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Banks Outlook 2024

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

Suvi Platerink Kosonen
Senior Sector Strategist, Financials
suvi.platerink-kosonen@ing.com

Marine Leleux
Sector Strategist, Financials
marine.leleux2@ing.com

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Banks Outlook 2024: Banks in a world of higher for longer

From TLTROs to European Taxonomy, capital requirements to commercial real estate, and bond supply to ESG, we've got banks covered in our comprehensive look at the challenges and opportunities facing financial institutions next year

Life after TLTROs: *Bank liquidity and funding will be tested in 2024.*

The final tranches of the European Central Bank's targeted longer-term refinancing operations (TLTRO-III) will mature in the course of 2024. The existing liquidity buffers will likely be used to absorb part of the further LTRO runoff. We see a higher risk for increased bank bond issuance, notably for Italian and German banks.

European Taxonomy*: Now the banking sector is gearing up for more disclosures.*

The second Taxonomy disclosures for banks include a variety of methodologies hindering comparability. Calculation differences aside, banks slightly improved their eligibility ratio with an average of 30% for 2022, 2pp above 2021. More banks reported their eligible asset share over their covered assets, in line with GAR requirements starting in 2024.

What banks can expect from the capital requirements regulation review:

Talks over banks' capital requirements aren't new, and 2024 promises to be no different. Once the final CRR III policy has been approved, banks will need to take a range of actions to implement it before January 2025. A delay in the final policy or national regulators' preferential treatment position could result in a sequencing issue for European banks.

Why commercial real estate concerns haven't subsided for banks just yet:

The softness in the commercial real estate market is not a concern of the past yet. Nordic banks remain most exposed to the CRE sector, but when it comes to climate change transition risks, these assets do not appear to be among the most vulnerable in Europe.

Five factors driving bank bond supply next year:

2023 has been a very significant year for bank bond supply, but we don't expect supply to turn lower in 2024. We expect bank bond supply to remain high in 2024, reaching €455bn. The five major drivers for bank bond issuance for 2024 are

1) At best, sluggish lending volumes
2) Less reliable deposit developments
3) End of the ECB funding support for banks
4) Bond redemptions remain broadly stable, and
5) Bail-in senior markets reaching a more mature stage.

ESG supply by banks set to stay strong in 2024:

ESG primary market activity by banks is set to remain strong in 2024 but isn't likely to be quite as prosperous as in 2023 due to slower lending growth. At €75bn, sustainable supply will still be lively, though, as banks will remain resourceful in identifying new assets suitable for ESG issuance.

Life after TLTROs: Bank liquidity and funding will be tested in 2024

The final tranches of the European Central Bank's targeted longer-term refinancing operations (TLTRO-III) will mature in the course of 2024. The existing liquidity buffers will likely be used to absorb part of the further LTRO runoff. We see a higher risk for increased bank bond issuance in particular for Italian and German banks

Suvi Platerink Kosonen
Senior Sector Strategist, Financials
suvi.platerink-kosonen@ing.com

Eurozone banks see their liquidity coverage ratios drop in 2Q

The liquidity position of eurozone banks weakened in the second quarter. The liquidity coverage ratio (LCR) of banks declined by 3ppt to 158% in 2Q, down from 161% in 1Q. The minimum requirement is set at 100%. The numbers are based on the ECB's supervisory banking statistics for the second quarter, covering 110 significant institutions in the eurozone that are supervised by the ECB.

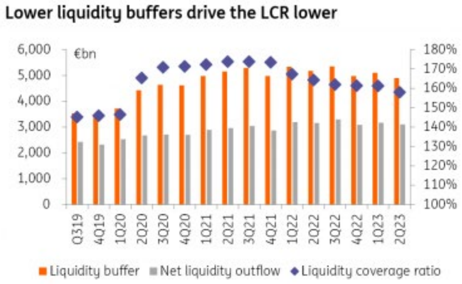
The LCR decline is mainly driven by the significantly lower Level 1 assets, forming the bulk of the €4.9tn aggregated liquidity buffer of banks. Banks have driven down their (adjusted) Level 1 assets by €235bn quarter-on-quarter. To offset just a small fraction of the reduction in (we think) cash and central bank deposits, banks have increased both their extremely high-quality Level 1 covered bond holdings (+€31bn QoQ) and Level 2 assets by +€30bn QoQ. However, both expected inflows and outflows fell, leading to a net reduction of €61bn for the net liquidity outflows over the quarter.

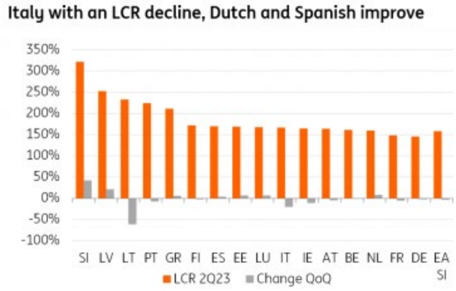
Based on bank balance sheet data, cash, cash balances at central banks and other demand deposits declined over the quarter by €303bn QoQ, while government bond holds increased by €34bn QoQ for the significant institutions. While these cash balances do include minimum required reserves held at the central bank, which are not eligible for Level 1 assets for the LCR purposes, the change in minimum reserve requirements has been very limited during this time period.

The decline in LCRs does not come as a surprise. The largest tranche of the TLTRO-III operation matured on 28 June. The outstanding LTROs halved in 2Q23 QoQ as banks paid back €503bn of funding to the ECB. We consider these repayments to be the major driver behind the lower liquidity buffers in 2Q as not all funds were refinanced.

The LCR remains well above the levels seen in 3Q19, i.e. prior to the allotment of the bulk of the TLTRO-III programme, when the LCR was 145% for eurozone banks.

Liquidity coverage ratios have turned lower





ING, ECB

Country differences are substantial; Italy leads the decline

Country differences in the development of LCRs are considerable and mixed.

Among the larger countries, in particular, Italy shows a substantial LCR decline of 20ppt to 166% from 187%. The largest LTRO repayments in 2Q23 were made by banks in Italy (€146bn), a likely driver for the lower LCR of Italy's significant institutions. The impact on liquidity buffers though is perhaps less negative than it could have been. For the significant institutions, the aggregated liquidity buffers declined only by €52bn during the same time period.

We show a ratio of the change in liquidity buffers against the change in LTROs for selected countries in the chart below. For Italy, this share was 36%, not far off the eurozone average of 40%. This means that instead of driving down their liquidity buffers, Italian banks have sourced liquidity elsewhere, as their net outflows were more or less stable. It is good to note that as we do not yet have data for the less significant institutions for 2Q, this analysis includes only the larger banks for the liquidity buffers while the LTRO numbers include the whole banking system of the country.

Other countries that show a larger LCR decline include Ireland, with a decline of 11ppt to 164%. Irish banks largely paid down their LTROs already in 2022. The lower LCR ratio was instead driven by an increase in net outflows.

Portuguese, French and Austrian banks show an LCR decline in the range of 5-8%, while German, Finnish and Belgian banks reported more limited declines in their LCR ratios.

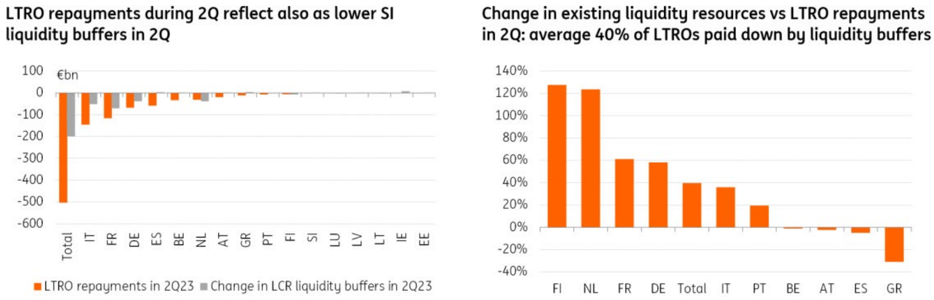
French banks paid back €117bn in LTROs in 2Q, while their liquidity buffers declined by €71bn with a ratio of the two just above 60%. The share of liquidity decline vs repayments for German banks is closely aligned with the French banks at 58%. French and German banks have thus perhaps utilised a larger share of their existing liquidity resources to pay back the ECB than their Italian counterparts, for example.

In the case of Austria, the aggregate liquidity buffers remained more or less unchanged, while the net outflows were somewhat higher, resulting in a lower LCR.

Not all LCR ratios declined, however. Dutch banks actually increased their LCR ratio by 8% QoQ to 160%. While the €39bn decline in liquidity buffers of large Dutch banks outpaced the repayments (€31bn) in LTROs in 2Q, the net LCR outflows declined by €41bn over the quarter, explaining the LCR improvement.

Also, Greek and Spanish banks have strengthened their LCR ratios over the quarter (by +6ppt to 211%, and +4ppt to 170%, respectively). Both reported higher liquidity buffers despite LTRO repayments, while for Spain the impact was further supported by lower net outflows.

The LTRO runoff has driven down liquidity buffers



Source: ING, ECB

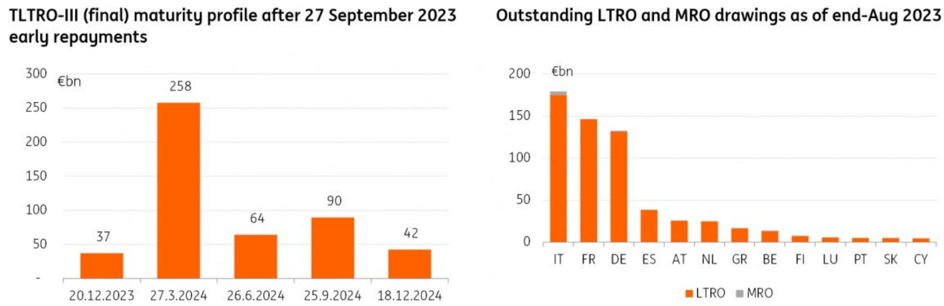
Will the LTRO repayment activity continue to push bank liquidity lower or will banks replace the funds?

European banks still had some €598bn in longer-term refinancing operations outstanding as of 2Q23. The LTROs slightly increased (+€4bn) from end-June until end-August, as banks increased their drawings from the shorter-term LTROs.

Since then, the September 2023 TLTRO-III tranche has matured with €67bn in balances, on top of which banks have paid back early €34bn across the other tranches. This leaves outstanding drawings for TLTRO-III operations of €491bn maturing between December 2023 and December 2024 (see chart below). A large part of the funds redeem in March next year.

The largest users of the ECB funding operations are banks in Italy, France and Germany with outstanding LTRO drawings of €175bn, €146bn and €132bn, respectively, as of end-August.

The TLTRO-III programme matures in the course of 2024



Source: ING, ECB

Choosing between existing liquidity buffers and refinancing

The TLTRO refinancing choices of banks will continue to drive both the development of liquidity buffers and the euro-denominated bank bond supply in the course of 2024. The differences between countries and between banks are likely to remain substantial.

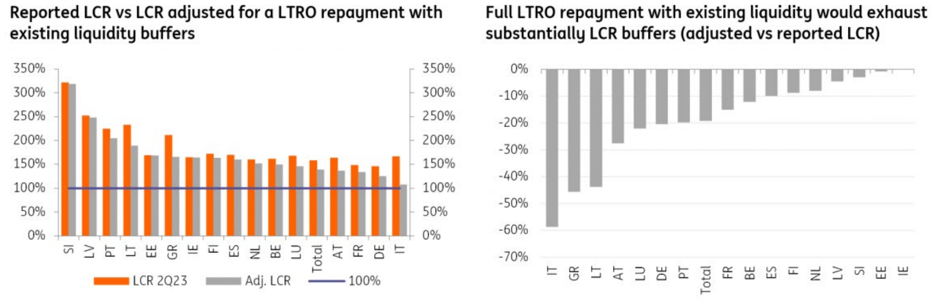
Alternative 1. Repayment of outstanding LTROs fully with existing liquidity buffers.
If banks were to fully repay all their LTRO drawings with their existing liquidity buffers, based on the aggregated numbers, the combined liquidity buffers would drop to €4.3tn and, assuming no change in net outflows, the LCR would adjust to a 19ppt lower level of 139%.

