

Bank Outlook 2025

Clearing the fog: bank risks and market shifts



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Bank Outlook 2025

Clearing the fog: bank risks and market shifts

Our comprehensive look at the challenges and opportunities facing financial institutions next year

Executive summary

How preferred is preferred senior?

The upcoming revisions to the CMDI framework and the CRR amendments from 1 January 2025 are on balance a negative for preferred senior unsecured bonds. While we recognise the challenges posed by these revisions in terms of bail-in risk, ratings, and potentially risk weights, we believe that the current spread levels for preferred senior unsecured bonds are already broadly pricing in these risks.

Keeping an eye on private markets' not so private vulnerabilities

NBFIs are under increased scrutiny due to the sector's growth. Private markets, in particular, are drawing significant interest because they lack transparency, have strong connections with the broader financial sector, and benefit from light regulatory oversight. We have identified five vulnerabilities within the sector. As a result, we believe that stress in this sector could spill over to banks, primarily through indirect channels. This makes it a sector worth monitoring closely in 2025.

ECB rate cuts will benefit bank loan quality

The strong tailwind from higher interest rates has come to an end. We believe that banks focusing more on fee-based income rather than solely on net interest income, and those with potential for mergers and acquisitions, are better positioned for 2025. This includes banks in Germany, Italy, Spain, and France, although French banks may face more challenges due to sovereign concerns.

The ECB rate cuts should ease some pressure on the loan quality side next year. While we consider names with a mix of higher NPEs and lower coverage more at risk of further weakness, names with higher NPEs will also benefit from the ECB's easing measures. This should be helpful for banks with particularly high cyclical exposures such as real estate. We expect credit costs in 2025 to remain elevated but fall below the levels seen in 2024.

From peaks to plateau: EUR bank bond supply in 2025

EUR bank bond supply remained high in 2024 and is expected to reach €420bn. We expect the market to remain active in 2025 despite falling behind the 2024 total with a full-year supply of €400bn. The end of the TLTRO repayments will negatively impact bank bond supply while lending growth is not expected to become a firm driver of next year's supply. However, the significant amount of redemption across the liability structure will push banks to remain active in refinancing the majority of maturing instruments.

Less sustainable issuance by banks

Against the backdrop of overall lower issuance volumes, banks are expected to reduce their issuance in sustainable format next year to €70bn. With lending growth improving only gradually, sustainable loan portfolios will grow modestly next year. 2025 is also the first year that issuers can opt to issue their green bonds under the EU Green Bond Standard. Considering the low first green asset ratio (GAR) disclosures by banks this year, we doubt we will see a lot of bank bond supply under this standard.

How preferred is preferred senior?

Potential revisions to the CMDI framework in the longer term and the CRR amendments effective from 1 January 2025 are generally negative for preferred senior unsecured bonds. However, the bulk of the impact has already been priced in, at least in the short term



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European bank liability hierarchies set to change

The European Bank Crisis Management and Deposit Insurance (CMDI) update might introduce not only minor adjustments to the bank resolution framework but also significant changes to the bank liability hierarchy, which could have major implications for the banking sector, in our view. However, there is still considerable uncertainty regarding the final format and timing of the package.

The European Commission released its proposals to reform the CMDI framework in the EU in April 2023. In April 2024, the European Parliament published its version of the text. Finally, in June 2024, the Council of the European Union presented its proposal for the CMDI framework. Negotiations are ongoing, and no agreement on the final text has been reached yet. Therefore, no changes are expected in the short term, and the package may potentially become applicable closer to 2028 at the earliest, in our opinion.

The changes were motivated by the need to enhance the resolution framework for small and medium-sized banks, as previous solutions were often found outside the existing harmonised resolution framework, relying on government funds rather than private sector or industry-funded safety nets.

The package includes three legislative proposals amending the Bank Recovery and Resolution Directive (2014/59/EU), the Single Resolution Mechanism Regulation (806/2014) and the Deposit Guarantee Schemes Directive (2014/49/EU).

According to the Commission, the focus of the CMDI update is on:

- 1) Preserving financial stability and protecting taxpayer money, by facilitating the use of privately funded deposit guarantee schemes in crisis situations to shield depositors from losses, where necessary, to avoid contagion to other banks and negative spillovers to the economy.

- 2) Shielding the real economy from the impact of bank failures as a resolution that preserves critical functions is thought to be less disruptive for the economy and local communities than liquidation.
- 3) Enhancing depositor protection by extending the deposit guarantee to public entities and certain types of client funds, while maintaining the coverage level at €100,000 per depositor per bank. For temporary higher balances during specific life events, the protection will be more harmonised with a higher limit.

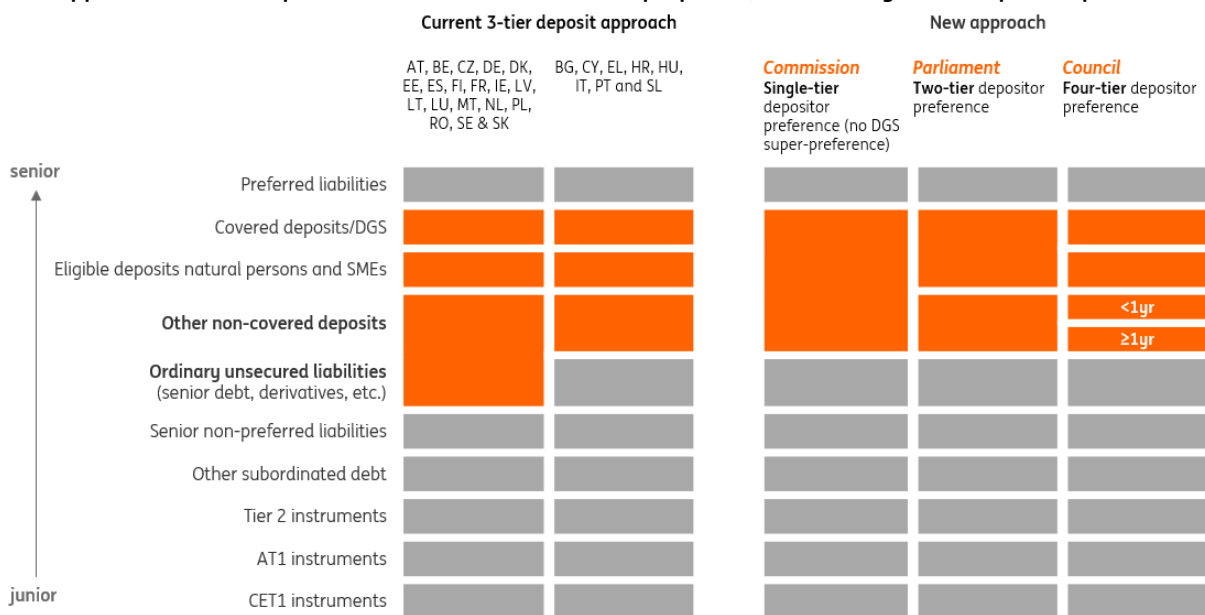
Some of the key focus/debated points in the package include:

- The introduction of a general depositor preference.
- The number of deposit tiers in the liability hierarchy.
- Extending resolution into mid-sized banks by widening the public interest assessment.
- Usage of DGS funds outside payout of covered depositors to finance resolution.
- Access to resolution funding by using DGS funds.
- Existence and consequences of the DGS super-preference.

While the European Commission, the European Parliament, and the Council of the European Union each have their own ideas on structuring, they all share a common overarching view. All three support the notion that all depositors in the EU should benefit from a general depositor preference in the future, ranking ahead of ordinary unsecured claims. Under the current BRRD, the ranking of some depositors is not clearly defined compared to other ordinary unsecured claims, leading to inconsistencies between EU countries.

All three proposals recommend altering the current three-tier deposit ranking system, but they differ in the number of deposit layers suggested: one (Commission), two (Parliament), and four (Council). The most significant difference is the Council's proposal to create an additional, more junior deposit layer for a four-tiered approach, compared to the Commission's single-tier approach.

While the approach to bank deposits differs between the three proposals, all share a general depositor preference



Source: ING, Based on European Commission proposal amending Directive 2014/59/EU of 18 April 2013, European Parliament adoption of 24 April 2024 and European Council adoption of 14 June 2024

The general depositor preference has been suggested to facilitate bank resolution. A risk of breaching the no-creditor-worse-off principle is seen to be more limited when bailing in ordinary senior unsecured claims if all depositors rank with a priority to these claims. As a depositor preference could allow for access to resolution funds without bailing in deposits, this could provide some stability to deposits in times of stress, with a more limited risk of a bank run.

The ranking of deposits is only one part of the debate. Other things under close watch include the broadening of the usage of DGS funds to other uses than the payout of covered depositors. The DGS funds could be used for banks to reach the required 8% bail-in to allow for accessing common resolution funds, like the SRF in the Banking Union, subject to certain conditions.

Widening the uses of DGS would probably extend the number of banks that could access the SRF, but it would also mean that some banks could access it with more limited loss sharing than others. This could arguably harm the level playing field. The wider usage of DGS funds may also come with a heavier cost burden for the sector as a whole, although the impact could be at least partly offset by the possibility of taking action earlier in the bank trouble process.

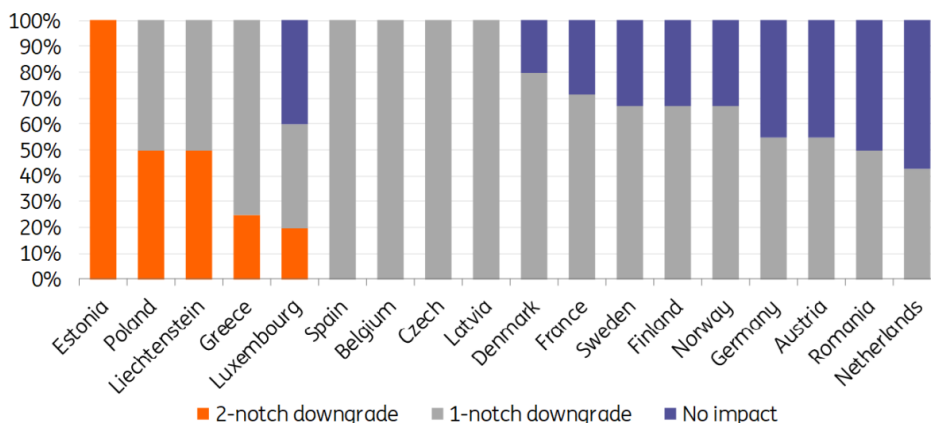
Implications for bank bond ratings

The introduction of a full depositor preference would have clear negative consequences for bank senior unsecured debtholders in the 19 EU member states in our view. Instead of the ordinary senior unsecured claims ranking alongside (and sharing losses with) the non-covered deposits, in the suggested hierarchy the senior layer would bear losses before all deposits. The change would also likely make bailing in of senior creditors easier in a resolution, assuming the other excluded liabilities are low enough to limit the chance of a legal challenge. The final impact would depend on the final wording of the texts and the following actions from banks. The other eight EU member states already have some kind of a depositor preference in place and the implications of the change would therefore be more limited.

The introduction of an overall depositor preference would have varying implications for bank debt ratings, with a more positive impact on deposit ratings and a more negative impact on senior debt ratings.

Moody's, for example, has indicated that a full depositor preference could result in a one-notch downgrade for 60% of banks in its sample of 89, while a smaller 6% could face a two-notch downgrade. However, 35% of ratings would remain unaffected by the change. These adjustments are due to a more limited uplift in the assigned loss given default notching.

Indicative share of banks with a potential senior rating downgrade at Moody's from an application of an overall depositor preference



Note: Moody's doesn't apply a full depositor preference in Greece as a small proportion of deposits are excluded
Source: ING

At some rating agencies, potential downgrades in preferred senior debt ratings may be less widespread and concentrated on a few, mainly small, banks that are not subject to MREL buffer requirements and that do not issue much senior debt of any type. Deposit ratings may see some upgrades for some banks that are using preferred senior in their MREL buffers.

At other rating agencies, the creation of a general depositor preference does not in itself imply rating changes as they reflect the likelihood of default and not loss given default. The depositor preference would be therefore unlikely to affect ratings directly assuming the banks' ability and willingness to service preferred senior debt would not meaningfully change, although the recovery prospects may decline.

That being said, it is good to note that banks that currently benefit the least from larger subordinated buffers in their senior ratings include banks in countries that have a depositor preference in place, such as Italy, Greece and Portugal. Banks with senior ratings that benefit from larger subordinated debt buffers are instead in countries such as Belgium, Finland, France, Germany, Ireland, the Netherlands, Denmark or Sweden, all systems that do not have a depositor preference currently in place.

All in all, while we think the potential rating changes across the board for preferred senior unsecured debt would largely depend on the final outcome of the framework and on the banks' reaction to the changes, on balance the impact is likely to be negative.

Reduced risk of a no-creditor-worse-off breach in the event of a preferred senior bail-in could facilitate this debt layer sharing losses during a resolution, potentially affecting the composition of MREL requirements. Banks might respond by decreasing their subordinated MREL buffers and relying more on preferred senior debt. This could lead to slightly less supply pressure on non-preferred senior debt and slightly more on preferred senior debt in the longer term.

The combination of increased supply, along with a potentially higher probability of default and loss given default in some cases, and pressure on debt ratings, could result in wider spreads on the product.

That being said, we consider that most larger banks will continue to support their loss absorption layers with non-preferred senior debt, which would likely continue to support their preferred senior debt ratings.

Deposits would face an even lower risk of a bail-in than before. Overall, a reduced risk of bank runs should be viewed positively for the system. Deposits as a funding option for banks would likely become more attractive due to potentially lower costs compared to

preferred senior debt. The most junior deposits, especially for large banks, may benefit the most from these changes, depending on the final wording of the texts. However, junior deposits of smaller banks with limited subordinated buffers could be more at risk under the four-tier approach.

Potential CMDI implementation may take time

Following the proposals, the CMDI process is entering the final stage of negotiations. It seems unlikely that an agreement will be reached this year. Substantial differences and considerable uncertainty about the final outcome suggest that serious talks will likely begin in 2025. Once the final format is agreed upon, Member States will have two years to implement the directive from its entry into force. This implies that the package could become applicable around 2028 at the earliest. There is also a risk that it may take even longer, meaning potential market impacts should not be considered imminent.

Potential impacts from the CMDI on banks

- Smaller risk of deposit burden sharing in most cases.
- Less limited risk of a bank run, a positive for stability.
- Preferred senior to become easier to bail in outside large layers of excluded liabilities.
- Preferred senior to share losses with a thinner layer.
- Potentially some issuance to move from non-preferred to preferred senior debt.
- Deposits to become more attractive in the bank funding mix.

What's in store for preferred senior under the CRR?

There are also other regulatory changes ahead that may impact preferred senior debt.

After the Banking Reform Package of 2019 introduced a distinct layer of non-preferred senior unsecured bonds to facilitate banks in meeting their bail-in buffer requirements, banks have felt a bit in the dark regarding the risk weight treatment of senior unsecured bonds used to meet banks' total loss-absorbing capacity (TLAC) and/or their minimum requirements for eligible liabilities (MREL).

The Capital Requirements Regulation (CRR II) lacked guidance on whether these bonds should be treated as exposures to institutions (CRR Articles 120-121), with risk weights under the standardised approach based on the second-best rating of the bond (varying from 20% [AA] to 150% [CCC]), or as equity exposures (CRR Article 133) subject to a risk weight of in principle 100%.

In 2022, the European Banking Authority (EBA) refused to give an opinion on this for non-preferred senior bonds, arguing that a revision of the legal framework would be required to address the question.

Now CRR III provides that clarity, at least for non-preferred senior unsecured bonds. However, when it comes to the treatment of preferred senior unsecured instruments some questions remain.

Risk weight treatment

The amended CRR gives clearer guidance on the risk weight treatment under the standardised approach for bonds that are used for TLAC/MREL purposes. At the same time, it provides for a more granular and, on balance, more penalising risk weight treatment for bonds further down the creditor hierarchy.

Under the amended CRR Article 128, the following exposures will be treated as subordinated exposures subject to a 150% risk weight treatment.

- Debt exposures, subordinated to the claim of ordinary unsecured creditors (eg non-preferred senior bonds).

