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Banks Outlook 2022

Bracing for transformation

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Bracing for transformation

Crisis management, digitalisation and sustainability will be key areas of focus for the European banking sector in 2022. In this series of articles, we explain why.

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1 Bank lending and deposits will continue to grow

On the macro side, things are tentatively moving back to more normal conditions. In step with that, we expect bank lending and deposit growth to further decelerate in 2022, likely even dropping slightly below pre-pandemic trend growth as excess deposits are spent instead of new loans taken out. A worse financial position in some corporate sectors and high cash availability in others may weigh on demand for loans. On the funding side, household deposit inflows will likely diminish further as government support is receding and lockdowns are lifted.

2 ECB support for bank funding remains, for now

Meanwhile, bank funding will remain strongly supported by the European Central Bank. Even though we don't expect the terms of Targeted Longer-Term Refinancing Operations to be eased further, we do believe that the TLTRO-III operation will remain an important part of the bank funding equation. Banks will probably not refinance all of their TLTRO funds after the most favourable interest terms expire in June next year. However, we do expect the partial refinancing of the TLTROs to result in higher bank bond supply in the course of 2022.

3 European banks: Let’s talk resolution

Next year will also bring a wave of binding loss absorption requirements to make banks more crisis-proof. At the same time, a review of the industry's crisis management framework is set to start. In the second half of 2022, the European Commission is expected to publish the proposal for the review of the crisis management framework, which may have implications for bank bond spreads and supply. As of January 2022, banks will also face the first extensive wave of binding loss absorption requirements in the form of interim minimum requirements for own funds and eligible liabilities (MREL). Banks are well-positioned to meet the 2022 interim requirements but are expected to have a €42b shortfall for the final binding targets in 2024.

4 Digital regulation - information overload

As if banks don't have enough to worry about, the European digital regulatory calendar is packed with initiatives that will have a profound effect on the banking business model in the near future. We discuss three themes in this article: data, crypto and central bank digital currencies. All three show how the regulatory and institutional framework is a key factor shaping the outlook for banks. Although the regulatory initiatives described will take time to be concluded and implemented, banks would do better to prepare and be ready for them.

5 Banks take up gauntlet against climate risks

The European banking sector will also continue to have its work cut out next year as it strives to meet the sustainability disclosure requirements set by European law. These disclosures will give market participants more insight into the environmental and social efforts made by banks. The 'E' in ESG, in particular, will remain in the spotlight, as banks take their first steps towards reporting on the taxonomy compliance of their balance sheets. Meanwhile, the anticipated proposals to expand the taxonomy regulation by social objectives will offer banks new opportunities to direct capital to socially sustainable activities.

Bank lending and deposit growth to decelerate

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On the macro side, things are tentatively moving back to more normal conditions. In step with that, we expect bank lending and deposit growth to further decelerate in 2022, likely even dropping slightly below pre-pandemic trend growth as excess deposits are spent instead of new loans taken out

People walk past an poster advertising mortgages at a bank in Milan, Italy

Macro overview: settling down after strong rebound

After a period of strong growth after lockdowns, economic growth in the eurozone is set to fade from here on. That is only natural, as the rebound in activity was mainly related to restrictions on everyday activities being lifted. At this point, GDP has recovered to 98.7% below pre-crisis levels. For 2022, we expect GDP growth to come in at 3.9%, which is still well above the pre-crisis trend but the quarterly pace is set to slow substantially. Nevertheless, this will be enough to close the gap with pre-pandemic levels.

> *"We expect the Pandemic Emergency Purchase Programme (PEPP) to end by March next year"*

In the coming quarters, we expect low levels of unemployment and some dissaving from consumers to still have some positive impact on growth, while business investment is also set to contribute positively to GDP growth as high levels of capacity utilisation and low interest rates provide a favourable environment for investment. At the same time, supply chain problems and shortages of inputs are causing production hiccups and are resulting in upward pressure on already high levels of inflation. Together with a possible resurgence of the virus and accompanying restrictive measures, these present some of the more prominent downside risks to the outlook for next year.

By country, we expect Germany to see growth accelerate to 4.6% next year thanks to a recovering auto sector which is currently still plagued by production stoppages due to semiconductor shortages. But we also expect the periphery to continue a powerful catch-up performance with growth of 5.3% in Spain and 4% in Italy and Greece.

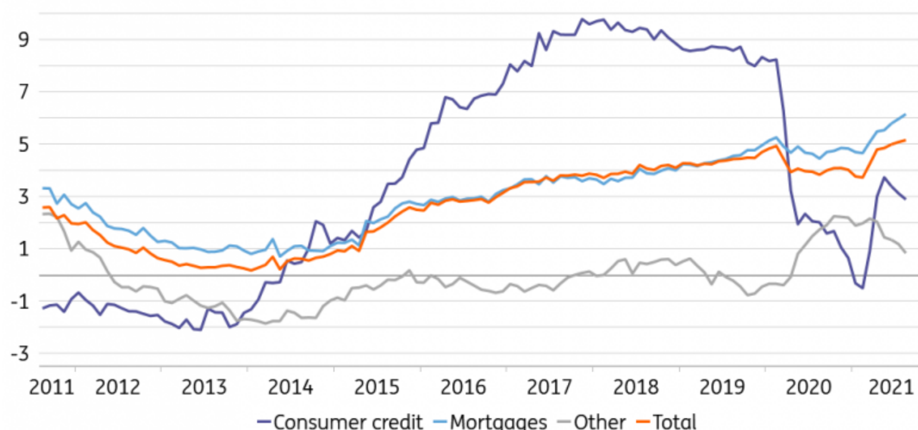
For the European Central Bank, this continued recovery with inflation trending above 3% - and expected to come in around 2% for 2022 – is likely to result in a somewhat more hawkish policy stance for next year than initially thought. We expect the Pandemic Emergency Purchase Programme (PEPP) to end by March 2022, after which we expect purchases to decline to about €50bn per month in the second quarter. This is set to decline further to about €20-30bn in the third. This would happen under the traditional Asset Purchase Programme but could also see a new transitional programme installed to deal with some particular problems related to returning to APP completely. This is a material decline in asset purchases, reflecting the improving economic circumstances and increased inflation expectations.

Household borrowing: nearing the peak

Eurozone bank mortgage lending has been accelerating since 2014. The start of the pandemic marked a temporary dip but growth forcefully resumed in 2021. Eurozone-wide net mortgage growth reached 6.1%YoY, the highest growth rate since March 2008.

In Germany, bank net mortgage lending reached 7%YoY, the highest since the ECB began recording growth in 2004. France and Belgium are above 7% too, though that is less exceptional in those countries than it is in Germany. Italy saw an acceleration in 2021 as well, while Spanish bank net mortgage lending turned positive in 2021 for the first time since 2010. Dutch mortgage borrowing has been growing since 2015, but is mostly supplied by non-bank lenders in net terms. Yet since 2021, Dutch net bank mortgage lending turned positive as well.

Eurozone bank lending to households



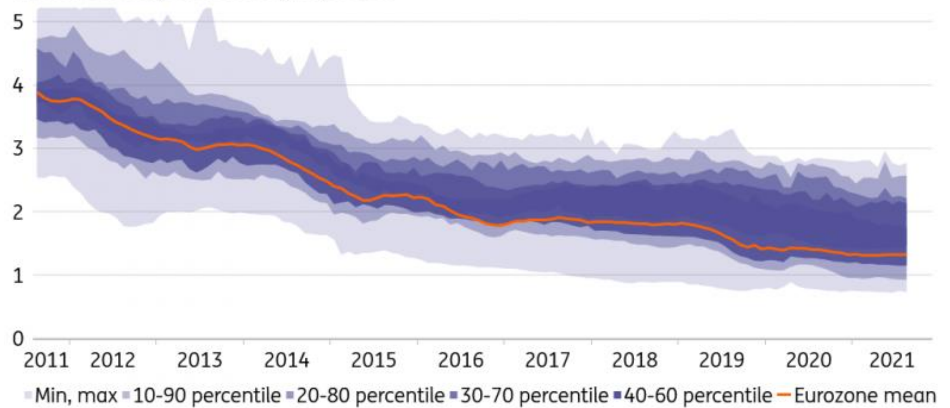
By type, Year-on-Year growth (%)
Source: Macrobond, ING-calculations

> *"Household borrowing rates have likely bottomed out this year"*

Mortgage lending has clearly benefited from low rates and buoyant housing markets. Whether the upward trend can be sustained going into 2022 however, remains to be seen. Housing supply constraints may start to bite a bit more in various markets. Moreover, with inflation making the headlines, market interest rates have been creeping up of late. There is no clear effect yet on household borrowing rates, as you can see in the chart below.

Nominal household rates fell on average 10 basis points in 2020 but flattened out in 2021. Though some further convergence between different countries remains possible, eurozone-wide it seems likely that nominal rates have bottomed out this year. Taking all this together, we consider it likely that the eurozone is near the peak of household borrowing.