The LCR impact would be larger for banks in countries with larger LTRO drawings as shown in the charts below. Italian banks, in particular, would see a substantial impact on their liquidity buffers and on their LCR ratios due to their large share of existing LTRO funding, with the adjusted LCR dropping below 110% (see charts below).

A large negative impact would also be seen for Greece, Austria and Germany, among others. The German LCR would drop towards 125%. While being substantially lower than the 2Q23 level, this would still retain some headroom over the requirements. French, Spanish and Benelux banks would see a smaller negative impact. In the case of Greek banks, the LCR would remain at relatively high levels even adjusted for the repayments.

While we argue that most banks could pay down their LTROs with the existing buffers, the impact on LCR ratios would be too large for this to be a likely scenario in our view. We believe a strong enough buffer over minimum LCR requirements is extremely important for retaining trust in financial markets.

If banks were to pay back the LTROs with existing liquidity resources, the impact on liquidity coverage ratios would be substantial



Source: ING, ECB

Alternative 2. Depleting liquidity buffers towards the levels seen before the TLTRO-III was allocated.

LCR ratios have increased substantially, supported by the TLTRO-III programme. Banks could decide to lower their LCRs towards more normalised levels and use the slack for the LTRO runoff.

The very first tranche of TLTRO-III in September 2019 saw very limited demand of only €3bn. The second one, which settled in December 2019, was larger (€98bn). Since then, the LCR of eurozone banks has trended higher in tandem with the size of the TLTRO-III programme. We use the quarter before the first larger settlement as guidance for the more normal or desired LCR level. In 3Q19, systemic institutions had an LCR of 145%.

If you assume this 145% is a more normal level for the LCR, banks could lower their LCR ratios by some 13ppt. This would translate in the eurozone's larger banks having some €400bn in excess LCR liquidity buffers. Comparing this to the c.€600bn in LTROs that were outstanding at end-2Q would leave €200bn to be refinanced to retain their 3Q19 LCR levels.

As often is the case, the country differences are substantial. The chart below shows that not all banks have actually increased their LCR ratios despite their higher TLTRO drawings. In Finland and Slovenia, banks were running with lower LCR ratios in 2Q23 than in 3Q19. As Finland runs with lower LCR ratios as compared with the 3Q19 level, there is no “excess” above these 2019 levels to refinance the maturing LTROs of €8bn. We show the excess liquidity buffers ahead of 3Q19 levels against outstanding LTROs by country in the chart below.

In Germany, the LCR of significant institutions in 2Q23 was closely aligned with that in 3Q19. Therefore if banks in Germany wanted to retain their current 3Q19 LCR levels, they would need to refinance their €130bn outstanding LTROs to a large extent.

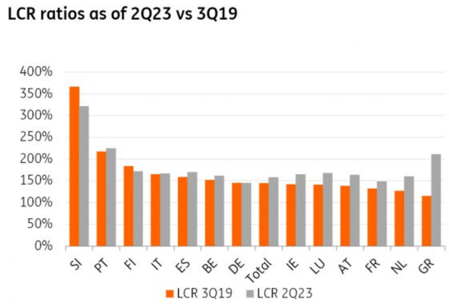
At the other end, in Greece, the LCR ratio of significant institutions in 2Q23 was almost double the level in 3Q19. If Greek banks were to return their LCR level to that in 3Q19, the banks could release up to €35bn in liquidity to fully redeem their €17bn LTROs.

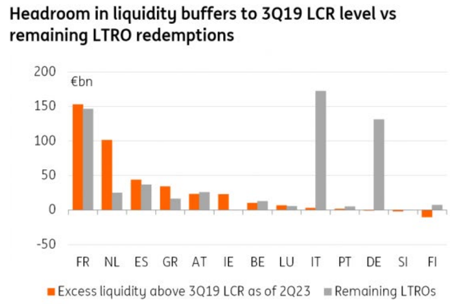
Therefore they could continue running with higher LCRs than they did in 2019 despite the LTRO runoff.

Banks in the Netherlands, Austria, Ireland and France have LCR ratios that are 15-30ppt higher than in 3Q19. Dutch banks would be able to comfortably redeem the remaining LTROs with existing liquidity buffers and remain ahead of 3Q19 LCR levels. Also, French banks would have room in their existing liquidity buffers to pay down LTROs and still just remain ahead of their LCR levels in 3Q19. In Austria, meanwhile, the outstanding LTROs would be a limited €2bn higher than the "excess above 3Q19" LCR buffers. Irish banks have already more or less fully repaid their LTROs.

In Italy, the LCR for significant institutions was some 1ppt higher in 2Q23 than in 3Q19. If these banks wanted to closely align their LCR ratios with 3Q19 levels, they would need to refinance the bulk of their outstanding €170bn LTROs to support their liquidity buffers. The gap would be the largest among countries. Portugal (€3bn), Belgium (€3bn) and Austria (€2bn) would also need to refinance part of their LTROs to keep their LCR at similar levels to 3Q19.

The TLTRO-III programme has inflated bank liquidity buffers





Source: ING, ECB

The potential impact from less significant institutions

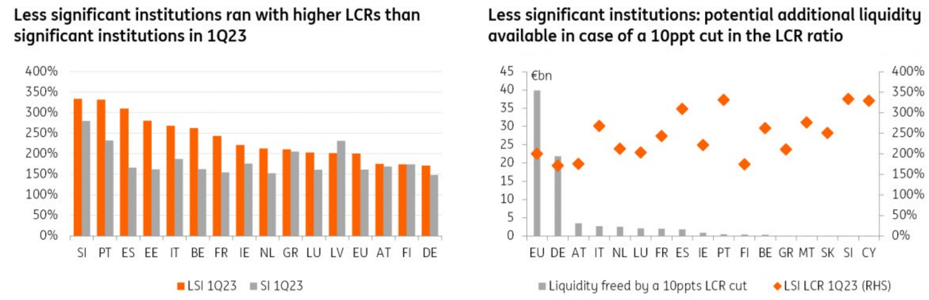
The numbers above do not give a full picture of the existing liquidity buffers of the banking system, as they include only the largest banks in the area and exclude the less significant institutions. The LTRO data instead is for the total system.

We would generally expect smaller banks to run with larger LCR ratios than larger banks due to, among others, weaker market access, less diversification and lower bond ratings.

The ECB is yet to publish the liquidity data for the less significant institutions for 2Q23. In 1Q23, these smaller banks carried LCR liquidity buffers of €800bn with an average LCR of 200%. This is a substantially higher LCR level than the average 161% for the larger banks in 1Q as shown in the chart below.

If these less significant banks were to lower their LCR ratios by 10ppt-20ppt, this would correspond to €40bn-€80bn in liquid assets that could be used to offset part of the LTRO runoff. The chart below shows that the country differences are very large, and around half of these funds would actually be in Germany. This data set is not available for the times before the TLTRO-III was allotted and as such we don't include a comparison to the 3Q19 LCR levels for the smaller names.

Less significant institutions tend to run with higher liquidity buffers than significant institutions



Source: ING, ECB

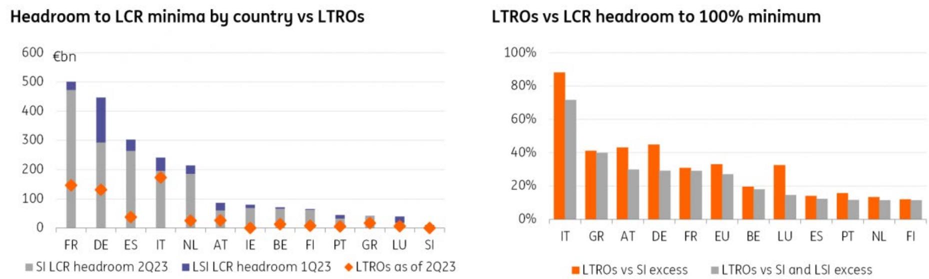
Banks have to meet an LCR level of 100%. The chart below shows the combined LCR liquidity headroom to this minimum LCR requirement for both significant institutions (as of 2Q) and less significant institutions (as of 1Q). In particular, in the case of German banks, smaller banks' excess LCR liquidity buffers make a considerable difference to the country comparison. For other countries, the impact of adding smaller institutions makes less of a difference.

In Italy, paying back the LTROs with the existing buffers would absorb the highest share of excess liquidity buffers above the 100% LCR ratio when including the buffers in the less significant institutions, followed by Greece, Austria and Germany.

It is good to note that while these charts show the headroom to the minimum requirement of 100%, we don't consider that any bank would actually want to see its liquidity buffers drop to a level that is very close to it. Instead, we would expect banks generally to target much higher levels and include a management buffer over the minimum requirement to retain market and client confidence.

Banks have substantial headroom above minimum LCR requirements

They may have enough to pay down the LTROs but keeping a strong enough management buffer is essential



Source: ING, ECB

So what's in store for 2024?

We expect banks to continue to partially deplete their still large liquidity buffers to redeem their outstanding LTRO drawings. Part of the drawings will likely be refinanced via bond markets to allow for longer maturity funding.

We think that banks with a higher LTRO-adjusted LCR ratio would be less likely to refinance their redeeming LTROs via other channels, including bond markets. Portuguese, Greek and Finnish banks would likely be among those that could retain relatively strong LCR levels despite their LTRO runoffs, and thus see less pressure to refinance their LTROs. The adjusted LCR in these countries would remain closer to, or above, 160% based on our analysis, leaving a relatively strong buffer above requirements. Nonetheless, Greek banks would see a substantial negative impact on their LCRs from paying down their LTROs with existing liquidity buffers. In these countries, bond supply will likely be driven by other factors such as bond redemptions, balance sheet development and the stage in loss absorption buffer build-up.

Lowering their LCR ratios towards levels seen prior to the TLTRO-III programme would allow many banks to absorb a substantial part but not all of their TLTRO maturities with existing resources. We believe that banks in France, Benelux, Austria and Spain could use a combination of drawing from existing liquidity resources and refinancing part of their LTROs via other sources including bond markets for the LTRO redemptions.

In Italy, existing liquidity resources would be severely hit if the LTROs were to run-off without refinancing. Italian LCR levels would drop to levels with a relatively tight margin above the minimum requirements and also clearly below the levels seen prior to the TLTRO-III allotment. Adding the liquidity buffers of the less significant institutions would only make a small difference.

Large German banks have not increased their LCR ratios during the TLTRO-III programme like banks in some other countries. While large German banks could absorb the LTRO impact with their existing buffers in our view, the headroom above minimum LCR requirements would drop substantially. Including the liquidity buffers in Germany's less significant institutions would change this picture a bit due to their more considerable size than in other jurisdictions.

As we think banks would rather exhibit stronger liquidity buffers, we would expect the bulk of the LTRO redemptions to be refinanced in Italy and also to an extent in Germany. Therefore we expect banks in these countries to be more likely to remain active in the bond markets to prepare for the expiry of the LTROs.

Alongside printing bonds, banks are likely to utilise other funding channels such as repos. In some cases, we may see a higher take-up in other central bank funding alternatives such as in the shorter LTROs or even MROs, in particular in an environment of more volatile market conditions. We see a risk that some stigma may be attached to increasing drawing funds from the central bank's shorter operations.