- Own funds instruments to the extent that those instruments are not considered to be equity exposure per Article 133(1) (eg T2 subordinated bonds).
- Exposures arising from the institution's holding of eligible liability instruments that meet the conditions of Article 72b (eg certain preferred senior bonds).

Risk weight treatment bank bond instruments (%)

Rating bucket		AAA / AA	A	BBB	BB	B	CCC	
Credit quality step		1	2	3	4	5	6	Relevant CRR article
Covered bonds	old	10	20	20	50	50	100	Old Article 129
	new	10	20	20	50	50	100	New Article 129
Preferred senior	old	20	50	50	100	100	150	Old Article 120
	new	20	30	50	100	100	150	New Article 120
	new (TLAC/MREL)	150	150	150	150	150	150	New Article 128
Non-preferred senior	old	100	100	100	100	100	100	Old Article 133
	new	150	150	150	150	150	150	New Article 128
T2 instruments	old	100	100	100	100	100	100	Old Article 133
	new	150	150	150	150	150	150	New Article 128
AT1 instruments	old	100	100	100	100	100	100	Old Article 133
	new	250	250	250	250	250	250	New Article 133 (1) and (3)

Source: European Commission, ING

So, while preferred senior unsecured bonds that are not used for TLAC/MREL purposes may benefit from the slightly more granular rating-based risk weight treatment under the amended CRR Article 120 if they are credit quality step (CQS) 2 rated, preferred senior unsecured bonds that are used as eligible liabilities are classified in the same 150% risk weight bucket as non-preferred senior and T2 bonds. That is if they meet the CRR Article 72b conditions for eligible liability instruments, which were already introduced in CRR II for TLAC.

Now, here is the thing. CRR Article 72b(2) point (d) requires that the claim on the principal amount of eligible liabilities is entirely subordinated to claims arising from liabilities that are excluded from the eligible liabilities, such as covered deposits, covered bonds or liabilities related to derivatives. In the case of preferred senior unsecured bonds, this requirement is often not met as the bonds rank in most countries pari passu to, for instance, liabilities arising from derivatives.

For that reason, CRR Article 72b(3) allows the resolution authority to permit additional liabilities (eg preferred senior unsecured bonds) to qualify as eligible liability instruments up to 3.5% of the total risk exposure amount for TLAC purposes, provided that all the other conditions of Article 72b(2), except for point (d), are met.

The other conditions prohibit, for instance, the inclusion of any incentives to call or redeem the notes before maturity, or to amend the level of interest or dividend payments based on the credit standing of the resolution entity or its parent. Instruments issued after 28 June 2021 (CRR II application date) should also explicitly refer to the possible exercise of write-down and conversion in the contractual documentation.

These additional liabilities must, in principle, rank pari passu with the lowest ranking excluded liabilities, and their inclusion should not give rise to a material risk of no-creditor-worse-off challenges or claims, where a creditor can validly argue to be worse off in resolution than in normal insolvency proceedings.

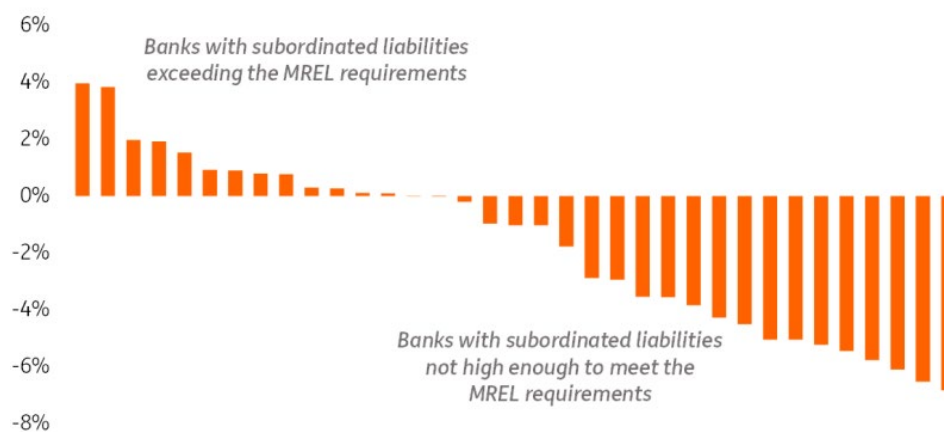
Even when a bank is not permitted to include Article 72b(3) items, resolution authorities can still agree to the use of additional eligible liability instruments under CRR Article 72b(4). These liabilities should also meet all conditions of 72b(2) except for point (d), and the aforementioned requirements on pari passu ranking with excluded liabilities and no-creditor-worse-off risks. On top of that, the amount of the excluded liabilities that rank pari-passu or below those liabilities in insolvency, should not exceed 5% of the own funds and eligible liabilities.

Article 45b of the Bank Recovery and Resolution Directive (BRRD) also refers to CRR Article 72b, except for point (2)(d), as part of the conditions for inclusion of a liability in MREL. While MREL is not subject to the subordination requirement of CRR Article 72b(2)(d), it is in principle subject to a subordination requirement of 8% of total liabilities and own funds that is set by the resolution authorities.

Not all preferred senior unsecured bonds are marketed for MREL purposes

European banks make abundant use of preferred senior bonds for MREL purposes. The graphic below shows, for a sample of 35 EU banks, that many of these credit institutions do not fully meet their MREL requirements with subordinated liabilities, such as capital instruments and senior non-preferred bonds. Most of them partially use preferred senior unsecured instruments to meet their MREL requirements.

Many banks use preferred senior bonds to meet their MREL



Source: Issuer Pillar 3 disclosures of 35 EU banks (2H24), ING

When it comes to the risk weight treatment of these instruments, the first uncertainty arises in the interpretation of the new Article 128(1)(c). Does the 150% risk weight apply to preferred senior bonds issued for MREL purposes, or only to preferred senior bonds issued for TLAC purposes? In other words, are senior bonds used for TLAC always subject to a 150% risk weight regardless of their preferred or non-preferred status, while in the case of MREL, only non-preferred senior bonds that are in the subordinated buffers have a 150% risk weight?

The practice among European banks regarding the use of preferred senior unsecured instruments for MREL purposes and their communication on it is also quite diverse. This leaves banks holding these preferred senior unsecured notes with even more questions than answers on what risk weights to assign, if the 150% would indeed apply to preferred senior notes used for MREL.

For example, some banks make a clear distinction in their prospectus and term sheets between the issuance of senior preferred notes used for ordinary funding purposes and senior preferred notes used for MREL purposes. Both types rank exactly at the same level in the creditor hierarchy. Hence, the no-creditor-worse-off principle would render it impossible to solely apply the bail-in tool to the bonds that are explicitly marketed for MREL purposes, while leaving the other senior preferred bonds untouched. This also applies to preferred senior unsecured bonds issued before banks began officially stating in the prospectus or final terms that the bonds would be used for MREL purposes.

So what risk weights should be assigned to these bonds? 150% if the bonds are distinctly marketed to the MREL requirements, and a risk weight based upon their ratings if they are not marketed as such? Or should in both cases a weighted approach apply: only

150% for the share of use for MREL purposes and a rating-based risk weight for the rest of the bond's notional amount?

There are also cases where preferred senior unsecured bonds can in principle be used for MREL purposes, but the institution has stated that, at this point in time, it has no intention of using the preferred senior unsecured bonds for MREL purposes. The MREL requirements of these banks are fully met with subordinated liabilities. However, the preferred senior notes are often still part of the total MREL buffer, for instance to have sufficient cushion against any potential maximum distributable amount (M-MDA) constraints on dividend payments or share buybacks.

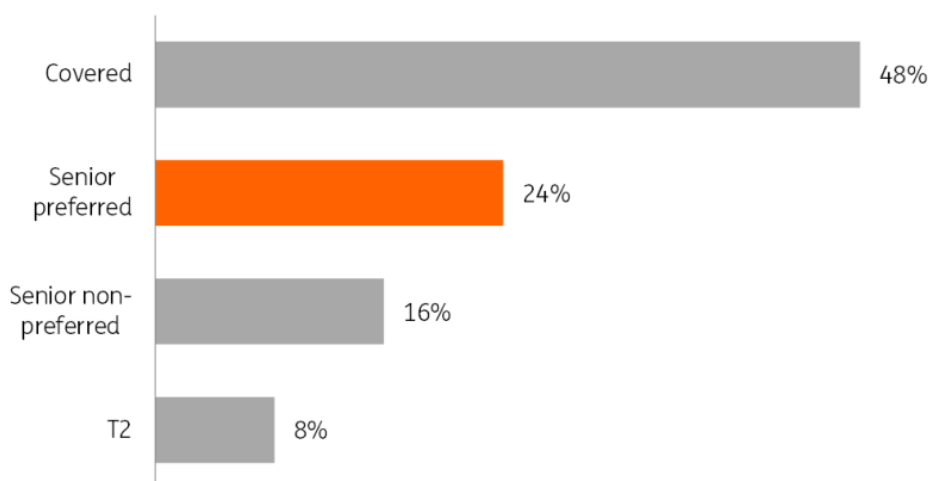
What does this mean for the risk weight treatment of the bonds? Can these bonds be risk-weighted based on the instrument ratings, or should they be risk-weighted 150% as, in the end, they are still part of the total MREL stack of the bank? The most logical take on this is that the 150% risk weight should indeed solely apply to that part of the bonds that are used to meet the MREL requirements.

Limited performance implications from a risk weight angle

The performance implications of the CRR III risk weight treatment of preferred senior unsecured bonds should probably not be that massive anyway. Banks are typically not the largest investors in the preferred senior unsecured bonds of other banks. Primary distribution statistics show that banks purchase only 24% on average of the preferred senior unsecured notes issued in the primary market. This is much lower than the 48% bought by banks in newly issued, and more favourably risk-weighted, covered bonds.

Distribution of bank bond deals to other bank investors

For bonds issued in 2023 and 2024 YTD



Source: IGM, ING

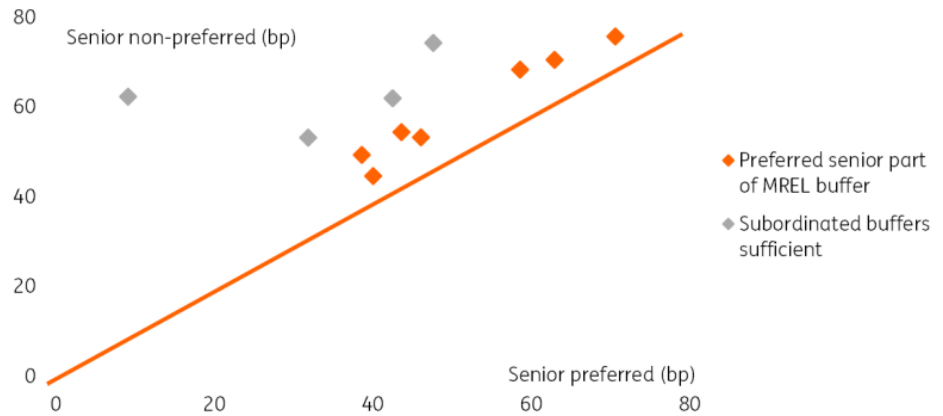
Unlike covered bonds, preferred senior unsecured bonds are also not eligible as high-quality liquid assets for Liquidity Coverage Ratio (LCR) purposes. Preferred senior unsecured bonds issued by eurozone banks are eligible for ECB collateral purposes though up to 2.5%. This explains why they are still more often bought by banks than bank-in senior unsecured or T2 debt instruments.

The use for MREL purposes is relevant for preferred senior spreads

Regardless of the risk weight treatment of preferred senior unsecured bonds, the expected losses, as assessed by investors or reflected in bond ratings, will remain the primary driver of these bonds' performance and their relative trading levels. The graphic below illustrates this for the non-preferred and preferred senior unsecured bonds

outstanding in the 2027 maturity bucket for the banks in our sample with both instruments outstanding in this tenor. Banks that do not use preferred senior unsecured bonds to meet their MREL requirements have tighter preferred senior unsecured spread levels at given non-preferred senior unsecured spread levels. Or to put it another way: they have wider non-preferred senior unsecured spreads at given preferred senior unsecured spreads.

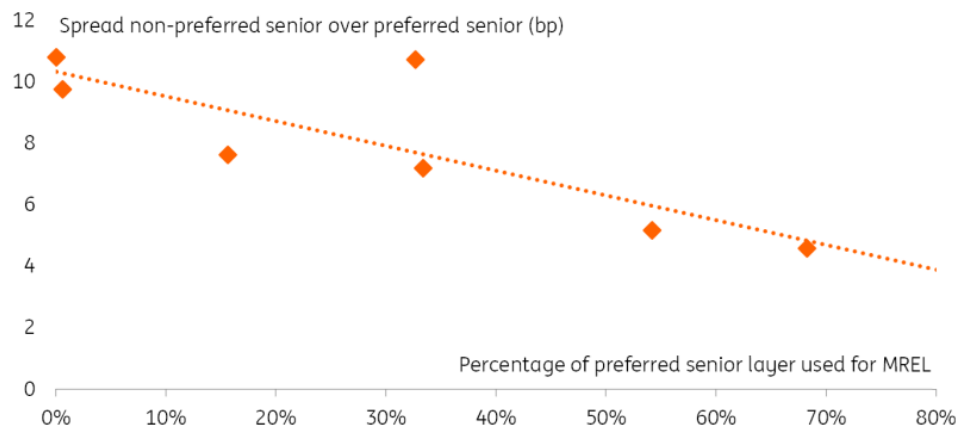
Banks that use preferred senior for MREL tend to have wider non-preferred vs. preferred senior spreads



*Preferred and non-preferred bonds in the 2027 maturity bucket
Source: IHS Markit, ING

The higher the share of the preferred senior unsecured layer that is used to meet the MREL requirements, the more negligible the spread differential between the non-preferred senior and the preferred senior unsecured bonds becomes.

The higher the share of preferred senior used, the closer spreads are to non-preferred



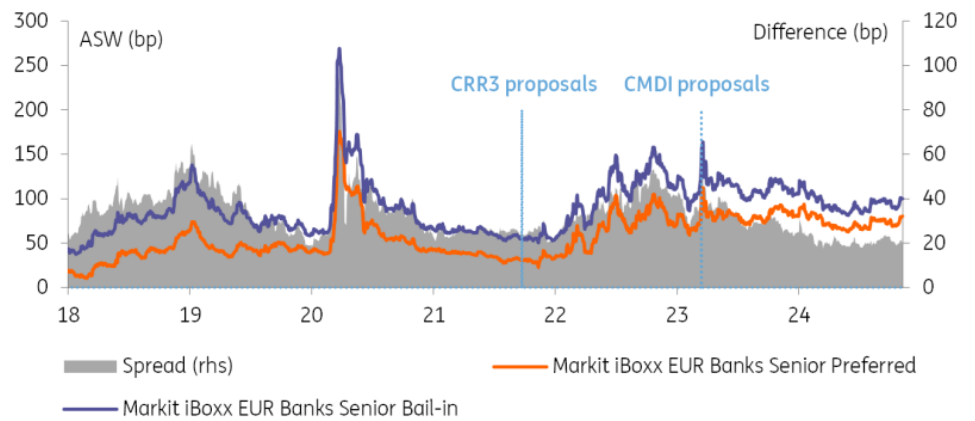
*Preferred and non-preferred bonds in the 2027 maturity bucket
Source: IHS Markit, ING

Any implications are already broadly priced in

Market participants have arguably had ample time to prepare for the upcoming CRR revisions, with the CRR III proposals published in 2021. Indeed, the spread differential between non-preferred and preferred senior bonds has become smaller in the past few years, with the difference quite tight at 20bp considering where absolute spread levels are.

We believe, however, that the proposed revisions to the CMDI have had a stronger impact here than the changes to the CRR. For the very simple reason that these ultimately affect a much broader investor base.

