirements.

The latter is interesting also in light of the CRD6/CRR3 proposals expected next year. These proposals may already include provisions for a more favourable risk weight treatment of green assets, such as green loans or potentially green bonds. The decision on the green bond standard will ultimately be taken in the context of the renewed sustainable finance strategy.

As such developments in this field will continue to be closely followed by issuers and investors in sustainable bonds in 2021.

Bank sustainability issuance - Holding up well despite soft bank supply

The sustainable bond market has seen rapid growth including in bank bonds

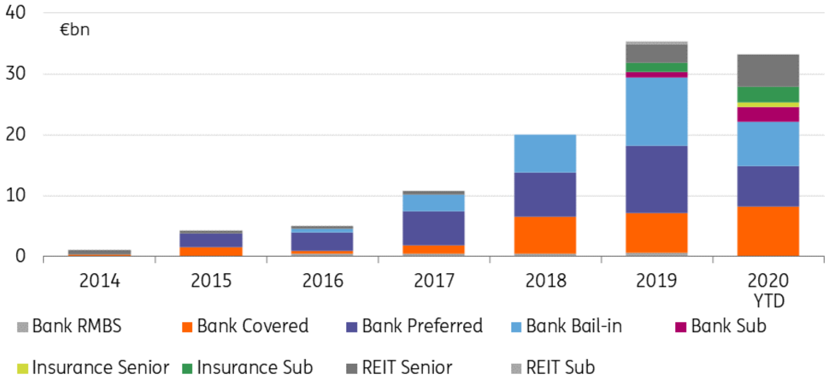
Over the first ten months of 2020, €33bn in sustainable bonds have been issued in the financials segment, of which €25bn was by banks alone. This amount covers only EUR-denominated instruments with a minimum size of €250m and marketed with dedicated sustainable use of proceeds. Hence, the year-to-date sustainability print almost matches the €35bn in EUR sustainable financials supply over FY19, of which €30bn was issued by banks.

> *The sustainable bond market has seen rapid growth, including in bank bonds.*

This is quite an achievement considering the significant decline in bank bond supply in 2020 given the pandemic. The €8bn issuance of sustainable covered bonds even trumped last year's supply by almost €2bn, while EUR benchmark covered bond supply has dropped this year around €40bn in comparison to last year. The unsecured sustainable supply pattern more or less matches the trend seen elsewhere in bank supply. Supply has been particularly slower in bank senior, where both preferred and bail-in senior unsecured supply falls around €4bn short on a year-to-date basis versus the full year print in 2019.

Instead, the subordinated issuance by banks in sustainable format has risen from €1bn in 2019 to €2.5bn in 2020, with this year even featuring the first EUR AT1 bond in green format.

Sustainable EUR financials supply across different products



Source: ING

*) Based on EUR denominated bonds with a minimum size of €250m

Sustainable issuance to rise in covered and senior bonds in 2021

For 2021 we expect banks to issue €32bn in EUR denominated sustainable bonds (with a minimum size of €250m), up from €25bn this year. Of this amount, €10bn will be issued in covered bonds (versus €8bn in 2020) and €22bn in other bank bonds (versus €17bn in 2020), mostly in senior (€20bn).

> *For 2021 we expect banks to issue €32bn in EUR denominated sustainable bonds, up from €25bn this year*

We doubt we will see the issuance of sustainable debt gain a much stronger footing in the AT1 segment. Some market participants question whether a combination of AT1 issuance and sustainable use of proceeds should go hand in hand. After all, AT1 instruments are capital instruments with, in principle, a perpetual nature despite their call optionality.

The green assets (re)financed by the bond proceeds have by definition shorter expiration dates, which raises concerns whether the proceeds of the bond can continue to be rolled over into sufficient eligible new green assets during the perpetual term of the bond. Besides, AT1 instruments are the deepest subordinated bond instruments, first in line to absorb losses after CET1 capital.

The higher risks involved with the bonds feels at odds with the sustainable character of investing in the bonds. Furthermore, sustainability investors typically follow common bond market indices, such as the Bloomberg Barclays or Markit iBoxx indices, which don't accept (the often sub-IG rated) AT1 bonds as eligible instruments for their indices. Hence, while green issuance in the AT1 segment is unlikely to see a rise, banks may still opt for sustainable T2 issuance if the bonds issued are investment-grade rated and as such eligible for inclusion in investment-grade bond indices.

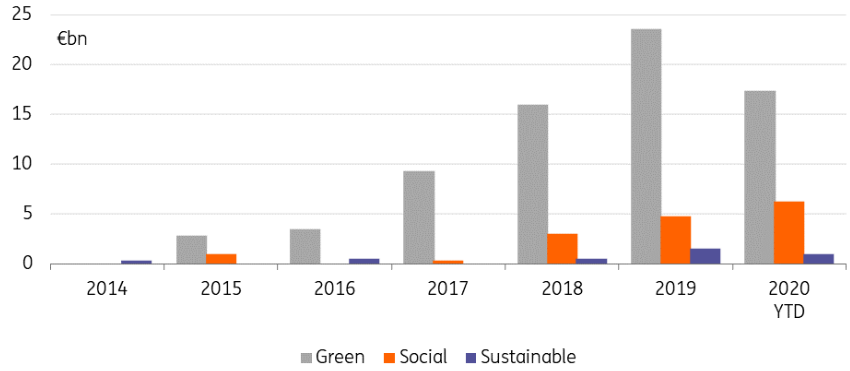
Supply is making a modest shift to social

The slower primary market activity in bank bonds in 2020 has primarily spilt over into a lower bank sustainability issuance in green.