In light of the sluggish economic environment, tuning down lending also remains among the likely alternatives to offset part of the funding needs.

Several ECB speakers in the past couple of weeks have commented on the level of minimum reserve requirements (MRR). Increasing the MRR from the current 1% to a higher level such as 2% would depress banks' Level 1 LCR liquidity buffers by a similar amount. In combination with the LTRO run-off, this would have a substantial impact on bank liquidity buffers, and we see a risk of unintended consequences in particular with a larger MRR increase. We wrote about the potential consequences earlier here. That being said, the ECB is still reviewing its monetary policy operations framework and the results of this are expected to be presented only in the spring of 2024. Any additional and more structural changes are unlikely to come before that.

What banks can expect from the capital requirements regulation review

Talks over banks’ capital requirements aren't new and 2024 promises to be no different. Once the final CRR III policy has been approved, banks will need to take a range of actions to implement it before January 2025. A delay in the final policy or national regulators' preferential treatment position could result in a sequencing issue for European banks

Marine Leleux
Sector Strategist, Financials
marine.leleux2@ing.com

View of the banking district in Frankfurt, Germany

The upcoming amendments to the European Capital Requirements Regulation (CRR) include several changes to banking supervision that have been adopted through the Basel III reforms. These changes aim to reduce the uncertainty related to discrepancies in the risk-weight assignment, increase the risk sensitiveness of the standardised approach and reduce the overall unequal risk treatment to enhance comparability between financial institutions.

While the reforms might strengthen trust in the European financial system, they also introduce significant changes to banks' capital ratio calculations and will modify the risk weight enforced on certain asset classes. These modifications will have an impact on financial institutions. However, the magnitude will vary depending on each institution’s asset portfolio, potentially negatively affecting certain banks. We thus deem it important to take a closer look at what the policy really entails.

The Capital Requirements Regulation in short

In the aftermath of the 2008 Global Financial Crisis, the European Union decided to strengthen the banking sector to better handle future shocks. The Capital Requirements Regulation (CRR) and Capital Requirements Directive (CRD) were first implemented in 2013 as the prudential regulatory framework for credit institutions operating in the Union. This prudential framework aims to enhance resilience in the event of severe stress in the sector. To do so, the CRR sets the adequate capital level that each bank must hold to limit insolvency. This capital requirement is calculated at the bank’s aggregated level by assigning different risk weights per asset class, depending on the expected risk.

The capital ratio is calculated as follows:

$$\frac{\text{Capital}}{\text{Risk Weighted Assets}} > \text{Capital requirements}$$

The calculation of the risk weight is done either through the use of a standardised approach or an Internal Ratings-Based approach. Risk weights are set by the regulator and largely based on the international standards developed by the Basel Committee on Banking Supervision (BCBS), known as the Basel III standards. As holding more capital is hampering banks' return on equity, setting global requirements is fundamental. Since its implementation, Basel III has already been updated to increase the quality and quantity of regulatory capital required. Following the Basel initiative, the CRR has evolved, reducing banks' excessive leverage, increasing resilience to short-term liquidity shocks, and reducing reliance on short-term funding and concentration risk.

Basel Committee on Banking Supervision in a nutshell
The Basel Committee was established in the mid-1970s by 10 European countries in the hope of enhancing financial stability and improving the quality of banking supervision at a global level. The Committee now comprises 45 institutions from 20 jurisdictions.

Through the inclusion of three sets of frameworks (Basel I, II and III), the committee aims to reduce the gap in international supervisory coverage, thus ensuring that banks do not escape supervision and have adequate and consistent supervision across countries. Because holding greater capital negatively affects banks' return on equity, harmonising capital requirements is essential to avoid a regulatory race to the bottom.

While Basel I and II focused on setting global standards for capital adequacy, Basel III was designed in response to the Global Financial Crisis. It reinforced the requirements stated in Basel II by not only enforcing stricter quality and quantity requirements on regulatory capital but also by implementing countercyclical buffers and even liquidity requirements. In 2012, the Basel Committee started to improve the calculation of capital requirements.

For countries part of the European Union, the Basel regulatory requirements must be translated into EU law to be enforced nationally. To do so, the Union drafted and enforced both the CRR and CRD.

In June 2019, the EU amended the CRR to implement the latest Basel III finalisation provisions. Amid increasing worries about discrepancies in risk weight assignments, mostly with the use of internal ratings-based models, and the belief that the standardised approach is not sufficiently sensitive to the riskiness of the underlying assets, the European Commission came up with a proposal to amend the existing CRR.

Legislative update

Since the Commission's proposal of a new CRR III was introduced in October 2021, it has been discussed at the European Parliament and the Council. The Trilogue negotiations reached a political agreement at the end of June 2023. This provisional political agreement will now have to be approved by the Economic and Monetary Affairs Committee and voted on in the Plenary. Finally, the Council will need to approve the document before it comes into force in early 2025.

The CRR has been evolving since 2013, following changes in the Basel agreements

Source: European Commission, Basel Committee, ING

What are the main changes in the CRR III?

The CRR amendments include several major changes to the current regulation. The following section will discuss the three main changes in our view and their expected impact on European financial institutions.

1 Inclusion of an output floor

Due to increasing concerns over the calculation of own funds requirements, the proposal makes changes to both the internal ratings-based and the standardised approach.

The most widely-discussed amendment of the CRR III proposal is the inclusion of a lower bound on banks' capital requirements when banks use the internal ratings-based (IRB) approach. The current CRR allows some financial institutions to calculate their required own funds using internal ratings-based models. However, there have been growing concerns regarding the excessive variability in institutions' own funds requirements with the use of these models. Indeed, banks might be inclined to underestimate their risk exposure and therefore also their own funds requirements. By amending this article, the EU is aiming to harmonise and limit the variability in own funds across countries and institutions, enhancing capital ratios' comparability and reinforcing confidence in capital ratios.

Until the end of 2017, European banks were subject to the Basel I floor which required own funds calculated with internal models to be at least 80% of the one resulting from the standardised approach. The European Parliament's impact assessment highlighted several flaws in the enforcement of this floor due to the heterogeneity of risk weights and failures to reduce the variability across risk-weighted assets. To mitigate this, the current rules would require national supervisors to approve the use of internal models case-by-case, making the standardised approach the default calculation method.

To increase the consistency in the IRB calculation, the proposal sets an output floor (OF) to the internal ratings-based capital requirement when calculated by institutions' internal models. This floor is set at 72.5% of the own funds requirements that would apply based on the standardised approach. Ultimately, this implies that financial institutions will be required to calculate both the IRB and standardised approach to make sure this output floor is respected.

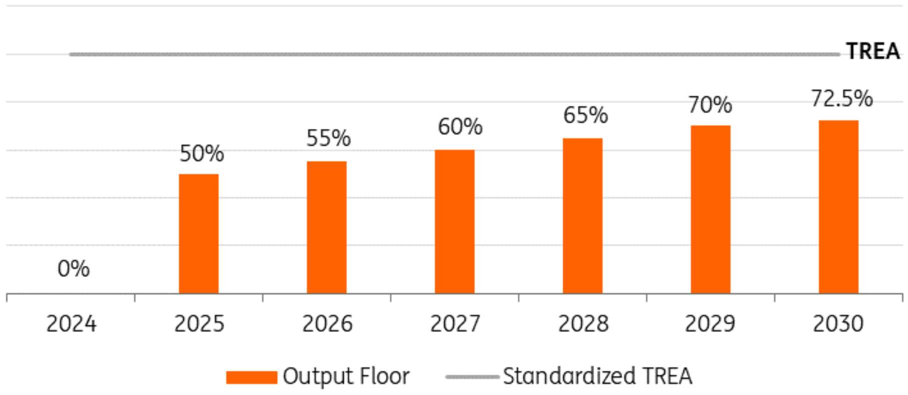
This new minimum own funds requirement (also called Pillar 1) should be used at the parent level of the banks. To calculate this, institutions must calculate their Total Risk Exposure Amount (TREA). This ensures that institutions using internal models to calculate their TREA reach at least 72.5% of the TREA resulting from the standardised approach.

It results in applying the following equation:

Total Risk Exposure Amount (TREA) = Max{Internal rating-based TREA; 72.5% Standardised TREA}

As this change could significantly increase the own funds requirements for some banks using the internal rating method, the proposal includes a gradual enforcement of this new output floor. This amendment would make the 72.5% output floor fully functional as of 2030 and give approximately five years for banks to transition.

Output floor is expected to be enforced gradually as of January 2025



Source: European Commission, ING

The impact of the output floor on institutions will vary significantly depending on banks' main activities, justifying a gradual implementation to limit sudden shocks. Indeed, depending on the institution's main activities, this new TREA floor could mean significantly higher own funds requirements.

Two asset types are expected to be significantly affected by the output floor:

Impact of the output floor on unrated corporate portfolios

With the new TREA calculation, institutions using internal models for their unrated corporates will now also have to calculate capital requirements through the standardised approach. The standardised approach for credit risk (SA-CR) requires the use of external ratings to determine the credit quality of the corporate borrower which typically doesn't exist for EU unrated corporates. Furthermore, as own funds requirements for unrated corporates calculated under SA-CR are usually stricter than for rated names, the implementation of the output floor could substantially increase the own funds requirements for institutions with large unrated portfolios.

Additionally, the new regulation is changing the risk weights to be more granular. A risk weight of 100% for all corporates that don't have any credit assessment available would be required. This could negatively impact the credit supply to unrated corporates as it would represent a significant increase in own funds required for banks. To avoid any negative impact, on top of the overall transitional agreement, banks are allowed to apply a preferential risk weight of 65% to their exposure to corporates that don't have an external rating. This is subject to the condition that those exposures have a probability of default of less or equal to 0.5% (coinciding with an "investment grade" rating). This preferential treatment will only be in place until the end of 2032.

As the transitional period gives time to the regulator to make both higher capital standards and stable credit flow for unrated corporates coincide, several options have already been highlighted. The first, but rather unlikely option, would involve making corporate ratings mandatory. Considering the cost of rating all European unrated companies, this is not a likely option.

A second possibility would be to start developing national central bank ratings for corporates. This solution could fill in the gap left by forbidding banks from coming up with their own rating of unrated corporates. This option already exists in some jurisdictions like France.

Impact on real estate

The second type of asset under scrutiny with the amendment of the CRR III is real estate, more specifically mortgages. Indeed, the proposal makes a differentiation between types of immovable properties. Therefore, depending on the category of property, the risk weight associated with the exposure will vary. The first important criterion is whether the exposure is backed by a constructed and already available property or an acquisition, construction or land (ADC). For built properties, the policy also distinguishes between commercial real estate and residential.

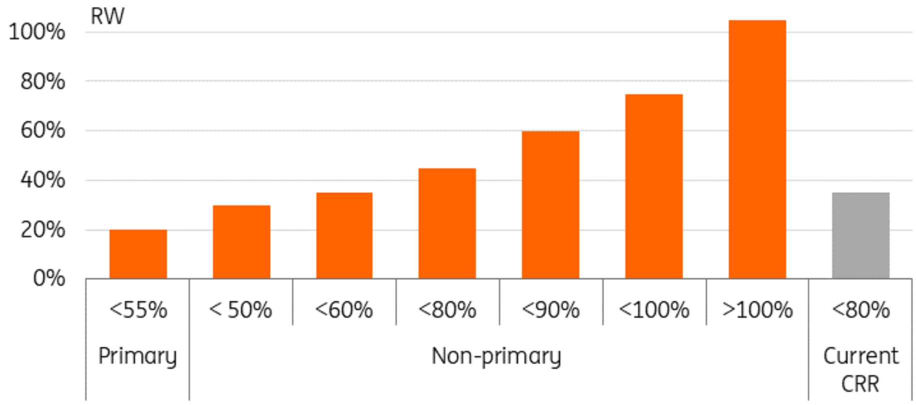
First, looking at residential properties, the current policy sets a risk weight of a minimum of 35% on properties occupied or let by the owner. That risk weight can be applied to a loan of a maximum of 80% of the market value of the house.