Spreads between non-preferred and preferred senior bonds have become tighter

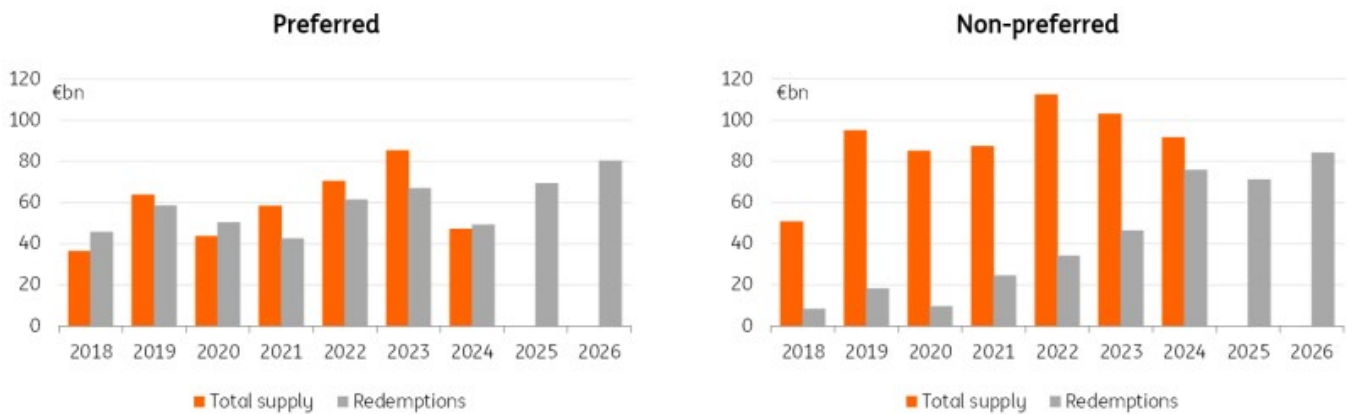


Source: IHS Markit, ING

Over the past year, the spread difference between senior non-preferred and preferred senior bonds has remained tight, despite the net supply dynamics being more favorable for preferred senior unsecured bonds compared to non-preferred senior unsecured instruments.

This trend is likely to continue in 2025, with an increase in fixed coupon preferred senior redemptions and a decline in fixed coupon non-preferred senior unsecured redemptions. However, we also expect a slight increase in preferred senior supply next year, while non-preferred senior supply is anticipated to be lower in 2025.

Fixed coupon senior supply and redemptions



Source: IHS Markit, ING

Should we worry about the regulatory impact on preferred senior spreads in 2025?

At current spread levels, we don't expect preferred senior bonds to become cheaper in 2025 versus non-preferred senior unsecured bonds. While we do acknowledge that the CRR revisions are negative for preferred senior instruments from a risk weight perspective, we think that spread levels are already broadly pricing in these risks for now.

In addition, there remains some uncertainty regarding the final shape and form of the CMDI package. The final implementation, once – and if – a compromise is reached, is likely to still take several years. The directive would need to be transposed into national law first. The potential negative implications, such as from a bail-in risk perspective and also from a ratings perspective, therefore may also take some time to reflect in more earnest on preferred senior unsecured bond spreads.

Keeping an eye on private markets' not so private vulnerabilities

The growth and influence of Non-Bank Financial Intermediaries are facing heightened scrutiny. Private markets, in particular, are attracting significant interest. The sector's inherent opacity, links with the broader financial system, competition with banks, and increasing vulnerabilities make it an interesting sector to watch in 2025



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Why you should keep an eye on NBFIs and private markets

Non-Bank Financial Intermediaries (NBFIs) have grown significantly since 2008 and as a result, the sector's influence has come under increasing scrutiny. One part of the sector, private markets, recently came under the spotlight due to its significant growth and the competition it represents for banks.

Private equity and credit entities have expanded their influence in today's economy by financing higher-risk corporations and providing a quicker, more flexible source of funding. However, their inherent lack of transparency, ties to the broader financial sector, and the lack of regulatory oversight indicate that their vulnerabilities may soon become more apparent.

We view the potential direct impact of stress in private markets on the banking sector as limited. However, indirect impacts could be more significant. Indeed, the growing interconnectedness within NBFIs and with banks increases contagion risks to the broader financial sector.

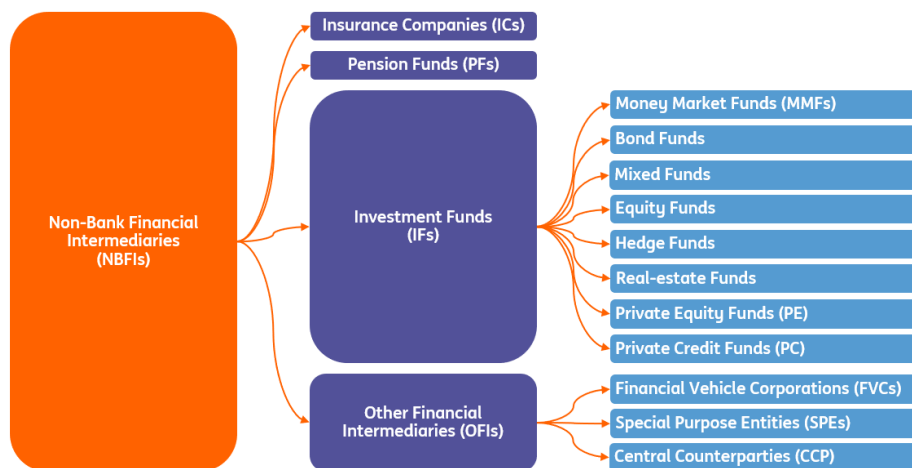
Additionally, retail investors' growing interest in private markets and the consequent increase in open-ended funds could also cause a shock spillover to the real economy and ultimately affect banks through higher default rates and lower credit quality. Considering all these points, we believe regulators and the banking sector should keep an eye on private markets in the coming year.

How is the NBFi sector doing?

The term NBFi is used to describe a large variety of institutions. We classify them as non-banks that take in cash and use it to generate a return. Most NBFis take in cash, just as banks do, and deploy it in various securities and derivatives.

Part of the complexity of understanding and analysing the sector stems from the various ways of subdividing it. Different international institutions use distinct classification methods for NBFis. The ESRB, for instance, separates Pension Funds and Insurance Companies, categorising the rest into two main groups: Investment Funds and Other Financial Institutions (OFIs). The graph below illustrates a non-exhaustive approach to viewing the different NBFi sub-sectors.

Non-exhaustive NBFi sector sub-division



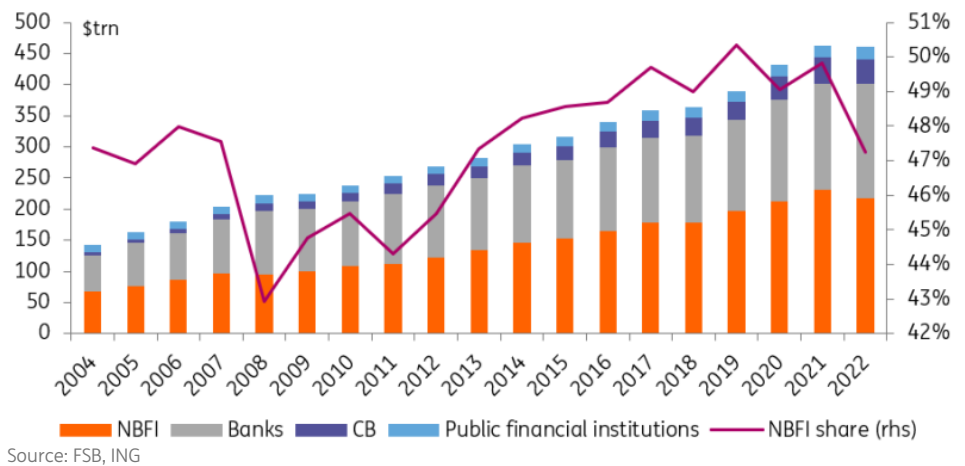
Source: ING

In this article, we won't explore each sub-sector individually. Instead, we'll assess the challenges posed by the broader NBFi sector and delve into the specifics of private markets. Private markets encompass, but are not limited to, private equities and private credit entities. Before turning to the sector's vulnerabilities and what this means for banks, an update on NBFi developments is necessary.

NBFi's significant growth after the 2008 Global Financial Crisis mainly stems from the stricter capital and liquidity requirements on banks. These made some parts of lending less attractive for the banking sector. Therefore, NBFis took over portions of this business as regulatory requirements grew for banks. Read more on this in our previous piece [here](#).

Nowadays, the crucial role played by NBFis in the broader economy is widely acknowledged. The share of assets held by the sector increased continuously between 2011 and 2019 to reach more than 50% of total global assets. However, since 2020, the sector's total asset size has stagnated, remaining between \$215tr and \$230tr. Furthermore, as global financial assets have grown, the NBFi sector's share decreased to 47% of total assets in 2022.

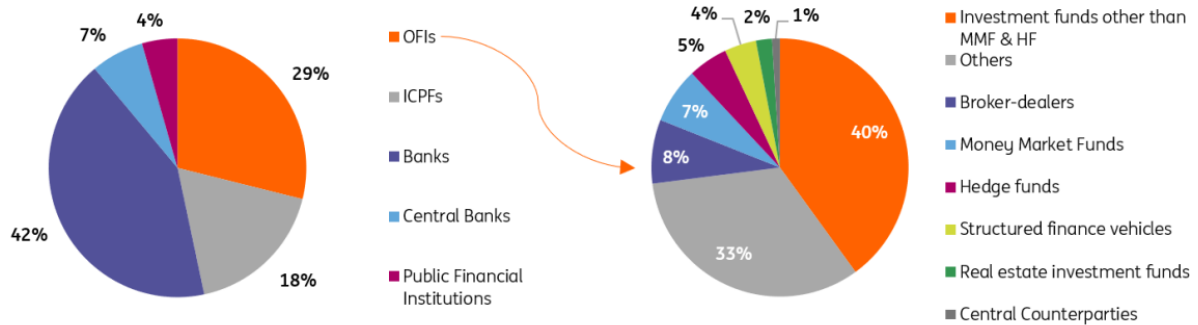
NBFI's share of global financial assets dropped by nearly 3pp in 2022



Data from the Financial Stability Board (FSB) indicates that a very large part of the NBFI sector is composed of insurance companies and pension funds (the aggregate of these two segments is known as ICPFs). At the end of 2022, ICPFs accounted for 18% of global financial assets, while other financial intermediaries (OFIs) made up 29%.

The OFI segment remains extremely diversified. Indeed, 7% of it is composed of Money Market Funds, 8% of broker-dealer entities and 40% is a diversity of investment funds.

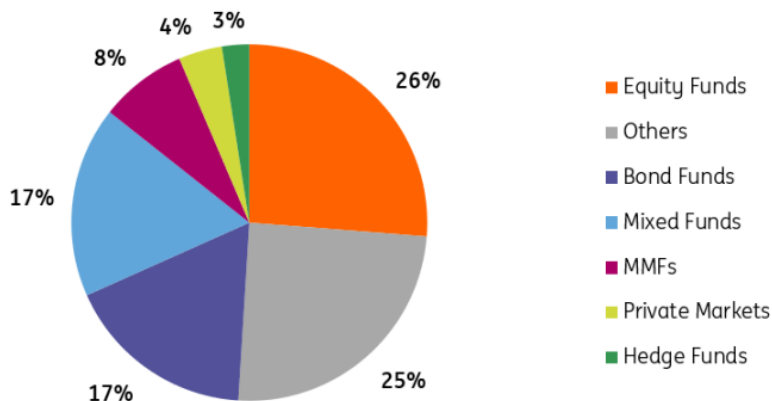
Insurance companies and pensions funds represent 18% of global financial assets



Source: FSB, ING

At the European level, data shows that despite significant growth over the last two decades, NBFIs are not yet as developed as they are globally. Looking at the sector excluding pension funds and insurance companies, the largest entities are equity funds followed by bond funds and mixed funds, each representing 17% of EU NBFI assets at the end of 2022.

Largest share of European OFIs are equity funds



Source: ESRB, ING

Private markets, an opaque but growing sector

Four percent of European OFIs are private markets. Private finance entities aim to provide funds to companies, mostly unlisted ones, via debt and equity investments. It therefore provides alternative funding sources to companies aside from public equity, corporate bonds markets and bank lending. The European Central Bank (ECB) underlines the importance of the sector as it provides financing to riskier entities through the risk-bearing capabilities of long-term investors.

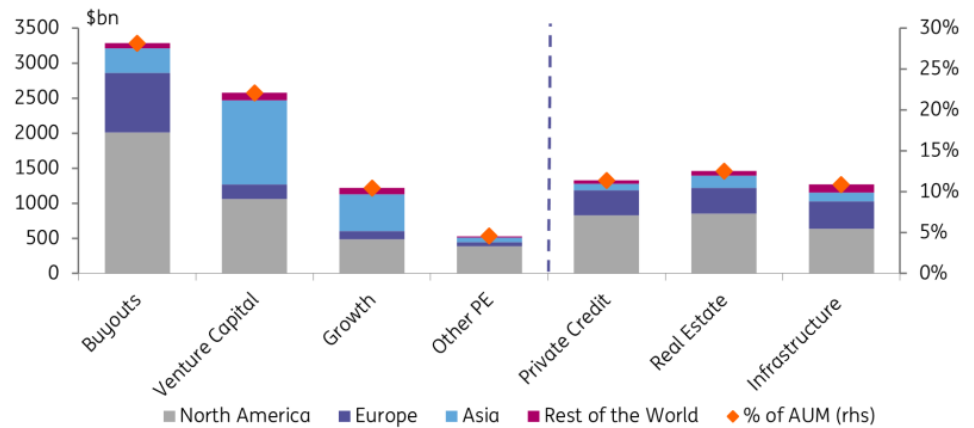
Private markets are composed of unlisted assets, private equity (investing in firms' equity), private credit (lending to firms) as well as real estate and infrastructure (investing in real estate and infrastructure assets).

Private equity entities represent the largest part of private markets and include three main investment types:

- Venture Capital funds (VC): investing in small firms in the growth phase, filling their need for liquidity, especially when they have limited bank credit access. It generally aims to hold minority equity stakes in those young firms.
- Leverages Buyout funds (LBOs): funding more mature firms with an investment horizon of up to 10 years which may be extended and aims to acquire controlling stakes in those entities. It thus includes larger investments than for VC due to the bigger size of the financed entities.
- Growth funds: stand halfway between VC and LBOs to fulfil the need for higher investments for small firms in the growth phase, such as unicorns (start-ups valued over \$1bn), but still taking a minority stake in the company.

The graph below shows the aggregated assets under management (AUM) of each of the three private equity segments as well as for the rest of the sector at the end of 2022. The majority of the funds are situated in North America, with the exception of Venture Capital concentration in Asia.

North America holds the highest AUM in the private markets sector

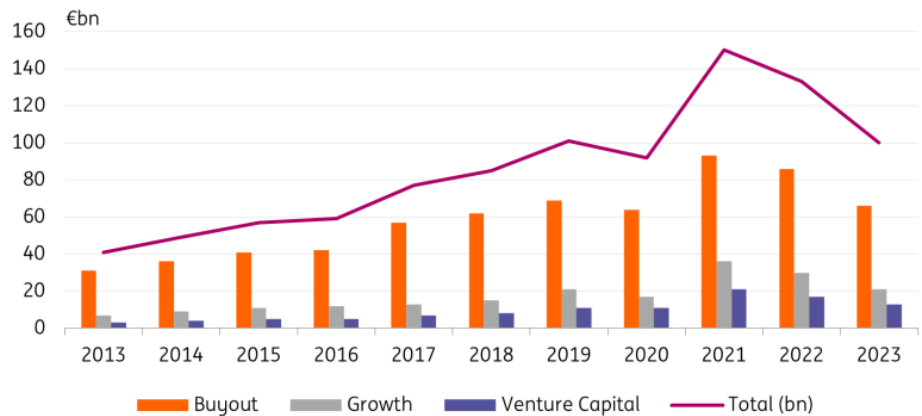


Source: AMF, ING

Private equity funds have grown significantly over the last few years to reach 65% of private finance’s AUM. This increase was mainly driven by investors’ search for higher returns (especially during the low-interest rate period) as well as companies’ need for faster and more flexible funding.