Composite borrowing rate for households, Eurozone (%)



Source: Macrobond, ING-calculations

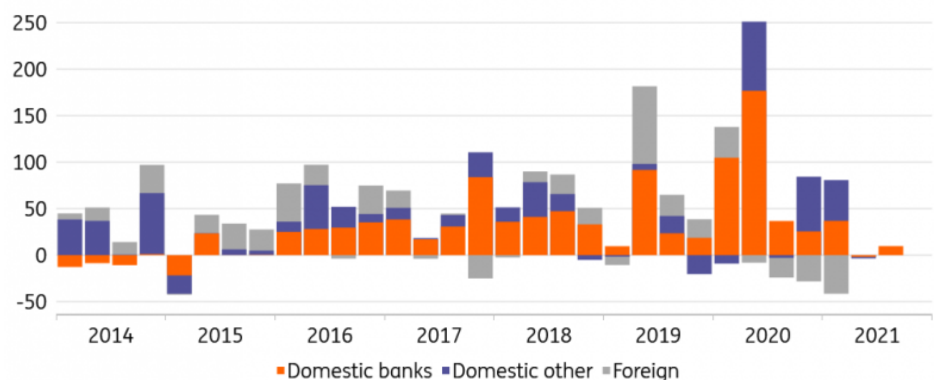
Business borrowing: easing down

Taking bonds and loans together, eurozone banks normally provide roughly half of the debt finance needs of non-financial businesses. As the pandemic engulfed Europe, business borrowing spiked in the first half of 2020. This initial spike was provided disproportionally by banks, partly because of government guarantee schemes put in place, but also because in several Eurozone countries market finance temporarily became more expensive than bank funding for firms having access to both. After the pandemic business borrowing spike in the first half of 2020, borrowing by non-financial businesses decelerated in the second half of 2020 and the first half of 2021. Yet the start and subsequent speed of the deceleration differed substantially between countries, relating to, among other things, the way in which lockdowns hit domestic economies and the dominant form of government support (e.g. loan guarantees vs direct grants).

> *"Eurozone net lending today is performing a bit weaker than it was pre-pandemic"*

For now, net bank lending trends appear to have returned to pre-pandemic trends in most countries. Net bank lending to businesses is holding up reasonably well in Germany and France, but has sunk below zero in Italy and, latterly, in Spain too. Overall, eurozone net lending is performing a bit weaker than it was pre-pandemic. The TLTRO benchmark deadline set at year-end may prompt a temporary acceleration in some countries, but we do not expect this, nor the provisional absence of further TLTRO incentives for bank lending down the line, to affect bank lending performance materially.

Eurozone, non-financial business borrowing by lending source (€bn/quarter)



Source: Macrobond, ING-calculations

The deteriorated financial position of some businesses is likely to have an effect on financing demand. Overall, consolidated non-financial business debt stood at 87% of eurozone GDP in 2021Q2, up from 80% in 2019Q4. Some businesses may focus on redressing their balance sheets, dampening overall net credit demand. At the same time, many businesses hoarded cash in 2020, due to, for instance, government support, postponed investments and precautionary borrowing.

> *"Eurozone businesses have some €300bn extra on hand"*

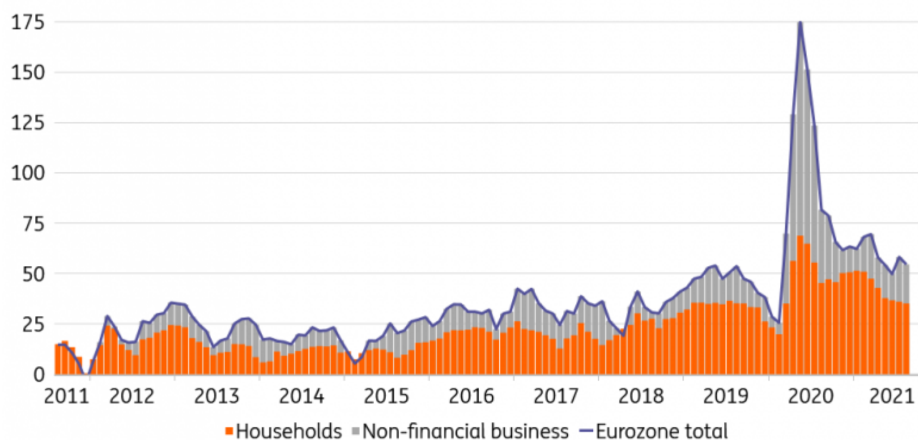
For the aggregated eurozone non-financial business sector, cash and deposits were up 16% in 2020, though cash holdings were growing by 5-10% per annum in the run-up to the pandemic too, Eurozone businesses now have some €300bn extra on hand compared to the pre-pandemic trend growth. This exceeds the yearly net financing needs of businesses in the previous decade. If businesses decide to put this cash buffer to use, it could substantially reduce their demand for external finance.

In our base scenario, the eurozone economy reaches its pre-pandemic size in the first quarter of 2022 and slowly settles down at a cruising speed of about 1.7% real GDP growth. Increased investment is positive for borrowing demand going forward, but the worsened financial position in some sectors and high cash availability in others both weigh down on demand. On balance, we expect net bank lending to business to trend below where it was before the pandemic over the next year.

Bank deposits: elevated inflows are ending

In 2020, eurozone bank deposit inflows roughly doubled to €1090bn, with households depositing €593bn and businesses €497bn. Over 2021, deposit inflows are returning to what could be considered normal. With government support receding and lockdowns lifted, and with pent-up consumption demand but also higher energy prices triggering a degree of dissaving, household deposit inflows are likely to diminish further. Businesses may use some of the cash they hoarded to pay down tax arrears or to finance new investments. Hence, we expect a further easing of business deposit inflows as well.

Eurozone banks, net monthly deposit inflow (3 month moving average, €bn)



Source: Macrobond, ING-calculations

ECB support for bank funding remains...for now

Bank funding remains strongly supported by the ECB. We don't expect the TLTRO terms to be eased any further, and we believe banks will start refinancing their TLTRO-III drawings in 2022. We expect early TLTRO repayments to peak in June 2022

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European Central Bank Governing Council meeting, Frankfurt Am Main, Germany - 28 Oct 2021

The TLTRO-III operation has been a success, especially when measured by its popularity among banks

The European Central Bank (ECB) launched the **third series of targeted longer-term refinancing operations (TLTRO-III)** for banks on 7 March 2019. The operations build on two previous series that were launched in 2014 and 2016. The TLTRO aims to provide attractive funding conditions for banks to support lending to the real economy. The interest rate of the funds may be as low as -1% between June 2021 and June 2022 and is being tied to requirements that banks meet the corporate and household (excluding house purchases) lending growth requirements in the Eurozone set by the ECB.

"TLTRO-III is an important part of the bank funding equation"

We consider the TLTRO-III operation an important part of the bank funding equation. While we don't expect banks to have to refinance all of their TLTRO funds, we do consider refinancing part of the TLTROs to result in a higher bank bond supply during the course of 2022.

The operation has been a success, especially when measured by its popularity among banks. European banks have drawn a total of €2,287bn from the TLTRO-III via nine tranches. By far the largest tranche to date was the fourth, which was allocated in June 2020, when 742 banks took €1,308bn from the operation. According to the October bank lending survey, the TLTRO funds have been used especially for granting loans, which has also been an ECB objective.

€2,287bn Initial size of the TLTRO-III operation

TLTRO drawings in December to remain limited

One more tranche in TLTRO-III remains with its allocation scheduled for December 2021. According to the bank lending survey, only 12% of banks plan to participate in the December tranche, while 43% had indicated not to participate and 42% remained undecided.

"We expect the December TLTRO drawings to remain limited"

We consider that the December TLTRO tranche will be amongst the smaller tranches. This is mainly driven by its availability, as most banks have already maxed out their TLTRO drawings. Banks that have some room in their TLTRO allowance, may seek to participate if they know that they will meet their lending objectives and are therefore able to take advantage of the most attractive -1% rate until June 2022, after which they can pay back the funds early if needed. Another reason to participate was outlined in the bank lending survey, where 12% of banks mentioned the fulfilment of regulatory or supervisory requirements as a motivation for future TLTRO participation. This probably refers to banks considering their NSFR compliance and the positive impact a longer TLTRO tranche could have upon it.

Secondly, rolling funds from previous TLTRO tranches are not attractive due to the strict conditions on the TLTRO rate setting. If a bank pays funds back early in the TLTRO tranches in December to refinance in the last 10th tranche, it will not be able to benefit from the additional special interest rate of -1% between June 2021 and the settlement date of the repayment. This is the case even if the bank theoretically meets the lending requirement, as these prepayments would take place before the lending data is transferred to the central bank and the interest rate is communicated to the bank. We consider this to be a strong incentive for banks not to roll funds at this stage to a longer tranche.

Drivers for an early repayment in December and March

The TLTRO-III offers three-year funding with a chance to repay funds early. Since September 2021 banks can pay back drawings on a quarterly basis in tranches 1-7 as long as at least one year has passed since the settlement date of the tranche. Furthermore, after June 2022 banks can repay early funds from tranches 8-10 on a quarterly basis. The first early repayment option for the first five tranches was in September 2021, when €79bn was repaid.

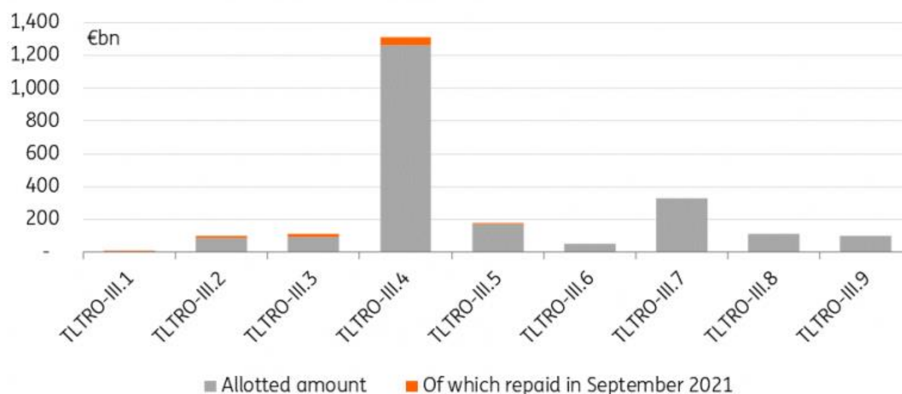
"Rollovers from previous tranches to remain limited in December"

Our expectation for a limited rollover to the December tranche from previous tranches means that this factor should not be a large driver for early repayments in December. One reason for early repayments in December could be the inability to meet the lending targets, as the lending benchmark period ends in December 2021.