Overall, banks did print more social bonds compared to last year. This in part is explained by the Covid-19 crisis which saw some banks taking the opportunity to print a social bond to finance the coronavirus pandemic.

In bank senior, almost €3bn in Covid-19 related social bonds were issued this year, roughly 75% of the total social senior issuance this year. In covered bonds €1bn in Covid-19 related social debt was issued, 40% of the total social issuance.

Social issuance by banks gains momentum where green supply falls



Source: ING

*) Based on EUR denominated bonds with a minimum size of €250m

While the Covid-19 crisis may continue to offer support to the issuance of social bonds, bank issuance is expected to remain mostly dominated by green issuance in 2021. We anticipate banks to issue €23bn in green bonds, €7bn in social bonds and €2bn in sustainability bonds next year.

That said, the pandemic has definitely brought social supply more to the fore. The ICMA's Q&A for social bonds related to Covid-19 published earlier this year is just one example.

We anticipate banks to issue €23bn in green bonds, €7bn in social bonds and €2bn in sustainability bonds next year

Meanwhile, in its June green bond consultation, the European Commission also made a side step to social in light of the increase seen in the issuance of social bonds this year in response to the Covid-19 pandemic. The consultation raises the questions whether a) social bonds are an important instrument to achieve social objectives, and b) social bonds targeting Covid-19 help fund the public and private response to the socio-economic impacts of the pandemic, or c) whether both should mostly be seen as a marketing tool with limited impact.

The Commission also hopes to receive feedback on whether it should develop an official EU social bond standard targeting social objectives and an EU sustainability bond standard covering both environmental and social objectives. Besides, it is also the idea that the taxonomy regulation will ultimately be expanded by other sustainable objectives, including social. This, however, was never anticipated to take place before the end of 2021.

What about sustainability linked issuance?

A feature we haven't seen yet in bank bonds is the issuance of bonds linked to predefined sustainability targets.

In September this year, the ECB made certain amendments to its collateral rules facilitating the acceptance of marketable debt instruments with coupon or increased redemption structures linked to pre-defined sustainability targets. While banks may use green bond proceeds to finance loans with certain sustainability linked performance targets, banks have up until today not issued any sustainability linked bonds.

Yet, linking the sustainable performance targets to for example the carbon emissions reduction of the total lending book could be a relevant performance indicator for a financial institution. However, one aspect that complicates the issuance of sustainability-linked bonds is that any incentive causing a bond to be redeemed early (such as a coupon step up if the predefined sustainability targets are not met) would render the bond ineligible for MREL purposes. Covered bonds are not eligible for MREL purposes, but this market is largely dominated by benchmark size fixed coupon structures.

That being said, including a cash premium at maturity in case the sustainability target isn't met could be an alternative that could be explored by banks, as it does not necessarily provide an incentive to redeem prior to maturity. In addition, the ICMA sustainability-linked bond principles allow for non-financial compensation as an incentive to reach the SPT. One could think for example of a corrective action plan that would help to reach the KPIs, linking them to executive compensation, carbon credit purchases or donations to relevant organisations.

For now, however, the changes made to the ECB's collateral rules remain of more importance to the corporate bond segment than to bank bonds, particularly considering the fact that for corporate bonds the eligibility under the CSPP is linked to the collateral eligibility of the bonds.

The ECB's monetary policy review

By mid-2021, the ECB is also expected to conclude its monetary policy strategy review.

One of the questions assessed for the purpose of the policy review is how issues such as employment, social inclusion and climate change fit within the central bank's mandate considering the risks they pose to financial stability. The idea that monetary policy should take a role in achieving environmental targets, has been much debated, even within the ECB. Some argue that the central bank should purely focus upon achieving price stability and should not set environmental targets. However, if the ECB were to conclude that social and climate factors should fall within its mandate it would have several options at hand to pursue these.

The idea that monetary policy should take a role in *achieving environmental targets, has been much debated, even within the ECB.*

The establishment of a separate green lending programme is one of the options that has been cited. Such a green TLTRO programme should be targeted towards lending to households and corporates that meet certain environmental targets. Another option often mentioned is by putting a stronger focus on sustainable bonds within the ECB's asset purchase programmes. One could also think of more sustainable portfolio management strategies with reference to the Eurosystem's foreign reserves or own fund portfolios, or for pension scheme purposes.

The ECB could also make changes to its collateral framework, by assigning (1) more favourable haircuts to sustainable debt pledged as collateral, or (2) to debt pledged as collateral issued by companies that meet certain minimum sustainability criteria or ratings, or (3) that operate in sectors or regions considered to be sustainable.

Whichever approach(es) the ECB opts for, it will have implications for banks either in terms of incentives provided to the further development of their green lending books, or otherwise in terms of their green funding. In any event, putting these options to practice would likely depend upon the taxonomy and green bond standard being fully in place.

Author

Maureen Schuller
Head of Financials Sector Strategy
Maureen.Schuller@ing.com

Disclaimer