The growth in Venture Capital at the global level is particularly significant, with an 8pp increase between 2019 and 2022. On an aggregate level, there has been a 10pp decrease in LBOs globally, despite a 2pp rise in Europe between 2019 and 2022, followed by a decline in 2023. Although less pronounced, there has also been a notable decrease in growth funds and Venture Capital. Overall, the decline in the three main private investment types over the past two years has returned them to pre-Covid levels.

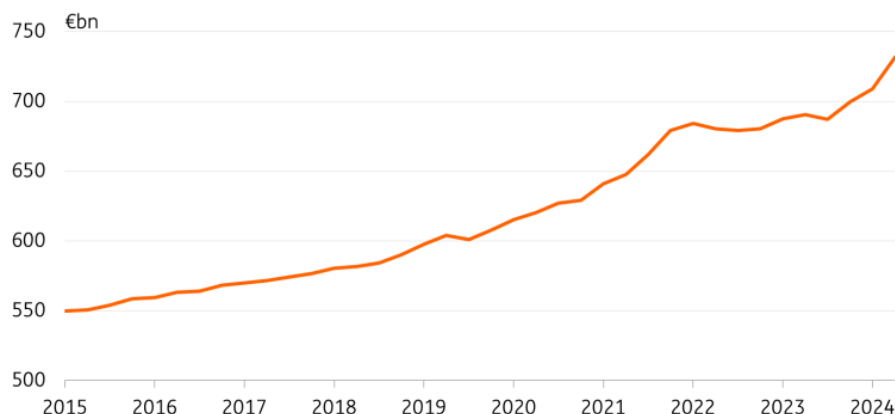
European private equity investments declined in 2023



Source: Invest Europe, ING

Despite lower investments, data from the ECB shows continuous growth in total assets held by private equities in Europe. The sector reached historically high levels of more than €700bn in total assets in the second quarter of this year.

European private equity total assets have still grown since 2015 reaching €700bn



Source: ECB, ING

One reason for the continuous growth of European private equity is the rising valuation of the sector’s assets. This leads us to the sector’s vulnerabilities, which we will discuss in the section below.

Private markets face five vulnerabilities

In our previous piece, we identified three vulnerabilities the broad NBFi sector faces. We estimated those risks as the largest known unknowns for the financial sector. With the recent public interest in private markets, this section will focus on the NBFi sub-sector and identify associated vulnerabilities.

As previously mentioned, private markets’ significant growth over the last decade can be explained by three factors: the development and increased regulatory burden on the banking sector making some parts of the economy less attractive for the sector. The second factor is investors’ search for higher returns during the extended low interest rate period. And last but not least, the sector has developed due to entities’ need for a faster and more flexible source of funding. Overall, private markets play a crucial role in the economy by providing funding to smaller, riskier and innovative firms. This is especially true when it comes to innovation for the green and digital transformation.

That being said, like any other NBFi, the sector is prone to several vulnerabilities: financial leverage, high interconnectedness, liquidity risk, valuation risks and procyclicality. In this section, we dive into each one of these risks before turning to the impact on the banking sector.

Overview of private market vulnerabilities

NBFi Sector	Financial Leverage	Liquidity risk	Interconnectedness	Valuation risks	Procyclicality
Private Equity	● / ●	●	●	●	●
Private Credit	● / ●	●	●	●	●
Other	● / ●	●	●	●	●

● Low risk ● Medium risk ● High risk

Source: ING

1. Financial leverage

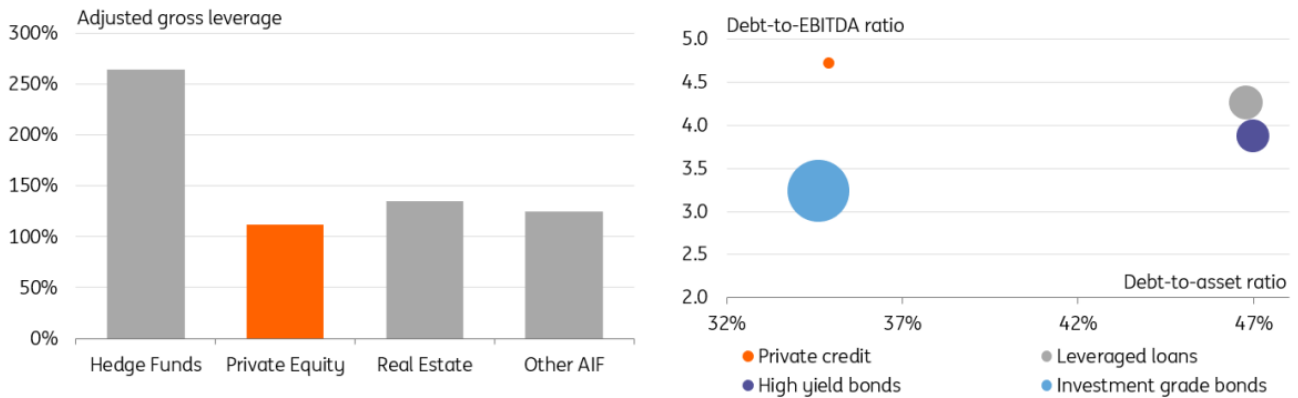
Although the IMF classifies financial leverage in private markets as low, we consider it medium due to significant data gaps, particularly regarding entities’ use of complex financial leverage. The lack of reliable data makes it challenging to accurately assess the

sector’s true exposure. Additionally, the use of complex financial leverage complicates the quantification of these risks.

That being said, available data shows that private equities have lower gross leverage than real estate funds and other investment funds. Nonetheless, it remains a point of attention as recent data from the IMF points out that the private credit sector is prone to higher debt relative to earnings while being smaller than high-yield or leveraged bonds.

Private markets show lower gross leverage but more debt to earning

Private equity gross leverage remains lower than for other IFs while private credit entities carry more debt relative to their earnings.



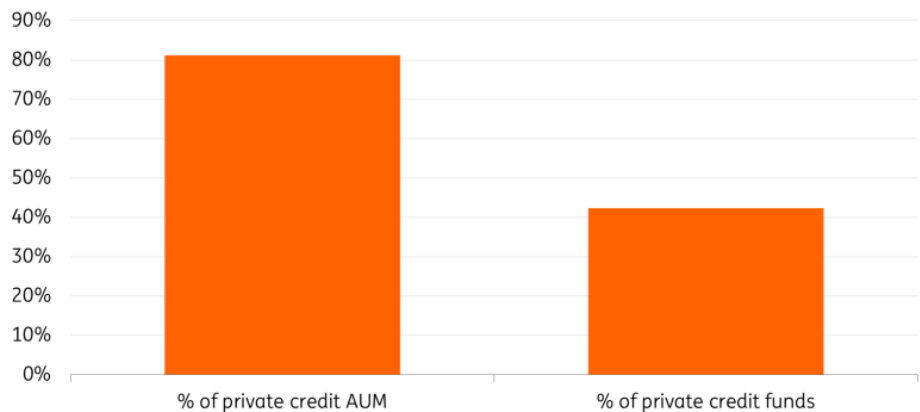
Source: ESMA, IMF, ING

2. Interconnectedness

As discussed in our previous piece, NBFIs interconnectedness has grown significantly over the last decade. It implies ties both within the sector and also with the rest of the financial market such as banks. Private markets don’t deviate from the general trend. Indeed, interconnections appear on several levels for the sector.

Firstly, we note the growing links between private credit and private equity. While these two entities used to be well-defined and act separately, this dividing line is getting blurred. For example, the IMF reports that 82% of private credit assets under management are now handled by firms also active in private equity funds. This number drops to a little over 40% when looking at the number of credit funds under management. However, it exemplifies how intertwined private markets have become.

Over 80% of private credit assets are managed by entities also active in private equity funds



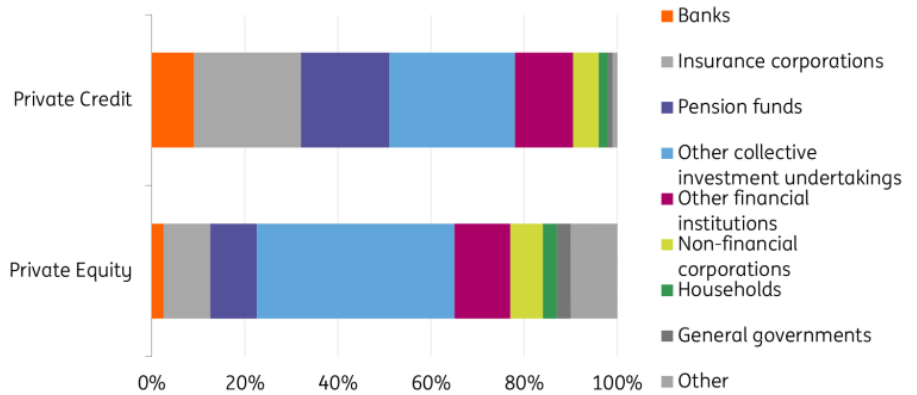
Source: IMF, ING

Secondly, interconnections between private markets and other NBFIs have increased. For instance, we note the prominence of ICPF investments in both private equity and

credit sectors. These represent a little over 40% in private credit and 20% in the private equities sector. The second largest investments stem from OFIs (with 20% and 40% respectively).

The graph below also points out the relatively small share of banks' direct investment in the sector, representing less than 10%, but we will come back to that in the next section.

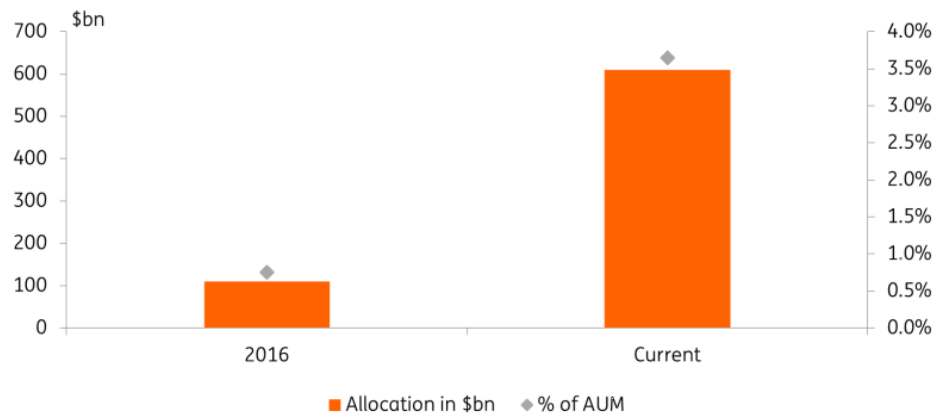
Split of investors in private credit and equity indicates large NBFIs contributions



Source: ESRB, ING

More importantly, the investment flow stemming from ICPFs has grown sixfold over the last eight years reaching over 3.5% of total investment in the private credit sector. The main reason for this is the sector's search for higher returns during the low-interest rate period.

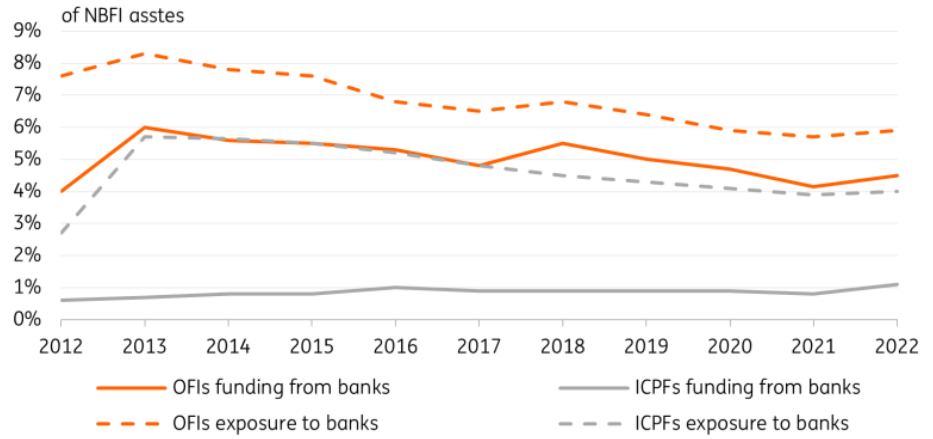
ICPF investment in private credit funds has grown sixfold to reach over \$600bn globally



Source: IMF, ING

Last but not least, the direct link between banks and the broader NBFIs sector has increased in recent years. As illustrated in the graphs below, the share of NBFIs' total assets funded by banks, as well as their exposure to banks, increased between 2021 and 2022. Banks now fund just under 5% of OFIs' assets globally and slightly over 1% of ICPFs' assets.

Increased interconnectedness with banks relative to NBFIs assets globally



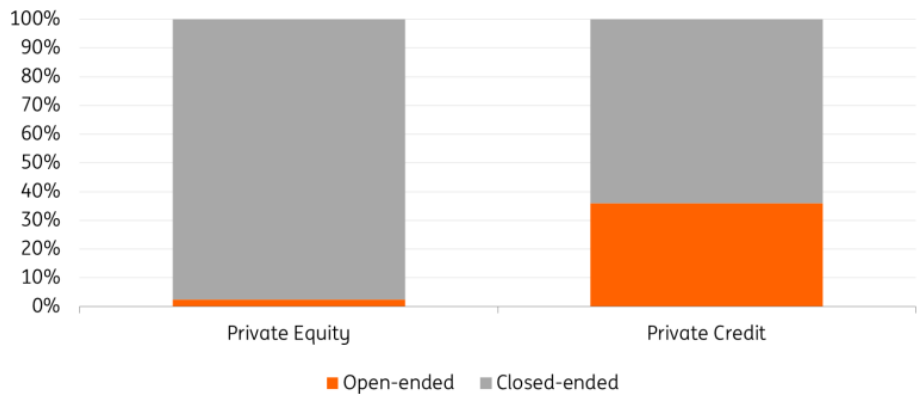
Source: FSB, ING

The growing links between the banking sector and NBFIs, in addition to the significant interconnection within NBFIs, exacerbates vulnerabilities. Indeed, interconnectedness implies greater spillover risks. It also indicates that the less regulated part of the financial system is growing in complexity which hardens the potential development and implementation of both regulation and safeguards.

3. Liquidity risks

One very well-known NBFIs vulnerability is its exposure to liquidity risk. Although private markets typically target illiquid assets, this sector is relatively sheltered from liquidity risks because most funds are closed-ended, preventing early redemption and limiting run risks. However, it's important to note that nearly 40% of European private credit entities are open-ended, allowing for early redemptions.

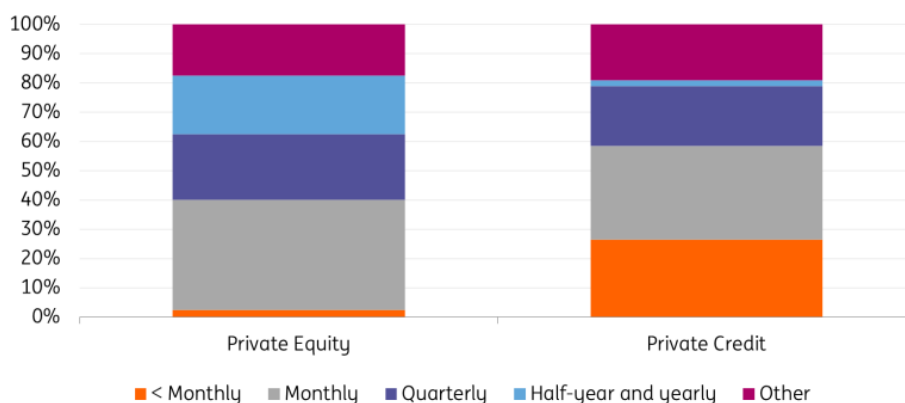
A large majority of European private funds remain closed-ended



Source: ESRB, ING

Despite that, liquidity risks remain contained even when looking specifically at the open-ended section of both private equity and credit funds. Indeed, most open-ended funds allow only infrequent redemptions from their investors, with 60% of private equity funds allowing for quarterly and longer redemptions while this represents a little over 40% of private credit funds. Consequently, the risk of sudden liquidity withdrawal from both types of funds is limited.

Within European open-ended private funds, the large majority restrict frequent redemptions



Source: ESRB, ING

Nonetheless, over the past few years, private markets have increasingly attracted retail investors. To do this, they have developed new fund types of which a larger share is open-ended and allows for frequent redemptions. While we consider liquidity risks low, the development of retail investors and the consequent increase in open-ended funds might trigger growing liquidity risks.