In addition, the temporary relief measure allowing for a deduction of central bank exposures from the leverage exposure measure calculation, is set to end in March 2022. The end of the relief could drive some banks to reconsider the impact of the TLTRO operation on their capital metrics, if they have substantial balances kept at the central bank. According to the ECB, the relief measure had a positive impact of 70bp on the leverage ratio of 39 significant institutions as of end-2020, and it improved the

headroom to the leverage ratio requirement by 50bp. Some large banks have already stopped utilising the relief measure in their leverage ratio calculation.

TLTRO-III drawings vs repayments



Source: ING, ECB

Early repayments to peak in June 2022

The ECB has already extended the special interest rate period by one year. This period was first set to run from June 2020 until June 2021. Then the additional special interest rate period was introduced to run between June 2021 and June 2022. If the TLTRO terms are retained as they are now, the TLTRO rates will increase from June 2022 onwards.

"TLTRO rates will increase from June 2022 onwards"

For tranches 1-7, banks see their TLTRO rate to move, so that it is in line with the deposit rate (-50bp) if the bank has met either the lending benchmark on the special or the additional special reference period. In the case of meeting only the benchmark lending in the second reference period, banks see the TLTRO rate being tied to the average main refinancing rate adjusted for the lending development. In the case of banks not meeting any of the lending benchmarks, the TLTRO rate increases to be in line with the main refinancing rate (currently zero).

For tranches 8-10, banks that have met the lending benchmark by end-2021 will see the TLTRO rate move to the deposit rate (-50bp). For banks that did not meet this, a rate in line with the refinancing rate (currently at zero) is to be expected.

Banks that see their TLTRO interest rate hiked to be in line with the main refinancing rate, are more likely to pay back funds early. Instead, banks that continue to benefit from a rate in line with the deposit rate, are more likely to retain funds until maturity.

We expect to see a larger early repayment after the end of the additional special interest rate period in June 2022. This is also when the maturity of the bulk of the TLTRO-III funds, those drawn in June 2020, will turn shorter than a year and as such lose part of their NSFR recognition.

Potential ECB rate hikes would translate into higher TLTRO rates

While the ECB may keep the reference rates unchanged for the time being, rate hikes may be on the agenda in the second half of 2023. This will have consequences for the TLTRO programme as well with tranches 5-10 maturing during or after 2H23.

As the TLTRO interest rates are tied to the average reference rates during the life of the operation, a rate hike (or a rate cut) will be directly passed on to banks. Only in the case of the (additional) special interest rate period running until June 2022, has the ECB has confirmed that the rate can not be higher than -1% for those banks that meet the relevant lending requirements.

> *"A rate hike would increase also the TLTRO interest rates"*

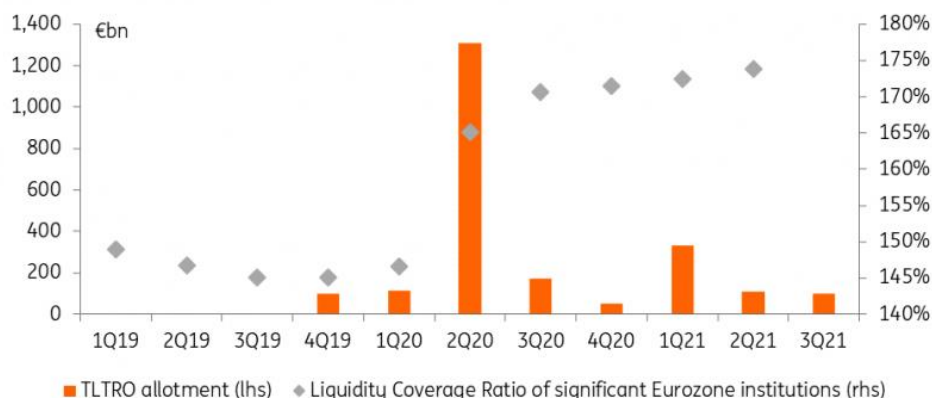
While a rate hike would not impact the most attractive TLTRO rate, this period ends in June 2022. After June 2022 any changes in both reference rates will directly reflect on the cost of the TLTRO for all banks.

The attractiveness of the TLTRO interest rates will always be benchmarked against the alternative, the price of issuing a bond. Bank bond yields have clearly recently risen, especially so for the covered bond segment, but also for preferred senior unsecured debt. This has resulted in the TLTRO rates being even more attractive than before. With the current bond yields, meeting one of the lending benchmarks would result in TLTRO funds looking more attractive than bond market funding. Furthermore, in the case of not meeting the lending benchmarks, the TLTRO rate may look attractive or at least break even due to the lengthy special interest rate periods.

An ECB rate hike is not likely to completely change this picture. Expectations for higher underlying rates also tend to push bank bond yields higher.

If the ECB did not want the expected rate hikes in 2023 to transform into higher TLTRO rates, it could change the terms by fixing the reference rates to be in line with the level during the allocation. It could also introduce another special interest rate period starting in June 2022, together with new tranches. Having said that, we consider that this would require the bank funding conditions to deteriorate considerably from the current levels, which is not currently our base case.

TLTRO drawings vs liquidity coverage ratio of significant eurozone institutions



We don't expect action to avoid a cliff edge effect…for now

With the current relatively strong recovery and inflation outlook accompanied by the benign bank funding markets, we see limited reasons for the ECB to extend the current TLTRO-III operation by adding new tranches. The last tranche of the current operation anyway extends until the end of 2024, offering some soothing for the central bank considering any cliff-edge effect of the operations. Furthermore, worrying about the end of the operation before the last tranche is even allocated, seems premature to us.

Banks can draw up to 55% of their eligible loans, as of February 2019 from the operations. We consider that banks have more or less used their maximum capacity to draw funds. Therefore, new tranches would only be substantially used if they were launched after the current operation matured, were paid back early or if the capacity of banks to draw funds was increased. Introducing new tranches to the TLTRO-III anytime soon, seems premature. This is especially so in the current environment with substantial uncertainty around the temporary nature of inflation. Additionally, in this context, we consider that it would be as difficult to find solid reasoning for easing the terms via increasing the drawing capacity of banks.

Interestingly the recent bank lending survey concludes that despite a lower take-up in the last TLTRO tranches, the large outstanding amounts of TLTRO funds continue to support banks' financial situation. This positive impact is expected to remain broadly similar over the next six months. This should act as a supporting argument for the ECB not to make changes in the current TLTRO programme anytime soon.

The Eurozone banks have utilised the TLTRO drawings to grant loans, but they have also gathered excess liquidity. The chart above shows that the liquidity position of the significant institutions in the Eurozone has improved hand in hand with the TLTRO drawings. This high liquidity is likely to support expectations that banks do not need to refinance all their TLTRO drawings.

"Due to the high liquidity, not all TLTRO funds have to be refinanced"

In addition, if the ECB does not extend the current TLTRO operation, we would not exclude the possibility of the ECB offering some support for the banking sector in the form of changes to the current tiering system. The tiering mechanism helps banks offset the impact of negative rates on their excess central bank reserves.

Leaving the TLTRO-III programme as it is, would translate into banks starting to refinance their TLTRO-III drawings in the course of next year. We would expect early repayments to peak in June 2022.

European banks: Let's talk bank resolution

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Next year will bring a wave of binding loss absorption requirements to make banks more crisis-proof. At the same time, a review of the industry's crisis management framework is also set to start

People enjoy a lunch break in the shadows cast by trees, with the office tower of European Banking Authority (EBA) at right and Commerzbank headquarters at left on background in Frankfurt am Main, Germany.

Drawing lessons from the financial crisis

One of the lessons that were learned from the financial crisis, that started 13 years ago, was that the banking sector has to have a better capacity to absorb losses when needed. In addition, it should be possible to put banks either in resolution, if there is a public interest to do so or wind them down, without causing wide-ranging havoc in the financial markets and the banking system.

The European **Crisis Management and Deposit Insurance (CMDI)** framework were created to set rules for handling failing banks while protecting depositors across the Union. The package is based on **the Bank Recovery and Resolution Directive (BRRD), Single Resolution Mechanism Regulation (SRMR)** and the **Deposit Guarantee Scheme Directive (DGSD)**. The framework is set to be reviewed with new proposals expected in 2022.

The Single Resolution Mechanism (SRM), including the **Single Resolution Board (SRB)** and national resolution authorities, were created to ensure an orderly resolution of banks that are failing or likely to fail while having a minimum impact on the real economy and public finances. Building sufficient loss-absorbing capacity allows banks to both absorb losses and also to be recapitalised in a resolution, in case of need. The **minimum requirements for own funds and eligible liabilities (MREL)** are set for banks for this purpose with the interim requirements to be met by 1 January 2022. Banks are well-positioned for the interim requirements and moving towards meeting their final targets for 2024.

The current resolution framework in short

The bank resolution framework provides tools that can be used before and at the point when a bank is considered to be failing or likely to fail. Measures that can be taken prior to this point include early intervention measures and preventive measures. Once a bank is considered to be failing or likely to fail, the bank can either be put into resolution or liquidated, depending on whether there is a public interest for a resolution of the bank.

Prior to any resolution action, the capital instruments of the bank have to be written down. As outlined in the BRRD, resolution tools include the sale of the business, the creation of a bridge institution, asset separation and the bail-in tools.

Effective bank resolution clearly requires resources, which is why banks are now required to build loss-absorbing capacity on top of their capital buffers. The target is that resolution financing arrangements can be accessed only after private resources have been tapped. For a contribution from the Single Resolution Fund, losses corresponding to 8% of the bank's total liabilities and own funds would first have to be borne by shareholders, holders of capital instruments and other eligible liabilities. In some circumstances, a **deposit guarantee scheme (DGS)** may be tapped to reach the required 8%. DGS intervention after a bail-in of liabilities is subject to the least-cost test, where the DGS contribution in resolution has to be less costly than reimbursing covered deposits in a payout event.