However, the policy states that the national regulator can apply a stricter risk weight but it should not be higher than 150%. If the <80% LTV conditions are not met, the risk weight applied should be 100%. This regulation allows for little differentiation in the quality of the collateral. Therefore, the CRR III amendments aim to enforce more granularity in the risk weights applied by looking in more detail at the exposure banks have to the property. To do so, it specifies different risk weights relative to the exposure-to-value (ETV).

The ETV is calculated as follows:

$$ETV = \frac{\text{Gross exposure amount}}{\text{Property value}}$$

The proposal aims to implement six risk weights dependent on the property's ETV



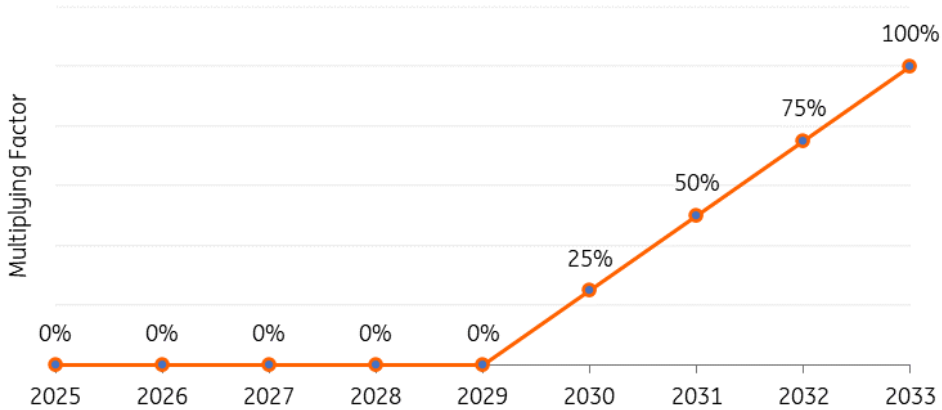
Source: European Commission, ING

Aside from the increased granularity of the risk weight distribution, it also sets a lower weight for the best ETV ratios.

However, the Commission also proposes allowing national institutions to apply a different risk weight when deemed necessary. The stricter weights should not be higher than 150%. As mentioned before, the review of the CRR aims to align the European capital framework to the most recent updates of the international Basel standards. Some changes to the international capital standards are therefore not motivated by the European situation but by the situation in other countries. This is specifically the case for the change in real estate risk weights as some jurisdictions, such as the United States, are facing much higher default rates on their residential properties. These increased risk weights are less necessary for European countries where default rates remain low due to social benefits. Nonetheless, European banks will have to align with their international counterparts on these higher risk weights.

The transitional period includes a multiplying factor on the RW

This multiplying factor increasing each year of 25pp to be 100% of the RW in 2033



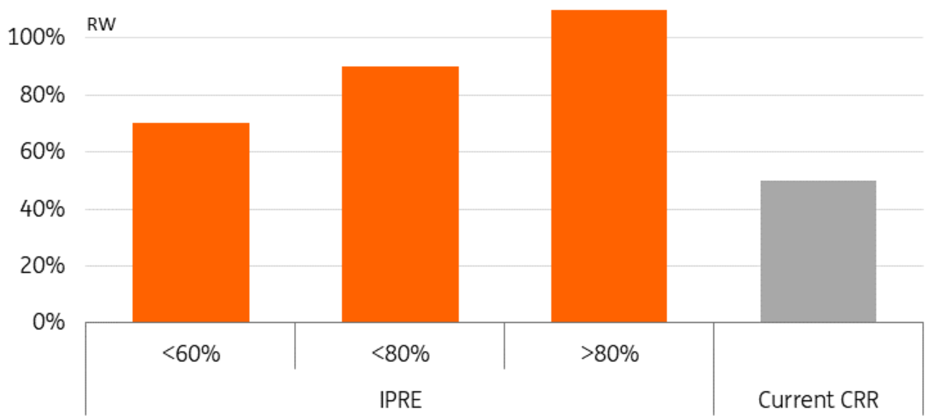
Source: European Commission, ING

The implementation of a transitional agreement can be granted to banks by each European member state independently. The transitional period consists of a multiplying factor of the mandatory risk weight to reach the final risk weight by 2033.

National regulators might be willing to grant this preferential treatment if they deem their banks sufficiently protected against potential shocks. On the other hand, other countries might not want to allow such deviation from Basel III agreements as they might deem their domestic financial institutions' buffers not sufficient. This could lead to competitive disadvantages across European jurisdictions. National regulators are expected to take a stand on this issue before the implementation of the CRR III revision but not before the final text of the policy is published. The impact resulting from such enforcement differences might be long-term and could seriously impact financial institutions with a large share of residential or real estate assets in their portfolio.

Turning to commercial immovable properties, the Commission's proposal follows the same idea as for residential assets by enforcing a more granular set of risk weights. The current policy calls for a risk weight of 50% for any loan fully secured by commercial real estate and allows national regulators to set a different rate up to 150% when deemed necessary. The new proposal makes a distinction between properties producing income (IPRE) and those not producing income (non-IPRE). For the latter, the proposed risk weight is 60%. However, for IPRE, the Commission proposes to differentiate the risk weights depending on the ETV of the property.

For commercial properties, risk weights vary depending on the ETV but start with a 70% RW

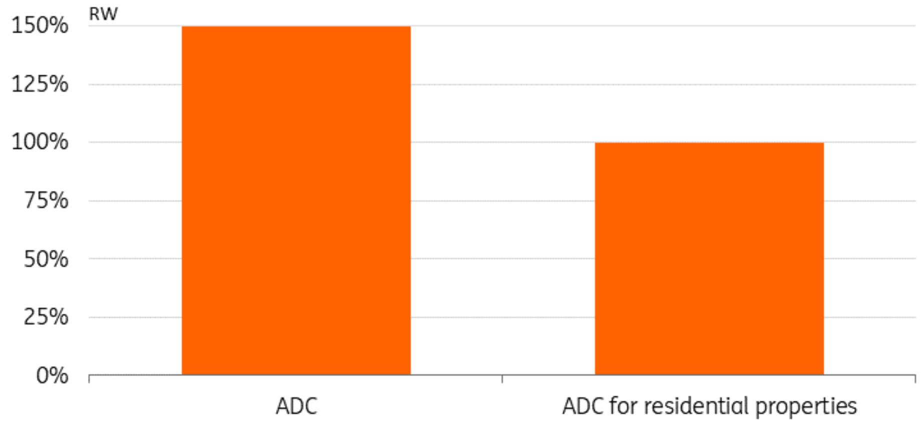


Source: European Commission, ING

As with residential mortgages, the transitional period and the long-term risk weight will differ depending on the national legislator. Therefore, it could lead to national discrepancies and unfair competition by reducing the required own funds for financial institutions in certain jurisdictions.

The Commission also includes a specific category for exposure to land acquisition, development and construction (ADC) with a default risk weight of 150%. However, the ADC for residential purposes could benefit from a lower risk weight of 100% under certain conditions.

ADC exposure aimed at residential properties benefit from lower risk weights under certain conditions



Source: European Commission, ING

2 Changes to the Internal Ratings-Based Approach

As discussed previously, the proposal's main objective is to reinforce the comparability and confidence in risk weights applied by financial institutions to different asset classes. One of the main issues stems from the important variability in the IRB approach. Therefore, the proposal aims to limit the use of IRB and prioritise the SA-CR method. In addition to setting an output floor to the internal ratings-based methodology, the use of advanced IRB models will be replaced by foundation approaches for some portfolios like large corporates. It will also be only permitted for banks to use IRB under the condition of being granted pre-approval from the national regulator.

To further limit discrepancies in the use of IRB models, the Commission introduces input floors. The current version of the CRR includes an input floor for the probability of default to corporates or institutions of a minimum of 0.03%. This rate would be increased to 0.05% with the new legislation. The proposal is also implementing input floors for the loss given default (LGD) calculations of corporate and retail exposures.

Both corporate and retail exposure is reclassified to increase granularity and assigned a risk weight up to 25%

<table>
<tr><th colspan="3">LGD input floor for corporate exposure</th><th colspan="4">LGD input floor for retail exposures</th></tr>
<tr><th>Unsecured exposures</th><th colspan="2">Secured exposures</th><th colspan="2">Unsecured exposures</th><th colspan="2">Secured exposures</th></tr>
<tr><td rowspan="6">25%</td><td>Financial collaterals</td><td>0%</td><td rowspan="2">QRRE*</td><td rowspan="2">50%</td><td>Residential properties</td><td>5%</td></tr>
<tr><td>Receivables</td><td>10%</td><td>QRRE*</td><td>NA</td></tr>
<tr><td rowspan="2">Residential or commercial immovable properties</td><td rowspan="2">10%</td><td rowspan="4">Other retail exposures</td><td rowspan="4">30%</td><td>Financial collaterals</td><td>0%</td></tr>
<tr><td>Receivables</td><td>10%</td></tr>
<tr><td rowspan="2">Other physical collaterals</td><td rowspan="2">15%</td><td>Immovable properties</td><td>10%</td></tr>
<tr><td>Other physical collaterals</td><td>15%</td></tr>
</table>

*QRRE: Qualifying Revolving Retail Exposure
Source: European Commission, ING

An input floor is also proposed for the credit conversion factor (CCF) which should be at least 50% of the off-balance sheet exposure not included in the revolving commitments calculated with the standardised method.

3 Changes to the standardised approach

The Commission's proposal also includes a revision of the standardised approach for credit risk (SA-CR). It aims to increase the risk sensitivity and further widen its use, especially as the legislator wishes to reduce the use of the internal ratings-based approach (discussed earlier). The changes target three types of asset class: off-balance sheet assets, exposure to institutions and exposure to corporates.

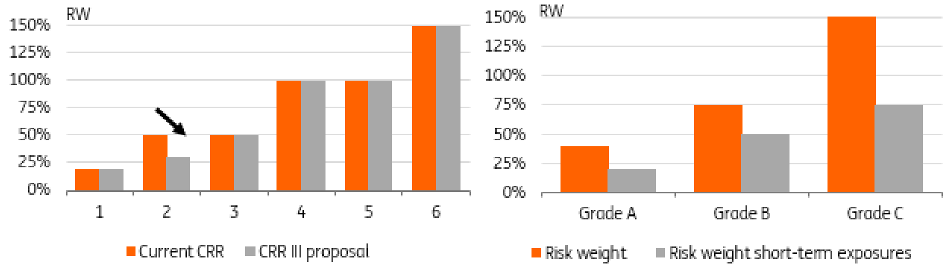
Looking at the off-balance sheet asset class, the proposal adds an extra risk bucket, increasing the risk weight granularity. With the current CRR regulation, risk classes are distributed in a range of four categories between low and high risk with risk weights going from 0% to 100%. The new proposal would implement five buckets and change the risk weights so that even the least risky bucket applies a 10% risk weight whilst the highest remains at 100%.

This increase comes at a cost for most financial institutions as it will increase their provisions and could reduce potential revenues. Therefore, the Commission also proposes a transitional period to allow banks to slowly implement the new regulation (as discussed previously).