4. Valuation risks

In contrast to the public market, supervisory oversight surrounding asset valuation and pricing is not as overarching for private markets. This adds to the inherent opacity of the sector and hardens the assessment of potential losses for external investors.

A report from the French Market Supervision Organisation points out that in addition to being infrequent, private market valuations suffer from three other vulnerabilities. Firstly, due to the nature of the projects funded, assessments often lack comparison potential. Secondly, the assets linked to the valuation are frequently intangible or linked to innovation making it difficult to estimate the liquidity premium. Finally, the sector's development also increased its complexity which further hardens the valuation tasks. Consequently, models used to derive private assets' valuation inherently contain a large part of subjective assumptions.

The difficulty of deriving a realistic assessment of private funds' underlying assets and the large place for assumptions in the models used adds to the infrequent reassessment of those valuations. All these variables make the sector prone to hiding potential losses and underlying volatility. The IMF estimates that in a downside scenario, the lack of transparency and adequate data can result in a deferred loss realisation for the sector. This could lead to a spike in defaults and a confidence loss in the assets.

5. Procyclicality

Last but not least, private markets suffer from procyclical features. While the sector's exponential growth stems from the low interest rate period and investors' search for yields, the extended period of higher interest rates may expose the sector to higher risks.

The higher for longer interest rate environment, in addition to inflation, exposes the private sector's vulnerability on two sides. On the one hand, financed companies might suffer from inflation with higher costs and lowered revenues. On the other hand, private finance funds might see their financing costs increase and, in some cases, struggle to refinance debt issued, even if we see this as a lower risk.

Next year's economic forecast points to sluggish growth despite some additional interest rate cuts. Higher interest rates for an extended period accompanied by slow

economic growth could deteriorate the sector and result in higher default rates. This circles us back to the importance of accurate valuations.

Private markets but not so private vulnerabilities

We have now identified five vulnerabilities that private markets face. However, one question remains: how does this affect banks? To answer this, we will examine the effects in two sections: direct impacts and indirect impacts.

Direct impact

As shown in the section above, banks only represent a limited part of the interconnectedness private markets have with the rest of the financial sector. In fact, credit institution investment in private credit represents less than 10% of their total funds and this number drops to about 4% for private equities. A shock on the sector would therefore have only a very limited direct impact on banks.

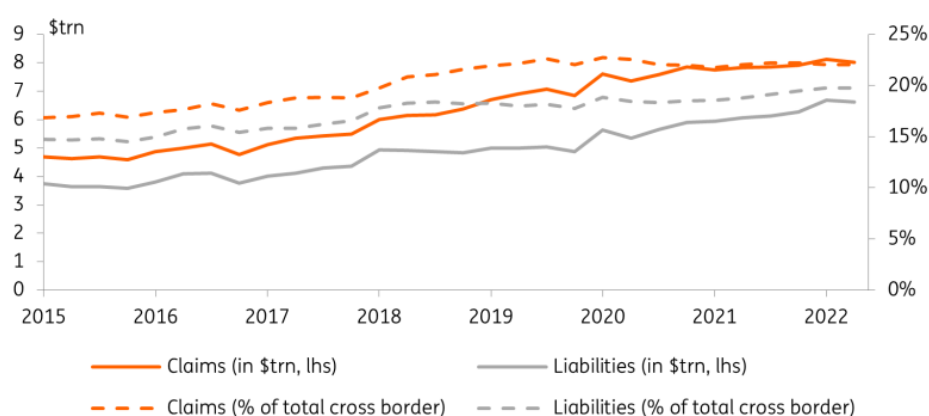
However, the heavy development of the sector over the last decade and especially its appetite for larger deals implies an important new source of competition for the banking sector. Some institutions point out that the growing competition could trigger a race to the bottom in deal quality. Some underline the risks of underwriting standards deterioration as well as weaker covenants. Nonetheless, we view these direct risks as limited simply due to the already low underwritings and covenants quality.

Indirect impact

Despite viewing direct impacts on banks as limited, it doesn't mean credit institutions would not suffer from stress in the sector. Indirect impacts are, in our view, of bigger concern and could be of a larger magnitude than direct ones.

While banks have limited direct exposure to private markets, they have a significant one in other parts of the NBFi sector. While we note a stagnation of banks' exposure to the NBFi sector as a whole over 2022, it still represents up to 22% of banks' claims and 20% of their liabilities globally.

Banks' claims and liabilities to the NBFi sector over time



Source: IMF, ING

We have established the increased connectivity between private markets and the rest of NBFIs, especially pension funds and insurance companies, and it is clear how indirectly the banking sector is connected. Stress on the private sector could spill over to the rest of the NBFi sector and ultimately also to banks.

As discussed in the liquidity section of this piece, we also note retail investors' increasing interest in private markets. Besides being generally less informed of the risks related to private investments and potential individual losses, the increased share of retail investors could amplify the impact of stress in the sector. Indeed, retail investors, aside from very high-wealth individuals, could pass on their losses from the private market to

the real economy by lowering consumption. In the medium term, that could also translate into an increase in default rate and ultimately affect banks.

Due to the fundamental role private markets begin to play in the economy, through financing small entities and startups, especially in the sustainable and innovation sector, stress would also hit the real economy with a spike in defaults and higher credit costs. Such a downturn could, in turn, affect banks' credit quality.

All risks listed above are based on the assumption that the stress originated from the private sector. However, a shock in the banking sector as we witnessed in early 2023 could quickly spill over to the real economy via the interconnectedness of banks to NBFIs including private markets. Considering the important role played by private equity and credits to innovative firms, a shock transmitted to private markets would enhance the pain to the real economy.

Conclusion

To conclude this piece, we would like to open the discussion to future expectations. While private markets proved resilient during the banking stress episode of early 2023 as well as through the higher interest rates period, we believe financial sector participants should keep an eye on two points in 2025.

The first point concerns the sector's **procyclicality**. As mentioned previously, private markets are prone to pro-cyclical behaviours. However, its recent development made it an inherent and crucial part of the financial system and real economy. While the sector developed over the extended period of low interest rates by offering investors higher yields, the extended period of higher interest rates will test the private market's ability to counter the increasing competition. We therefore expect to see more performance variation among private market participants.

As economists' consensus points to another year of sluggish growth despite pencilling in several additional rate cuts, 2025 will test the private market's strength against credit risks.

The second point to keep an eye on is the development of the sector, especially when it comes to its share of **retail investors**. While the sector is expected to find new ways to develop and counter the competition increase linked to higher interest rates, the subsequent increase in retail investment could switch liquidity risks from low/medium to medium. In addition, a structural change of the sector towards more open-ended funds would increase liquidity mismatches.

While major financial markets regulators such as the Bank of England and the Federal Reserve are still battling on the enforcement of the Basel requirements, the development of regulations targeting NBFIs is lagging.

The lack of data especially when it comes to the sector's financial leverage and interconnection is the main challenge to adequate regulatory oversight. Considering the inherent international characteristics of the NFI sector and more specifically private markets, international cooperation will be crucial in the coming years to enhance transparency and improve data collection and sharing.

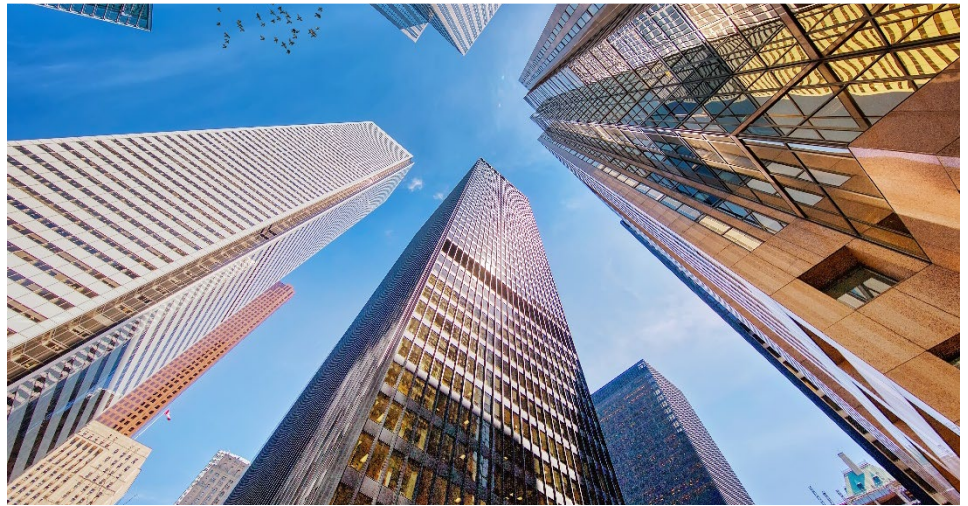
Overall, the rise of private markets could come with hefty and not so private consequences. Therefore, the monitoring and development of data-gathering solutions to enhance the understanding of the sector's vulnerabilities is essential to ensure the financial market's stability.

ECB rate cuts will benefit bank loan quality

The strong boost from higher interest rates has ended. Banks relying more on fee-based income rather than solely net interest income and with the potential for mergers and acquisitions are somewhat better positioned.



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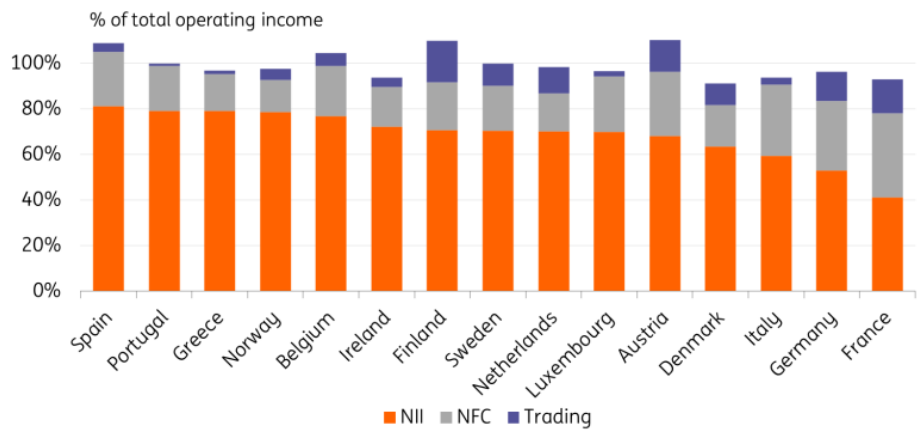


The ECB shifts to rate cuts to support bank loan quality

European bank fundamentals have been supported by the positive effect of high interest rates and the (for the most part) relatively benign loan quality conditions. While we have seen a clear shift higher in non-performing loans in some specific sectors such as real estate and construction, the substantial revenue boost from high rates has largely offset these impacts on a net basis so far.

The ECB is however increasingly moving to a rate-cutting mode with 125bp of rate cuts expected by our economists by the end of 1H2025. We expect the interest rate cuts to negatively affect net interest margins, although some banks are relatively well hedged against this impact. It may be challenging to offset this effect solely through volume growth in the current economic climate. Southern European banks may get some support from stronger expected economic growth. To achieve growth, we think that the focus is increasingly turning to fee and commission income instead, alongside mergers and acquisitions (M&A).

With lower rates, banks less reliant on NII are better off



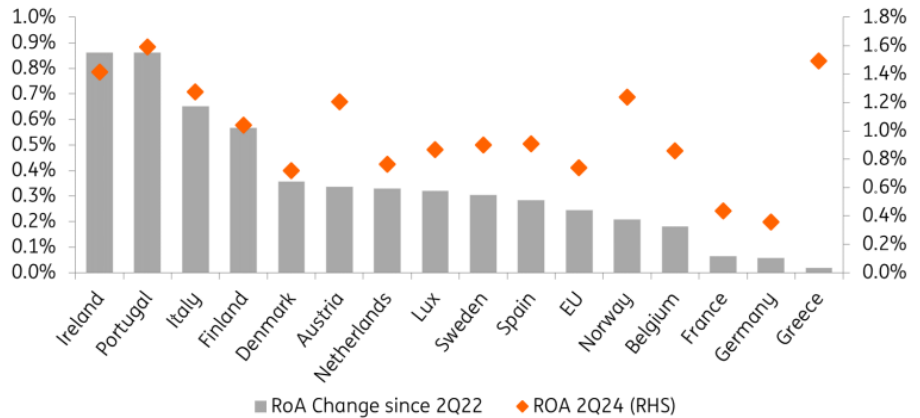
Source: ING, EBA

We have seen more life in the European bank M&A scene this year than we have in years.

Two major eurozone banks are still pursuing their targets, and 2025 may give a better indication of how these stories will play out in the end. Both are facing tight resistance in the respective target countries.

If the deals do not succeed, we would take that as a sign that pulling off a merger or acquisition in the eurozone, despite apparent support and even encouragement from authorities, remains challenging due to substantial (possibly unofficial) barriers.

Eurozone periphery leads bank profitability higher



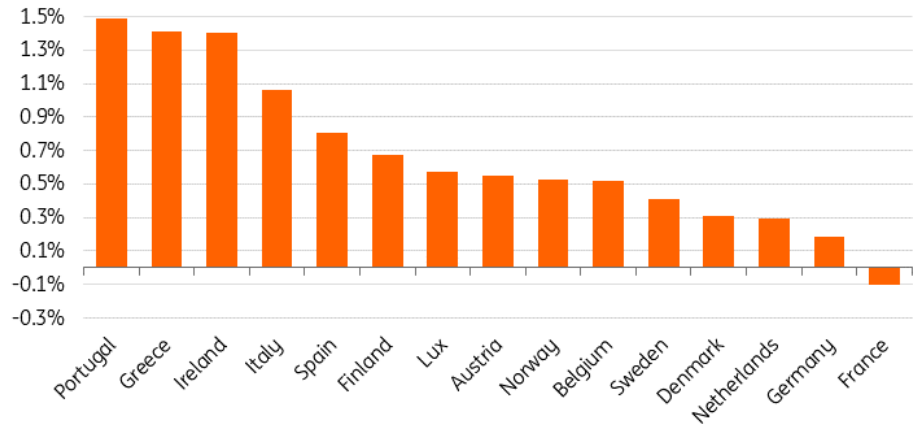
Source: ING, EBA

Since the ECB started its series of rate hikes, we have seen the return on assets improve by 25bp for EU banks based on EBA country data. In the eurozone, Irish, Portuguese and Italian banks have seen the strongest improvement since the summer of 2022, and in 2024 Greek banks showed the strongest improvement year-to-date.

The robust developments reflect higher net interest margins, supported by the ECB rate hikes between July 2022 and September 2023. Spanish banks have also benefited from the higher rates, but the improvement hasn't significantly impacted their bottom line. Dutch banks fall somewhere in the middle. Only French banks haven't seen their margins improve due to local regulations, which has resulted in their profitability lagging, placing them at the lower end of the range alongside Germany.

Rate hikes have contributed to stronger margins

Change in NIM since 2Q22



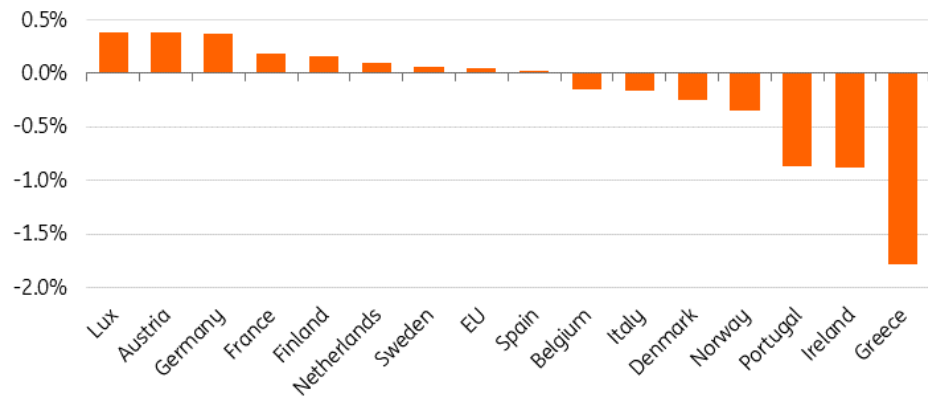
Source: ING, EBA

Overall, the positive margin impact has counterbalanced the relatively minor decline in loan quality so far. Since the summer of 2022, EU banks have experienced a 6bp increase in their cost of risk, reaching 51bp, while the non-performing loan (NPL) ratio inched 5bp higher to 1.9%.