"The hierarchy of claims is based on national insolvency laws that may differ between countries"

The hierarchy of claims is based on national insolvency laws that may differ between countries. This hierarchy should also be respected in a resolution (no-creditor-worse-off principle). The regulatory capital instruments, CET1 capital, Additional Tier 1 capital and Tier 2 capital are the first to absorb losses. These would be followed by other subordinated items and non-preferred senior unsecured debt. This ranking is shared across countries.

What comes thereafter, differs between countries. While preferred senior unsecured debt, ranks straight after non-preferred senior unsecured across the Union, items ranking pari passu to preferred senior debt, vary. In most EU countries non-preferred deposits rank alongside preferred senior unsecured, such as in Belgium, France, Germany and the Netherlands, among others. Instead, some countries have introduced a depositor preference. For example, in Bulgaria, Croatia, Cyprus, Greece, Italy, Portugal and Slovenia non-preferred deposits, rank ahead of preferred senior debt in the hierarchy. This means that preferred senior debtholders may be on the hook for losses prior to all depositors in these countries in a resolution. In general EU countries have deposit ranking on three different levels, with covered deposits having the safest status followed by preferred deposits and non-preferred deposits.

"No-creditor-worse-off principle is a guiding principle in resolution"

Debtholders should not be worse off in resolution than in insolvency. This no-creditor-worse-off system is a guiding principle when it comes to the bail-in tool. While MREL requires banks to hold a minimum level of buffers that are bail-in-able, it is good to note that in resolution, the scope for a bail-in may be wider than the MREL buffers. The scope for a bail-in may extend to **all** liabilities, subject to the creditor hierarchy based on the national insolvency law unless the liabilities are **specifically excluded** from a bail-in. The BRRD excludes from a bail-in among others: covered deposits, secured liabilities such as covered bonds, client assets and liabilities with an original maturity that is shorter than 7 days.

For loss absorption, an item ranking alongside an excluded liability may pose problems with the no-creditor-worse-off principle. To this end, the amount of excluded liabilities should not be too high. The EBA has assessed that the mandatory exclusions from a bail-in for items ranking between non-preferred senior and non-preferred deposits, amount to 5.5% of the respective liability class, giving some insight into the matter. Items facing a mandatory exclusion from a bail-in would be slightly higher for large and small banks as compared with medium-sized banks.

Setting the resolution approach for complex banks

The Single Resolution Board (SRB) makes detailed plans for any potential future bank problems and draws resolution plans for larger, complex banks. These plans identify critical functions and any impediments to resolvability and present the preferred resolution strategy and tools. The aim is to ensure the continuity of these critical functions, avoid significant adverse effects on financial stability such as contagion, protecting public funds, covered depositors and client funds.

"MREL targets build on resolution plans"

The resolution approach differs between different banks. It can be based on a single or a multiple points of entry approach. The point of entry here refers to where in the bank's organisation, the resolution is in practice conducted. This depends especially on the bank's legal structure and perhaps on its geographical reach.

With a **single point of entry** the resolution is done via one entity, usually the parent entity of the bank. The parent entity may be an operating parent entity or a holding company. In this case, losses from any subsidiaries are transferred to the parent entity, and the parent entity's buffers (and investors) absorb losses when needed. In this case, external MREL resources are issued from the parent entity to third party investors. This is by far the most common approach for larger European banks.

The **multiple point of entry** approach is used for banks with complex structures that have substantial exposures via independently-run subsidiaries in several different countries. If one or some of the resolution entities run into trouble, only those entities may be put into resolution. In a multiple point of entry approach, external MREL resources are in practice gathered at all resolution entry points. This approach is used among others by certain global, Spanish and Austrian banks that exhibit a more complex structure with substantial independent subsidiaries.

Resolution authorities utilise resolution plans when setting MREL targets.

Logic behind MREL targets

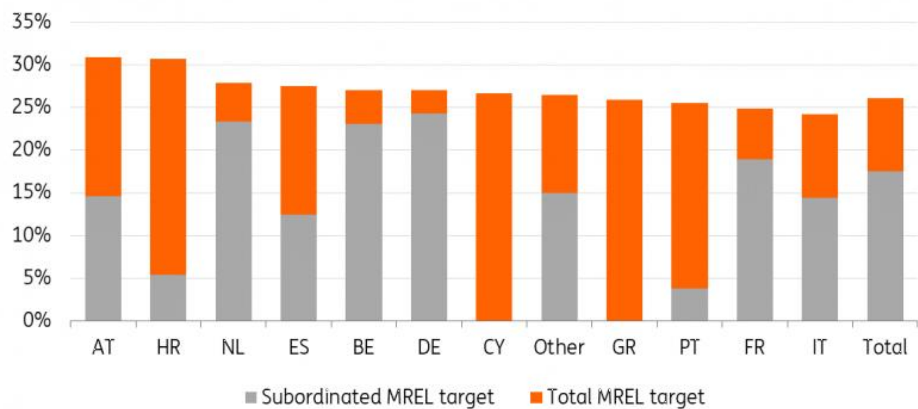
MREL requirements are designed to be set so that after the usage of the bail-in tool, the bank's capital position would be high enough to continue functioning with sufficient market confidence. The recapitalisation capacity should be in a format that is long enough and can be credibly written down or converted into equity as outlined in the CRR.

The SRB sets MREL requirements based on risk-weighted assets and against leverage exposure measures. They consist of a loss absorption amount (LAA) and a recapitalisation amount (RCA). The LAA and RCA are both based on the Pillar 1 (8%) and Pillar 2 requirements (bank-specific). The combined buffer requirement, that has to be met by CET1 capital, is added on top. The leverage-based LAA and RCA requirements are set in line with the leverage ratio requirement. The amounts can be adjusted, for example, either upwards by the SRB, to include a market confidence charge, or downwards to reflect a selected resolution strategy, such as using a transfer tool.

> *"MREL requirements are bank specific"*

So-called Pillar 1 banks include global systematic banks and other large banks that have assets above €100bn or that may pose a systemic risk. They have to meet a non-adjustable subordination requirement. Depending on the bank, the subordination requirement may be set at 8% of total liabilities and own funds (but the level will be capped at a maximum of 27% of RWA for top tier banks), based on RWA or based on LRE. Global systematic banks should meet subordination requirements of 18% of RWA (with a 3.5% exemption in certain cases) or 6.75% of LRE as of 1 January 2022. Other Pillar 1 banks should build subordination levels of 13.5% of RWA or 5% LRE. Non-Pillar 1 banks may face a subordination requirement to avoid a breach of the no-creditor-worse-off principle.

Total and subordinated MREL targets by country



Source: ING, SRB

Subordinated MREL requirements vary between countries

Subordination requirements can be met by own funds and eligible liabilities that are subordinated to all claims arising from excluded liabilities. G-SIBs may be allowed to utilise the 3.5% senior add-on for TLAC requirements.

The SRB has communicated to banks their MREL requirements in line with the BRRD2 framework. The interim requirements have to be met by 1 January 2022 and the full MREL requirements by 1 January 2024.

The average MREL targets by country are shown in the chart above. In addition to the differences in risk density, the size of the banks (ie, the number of the Pillar 1 banks) and the no-creditor-worse-off principle, also have an impact on setting the subordination requirements. Banks in Germany, Belgium and the Netherlands have to meet the highest subordinated MREL targets both as compared to RWA and as a proportion of their total MREL requirement. The subordinated requirement for these banks is clearly above 80% of their total requirement.

The lowest subordination requirements have been set for banks in Southern Europe. Banks in Greece and Cyprus are not subject to subordination targets. It is noteworthy that countries that have the lowest proportional subordination requirements of their total requirement include those countries that have also introduced a depositor preference.

€42bn Total MREL shortfall

MREL shortfalls are manageable for most banks

Banks have made substantial progress in building their MREL buffers in recent years. The stock of MREL eligible liabilities and own funds has increased to €2,208bn in 1Q21. The stock has increased by €118bn or 6% since 2019. The amount of subordinated MREL has increased by an even faster 8% since 2019, reflecting the action taken by banks to meet their interim MREL requirements by 2022.

Shortfalls of the interim targets as of 1 January 2022, were very small (€238m or €5.4bn including CBR) for the whole system and driven only by the subordinated component as of 1Q21.

Excluding the combined buffer requirement, the overall MREL shortfall was €23.6bn according to the SRB in 1Q21 when comparing the MREL capacity against the final MREL targets. Furthermore, including the combined buffer requirement, the total shortfall would increase to €42bn for the whole system.

"Banks especially in Greece, but also in Croatia, Cyprus and Portugal, have work to do in terms of MREL buildup"

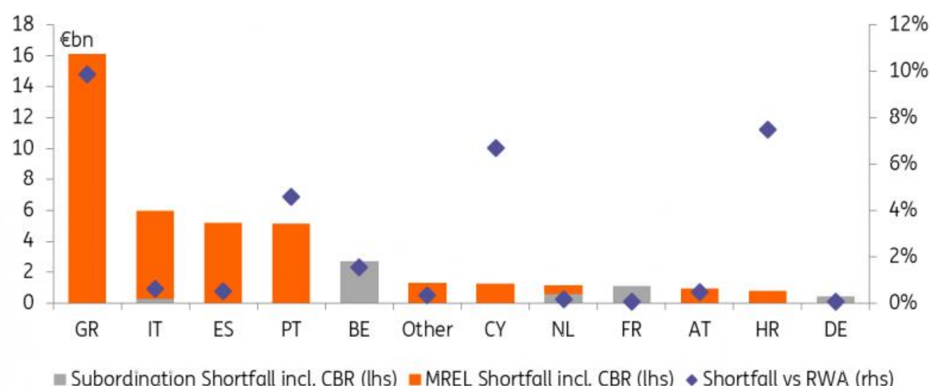
€16bn or 38% of the total shortfall is for Greek banks, corresponding to almost 10% against their RWA, as shown in the chart below. Greek banks have until the end of 2025 to meet the requirements. Following Greece, in Croatia, Cyprus and Portugal the MREL shortfalls are between 4-8% against RWA, meaning that banks in these countries also still have some work to do in terms of buildings their buffers. As banks with the largest gaps relative to RWA have on average lower issuer ratings, we consider a benign market sentiment is especially important for the further build-up of their MREL buffers.