Regarding the exposure to institutions, the proposal also aims to increase granularity. In addition to the current requirement to get an external rating, the proposal introduces a standardised credit risk assessment approach (SCRA), requiring institutions to classify their exposure in three buckets. To do so, it makes a distinction between rated and unrated institutions. For rated institutions, the risk buckets are kept as they currently exist, but the risk weight is corrected lower. The change would also mean specific risk weights for unrated institutions.

Second bucket risk weight would be lowered with the enforcement of the proposal

Three new buckets will be created to classify and risk weight unrated institutions

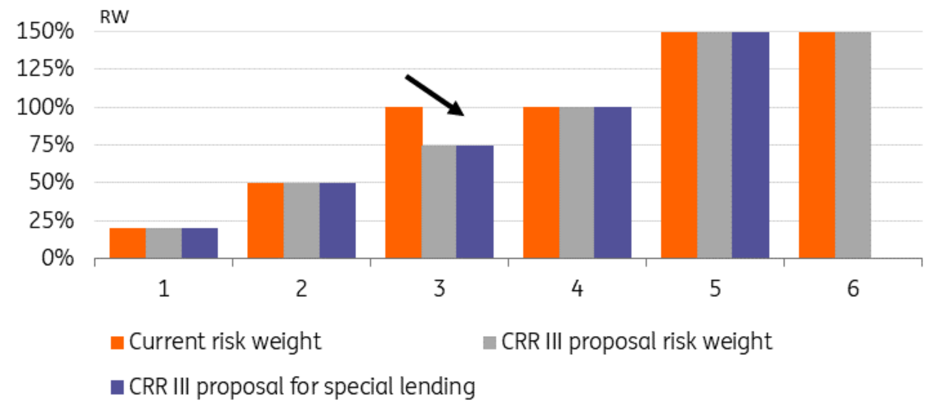


Source: European Commission, ING

Additionally, the regulation gets rid of the link between institutions and their sovereign by eliminating the option to link the risk weight to the sovereign's rating. This could be beneficial for institutions situated in lower-rated countries.

Turning to corporates, the proposal keeps most of the risk weights identical to the current regulation, with the exception of one bucket that is lowered. To improve granularity, it introduces a risk weight for special lending exposures.

Third bucket risk weight would be lowered for both normal and special corporate lending



Source: European Commission, ING

However, the main change for corporate exposure is expected to cascade from the implementation of the output floor (discussed previously), requiring financial institutions, that until now solely used the IRB approach, to also estimate their exposure using the SA-CR method. They would therefore potentially apply higher risk weights to their portfolio.

What is on banks' agenda for 2024?

The implementation of the latest Basel reform at the European level has been a topic of debate for a few years already. Nonetheless, as we approach the January 2025 enforcement date, several important points remain unclear as the final version of the policy is still not available. It appears that 2024 will also be marked by a sequencing problem.

Indeed, the three points discussed earlier are based on the current proposal of the CRR reform. Firstly, several steps remain in the legislative process before the final version of the policy is amended and enforced. 2024 will therefore be crucial as the legislative process will come to an end.

Only once the final policy version is published will financial institutions be able to start making the necessary changes to their risk scenarios approaches. With the final version of the policy will also come the necessary technical implementation documentation. In some cases, these new methodologies must be approved by the regulator. Banks will thus need to act fast between the publication of the final CRR III and the enforcement date, to draft their new capital requirement calculation and get them approved by the supervisory authority.

Furthermore, the current proposal notes the possibility for national regulators to enforce a preferential transitional period for their domestic banks. It remains challenging to predict which EU jurisdiction will grant such preferential treatment to their financial institutions. Nonetheless, if such deviation from the Basel agreements is enforced, it could trigger a competitive disadvantage for the rest of the banks in the Union. Here again, 2024 will be crucial as we expect national regulators to disclose their stance only once the text is final and before its enforcement.

The sequencing problem will be enhanced by the delay in the UK and US enforcement of the Basel regulation. Both countries announced that their national implementation will not be enforced as of January 2025 but rather July 2025. This implies inconsistencies between jurisdictions for the first six months of the policy enforcement. This is not without consequence for some institutions such as investment banking and institutions heavily relying on international investments as they will have to comply temporarily with two different sets of capital requirement standards.

On the brighter side, European regulators seem to be willing to put an end to the capital requirement negotiations and start enforcing and monitoring the newly reviewed policy. Andrea Enria, chair of the Supervisory Board of the ECB alluded to it in his speech at the EUROFI 2023 financial forum: *"Let's move on from the debate on the calibration of capital requirements. Let's implement the international standards we have all agreed on. And let's focus on making sure that banks take the right corrective actions to address the shortcomings that their supervisors identify. It is in banks' own interest to engage with us in this endeavour and make sure that, the next time market confidence dwindles, no weak links can be identified."*

Financial institutions still have a lot of work to do in 2024 to prepare for the enforcement of CRR III. But once this is in place, one can hope for a period of pure monitoring, making these changes the last major improvement in the European capital requirements regulations.

To conclude

Overall, the review of the current CRR will trigger three major changes for European financial institutions. The first one is the implementation of an output floor on the risk weights applicable to the IRB model. This will heavily impact the Union's unrated corporates and real estate. The possibility to include a transitional period might help to smooth out the changes but at the cost of setting comparative disadvantages between jurisdictions.

The second important change relates to the implementation of an input floor when using the IRB and its usage limitation. Finally, the increased risk sensitivity of the SA-CR for certain asset classes will also affect the European financial sector.

Looking forward to 2024, banks will only be able to start implementing the new requirements once the legislative process is over. Once done, they will be able to look into technical requirements, getting some of their new risk processes approved. This might be challenging in such a short time before the official January 2025 enforcement date.

European Taxonomy: Now the banking sector gears up for more disclosures

The second Taxonomy disclosures for banks include a variety of methodologies hindering comparability. Calculation differences aside, banks slightly improved their eligibility ratio with an average of 30% for 2022, 2pp above 2021. More banks reported their eligible asset share over their covered assets, in line with GAR requirements starting in 2024

Marine Leleux
Sector Strategist, Financials
marine.leleux2@ing.com

Mairead McGuinness, the EU Commissioner for Financial Stability, Financial Services and the Capital Markets Union

Why should we keep an eye on the European Taxonomy?

While the European Union is showing its dedication to making the financial system more sustainable with the introduction of the Sustainable Finance Framework, the European Taxonomy is still being improved via the first disclosures.

For the first time, European corporates were required to disclose their share of Taxonomy-aligned activities this year. Next year, it will be the turn of the banking sector. For FY 2022, financial institutions were still required to disclose their share of Taxonomy-eligible assets. Surprisingly, this second year of disclosures is still marked by differences in the eligibility calculation. Comparing results with last year's disclosures and between peers is, therefore, complex. However, several indicators are still worth analysing as the Taxonomy disclosures' tradition is building.

Banks must rely on their clients' disclosures to derive their own eligible and aligned share of assets. Hence, it is also interesting to have a look at corporates' disclosure patterns. Furthermore, these requirements are still evolving as the regulator recently shared the delegated acts covering the last four environmental objectives of the framework. With time, the European Taxonomy promises to be the cornerstone of sustainability both for financial and non-financial entities, limiting greenwashing by being the first comprehensive list of green activities.

The following sections give a refresher on the EU Taxonomy before diving into this year's financial institutions' disclosure results. To conclude, we'll look into the next steps and current challenges.

EU Taxonomy what?

The European Commission introduced its sustainable finance framework in June. The package aims to complete the EU sustainable agenda to support corporates and financial institutions' transition to a carbon-neutral and sustainable economy, starting with lowering implementation costs and enhancing the usability of the EU Taxonomy for all market participants. Indeed, the fundamental part of the European Union's action against climate change lies in the classification and definition of sustainable activities; in other words, the European Taxonomy.

The European Taxonomy classification system lists environmentally sustainable activities to enhance the transparency and comparability of ESG performance metrics. To do so, it uses six environmental objectives:

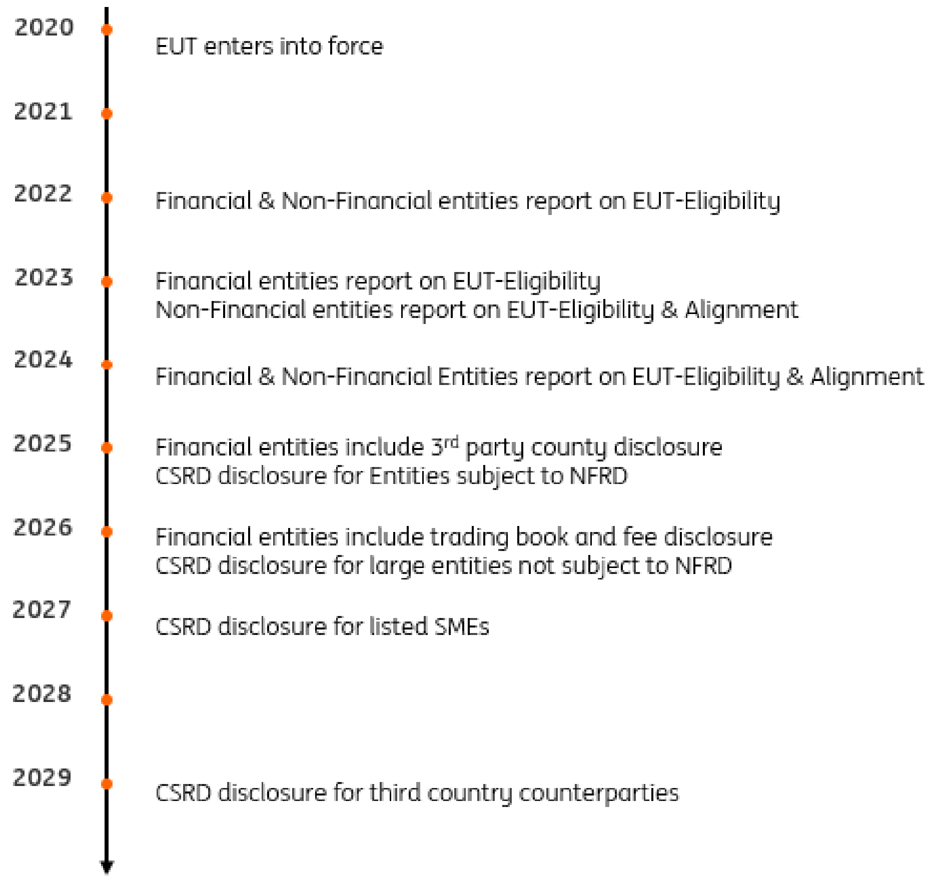
- Climate change mitigation
- Climate change adaptation
- Sustainable use of water and marine resources
- Transition to circular economy
- Pollution prevention and control
- Protection and restoration of biodiversity and ecosystems

The framework targets corporates as well as financial institutions and insurers in the EU. The first milestone was reached last year as both financial and non-financial institutions disclosed, for the first time, their Taxonomy-eligible assets as part of the **Non-Financial Reporting Directive** (NFRD).

Enforced in 2014, the NFRD aims to improve the transparency of social and environmental information provided by companies in all sectors. Large, listed companies but also banks and insurance companies with more than 500 employees fall under the NFRD and are therefore required to publish annual reports on their sustainable policies. These include a broad range of criteria such as social responsibility, respect for human rights, anti-corruption & bribery, but also diversity on their boards. As this directive only covers the largest European financial and non-financial entities, it includes around 11,000 companies having activities falling under the Taxonomy-eligible criteria. This number is expected to significantly increase with the enforcement of another directive, the **Corporate Sustainability Reporting Directive** (CSRD).