It is mainly banks with higher CRE exposures that have seen a stronger weakening in their loan quality metrics. The most significant increase in NPL ratios, nearly 40 basis points, was observed in banks from Luxembourg, Austria, and Germany, all of which have banking sectors heavily exposed to real estate.

Lux, Austria, Germany and France see NPLs grow...

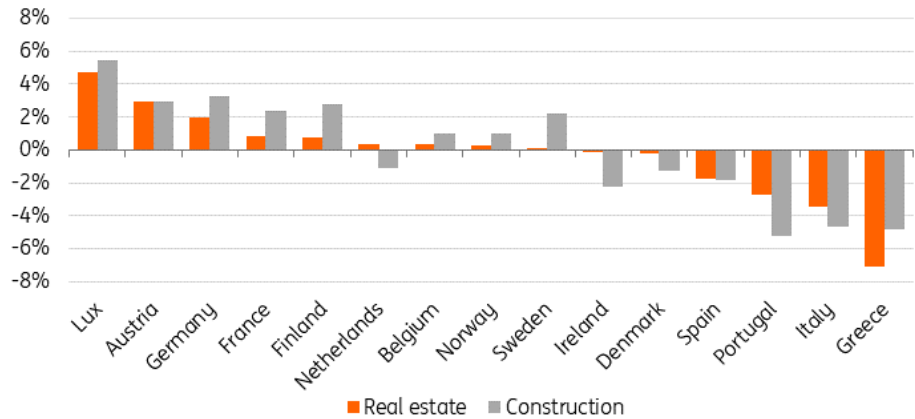
Change in NPL ratio, 2Q24 vs 2Q22



Source: ING, EBA

...driven by the move weaker in RE related lending

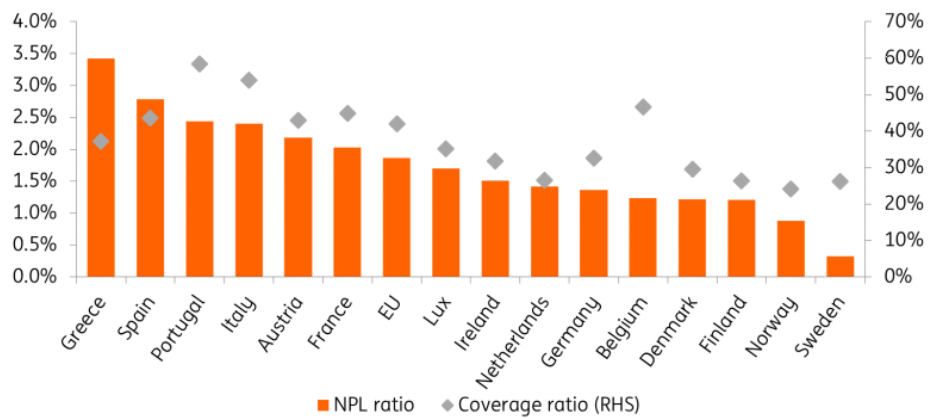
Change in NPL ratio since 2Q22



Source: ING, EBA

Despite these increases, the overall levels continue to remain below those of the eurozone periphery which still carries some legacy NPL burden.

The highest problem loans remain in the eurozone periphery



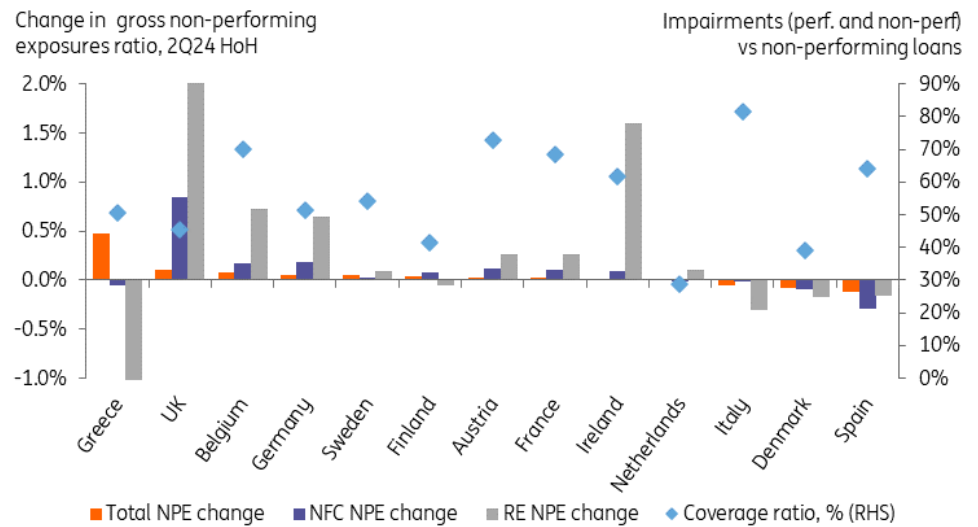
Source: ING, EBA

The chart below shows how non-performing exposures (NPE) for a selection of 39 banks performed in the first half of 2024 compared with the end of 2023, just before the ECB started to cut rates. For these banks, the NPE ratio was on average at a low level of 1.4%, just 3bp higher from the year-end with the coverage ratio including impairments for both non-performing and performing exposures a tad below 58%.

Furthermore, the non-performing exposures for non-financial corporates have increased, although only by 3bp on average, with the strongest increases reported by banks that have also seen their non-performing loans to real estate counterparties clearly increase at the same time.

The largest increases in non-performing exposures were reported by banks in Greece, the UK, Belgium and Germany. Of these, the share of problematic real estate assets increased in all the sampled banks but the Greek one. Instead, banks in Spain, Denmark, and Italy all reported lower non-performing exposure ratios compared to the year-end, coinciding with lower NPE for corporates and more specifically for real estate counterparties.

Most countries with the strongest increase in non-performing corporate loans also saw weaker real estate exposures



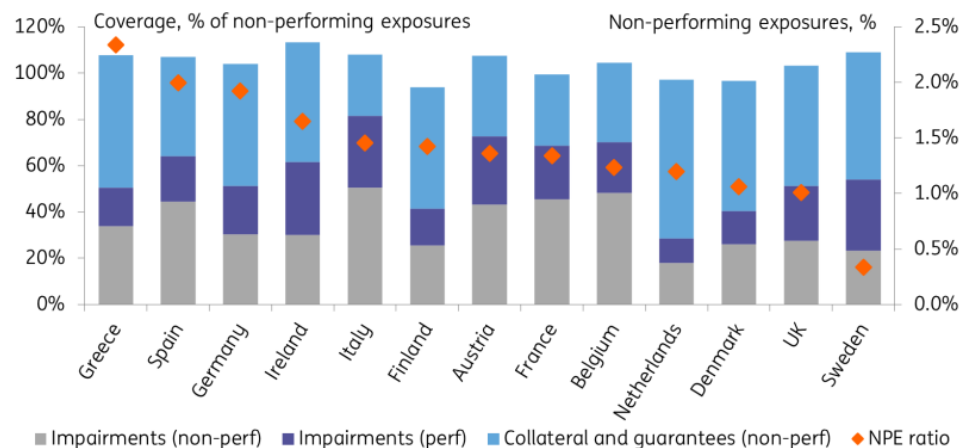
Note: data for 39 banks
Source: ING, company data

In terms of overall loan quality, Swedish banks are at the top of the range, with robust coverage for potential further weakening.

The highest problem exposures are for the selected German commercial real estate-centric banks that tend to have relatively limited direct coverage via impairments but have topped up the support with collateral and guarantees.

However, on a national level, Germany’s non-performing exposures are generally lower than those in Southern Europe. Spanish and Italian banks, which have higher NPE ratios, also have somewhat higher impairment coverage ratios, potentially mitigating the impact of further weakening on their earnings.

Banks are overall well prepared for weakening in exposures, while lower impairment coverage points to higher risk ahead



Note: data for 39 banks
Source: ING, company data

To conclude, the strong tailwind from higher interest rates has come to an end, and banks that are relying more on fee-based income instead of solely net interest income, and with the potential for M&A are a bit better positioned. This should include banks in Germany, Italy, Spain and France, for example, although French banks may suffer more from sovereign worries.

Loan quality should be supported by ECB rate cuts. We expect credit costs in 2025 to remain elevated but come below the levels seen in 2024. While we consider banks with a

mix of higher NPEs and lower coverage more at risk for further weakness, those with higher NPEs will also benefit the most from the ECB easing measures. This should be helpful for banks with higher cyclical exposures such as real estate, in particular.

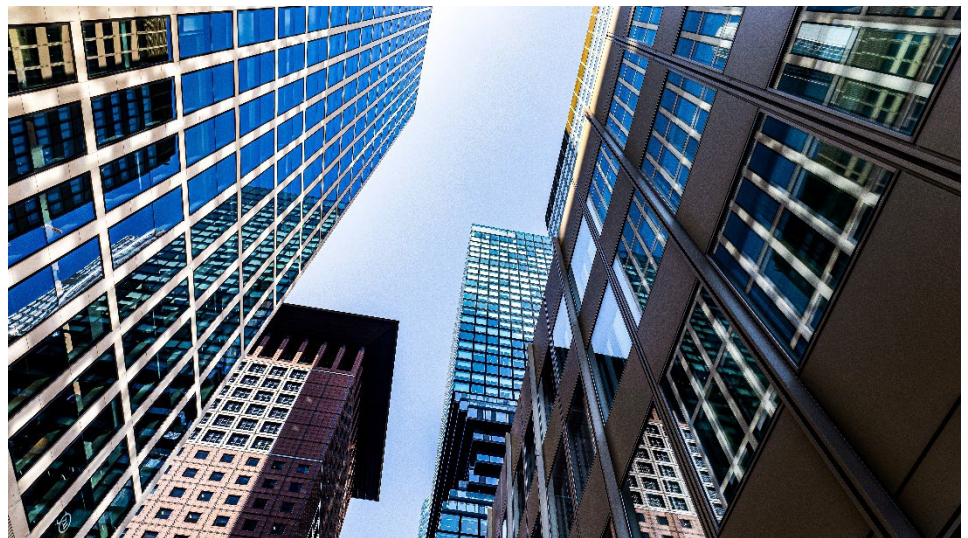
Although it's too early to declare the all-clear, the ECB rate cuts are expected to alleviate some pressure on loan quality next year.

From peaks to plateau: EUR bank bond supply in 2025

Next year's EUR bank bond supply is expected to stay high albeit less heavy than in 2024. We've identified three variables that are going to weigh on issuances level in 2025



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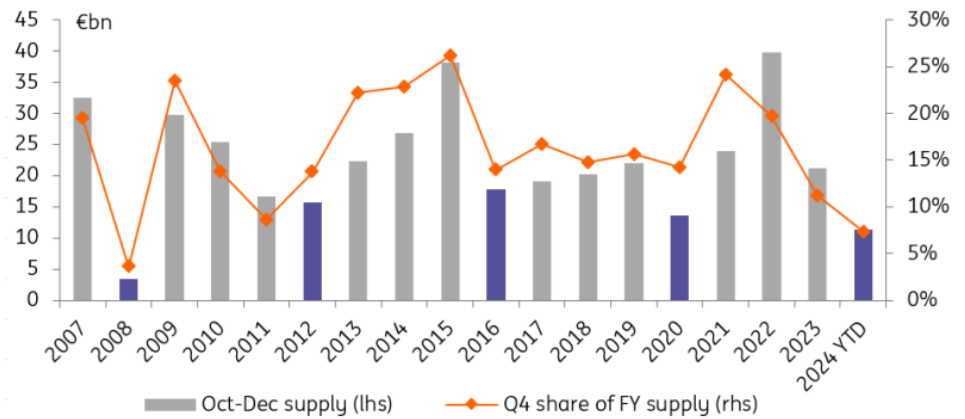
2024 bank bond supply review

EUR bank bond supply remained high in 2024 and is expected to reach €420bn at the end of the year. However, the YTD numbers are currently about €35bn short of the 2023 YTD level, with €391bn printed across the liability structure. Supply is split with just below €156bn in covered bonds, €186bn in senior unsecured instruments (with €74bn in senior preferred bonds and €112bn in senior bail-in bonds) and finally €49bn in subordinated debt issuance.

While we still expect a little below €30bn to be issued across the liability structure until the end of 2024, we foresee the overall supply levels staying below the 2023 total - despite the record-high issuances in 1Q24. We identify two reasons for that:

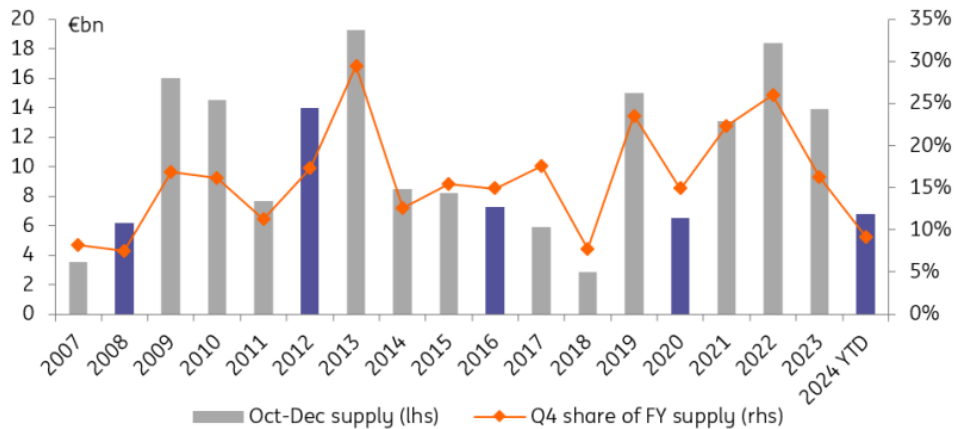
Firstly, **banks have historically been less active in the primary market during the 4th quarter of US presidential election years.** Data already points to a slowdown in issuances in the EUR market in October.

Covered bond supply history shows issuance drop in 4Q of US election years



Source: ING

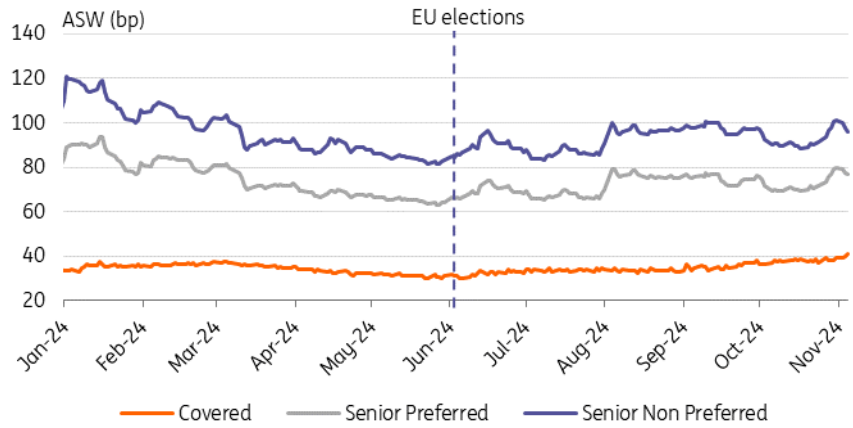
Senior preferred bond supply history also shows issuance drop in 4Q of US election years



Source: ING

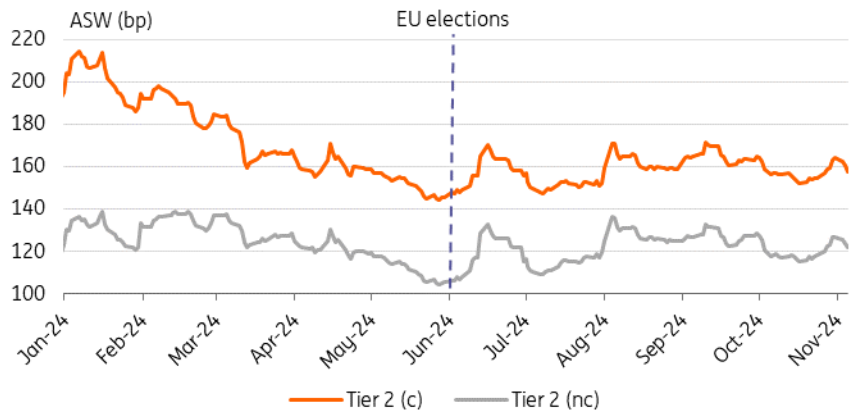
Secondly, the early summer volatility recorded following the European Parliamentary elections negatively impacted the bond primary market. The political turmoil was especially significant in France following Macron’s dissolution of the National Parliament. The consequent volatility affected bank bond spreads with a widening in all segments but more significantly in the higher beta part of the liability structure. Tier 2 bonds widened by about 20bps in June, while senior unsecured bonds underperformed by 10bps. Nonetheless, the EUR bank bond market recovered rather swiftly (at an aggregated level) with spreads back at their May levels as early as July, just a month after the election results.