The shortfall, excluding Greece, was €26bn, with the largest gaps in Italy, Spain and Portugal. The MREL shortfalls in Italy and Spain however are limited when comparing them to the total RWA. Banks in Germany, Austria, France and the Netherlands have very limited MREL shortfalls.

When including the combined buffer requirement, half of the resolution entities were listed by the SRB as reporting a shortfall against their MREL targets. Banks that have a shortfall especially include smaller entities with 72.4% of the total reported by non-Pillar 1 banks.

In our view, gathering MREL resources may take more time for some smaller entities. Some smaller banks may have traditionally relied more on CET1 capital in their capital structure and deposits in their funding mix. This could have resulted in these banks being less active in financial markets and investors not being familiar with the name. In addition, their smaller size may result in a smaller targeted issue, which means the bonds may not be included in the main bond indices and will therefore attract less attention from investors.

MREL shortfall by country as of 1Q21



Source: ING, SRB

Changes ahead in the resolution framework

The CMDI resolution framework currently guiding the treatment of bank failures may be subject to change, with the first notes set to be played in the course of 2022. The review aims to increase the framework's efficiency, proportionality, and overall coherence to manage bank crises in the EU, irrespective of the banks' size and business model, and to enhance the level of depositor protection according to the EBA. The European Commission launched a targeted consultation on the review of the CMDI framework in January 2021. A Commission proposal for the review is expected in the second half of 2022.

"A Commission proposal for the CMDI review is expected in the second half of 2022"

The Commission consulted on promoting further harmonisation of the creditor hierarchy in bank insolvency and in particular on depositor preference across the union. The CMDI framework does not provide harmonisation of the hierarchy of claims across the union, which means that in some member states, non-eligible deposits rank pari passu with ordinary unsecured claims, while in some other member states all deposits have a preferred status. Furthermore, the deposit guarantee schemes are national. The treatment of depositors beyond the deposit guarantee (€100k) and the functioning of national DGS, differ across countries. The consultation raises the question of whether the framework has managed to shield public funds from bank failures, especially in the case of smaller and mid-sized banks.

The EBA published its opinion on the review in October 2021. The report concentrates especially on the bank funding sources required to handle a bank failure in either a resolution or insolvency. The sources include having sufficient loss-absorbing instruments and access to resolution financing arrangements. In its report, the EBA analyses the implications of introducing a depositor preference across the Union. The analysis concentrates on 368 resolution entities and a total number of 862 bank institutions, covering 63%-74% of the EU domestic bank assets.

According to the EBA, 187 of the total 368 banks have a resolution strategy, while 181 have a liquidation strategy. The choice between the two is driven by the public interest assessment (PIA). The SRB revised its approach to the PIA in May 2021 to account for system-wide events, likely broadening the universe of banks facing a resolution instead of liquidation. A wider application of the PIA would, in practice, mean that a wider range of entities would need to raise MREL liabilities pushing up MREL supply.

The EBA compares the ability of banks to reach an 8% threshold to tap resolution financing arrangements with their buffers as of end-2019 and with the current hierarchy of claims. This baseline is then compared with introducing a depositor preference across the Union.

> *"An EBA study finds that 74% of banks have sufficient bail-in capacity to reach the 8% TLOF threshold without touching deposits"*

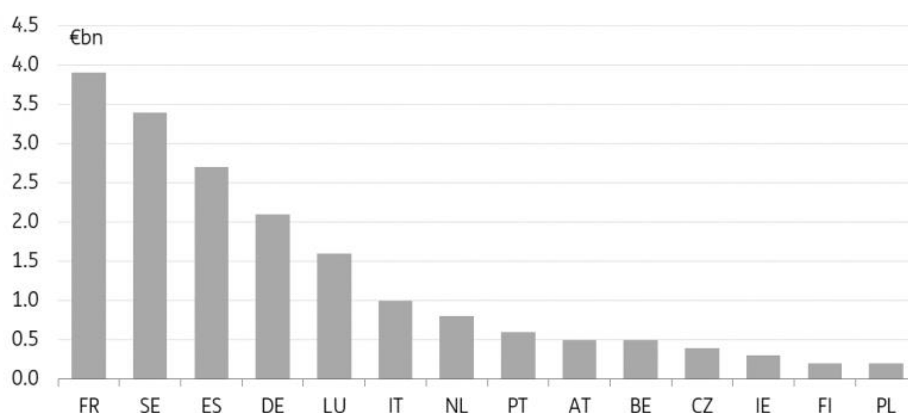
The study finds that 272 banks out of 368 would, in the current regulatory framework and non-stressed level of loss-absorbing capacity, have sufficient bail-in capacity to reach the 8% TLOF threshold that is required to access resolution financing arrangements, without touching any deposits. 96 banks would incur losses on some types of deposits, impacting €18bn of (mainly non-preferred) deposits. The chart below shows that the largest losses on deposits would be borne by banks in France, Sweden, Spain and Germany. Deposit losses would be borne especially by medium-sized banks that have a relatively high reliance on deposits as a funding source. The EBA data suggests that 74% of small banks have either a high or medium-high reliance on deposits. The ratio for medium-sized banks is 48% while for large banks it is only 27%.

Furthermore, of the 96 banks, 81 would see their non-preferred deposits being hit, while eight banks would need to bear losses on their preferred deposits as well. Two banks would see losses on all types of deposits (including covered deposits). Five banks would not meet the 8% threshold even if exposing all deposits, and interestingly of these, two were large banks.

The EBA also assesses the ability to tap DGS in the case of bank problems. Of the 91 banks that would need to share losses with deposits to meet the 8% threshold, only three could access a DGS and only two out of them could draw funds that would be sufficient to reach the 8% threshold.

In the case of a depletion of CET1 capital both for the combined buffer requirement and Pillar 2 requirement in the run-up to the resolution, there would be a change in the picture such that only 60 banks would meet the 8% threshold without exposing deposits. Only a 75% depletion of buffers would result in 122 banks reaching the threshold, while 198 banks would see deposits being hit. Also for the different CET1 depletion scenarios, the number of banks that could access a DGS and that could obtain an intervention to reach 8% TLOF is limited.

Burden sharing on deposits by country to reach 8% TLOF threshold



Source: ING, EBA

EBA examines how a depositor preference would change the picture

The EBA studies the impact of an introduction of a depositor preference that would change the creditor hierarchy. It would remove non-preferred deposits from the layer that also includes preferred senior unsecured, structured debt and derivatives. This layer would therefore become thinner in countries that have so far placed all these at the same level. This could be reflected as a higher loss given default for preferred senior unsecured in these countries, other things being equal, which should also be reflected as

higher cost of preferred senior funding for these banks. Depositor preference would aim to provide more protection for deposits as they would move up in the hierarchy of claims. The impact on each type of deposit would depend on the details of the deposit preference (single-tier, 2-tier or 3-tier approach).

> *"EBA notes that a deposit preference would increase the number of banks reaching the 8% TLOF threshold without jeopardising deposits"*

Assuming a deposit preference over other ordinary unsecured claims would according to the EBA significantly increase the number of institutions that could reach the 8% TLOF threshold without jeopardising deposits from 272 banks to 317 banks. The burden-sharing on deposits to reach the 8% TLOF threshold would decrease from €18.3bn to €6.4bn for all different deposit preference options. The EBA notes that here the loss exposure of covered deposits should be seen together with a potential for more extensive usage of DGS funding in resolution. The number of banks that could access a DGS would increase to 41 banks, assuming a single-tier deposit preference. This would result in a maximum amount of available DGS funds across the different deposit preference options due to the highest-burden on covered deposits, the main driver for the DGS contribution.

According to the EBA, the analysis is very sensitive to the recovery rate assumption, with lower recovery leading to a higher DGS usage frequency. The EBA notes that banks that would not obtain a high enough contribution from a DGS are concentrated in one member state. More frequent involvement of DGS would however result in higher costs for the industry and clients according to the EBA, because of the required payment of contributions needed to increase the DGS back to the targeted level. In general, the number of banks accessing DGS would potentially be higher with a single-tier depositor preference than with a three-tier depositor preference.

Conclusion

2022 will see advances in making European banks more crisis-proof. In the second half of 2022, the European Commission is expected to publish the proposal for the review of the crisis management framework. Bank resolution planning and the MREL, builds on this framework.

According to the EBA analysis, an introduction of a depositor preference would increase the number of banks that could reach the 8% threshold to access resolution financing without putting deposits at risk, compared with the current system. As depositor preference is not currently in use in most EU countries, the change could potentially result in a higher cost of issuing preferred senior unsecured debt for many banks, while the status of deposits could become safer. It is possible that an introduction of a depositor preference system could also have a lower impact on subordinated MREL requirements, as seems to be the case for Southern European banks. In the longer term, this could even result in some shift between non-preferred senior and preferred senior issuance for the MREL.

If the review resulted in a larger set of banks being put under the resolution umbrella, further smaller entities would be required to build MREL buffers. Broader access to DGS funds could instead potentially result in less public-sector involvement, but might also result in a higher burden for the banking sector, in the form of higher contributions to the system.

In addition to the potential proposal for the CMDI review, in 2022 banks also face the first extensive wave of binding loss absorption requirements in the form of interim MREL requirements, which begin in January. The final requirements will be binding in 2024. Banks are well-positioned to meet the 2022 interim requirements but are expected to have a €42bn shortfall for the final targets for 2024.