The CSRD aims to complete the current NFRD by gradually increasing its scope to incorporate smaller companies and third-country entities in the reporting framework. It will also tackle some NFRD issues by enforcing a common reporting framework. In December 2022, the European Commission amended the CSRD; it will become applicable in 2024. Entities gradually falling under the CSRD scope will automatically also have to disclose their Taxonomy-alignment under the European Taxonomy.

The EU Taxonomy is expected to be fully implemented in 2029



Source: European Commission, European Parliament, ING

All these disclosure frameworks are implemented to direct the European economy towards a greener future through more transparency and comparability between market players. **The Green Asset Ratio** (GAR) seeks to do exactly this by giving at a glance, with one ratio, the sustainability of financial institutions.

The Green Asset Ratio in a nutshell

The European Commission requires credit institutions to publish several **Key Performance Indicators** (KPIs) giving insight into the extent to which their operations are environmentally sustainable, the most important one being the **Green Asset Ratio**. The GAR measures the share of the credit institution's Taxonomy-aligned balance sheet exposures over the total eligible exposures. This allows to give a quick and comparable overview of the credit institution's alignment with the Taxonomy.

GAR equation

$$\text{Green Asset Ratio (GAR)} = \frac{\text{Taxonomy – aligned exposures for loans and advances, debt securities and equity holdings}}{\text{Total eligible exposures}}$$

The following on-balance sheet exposures are considered as eligible:

- Non-financial corporates subject to NFRD disclosure obligations
- Financial corporates
- Retail exposures
- Loans and advances financing public housing
- Repossessed real estate collateral

Taxonomy-eligible: Activities identified in the Climate Delegated Act and Environmental Delegated Act as eligible for the purpose of financing the EU Taxonomy six environmental objectives.

Taxonomy-aligned: Taxonomy-eligible activities that fully comply with the EU Taxonomy's technical screening criteria for substantial contribution; they do no significant harm and with the minimum safeguards.

Exposures to central governments, central banks and supranational issuers are excluded from the calculation of the numerator and denominator of the GAR. Exposures to undertakings not (yet) obliged to disclose non-financial information under the NFRD (or CSRD) will be excluded from the numerator of the GAR.

What's new this year?

Financial institutions were already required to report their share of Taxonomy-eligible assets for FY 2021. In that sense, nothing changed this year as banks were only required to declare that same ratio but for FY 2022. Financial institutions were granted a one-year transition period in comparison to corporates as they rely on their clients' disclosures to estimate their own portfolio alignment.

Financial institutions' first reports shed light on some important discrepancies in both methodologies and results, both between jurisdictions and banks domestically. When aggregating FY 2021 results at the national level, the highest Taxonomy-eligible assets rates were disclosed by both Belgian and Spanish banks (with 46%), followed closely by Norwegian banks (45%). Nonetheless, Belgian banks' eligibility rates varied domestically between 20% and 83%.

The same pattern was seen in Sweden, where banks reported Taxonomy-eligible asset shares between 19% and 67%. We explained these differences through the structure of each bank's assets on their balance sheet. Indeed, as for corporate exposures, only the NFRD assets are considered in the eligibility criteria, banks with a portfolio mainly built of residential real estate disclosed higher Taxonomy-eligible rates than those active mainly in the corporate lending sector. To find out more about banks' FY 2021 disclosures, read our previous research here.

Building on last year's results, we dived into the Taxonomy disclosures of the same sample of 31 European banks (from 13 countries) and derived the average national Taxonomy-eligible asset share. However, even with better accessibility to each financial institution's documentation, one problem remains: there are still significant differences in the methodology used to derive the eligibility ratio. Indeed, the regulation allows corporates to calculate this share using three Key Performance Indicators based on the following:

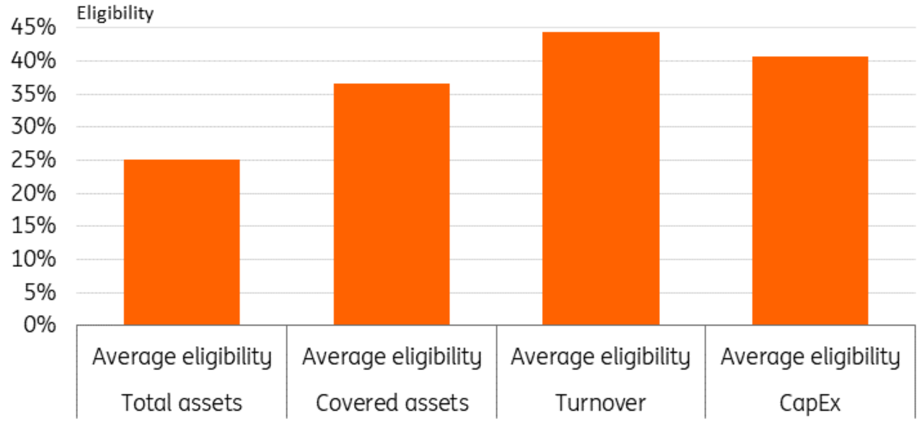
- Their Turnover
- Their Capital Expenditure (CapEx)
- Their Operational Expenditure (OpEx)

Corporates are, therefore, reporting their eligibility over one or several of these KPIs. Consequently, banks disclosed their eligibility very differently, sometimes as a share of their non-financial counterparties' KPIs, sometimes as a share of total assets and in most cases, as a share of covered assets. These discrepancies are even more important than last year's disclosures, in which the vast majority of credit institutions in our sample disclosed over their total assets and only a few over their covered assets.

These differences significantly hinder the results' comparability. Indeed, when aggregating the respective Taxonomy-eligibility ratio per methodology, we can see that, on average, banks disclosing over their Turnover have a better result (44.5% eligibility) than when disclosed over their total assets (with only 25%). It's important to note that 22 of our sampled banks disclosed their results with at least two different methodologies.

Banks disclosing their eligibility over their Turnover KPI were on average showing 44% eligibility

This rate drops to 25% when reporting over total assets



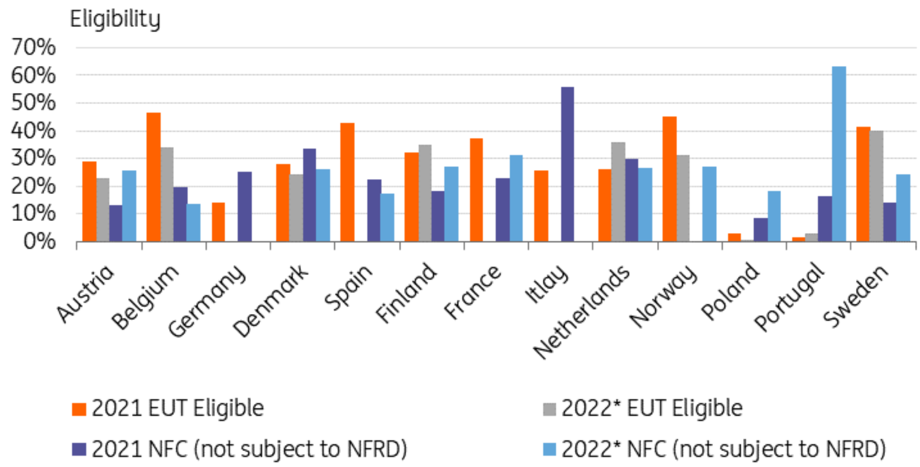
Source: Financial institutions' disclosures, ING

The most commonly used methodology remains Taxonomy-eligible share over total assets (used by 22 institutions); second comes the eligibility over total covered assets reported by 19 banks. Therefore, we can attribute the higher shares of eligibility when using Capex and Turnover ratios to both the methodology itself but also the sample of banks deciding to report in such a way.

Considering that last year's reporting was mostly done over banks' total assets, to identify national variations in Taxonomy-eligible assets, we only selected data points from the 22 banks that disclosed their eligibility as such this year. Aggregating the data nationally and averaging it allows us to highlight some changes.

At first glance, banks' FY 2022 disclosure seem to indicate lower eligibility asset share

Nonetheless it's both related to the sample and change in used denominator.



*Only sampling banks reporting over their total assets
Source: Financial institutions' disclosures, ING

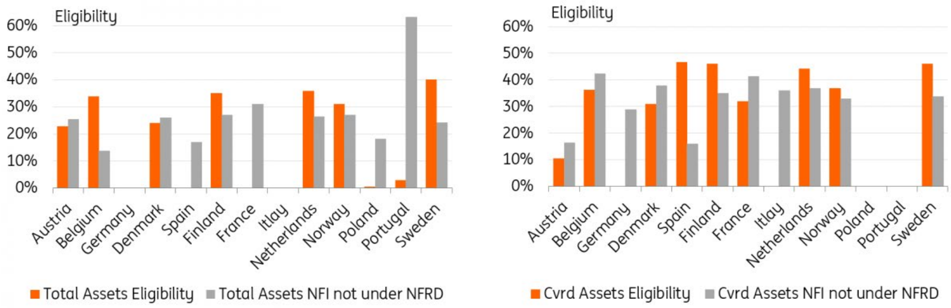
Firstly, some countries such as Germany, Spain, France and Italy show no eligibility this year, but this is strictly due to a change in disclosure methodology. Their domestic banks are no longer reporting over total assets but opted for covered assets as the denominator.

Secondly, only three countries show an improved average eligibility disclosure over their total assets: Finland, The Netherlands and Portugal. This cascades from both a change in their portfolios' sustainability and a potential bias from banks changing their methodology since last year (thus being excluded from this graph and the national average).

The other interesting variable to look at is the share of non-financial counterparties not subject to the NFRD (NFC not subject to NFRD). Indeed, this part of the banks' portfolio is currently not eligible under the Taxonomy, mostly because it is composed of small and medium-sized enterprises. Nonetheless, these entities will gradually become eligible through the enforcement of the CSRD. The higher the rate of NFC not subject to NFRD, the higher the eligibility might get in the future. This is exactly what we can observe in our data as Poland and Portugal disclosed, on average, the lowest Taxonomy-eligibility asset share but also have an important share of NFC not subject to the NFRD. Zooming in on disclosures over covered assets, this year is led by Spain, Sweden and Finland, which, on average, are disclosing more than 40% of Taxonomy-eligible assets.

Putting calculation differences aside, on average, the eligible asset share increased by two percentage points compared to the FY 2021 disclosure, reaching 30% for FY 2022. Unfortunately, deriving further conclusions from these data points remains difficult as national averages can be biased by the number of institutions choosing each methodology. In the future, we can only hope for the further harmonisation of methodologies as reporting standards are evolving.

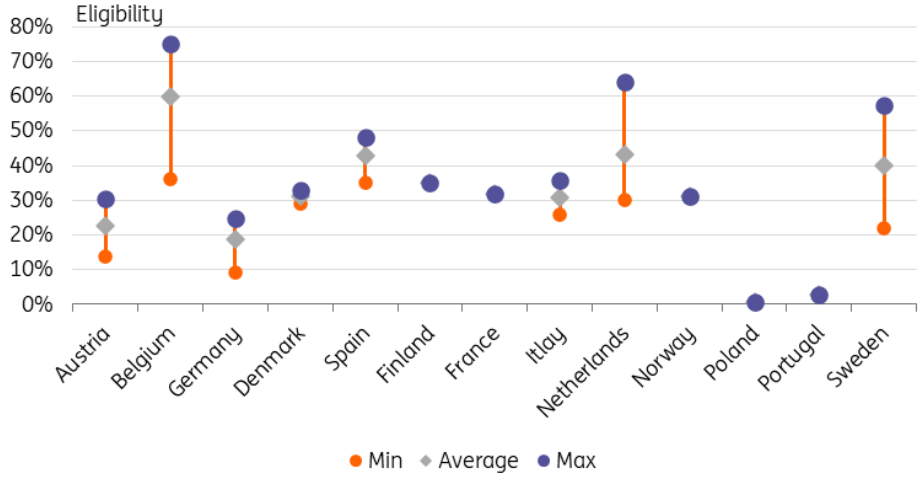
German, Spanish and French banks only disclosed their eligibility ratio over their covered assets this year



Source: Financial institutions' disclosures, ING

Nonetheless, we can highlight important national differences in the disclosed eligible asset shares as we could last year. The most important one remains for Belgian banks, in which the variation between the highest and lowest disclosures is more than 40 percentage points. Important variations are also noted in the Netherlands and Sweden with respectively 34 and 35 percentage points differences. These discrepancies are both related to the methodology variation and the banks' portfolio composition, as discussed above.