Covered and Senior bonds Iboxx index performance over 2024



Source: IHS Markit, ING

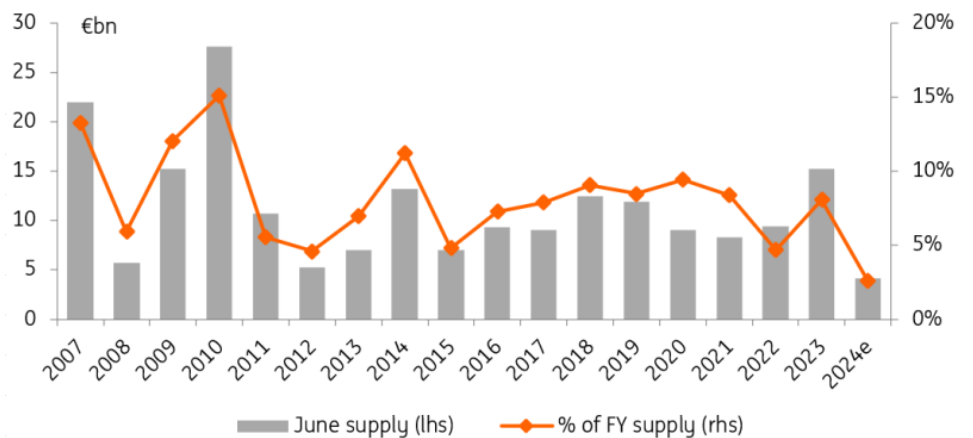
Tier 2 bonds Iboxx index performance over 2024



Source: IHS Markit, ING

Despite being short-lived, the volatility episode affected bank bonds' supply as issuers opted for a delay in their issuance rather than enter a volatile market associated with wider spreads. While May issuances were well on track with our estimates, June's total supply reached a historically low level, especially in the covered bond segment, as you can see in the graph below. Indeed, covered bonds issued in June represent only 3% of full-year expected supply versus an average of 8% over the last decade.

June covered supply reached historically low levels



Source: ING

Three variables affecting bank bond supply in 2025

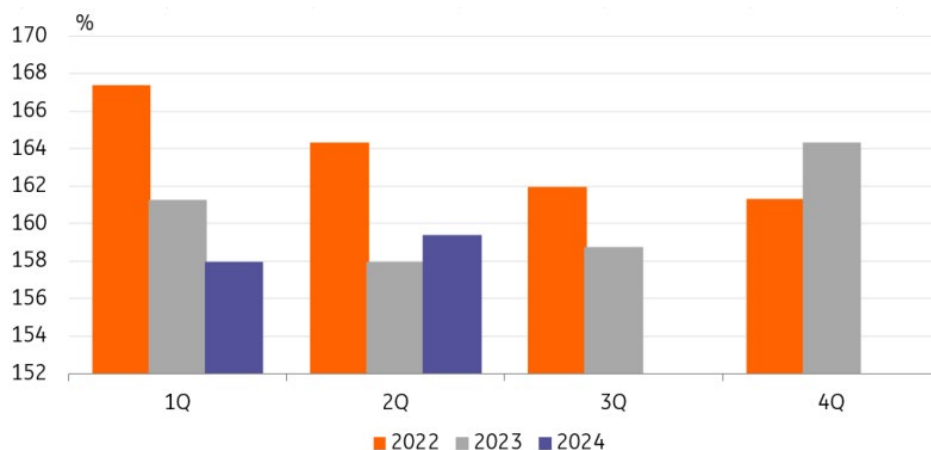
Those two points explain the 2024 supply levels, but what can we expect for 2025? We foresee the market remaining active despite banks issuing a slightly lower amount of bonds than in 2024, with a total supply of €400bn. The following section explores the three main variables affecting next year's EUR bank bond supply.

1. The end of the TLTRO III era

The ECB Targeted Long-Term Refinancing Operations III (TLTRO III) last reimbursement leg is set for December 2024. Banks' heavy activity on bond primary markets over the last two years partly reflects the switch from the ECB to other funding types.

Data also shows that some European banks reduced their Liquidity Coverage Ratio (LCR) instead of fully replacing the repaid TLTRO and increased their MRO and LTRO drawings. Despite some national variations, LCR ratios remain well above the 100% minimum threshold.

Aggregated LCR ratio dropped in 1Q24 YoY but remained stable in 2Q24



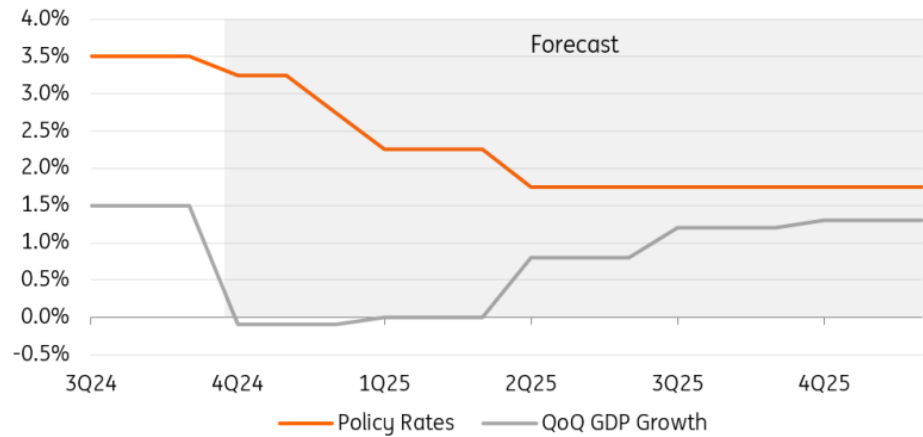
Source: ECB, ING

All in all, **the end of TLTRO repayments is expected to negatively impact European bank bond supply** as issuers have already substituted their expiring TLTRO fundings on the primary market over the last few years and won't need to replace expiring ECB funding as of 2025.

2. No growth miracle

The ECB announced an additional 25bp rate cut in mid-October. This marked the third cut in 2024 in response to the decrease in inflation and a slowing economy. Our economists are pencilling in several additional rate cuts for 2025, bringing interest rates down from 3.25% to 1.75% at the end of the year. The EU GDP growth forecast is expected to remain sluggish next year, below 2%.

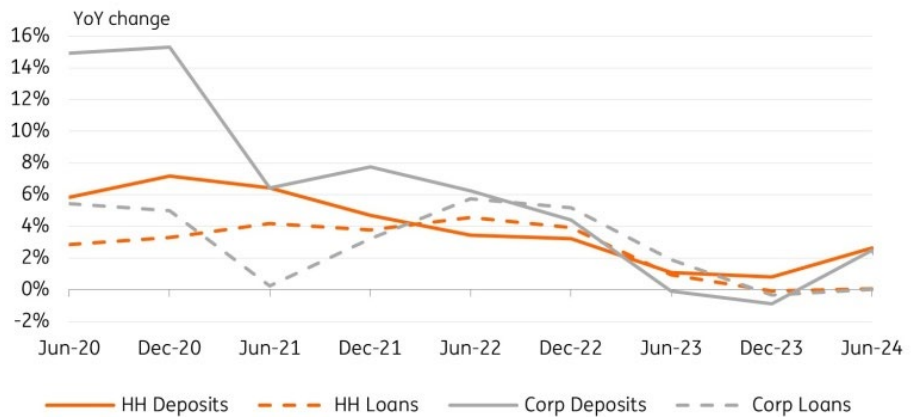
Policy rates and GDP growth projections



Source: ING

In that environment, we expect lending to also remain subdued. Furthermore, over the first half of 2024, the ECB recorded an increase in banks' lending and deposits for both households and corporates. However, the progression was about 2.5pp higher for deposits than it was for loans. In our view, **lending growth will, therefore, not become a firm driver for bank bond supply in 2025.**

Households & Corporates deposits increase over 1H24



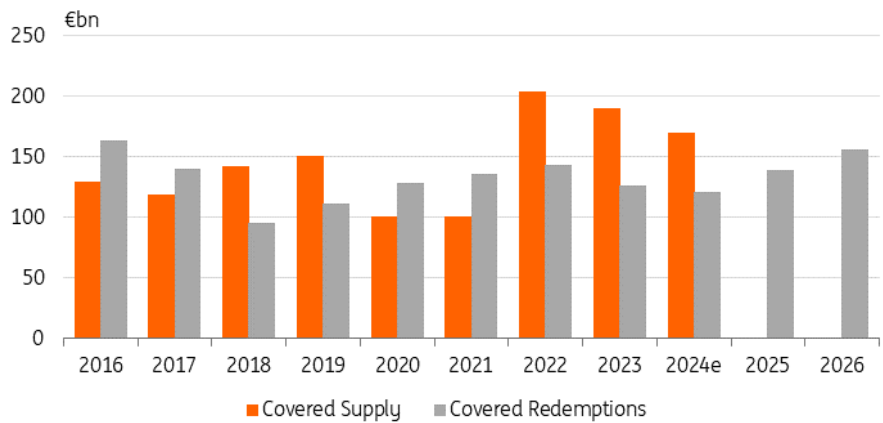
Source: ECB, ING

3. Higher bond redemptions

While the two points mentioned above suggest a lower bond supply in 2025, the higher redemptions level will be the main driver pushing new issuance levels upwards. Indeed, redemptions for 2025 will surpass levels seen since 2022 in all segments of the liability structure.

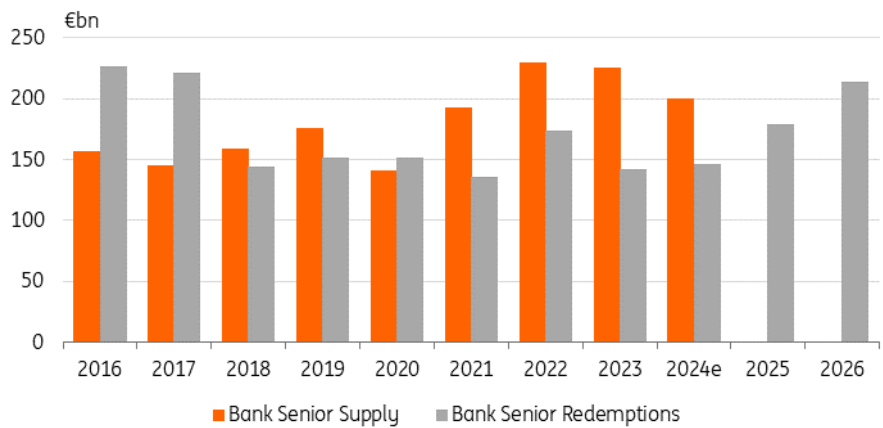
Covered bond redemptions will reach €139bn in 2025 and €156bn in 2026 versus €121bn this year. The increase is also seen in the senior unsecured segment with an aggregated redemptions increase of €33bn. Finally, bank capital redemptions will also surge in 2025 to reach €43bn (with €28bn in Tier 2 bonds and €15bn in AT1 segments). That's €18bn higher than in 2024. However, contrary to the covered and senior segment, redemptions of both Tier 2 and AT1 bonds will stagnate as of 2026.

Covered bond redemptions will increase in 2025



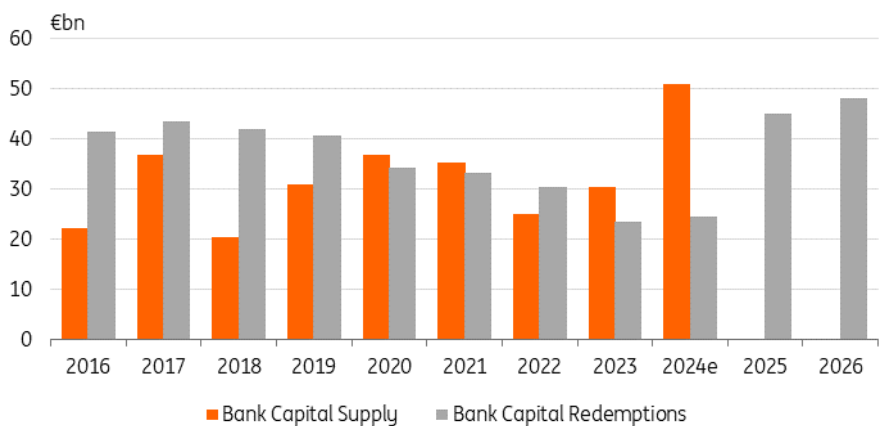
Source: ING

A similar increase can be seen for senior unsecured bonds



Source: ING

Increase even more significant for bank capital issuances



Source: ING

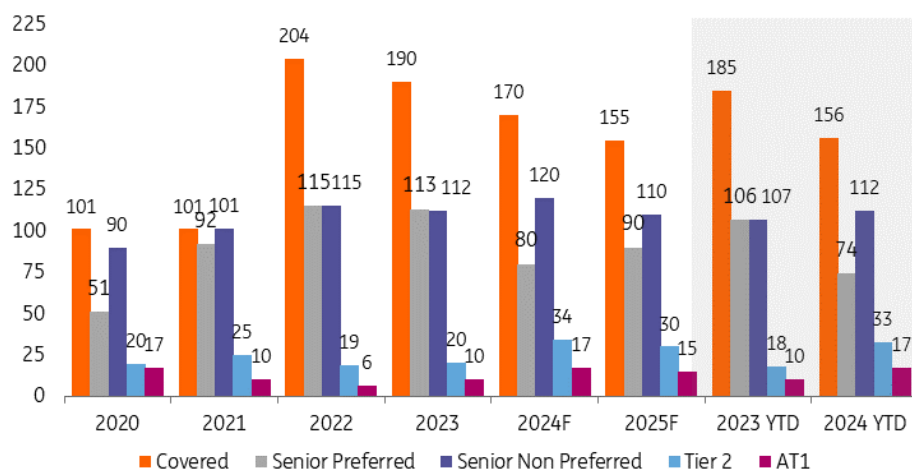
We expect banks to remain active in the EUR bond market next year and refinance the vast majority of maturing instruments in the next two years.

All in all, we foresee next year's bank bond supply remaining high but below levels seen since 2022 as a consequence of both the end of TLTRO III repayments and sluggish lending growth. The main supply driver will be the high redemption levels across the board, issuers looking to refinance those expiring bonds, and potentially pre-funding the heavy 2026 redemption flow.

Our 2025 bank bond supply expectations

Taking into account all those variables we've just discussed, we estimate gross bank bond supply to reach €400bn in 2025. We expect issuances to be split, with €155bn in covered bonds, €200bn in senior instruments and €45bn in bank capital. Overall, that's €21bn lower than our current forecast for the full year 2024. Nonetheless, it still implies a positive net supply of €37bn for next year.

Forecast bank bond supply for 2025



Source: ING

Covered bonds supply pressured downward due to the end of TLTRO III reimbursements

We forecast that covered bond supply will reach €155bn, including sub-benchmark and floating-rate notes. This is a €15bn decline compared to our expected levels for 2024, mostly stemming from the end of TLTRO refinancings. In addition, we believe that banks have already turned to the primary market to pre-finance the high redemptions of 2025. This limits the impact of maturing bonds on the overall supply for next year.