On a country level, we consider that Greek banks especially lag behind in terms of building loss-absorption buffers. While Greek banks have a longer time to meet the requirements, the shortfall is substantial for the sector and meeting the targets, is in our view, highly reliant on the market prospects remaining supportive.

Digital regulation - information overload

As if banks don't have enough to worry about, the European digital regulatory calendar is packed with initiatives that will have a profound effect on the banking business model in the near future.

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A digital Chinese yuan (e-CNY) payment card used at the first China International Consumer Products Expo earlier this year

The reconfiguration of finance leads to a host of regulatory responses

Neobanks and fintech players specialising in one or a few specific services are disrupting banking markets one by one. Prominent examples include services around payments, buy-now-pay-later, or working capital finance. Big-techs are integrating payments into their platforms, and more banking services look set to follow. Cryptocurrencies and "decentralised finance" (DeFi) are a pressure cooker laboratory for new configurations of financial services. While we do not believe that financial intermediaries will become superfluous in crypto- and DeFi-land, nor in a big tech-dominated landscape, we do think they will have to fundamentally re-think their roles and business models.

> *"Banks will have to fundamentally re-think their business models"*

Rapid changes in digital markets have also invited a flurry of regulatory initiatives coming from Brussels. We are not going to discuss the regulation on cybersecurity and operational resilience in this report today; important regulatory initiatives here are the revised Directive on Security of Network and Information Systems, "NIS2", and the Regulation on Digital Operational Resilience Act for the financial sector, "DORA". The digital themes we want to focus on in this article are data portability and digital identity, the crypto universe and the digital euro. What these themes have in common is that they, each in their own ways, put the traditional banking business model under pressure. The challenge for banks is to focus not on the threats but on the opportunities posed by these (regulatory) changes.

1 Data portability and digital identity

By now, banks have become used to sharing account and payment data under the second Payment Services Directive ("PSD2"). Under this scheme, users can opt to "port" their payments data to third party providers, have those parties review their account data, or initiate payment on their behalf (as such, financial data portability under PSD2 is enhanced over the generic data portability enforced by the General Data Protection Regulation GDPR). A few years after PSD2 came into force in all countries, the European Banking Authority's register today shows 178 Payment Initiation and 286 Account Information Service Provider licenses active in the EU. These are companies with dedicated licenses. In addition, banks may offer these services within the remit of their banking license.

The availability of services built on PSD2 data portability and their uptake among consumers may have developed less quickly than some had hoped. Yet the live payments data portability enabled by PSD2 has created a more-or-less standardised, API-based data exchange infrastructure among banks and third parties service providers.

The European Commission is working on multiple data-related initiatives, including AI regulation, a review of PSD2 and a Data Act. Furthermore, the Digital Markets Act ("DMA") seeks to regulate so-called gatekeeper platforms (in practice, the big techs). The DMA also includes enhanced data portability stipulations.

"Over the coming years, banks may have to open up more of their data"

To summarise these multiple data-related regulatory initiatives, over the coming years banks will likely have to open up more of their data for real-time portability. At the same time, they may also find themselves on the receiving end of more real-time ported data. Banks that are willing and able to use that data to improve their services will be at an advantage compared to their peer banks. They will be better able to compete with non-bank fintech and big tech providers of banking services. At the same time, they are a more attractive potential partner to those very same non-bank providers. Thus banks face important questions about their data capabilities, and about how they want to put data to work in their organisation. Banks will also need to carefully consider how to reconcile any data ambitions with their role as trusted custodians of money and sensitive financial data.

"Banks face important questions about their data capabilities"

In this regard, another regulatory initiative deserves mention: the proposal to establish a European digital identity framework. The aim is to create a digital identity wallet for citizens, which holds their digital identity papers and other attributes. These can then be shared on an as-needed basis with digital services providers across the EU. As such, the wallet should become the single access key to digital markets. Given all the sensitivity and importance around this, developing digital identity solutions is likely going to be a public-private partnership. Banks are well-positioned to participate in such partnerships, given the extensive knowledge and documentation they tend to have on their clients. In any case, the regulatory initiatives around digital identity and data will in the coming years provide opportunities for those who see them and are able to reap them, while posing threats to those unable to follow.

2 Crypto and Decentralised Finance

Another area with rapid developments is the crypto-universe. No doubt helped by persistently low interest rates and high stock market valuations, interest for crypto assets among clients (both retail and wholesale) has increased over the past two years. Moreover, "decentralised finance" (DeFi) has rapidly become more popular.

"With Bitcoin, the middle man has not disappeared, he just changed roles"

Where the original aim of Bitcoin was to take out the middle man in payments, the aim of DeFi is to take out the middle man in other financial services, starting with saving, investing and borrowing. Yet with Bitcoin, things have turned out differently so far. The middle man has not disappeared, he just changed roles. Where in traditional payments, money is held in bank accounts and transferred between them via various methods, the crypto-universe saw the emergence of wallet providers and exchanges. In principle, it is possible to use cryptocurrency for payments without an intermediary. Yet in practice, many people, for now, choose to use an intermediary after all, for security or ease of use.

"The majority of people may prefer to rely on a trusted intermediary"

We expect similar developments in DeFi. In principle, it may be possible to use decentralised platforms to invest or borrow without the intervention of an intermediary. But the number of people willing to spend the time to do their own research, for example, vetting borrowers, and with the ability to, for instance. review smart contract code for bugs or scams, is likely limited. The majority of people may prefer to rely on a trusted intermediary to do the vetting for them. Roles of intermediaries may include offering credit assessment, contract code verification, curated portfolios, risk hedging and other aspects of asset management. Intermediaries may also help individual or corporate borrowers to obtain the best rate and conditions on DeFi markets.

"Regulation and supervision are inherently built around entities"

From a regulatory perspective, a key issue is that regulation and supervision is inherently built around entities. Licenses are handed out to registered businesses, and supervision relies on registered businesses that can be supervised, visited, fined or sued when in non-compliance. An open-source DeFi platform, not owned by a particular business or person, and run on a decentralised blockchain, does not fit such an entity-based approach; it cannot be licensed, fined or shut down without going after each individual user running the software.

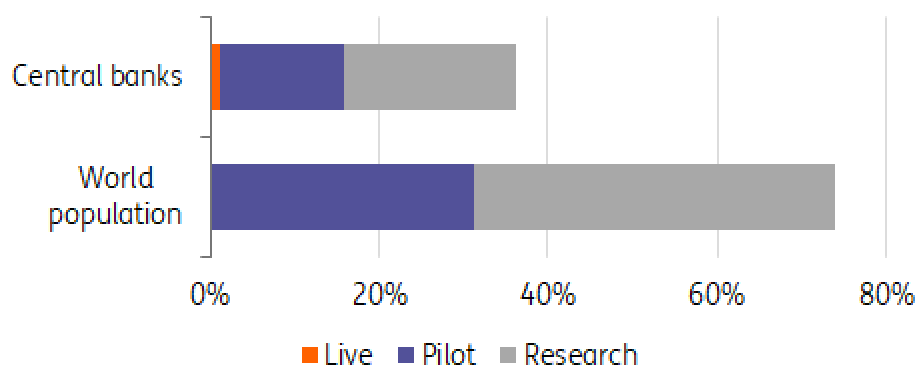
While this is a fundamental problem yet to be resolved, it is not a problem for banks – or other intermediaries, wishing to become active in crypto or DeFi. Entity-based supervision works perfectly well for them. Indeed European policymakers are negotiating the "Markets in Crypto Assets" regulation ("MiCAR"), while the Basel Committee is considering the prudential treatment of crypto-assets on bank balance sheets. Getting further clarity on regulatory requirements, be they from a consumer protection, market integrity or prudential perspective, is a key prerequisite for regulated financial institutions to take further steps in the crypto- and DeFi-space.

3 Central bank digital currency: the digital euro

The third thing we want to discuss here is the digital euro, the Eurosystem's version of a retail-oriented central bank digital currency (CBDC). Only three or four years ago, CBDC was a niche topic, with most central banks only sniffing the idea from tech and abstract scholarly perspectives. That all changed when Facebook announced its Libra plans in 2019, and central banks subsequently realised that the Chinese central bank was already far advanced in developing its CBDC called DC/EP. Today, 36% of the world's central banks, covering 74% of their population, is looking into CBDC.

Who is looking into CBDCs?

% of world central banks, respective of global population



Source: BIS

The main motivations for considering CBDCs in Europe appear to be to avert threats to "monetary sovereignty". In concrete terms, policymakers want to prevent big tech-issued and non-euro-denominated stablecoins from taking over the role of the euro in daily life, as that would impair the central bank's ability to steer the economy with its monetary policy. Issuing their own stablecoins would also help big techs in building closed ecosystems ("walled gardens"). Yet policymakers are trying to open up such ecosystems, for example by enhanced data portability (Digital Markets Act, Data Act). They'd rather see a common, publicly issued digital euro than a few dominant platform-bound stablecoins.

Moreover, currencies and their infrastructures are seen as a tool in geostrategic positioning. The dollar is currently the uncontested 'number one' for trade and global financial markets. But an internationally available, easy to use and safe CBDC infrastructure could give other currencies an edge.

CBDC worries: balance sheet disintermediation

For banks, a retail-oriented CBDC, like the digital euro is shaping up to be, has implications both from a balance sheet and client perspective. As for the former, the availability of CBDC likely implies both a structural drain on retail payment accounts as well as more volatility, especially in recession and crisis times. Worrying about bank funding may seem superfluous in today's world of abundant TLTROs but those will one day disappear.