Belgium, the Netherlands and Sweden have the most important eligibility variations nationally



Source: Financial institutions' disclosures, ING

The first Taxonomy-alignment disclosures happened this year for corporates falling under the NFRD. Entities were also required to disclose their share of activity eligible to the Taxonomy over one of the following three KPIs: Turnover, CapEx or OpEx. In their 2022 Taxonomy barometer, EY highlighted that on average, aggregating data from all sectors sampled, eligibility disclosed over CapEx is showing the highest results with 35% eligibility, followed by shares over the OpEx and Turnover, respectively at 28% and 27%.

Most importantly, across all methodologies, EY reports that the sectors disclosing the most important eligibility ratio were the construction, energy, mobility and mining sectors. Health, manufacturing, consumer goods and oil & gas industries lie on the other end of the list. For energy companies, the share of Taxonomy-aligned activity depends on the KPI used. The disclosed shares of Taxonomy-alignment are between 1% and 20% lower than the one reported as eligible (the most important difference with Turnover KPI).

Insights on sectors declaring the highest share of eligibility can give a first idea of which type of bank will be able to improve or declare a high eligibility, now and in the future, Taxonomy-aligned share of their assets. Banks with an important mortgage and real estate portfolio but also banks with large corporate lending in construction, energy and mobility sectors will automatically be able to disclose higher shares of Taxonomy-aligned assets. However, banks that have an important portfolio of small and medium enterprises will see their Taxonomy-eligible share at a low level until the CSRD is enforced and more of these entities are required to disclose on their sustainability.

Step by step, going towards better disclosures?

Considering disclosures results from both financial and non-financial institutions, one question remains: are we heading in the right direction to reach the EU's sustainable goals?

The Taxonomy's ultimate objective is to develop a financial system and economy as a whole, rewarding sustainable activities and supporting every sector to transition to more sustainability. Classifying and labelling an activity as green also involves comparing it to its industry peers. Nonetheless, **results currently derived from the disclosures don't allow a smooth comparison between actors, thus also preventing coming to extensive conclusions.** It's the main issue hindering a thorough analysis is the variety of methodologies used.

Indeed, the Directive states that corporates should disclose a share of their assets over one of the three aforementioned KPIs. This affects results solely due to differences in the equation denominator. **Through the nature of their business, banks inherently have to adapt to their clients' variety of taxonomy disclosures when reporting on their own portfolio.** That means that both the initial data points and calculation can vary between financial institutions.

We notice there's been a big decrease in calculations over total assets for financial institutions this year. Some banks started disclosing over CapEx KPI, which was unseen last year. However, we highlight the largest increase in the use of total covered assets in the denominator. This is rather unsurprising as it aligns with the GAR disclosure requirement for financial institutions entering into force in 2024.

Just as last year, **obtaining sufficient and accurate information to qualify their portfolio remains an important challenge for credit institutions.** There has been some improvement compared to FY 2021 in data accessibility as most banks are now more clearly disclosing their Taxonomy disclosures in their annual or sustainability report. The European Commission will further improve information sharing with the implementation of the European Single Access Point, a Directive aiming to improve data sharing for regulatory disclosures. The single access point is still in the legislative process. Nonetheless, the current proposal aims at an implementation in 2027 with a slow phasing in. This platform, once in place, will allow banks to gather companies' disclosed data for their own regulatory disclosure.

Besides the difficulty of sourcing adequate information, **the lack of suitable processes is also harming financial institutions' ability to closely report on their portfolio.** The EU Delegated Act on the first two objectives of the Taxonomy, climate change mitigation and adaptation, was only published in mid-2021. It left very little time for both corporate and financial institutions to prepare their first-year report. As time passes, we can expect an improvement in the application of the policy as more information will be available to banks and experience will be developed. That said, the Taxonomy still includes rather significant room for interpretation. It will require several years for European Institutions and the involved parties to smoothen the process.

Next year's Taxonomy-aligned asset disclosures for financial institutions are the next important milestone in the implementation of the policy. It will be the second year for corporates, but as we can expect a bit more expertise in their disclosures, a lot is still to be done on the banks' side to gather and analyse their clients' data and draw their own share of Taxonomy-aligned assets. This process will also require a qualified workforce to both enforce the policy for the first time and gather the large amount of data necessary to comply with Taxonomy requirements.

European Institutions also have a consequent amount of work to provide. Indeed, only two of the Taxonomy objectives (climate change mitigation and adaptation) delegated acts are currently enforced. In June this year, the four other delegated acts were adopted (covering sustainable use and protection of water, transition to a circular economy, pollution prevention and protection and restoration of biodiversity and ecosystems). It is now time to enforce these new environmental objectives.

On the Financial Institutions' side, this year was marked by a strong increase in reporting over the total covered assets, in line with the GAR disclosures. If that trend further develops next year, it will enhance peers and national comparison. It would also allow us to derive a potential improvement in banks' portfolios.

Why commercial real estate concerns haven't subsided for banks just yet

The softness in the commercial real estate market is not a concern of the past yet. Nordic banks remain most exposed to the CRE sector, but when it comes to climate change transition risks, these assets do not appear to be among the most vulnerable in Europe.

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

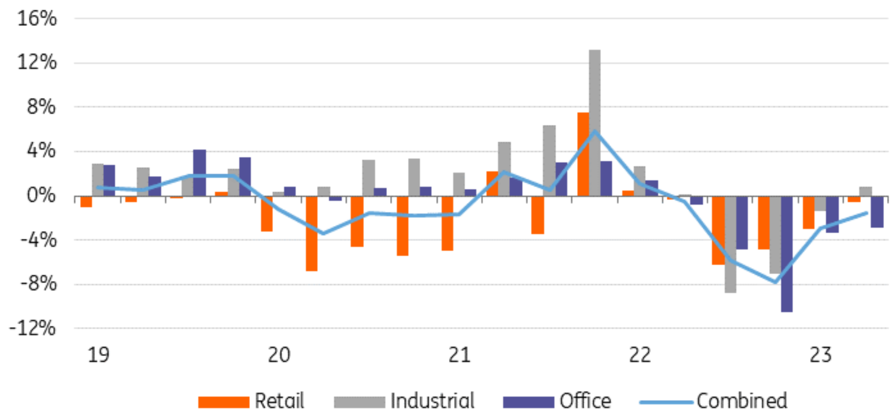
The worst price declines in commercial real estate are levelling off, but supervisors and market participants are staying vigilant, with Nordic banks among the most exposed to turmoil in the CRE sector

Since central banks aggressively started hiking rates to fight rising inflation levels, commercial real estate (CRE) has been a key area of concern. Rising interest rate levels and a declining need for office space (due to the effects of working from home) have caused vacancy rates to rise and property values to decline. While the worst price declines are levelling off, concerns remain over tougher financing conditions and that high CRE debt maturities will continue to exert pressure on the heavily debt-reliant CRE sector.

The increased presence of real estate investment trusts (REITs) in commercial real estate adds an extra layer of concern, especially if these companies need to sell properties to meet their forthcoming redemption payments. Real estate investment volumes are declining and climate transition risks are looming, but it is reassuring that rental income growth remains stable. Banks are also much better capitalised now than during the financial crisis. That said, supervisors remain alert regarding the stresses that may arise from the commercial real estate sector – particularly if interest rate levels stay high for a long period in what is a still very uncertain geopolitical, inflationary, and economic environment.

Worst price declines appear to be over in commercial real estate

EU-15 prime capital value index, QoQ change



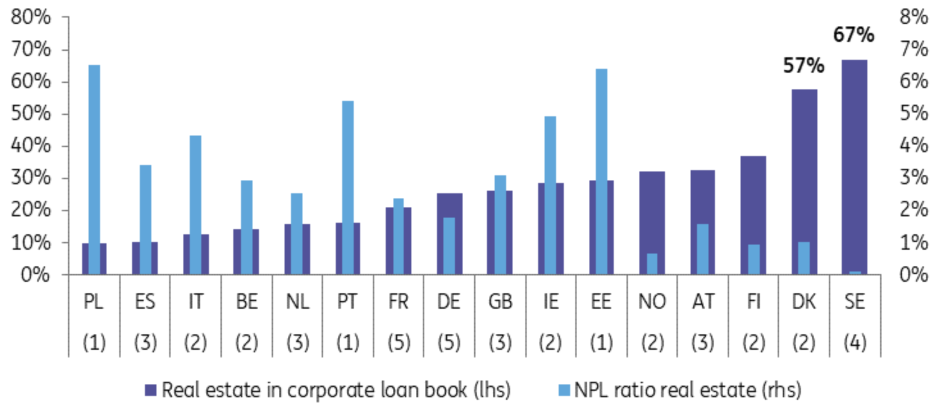
Source: CBRE, ING

Nordic banks remain most exposed to commercial real estate firms

While many banks reduced their commercial real estate exposures over the past decade and became stricter on their lending conditions, loans to the CRE sector still represent around 30% of corporate lending books for European banks. However, exposures differ substantially from country to country. In Nordic countries such as Sweden and Denmark, loans to CRE companies comprise 57% and 67% respectively of bank loans to non-financial companies. In Spain and Italy, only 10% and 13% of banks' corporate lending books are loans to CRE companies.

Despite the substantial exposures of Nordic banks to the CRE segment, the performance of these CRE loans remains solid so far. Swedish banks report the lowest NPL ratios for their corporate real estate exposures, closely followed by Nordic peers from Norway, Finland and Denmark. Austrian and German banks also report modest NPL ratios on their loans to CRE companies. The highest CRE NPLs are recorded by Polish, Estonian, Portuguese and Irish banks.

Nordic banks have high exposure to the CRE sector but with low NPLs

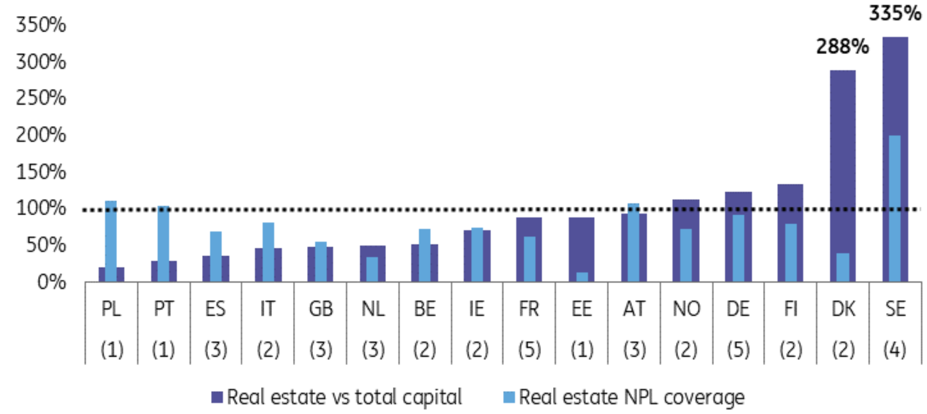


Source: Issuer Pillar 3 disclosures, ING | Number of issuers per country in brackets

Even though CRE loan performance remains reassuring for Nordic banks, it is no surprise that supervisors still pay close attention to commercial real estate market developments. For Danish and Swedish banks, exposures to commercial real estate companies are around threefold the size of their capital stack. Severe troubles in the CRE sector – resulting in notable write-offs and provisioning on loans to CRE companies – could form quite a risk, even to these well-capitalised banks versus risk-weighted assets.