Stagnant senior unsecured supply to compensate the bulk of redemptions

We see senior unsecured issuances stabilising over 2025 and thus offsetting part of the decline in covered bond prints. We forecast a solid senior preferred supply, reaching €90bn, and senior bail-in bond issuances at €110bn. The share of senior bail-in bonds over total senior unsecured instruments is expected to decline a tad (5pp) compared to 2024, as this year's senior preferred issuances were exceptionally low (lowest levels since 2019). We thus expect the share of senior preferred bond issuance to increase closer to historical averages over 2025.

The aggregated stabilisation of the senior unsecured supply versus 2024 stems from the significant increase in redemptions for both 2025 and 2026. Thus, despite some of the refinancing already taking place over 2024, banks are expected to take the opportunity to refinance their bonds maturing in 2026 upfront, avoiding the bulk of supply the following year. However, this will be dependent on adequate market and economic conditions.

Another strong year for bank capital supply

Primary issuances in euro-denominated regulatory bank capital debt have been very strong in 2024, and we expect another substantial supply year ahead despite pencilling in an aggregated €6bn decrease in Tier 2 and AT1 supply next year. This brings our capital supply forecast to €30bn in Tier 2 instruments and €15bn in AT1 bonds.

In the AT1 segment, our baseline is that most banks seek to refinance upcoming calls instead of extending their outstanding deals. Furthermore, we also expect banks to continue to take a cautious approach to refinancing approaching calls next year. In the end, the decision to call will be driven by the market backdrop heading closer to the call date and in particular by issuer (and in some cases bond) specifics.

As for Tier 2 bonds, despite relatively high redemptions in 2025, we don't expect all redeeming bullets to be refinanced in the same format due to the loss of their regulatory capital eligibility. Thus, we expect part of these bonds to be refinanced as senior instrument instead and therefore account for MREL eligibility. Read more on banks' regulatory capital [here](#).

ING's bank bond issuance estimates (€bn)

	FY19	FY20	FY21	FY22	FY23	FY24F	FY25F	2023 YTD	2024 YTD
Covered bonds	151	101	101	206	191	170	155	185	156
<i>Covered redemptions</i>	118	134	143	143	126	121	139		
Bank senior unsecured bonds	176	141	193	230	227	200	200	213	186
<i>Preferred senior unsecured</i>	81	51	92	115	115	80	90	106	74
<i>Bail-in senior unsecured</i>	95	90	101	115	112	120	110	107	112
<i>Senior unsecured redemptions</i>	155	154	138	175	144	144	179		
Bank subordinated bonds	31	37	35	25	30	51	45	28	49
<i>Tier 2 debt</i>	21	20	25	19	20	34	30	18	33
<i>Additional Tier 1 debt</i>	10	17	10	6	10	17	15	10	17
<i>Bank capital redemptions</i>	41	34	33	31	24	27	43		
Total bank supply	358	278	329	461	448	421	400	426	391

Source: ING

Less sustainable issuance by banks in 2025

Banks are expected to reduce their issuance in sustainable format next year against the backdrop of overall lower issuance volumes



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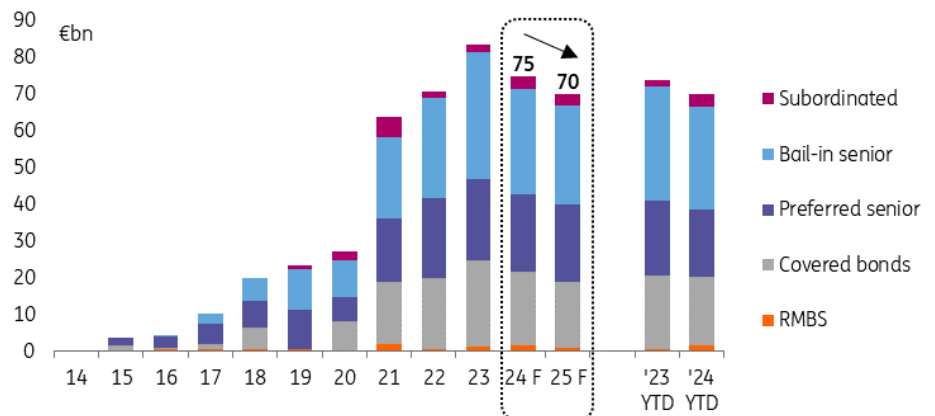


ESG issuance falls short to last year

For the first time in a decade, the supply of EUR sustainable bank bonds will not surpass the previous year's volumes. With lending growth stagnating and overall supply activity by banks slowing down, ESG bond issuance by banks in 2024 is likely to end the year close to €75bn.

Banks globally have issued €70bn in EUR-denominated ESG bonds so far this year, down from €74bn last year. Covered bonds and preferred senior unsecured bonds represent 27% and 26% of the year-to-date ESG print, respectively, while bail-in senior issuance makes up 40% of the green and social use of proceeds supply. Subordinated bonds and RMBS have a modest share of 5% and 2%, respectively, in the 2024 ESG print of banks.

Lower issuance by banks will coincide with less ESG supply in 2025



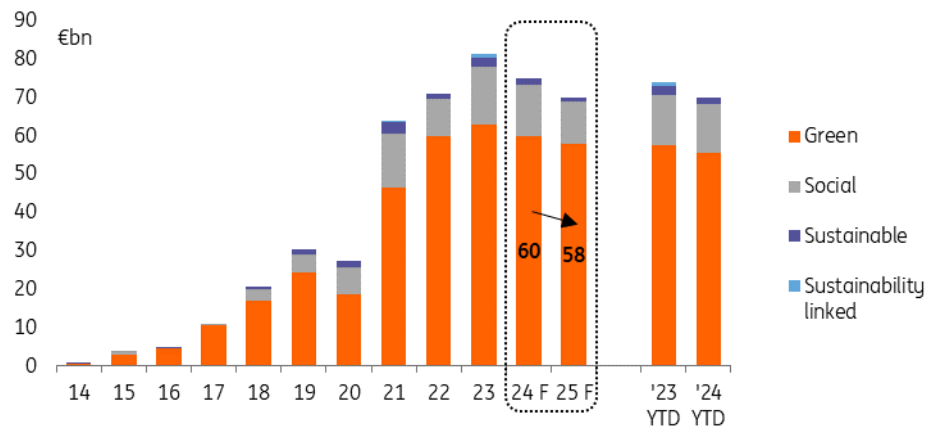
*Only bonds included with a minimum size of €250m
 Source: ING

The slower ESG issuance by banks this year has been well spread across the different use of proceeds categories, with green, social and sustainability issuance all three slightly below last year's YTD print. Green issuance still represents the bulk of the ESG supply with a share of 79%, followed by social issuance with 18%. Sustainability (i.e. a combined green and social use of proceeds) only made up 2% of the ESG issuance.

This shows that social bond issuance continues to struggle to gain momentum following the surge after the Covid-19 pandemic. Part of the reason is the stronger regulatory emphasis on green bonds, as outlined in the EU taxonomy regulation and the EU green bond standard.

In the unsecured segment, the proceeds use remains predominantly green. However, in covered bonds, social issuance is keeping better pace with green issuance. For example, social and sustainable covered bond issuance has reached nearly €8bn YTD, surpassing the €6.5bn in unsecured social and sustainable issuance. In contrast, the €11bn in green-covered bond issuance is only a quarter of the unsecured green supply.

Green will remain the dominant use of proceeds type



*Only bonds included with a minimum size of €250m
Source: ING

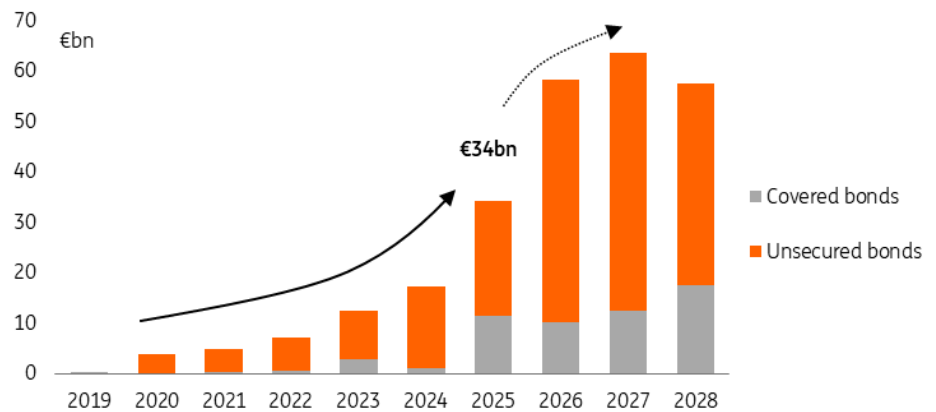
The 2025 ESG print by banks will fall to €70bn

We anticipate a slight decrease in ESG supply by banks in 2025 compared to the previous year, with expected ESG issuance around €70bn. Of this, 80% is projected to be in green format. Banks are expected to issue €20bn less in total (including both vanilla and ESG bonds), and lending growth is forecasted to increase only gradually next year. Hence, sustainable loan portfolios will see modest growth.

Banks may find opportunities to further grow their sustainable assets through the criteria set in the EU Taxonomy's environmental delegated act (e.g. to support the circular economy), but climate change mitigation will remain the key driver of green supply.

ESG redemption payments will rise from €15bn to €34bn. This will also free up sustainable assets for new ESG supply, but probably not for the full amount due to the changes made to some of the green bond eligibility criteria since the bonds were issued.

Banks will repay €34bn in sustainable bank bonds in 2025

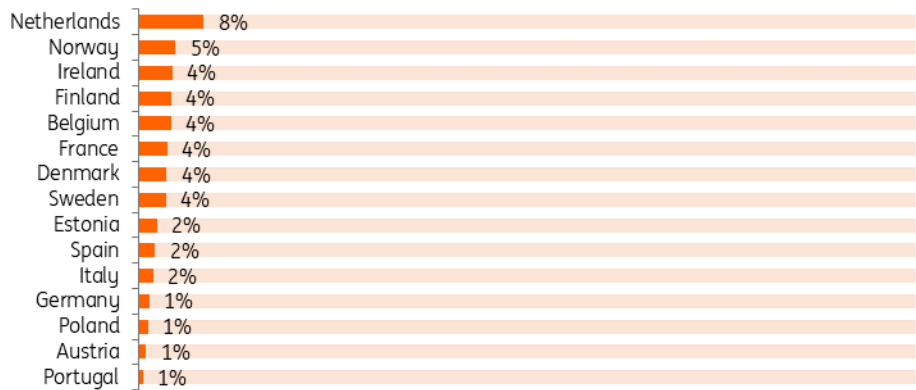


*Only bonds included with a minimum size of €250m
Source: ING

Limited issuance expected under the EU green bond standard

As of next year, banks can also opt to issue their green bonds under the EU green bond standard. Considering the low first green asset ratio (GAR) disclosures by banks this year, we doubt we will see a lot of bank bond supply under this standard. Based upon the Pillar 3 disclosures of a selection of 45 banks, the average Taxonomy alignment of bank balance sheets per country varies in a low range of 1% to 8%.

Green asset ratio disclosures point to low Taxonomy alignment

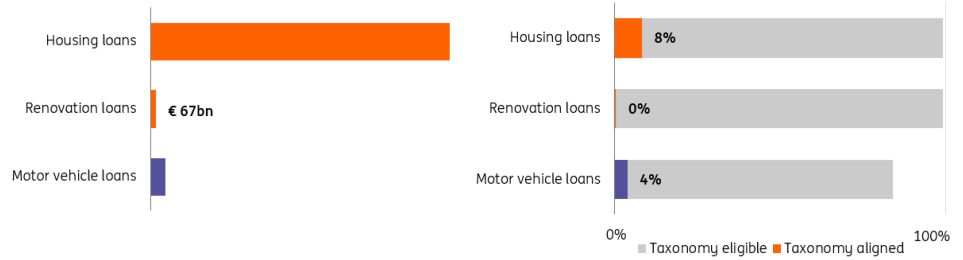


Source: Issuer Pillar 3 disclosures of 45 banks (1H '24), ING

Given the low reported EU Taxonomy alignment of banks' mortgage lending books, many banks may struggle to assemble a sufficiently large portfolio of Taxonomy-aligned assets to support green issuance under the EU GBS format. This is unless they are confident in the growth prospects of their Taxonomy-aligned assets within five years of issuance, particularly for standalone deals where a portfolio approach is not used.

Loans to households have a low Taxonomy alignment

Banks have few renovation loans outstanding and they are almost 0% taxonomy aligned

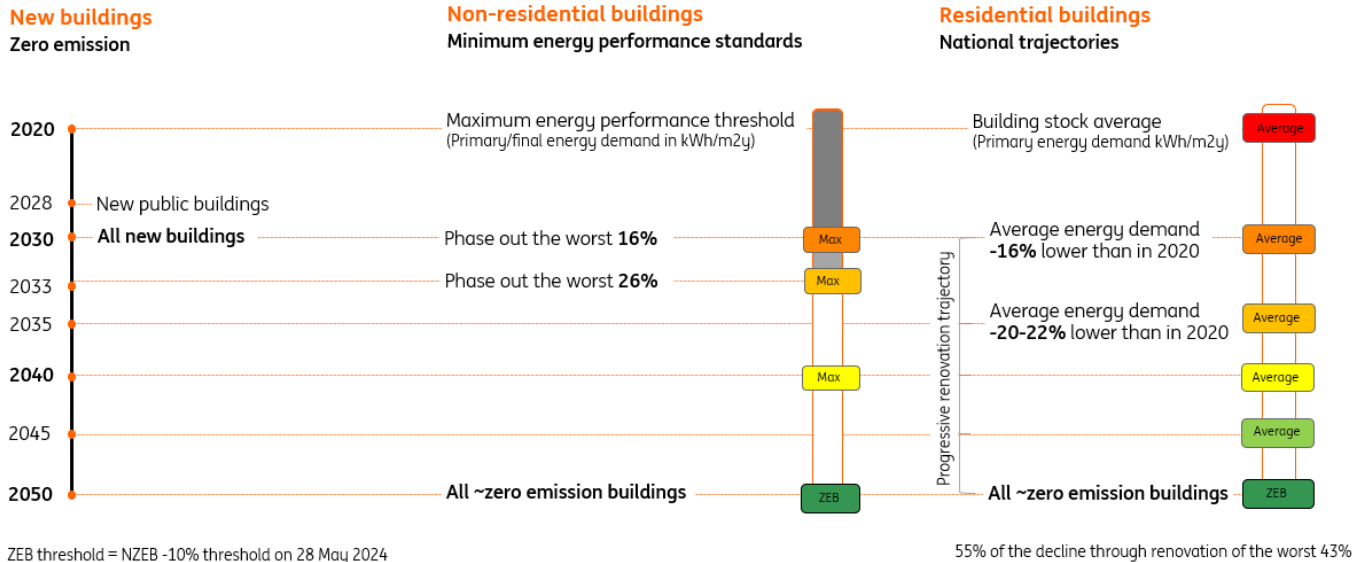


Source: Issuer Pillar 3 disclosures of 45 banks (1H '24), ING

Regulatory initiatives, such as the Energy Performance of Buildings Directive (EPBD), promoting the renovations of buildings within the EU, should in time see the portfolios of Taxonomy-aligned assets grow. Given the timelines set, this will not be a major support in 2025.

To encourage banks to provide lending for the renovation of the worst-performing buildings, the European Commission is working on a separate delegated act for a comprehensive portfolio framework for voluntary use. The response period for the European Commission's call for evidence on the portfolio framework ended on 5 November, with the Commission now aiming to launch a public consultation on this topic before year-end.

Timelines under the Energy Performance of Buildings Directive



ZEB threshold = NZEB -10% threshold on 28 May 2024
Source: European Commission, ING

Banks with a more balance sheet size and the ability to select enough Taxonomy-aligned assets for a benchmark-sized deal are likely to be among the first to test the waters by issuing bonds under the EU Green Bond Standard.

For the issuance of bonds with a longer maturity, banks may wish to finance a distinct set of Taxonomy-aligned assets rather than allocate their bond proceeds to a portfolio used for multiple European green bonds (ie portfolio approach). If the EU Taxonomy technical screening criteria are amended, assets not meeting the amended criteria can stay part of the green portfolio for seven years at most. Instead, standalone deals will in principle keep their EU green bond status based on the old technical screening criteria if these are amended before the bond's maturity.

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