> *"Central banks may have to enhance existing backstop funding facilities"*

The digital euro is a long term project; banks will need to adjust their funding plans accordingly. The impact on bank balance sheets might be limited if the digital euro were to be a means of payment only, not a store of value, as the Eurosystem emphasises. Yet that is a big 'if'. Caps on CBDC transactions and/or holdings are often mentioned as a way to restrict CBDC usage. Yet political pressure could develop over time to lift such seemingly arbitrary caps.

Moreover, CBDC use by businesses (such as retailers) and cross-border/cross-currency transactions are hard to square with caps. To cushion increased bank deposit volatility, central banks may have to enhance existing backstop funding facilities (such as the ECB's marginal lending facility). In more far-reaching scenarios, permanent longer-term funding facilities may even be considered.

CBDC worries: client and data disintermediation

Apart from the funding aspect, CBDC means that competition for the (retail) client will intensify. Traditionally in many markets, the payment account has been the primary contact point for banks to engage with their clients. Competition in payments has been intensifying over the past years, and this will continue in the near future. Banks, neo-banks, fintechs and big-tech would all like to be the first brand the customer encounters and be at the epicentre of client interaction.

The data generated by this interaction is a valuable source of information. This ties into banks' responses to data portability and digital identity regulatory initiatives discussed above. A digital euro would be a new opportunity for non-banks to develop account/wallet management and payment services and thus compete with more traditional financial institutions.

The motivators for a digital euro

Monetary sovereignty and geostrategic autonomy are clear motivations for a digital euro. From a more narrow end-user perspective, the gains of a digital euro are less clear.

"The gains of a digital euro are less clear"

Digital means of payment are readily available today, though acceptance and use vary across the EU. That said, banks better follow discussions closely in the coming two years, during the ECB's "investigation phase". The European Commission is due to adopt a regulation in early 2023, setting out key design features. Crucial decisions are, therefore, being made in the coming 18 months, and this is also the phase determining whether the digital euro will turn out useful for banks or will instead be primarily weakening them vis-à-vis big techs incorporating the digital euro seamlessly into their ecosystems.

Fundamental questions to be considered

The three themes discussed here, data, crypto and CBDC, show how the regulatory and institutional framework is a key factor shaping banks' perspectives. Although the regulatory initiatives described will take time to be concluded and implemented, banks would do better to prepare and be ready for them. Several of the issues raise fundamental questions about the bank business model: what role for data in banking? What role for financial intermediation when decentralised financial services take hold? And even: what role for the bank balance sheet, for money creation in a world of CBDC and non-bank issued stablecoins?

These will not be issues that separate the winners from the laggards already over the coming year. Yet these are defining questions that will shape banking over the next decade.

Banks take up gauntlet against climate risks

Reducing exposure to ESG risks and identifying and improving the taxonomy compliance of balance sheets will remain a high priority for banks in 2022, particularly as developments here could increasingly start to impact funding costs

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Benches That Once Provided a Marvellous Sea View Vantage Point Have Succumbed to the Rapidly Rising Water Level on the Island of Hallig Hooge Off the Northern German Coast

Moving forward from E to S and G

The European banking sector will continue to have its work cut out next year as it strives to meet the sustainability disclosure requirements set by European law. These disclosures will give market participants more insight into the environmental and social efforts made by banks. The 'E' in ESG, in particular, will remain in the spotlight, as banks take their first steps towards reporting on the taxonomy compliance of their balance sheets. The supervisory climate stress test, to be conducted by the European Central Bank for individual banks in 2022, will give further information on the climate risks that European banks may be exposed to.

> *"Proposals on an extension of the taxonomy are looming"*

Meanwhile, regulatory and supervisory developments will continue to move forward at full speed, providing banks with new opportunities and challenges. While the technical screening criteria for the remaining four of the taxonomy's six environmental objectives have yet to be established, new proposals by the European Commission on an extension of the taxonomy are looming. These will ultimately give banks further guidance on how to inform market participants about their efforts to transition away from environmentally harmful activities, and instruction on social and corporate governance. However, these developments will also likely give rise to new reporting challenges, while banks are already struggling to prepare for disclosure requirements related to the current environmental taxonomy.

We believe that showing a commitment towards meeting ambitious ESG objectives will remain crucial for the banking sector from a reputational point of view, but also increasingly from a funding costs perspective.

1 Banks will take the first step towards reporting green asset ratios

As part of their non-financial disclosure requirements, European banks will have to publish a number of key performance indicators (KPI) giving insight into the environmental sustainability of their business operations. The most important KPI is the green asset ratio (GAR). This ratio measures the share of the credit institution's taxonomy-aligned balance sheet exposure versus its total covered balance sheet exposure, which will initially exclude exposure to central governments, central banks and supranational issuers.

The key performance indicators measuring the taxonomy alignment of the banks will not have to be disclosed until 1 January 2024. However, from 1 January 2022 onwards, banks will have to start disclosing their exposure to taxonomy-eligible and taxonomy-non-eligible economic activities. Reporting a large proportion of taxonomy-eligible exposure means that the credit institution will have a broader base of exposure from which to measure its taxonomy alignment later on. As such, this could be seen as supportive towards the institution's future green asset ratio disclosures.

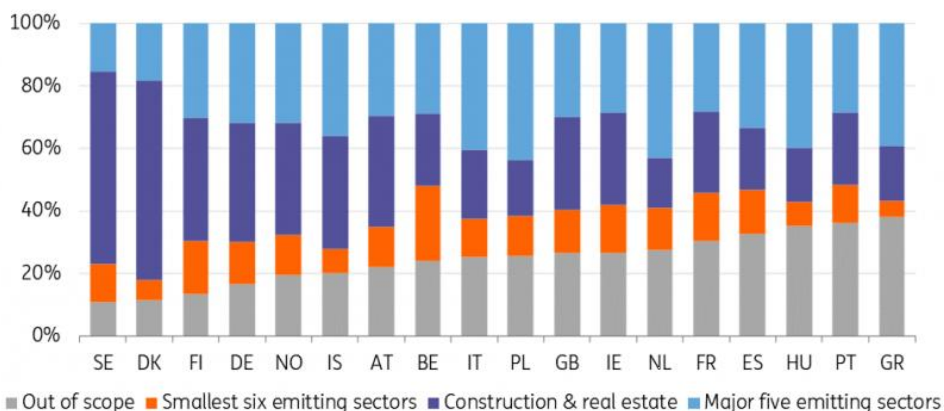
"Being taxonomy-eligible is not the same thing as being taxonomy-aligned"

Taxonomy-eligible are activities which have been specified in the European Commission's climate delegated act as most important in making a substantial contribution to the climate change mitigation and climate change adaptation objectives. The climate delegated act will be complemented by the environmental delegated act, setting the criteria for the other four environmental objectives over the course of next year.

Taxonomy-aligned are activities which not only make a substantial contribution to one of the taxonomy's six environmental objectives, i.e. that meet the technical screening criteria defined by the delegated acts, but also do no significant harm to any of the other five environmental objectives, while complying with the minimum safeguards.

As an indication, in our report "Green asset ratios – What's in store for banks?" we estimated that roughly 25% of the European banking sector's loans and advances to non-financial corporations would not be taxonomy-eligible, as this exposure represents level 1 NACE activity which is not covered by the climate delegated act. Nordic banks would, on average, likely have the highest corporate loan exposure to taxonomy-eligible activity. In the report, we also found that Nordic banks tend to be less exposed to the more polluting activities covered by the climate delegated act, which will likely support their future green asset ratio disclosures.

Nordic banks have least exposure to corporate sectors that are out of the taxonomy scope



Source: EBA (Transparency Data 1H 2020), ING

2 Disclosing meaningful taxonomy KPIs will take time

While at first, banks only have to disclose the proportion of taxonomy-eligible activities, some may already wish to publish preliminary green asset ratio estimates as a means of informing investors who are in the process of preparing their own taxonomy-related disclosures. These taxonomy-alignment indications will probably not be very high.

"The EBA estimates that the aggregated green asset ratio for EU banks is only 7.9%"

The EBA estimated earlier this year that the EU aggregated green asset ratio at this point would be as low as 7.9%. The European Central Bank recently came to a similar conclusion for the taxonomy alignment of European bond and equity market exposure. The central bank projects that only 1.3% of EU bond and equity markets are now financing activities aligned with the taxonomy for the objective of climate change mitigation, whereas around 15% of the market currently finances eligible activities.

Low taxonomy compliance numbers are not yet a realistic measure of environmental performance. An important reason is that banks are still in the process of obtaining all the required information allowing them to identify assets on their balance sheet that are taxonomy compliant. Besides, even within the group of activities that are covered by the climate delegated act some level of exposure may not initially count towards the green asset ratio. This includes, for instance, exposure to non-EU companies and SMEs, which for data availability reasons will probably be recognised in the numerator of the GAR only at a later stage as of 2025, subject to an impact assessment.

Coverage limitations, data availability and cautiousness on the side of the banks when reporting green asset ratios are reasons why it will possibly take a number of years before banks are able to report meaningful green asset ratios that properly reflect the environmental sustainability of their balance sheets. Meanwhile, the potential expansion of the taxonomy regulation will likely present banks with new disclosure challenges and/or opportunities in the years to come.

SFDR disclosures promote taxonomy compliance

The sustainable finance disclosures regulation (SFDR) requires financial market participants, such as asset managers or banks providing portfolio management services, to disclose whether their products (a) promote environmental or social characteristics (Article 8 products), (b) invest in an economic activity that contributes to an environmental or social objective (Article 9 products), or have neither one of these two purposes (Article 6 products). The EU taxonomy regulation introduced additional transparency requirements under the SFDR on the taxonomy alignment of Article 6, 8 and 9 products. While the SFDR's level 1 disclosure provisions have already been applicable since 10 March 2021, the level 2 regulatory technical standards (RTS), including those on the taxonomy related disclosures, will likely become applicable per 1 July 2022, once adopted by the European Commission.

These disclosure requirements will make investors more demanding towards issuers regarding the information offered on the taxonomy compliance of their activities.

This also may have consequences for the (bond market) funding costs of financial and non-financial corporations. Bonds that are 100% taxonomy compliant will likely see the best investor demand, particularly if they are sold as EU green bonds under the future EU green bond regulation. Sustainable bonds that are not fully taxonomy compliant will also count towards the taxonomy KPIs of investors for the part that they do finance taxonomy compliant activities. The same holds for vanilla bonds, which will be able to count as taxonomy-aligned to the extent that the entity issuing the bonds is taxonomy compliant as disclosed under the NFRD. This alone will already form an incentive for banks to report solid green asset ratios.

3 Expanding the taxonomy: setting standards for environmentally harmful and social activities

By the end of this year, the European Commission will publish a report on the extension of the scope of the taxonomy regulation by:

- Economic activities that do not have a significant impact on environmental sustainability (NSI);
- Economic activities that significantly harm environmental sustainability (SH);
- Other sustainability objectives, such as social objectives.

In preparing its advice to the European Commission, the EU Platform on Sustainable Finance (PSF) presented two draft consultation reports on 12 July 2021, one discussing the ideas on a social taxonomy, and the other one discussing the possible extension of the taxonomy by activities significantly harmful to environmental sustainability and activities with no significant impact on environmental sustainability.

Significantly harmful versus no significant impact activities

An expansion of the taxonomy for significantly harmful and no significant impact activities will, in the opinion of the platform on sustainable finance, help improve clarity in financial markets regarding different environmental performance levels and different levels on environmental impact. As such, it will make efforts made by banks to support the transition of certain activities from a significant harm performance level to an immediate performance level (intermediate transition) more transparent. Under current regulation, only improvements towards the significant contribution level (green transition) show up in the form of higher green asset ratio disclosures.

The PSF proposals for integrating SH and NSI activities into the green taxonomy

The platform of sustainable finance proposes extending the current green taxonomy for activities that significantly harm (SH) environmental sustainability and economic activities that do not have a significant impact (NSI), by means of a matrix structure.

The rows in this structure represent three levels of the environmental performance of economic activity by means of a traffic light system:

- **Significant contribution (SC) performance** level (**green**): activities that meet the technical screening criteria for significant contribution to an environmental objective.
- **Intermediate performance** level (**yellow**): activities with environmental performance levels between the technical screening criteria for significant contribution and the do no significant harm level.
- **Significant harm (SH) performance** level (**red**): activities that do significant harm to the environmental objective and perform below the threshold set in the technical screening criteria for do no significant harm.

The columns in the matrix represent all activities in the real economy organised in four different boxes:

- Box 1: **activities excluded from the green taxonomy** as they are significantly harmful to one or more of the six environmental objectives, and are unable by their nature to transition.
- Box 2: **prioritised activities under the climate delegated act** for the climate change mitigation and climate change adaptation objectives of the green taxonomy.
- Box 3: **activities** to be included in the yet to be developed **environmental delegated act** for the other four environmental objectives identified in the green taxonomy.
- Box 4: **activities** that might be **classified as not having a significant impact** (NSI).

The platform on sustainable finance would prioritise the extension of the taxonomy regulation towards significantly harmful activities and recommends a rapid phasing in of an extended SH taxonomy, aiming at a first reporting by 2023.

However, the concept of a 'valid transition' away from the significant harm category would still stand or fall with the criteria to be defined to identify significantly harmful activities. The platform on sustainable finance proposes making the do no significant harm criteria fit for purpose to act as significant harm criteria. This could mean that based upon the criteria for doing no significant harm to the climate change mitigation objective, construction and real estate economic activities would then potentially be considered significantly harmful in the following cases:

- Buildings dedicated to the extraction, storage, transport or manufacture of fossil fuels;
- Buildings built before 31 December 2020 that are in the energy performance class (EPC) of D or lower, or as an alternative are not within the top 30% of the national or regional building stock expressed as operational primary energy demand (PED).
- Buildings built after 31 December 2020 and newly constructed buildings for which the primary energy demand (PED) setting out the energy performance of the building fails to meet the threshold set for nearly zero-energy buildings.

"Reshaping do no significant harm provisions as criteria for significantly harmful activities may not always be easy"

Any improvement in the energy performance of a building from a G to D category would, in this case, not be seen as a valid transition as the building would still remain in the significant harmful space. Alternatively, setting the cut-off towards the intermediate performance level at 30% best in class, would leave quite a substantial part of the building stock being classified as significantly harmful. The 30% is also a fixed percentage, meaning that a transition of one building to the top 30% will in parallel see another building migrate to the 70% worst performing category. This shows that making the DNSH criteria fit for purpose to act as SH criteria may not always be simple.

Social taxonomy has the purpose of directing capital to socially sustainable activities

Shaping a social taxonomy, including the related technical screening criteria and do no significant harm provisions, will also be high on the agenda of regulators in the coming year. However, key to the impact of the social taxonomy will be how it is integrated within the environmental taxonomy. The platform on sustainable finance discusses the implications of two options in more detail. Both take a separate social and environmental taxonomy as the basis, with governance safeguards binding to both taxonomies.

"Taxonomy compliance will be impacted by the way the social taxonomy is introduced next to the environmental taxonomy"

The link between the social and environmental criteria can then be introduced in different ways. 1. Environmental minimum safeguards can be added to the social taxonomy comparable to the minimum social safeguards complementing the environmental taxonomy. 2. Environmental and/or socially-sustainable activities would have to meet all the relevant environmental and social do no significant harm criteria (leaving no need for separate minimum safeguards). In both situations, companies would report separately on their social and environmental taxonomy alignment. However, the platform on sustainable finance recognises that the second option would probably leave fewer

activities compliant with the social or environmental taxonomy as they would have to meet the complete set of do no significant harm criteria for both social and environmental objectives. Such an approach could therefore result in lower reported KPIs on taxonomy alignment, and fewer assets being linked to taxonomy compliant activities for the purpose of sustainable bond issuance.

The potential dimensions to a social taxonomy

Where it comes to the development of a social taxonomy, the platform on sustainable finance proposes a two dimensional approach. The **vertical objectives** will focus on improving a) the accessibility of products and services for basic human needs (e.g. water, food, housing, healthcare or education) and b) the accessibility to basic economic infrastructure (e.g. transport, telecommunication, electricity, financial inclusion or waste management). The **horizontal objectives** will focus more on the entity level processes promoting positive impacts and avoiding negative impacts on affected stakeholder groups, for instance by a) ensuring decent work (impact on workers), b) promoting consumer interests (impact on consumers) and c) enabling inclusive and sustainable communities (impact on communities). **Governance** will be addressed separately, as a distinct pillar to a social and environmental taxonomy, and covers a) good sustainable corporate governance and b) transparent and economic tax planning.

4 Climate stress testing to support a greening of bank balance sheets

The economy-wide climate stress test results, published by the ECB in September, mark the beginning of the central bank's roadmap towards a climate stress-testing framework. This stress test will be followed by a separate supervisory climate stress test for individual banks in 2022, which should form the basis of an introduction to more regular climate stress-testing of banks in 2023-2024. The ECB sees climate change as a major source of systemic risk, particularly for banks that are highly exposed to economic sectors and/or geographical areas facing high physical or transition risk. Physical risks, such as wildfires in particular, are seen as the most important risk to banks if no action is taken. The central bank anticipates southern European countries will suffer the most from wildfires as a consequence of climate change, exposing the banks located in these countries to high physical risk if climate change is not mitigated. We believe the ECB's climate stress testing framework will form an increasingly important additional incentive for banks to green their balance sheets in the years to come, particularly once these climate risks also become clearer on an entity level.

"The ECB's climate roadmap will support a further greening of bank balance sheets"

The development of the climate stress testing framework for banks is just one of the ambitions the ECB has set in its climate roadmap for the coming years. By mid-2022, the central bank also intends to complete a review of its collateral valuation and risk control framework for climate change risks. The ECB is contemplating the introduction of disclosure requirements for private sector assets as a new diversifying eligibility criterion to the collateral and asset purchase treatment of these assets. These requirements are expected to become applicable in 2024 and will take into account the EU regulatory disclosure initiatives. The plans may encompass the first steps towards a more favourable haircut treatment and a stronger asset purchase focus for assets that, based on the sustainability key performance indicators (KPIs) to be disclosed, are considered to have lower climate risks. The changes to be made to the collateral framework could, in our view, contribute to a shift in demand from banks towards debt instruments less exposed to climate risks.

5 Draft Basel-III reform proposals recognise the urgency of climate risks

That the recognition of ESG risks continues to gain firmer footing in bank regulation was also underscored by the draft Basel-III reform proposals published on 27 October 2021.

CRR Article 449a already requires large institutions with securities traded on a regulated EU market to disclose, as of June 2022, information on ESG risks, including physical risks and transition risks. The European Commission's amendment proposals to the CRR now suggest expanding this requirement to institutions in general, including non-complex institutions, with an annual reporting obligation for non-complex institutions and a semi-annual one for the other institutions. The draft Basel-III reform proposals also introduce harmonised definitions on different types of ESG risk, such as environmental risks, physical risks, transition risks, social risks and governance risks.

"By June 2023, the EBA will advise on a differentiating risk weight treatment for high climate risk exposures"

However, the most important ESG takeaway from the draft Basel-III reform proposals is, in our view, the suggestion to bring forward by two years the EBA's mandate to assess the justification for a dedicated prudential treatment of assets exposed to ESG risks. The EBA has to formulate an opinion by 28 June 2023 on whether, for instance, assets with particularly high exposure to climate risk, such as assets in the fossil fuel sector and high climate impact sectors, should be subjected to a different risk weight treatment. The potential future introduction of a less favourable risk weight treatment for exposure to more polluting sectors may at some point form a further incentive for banks to reduce this exposure or to attach a different price to them.

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