Most Swedish banks have already set aside quite sizeable provisions to cover non-performing CRE exposures. They distinguish themselves in that regard from Danish peers who have taken fewer impairment provisions against their outstanding CRE loans. That said, in Denmark, the Systemic Risk Council recently recommended to introduce a 7% sector-specific systemic risk buffer for bank exposures to real estate companies from 30 June 2024. Such a buffer would serve to improve bank capitalisation levels to better withstand impairment charges and losses on loans to commercial real estate firms.

CRE activities are about 3x the capital stack of Danish and Swedish banks, but Swedish banks have better NPL coverage



Source: Issuer Pillar 3 disclosures, ING | Number of issuers per country in brackets

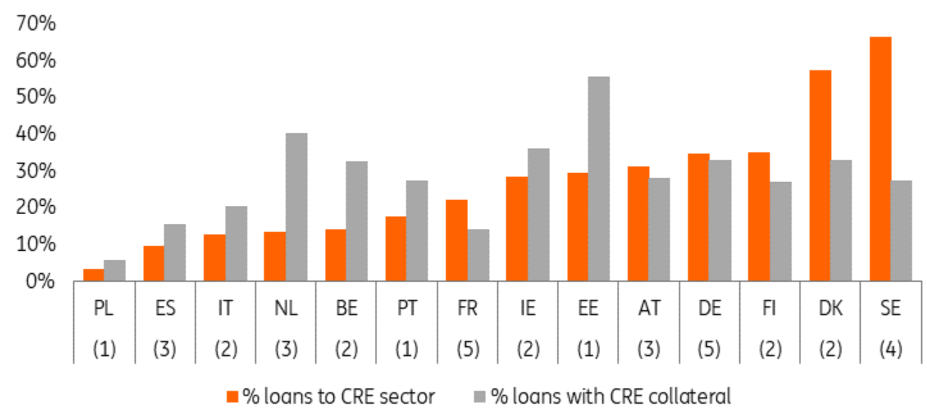
Property price developments matter for CRE collateralised loans

Properties that are pledged as collateral for loans to commercial real estate companies form an important security against a rise in non-performing loans. This does not only hold for loans to CRE companies, but also applies to the other parts of the corporate lending books secured by commercial real estate.

CRE collateralised loans have a relatively prominent position in the corporate loan books of Benelux banks, even though these banks have lesser direct exposure to CRE firms. Banking sectors with higher exposures to commercial real estate companies are indeed also among the banks with relatively higher shares of CRE collateralised loans, a sign that the loans to commercial real estate companies are often collateralised.

Exposures to the CRE sector versus CRE collateralized corporate loans

% of non-financial corporate exposures



Source: Issuer Pillar 3 disclosures, ING | Number of issuers per country in brackets

The commercial real estate collateral should protect banks against loan losses in the event of company defaults. However, the loan recovery prospects become worse if the value of the commercial real estate collateral declines significantly. The effect on banks of worsening conditions in the CRE market therefore stretches beyond their direct exposures to commercial real estate firms alone.

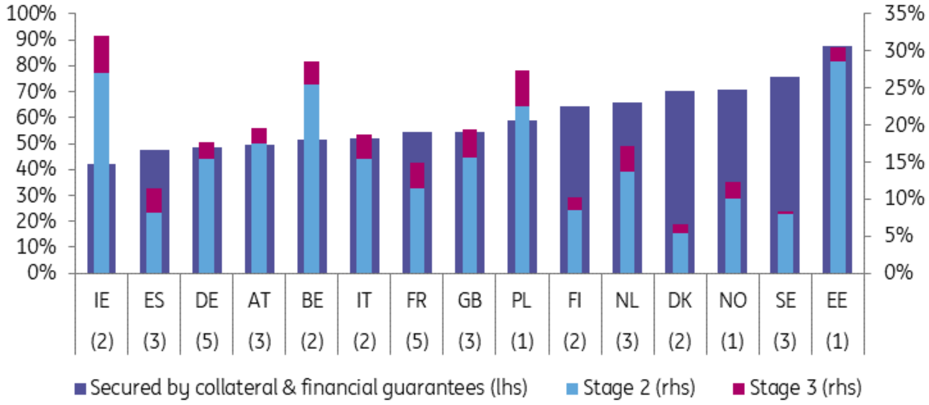
Corporate loan performance has remained relatively stable in the past two years. However, the trend is turning worse with our credit strategists expecting European speculative-grade default rates to rise to 5.5% in 2024 (see here). With corporate default rates on the rise, the collateral value of commercial real estate becomes an increasingly important backstop, even for banks with less direct exposure to CRE companies.

Real estate valuations may overestimate true value

The security offered by real estate collateral, or by financial guarantees for that matter, is generally reflected in a lower percentage of corporate loans being earmarked as increased credit risks (stage 2) or credit impaired (stage 3). If the value of the security becomes less, this could coincide with a deterioration in loan performance and rising impairments. This will impact banks that rely relatively heavily on real estate collateral.

Fewer stage 2 & 3 loans if there is more security from collateral

% of non-financial corporate exposures



Issuer Pillar 3 disclosures, ING | Number of issuers per country in brackets

Commercial real estate loans usually have a decent cushion against property price declines due to their on average low loan-to-value (LTV) ratios. These LTV levels have improved further during the past decade of low interest rates and property price rises. In its May 2023 Financial Stability Review, the European Central Bank (ECB) showed that more than 60% of the CRE loans in the eurozone had LTV levels below 60% at the end of 2022, while little more than 10% of the CRE loans had LTV levels of more than 100%.

Nevertheless, collateral valuation risks have emerged as one of the top supervisory priorities for the ECB. In an August 2022 supervision letter, the central bank identified collateral valuation as a blind spot for various banks. On-site inspections revealed flaws in the updating of appraisal reports as per the CRR and in ad-hoc revaluations upon changed market conditions. The ECB is also concerned that valuation approaches and inadequate parameters give rise to a significant asset overstatement.

These concerns could at some point lead to more aggressive valuation adjustments by banks on their commercial real estate collateral. This may cause provisions to rise, for instance, if certain LTV covenants were to be breached. We do note however, that alongside LTVs, debt servicing indicators such as interest rate coverage ratios (ICR) have become increasingly important for the assessment of default risks related to CRE corporates. (See also our note here, which focuses on bond covenants in the CRE sector).

Valuation requirements under the CRR

Article 208 of the EU capital requirements regulation (CRR) requires commercial property values to be monitored on a frequent basis, and at least once a year. If there are signs of a material decline in property values relative to general market prices, property values must be reviewed by a qualified valuer. For loans exceeding €3m or 5% of own funds, an appraisal review should take place at least every three years. Moreover, CRR Article 229 requires properties to be valued at or less than the market value or the mortgage lending value. The value of collateral should be reduced as appropriate to reflect the results of the monitoring.

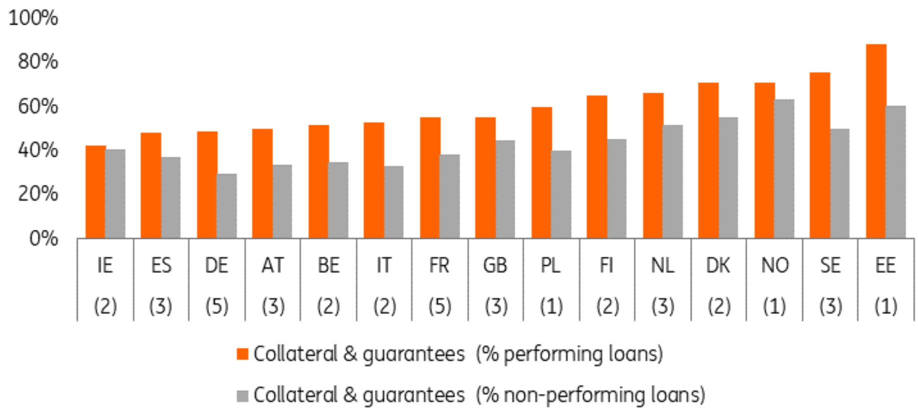
With the implementation of the Basel III reforms, the CRR will be amended to reduce the impact of cyclical effects on property valuation and keep the own funds requirements on mortgages more stable. Upward revisions to commercial real estate values will for instance be restricted versus the original value of the properties to the average value over the last eight years. Upward price modifications can however be made to above this average value if they are the outcome of energy efficiency improvements to the building.

(See for a further discussion of the CRR review the article linked here).

Commercial real estate collateral values also tend to be adjusted lower once corporate counterparties default. This too may deteriorate the recovery prospects on the loans if the bank were to move forward on selling the collateral to recover (part of) the loan.

Security from collateral and guarantees is lower for NPLs

% of performing and non-performing non-financial corporate exposures



Issuer Pillar 3 disclosures, ING | Number of issuers per country in brackets

The impact of climate change on commercial real estate assets

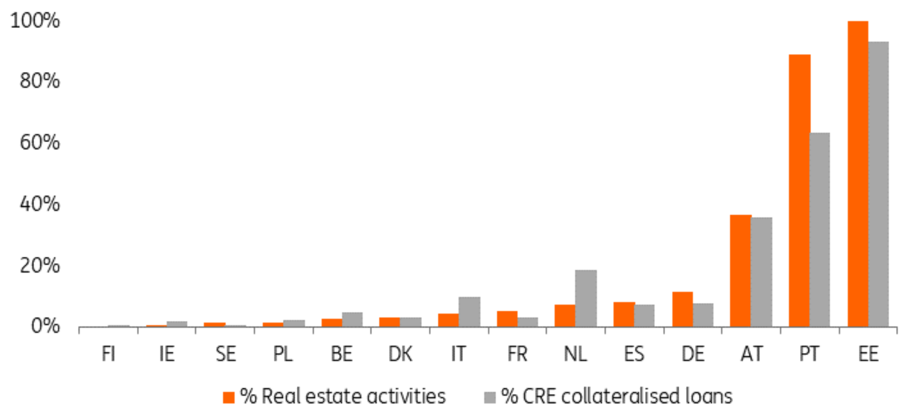
Climate change can act as a further source of pressure on the commercial real estate market. Physical climate risks such as sea level rise (chronic) or wildfires, storms, floods, drought, and subsidence (acute) can cause severe damage to properties. Besides, energy-inefficient buildings can lose value due to their higher energy consumption costs, or by not transitioning in time to meet the energy performance targets set by regulators (transition risks). Renovating or replacing inefficient buildings also brings extra costs at a time when company earnings are already under pressure from higher energy prices, wage rises and funding cost increases.

Since the end of 2022, European banks have reported on a subset of climate risk metrics via their Pillar 3 disclosures. These disclosures encompass physical and transition risk indicators for commercial real estate activities and CRE collateralised loans. The first disclosures still heavily rely on estimates, making it difficult to draw valuable conclusions. Besides, the **physical climate risk** assessments of banks are based on a broad variety of assumptions and approaches, sometimes resulting in substantial reporting differences.

Finnish and Estonian bank disclosures (almost neighbouring countries) form two reporting extremes on physical climate risks. Finnish banks classify only a few real estate assets as exposed to physical climate risks, while a very high portion of Estonian commercial real estate assets is assumed vulnerable to chronic and acute physical climate risks. Adjusting for the high physical risk outliers, real estate assets of German, Spanish and Dutch banks appear to be a tad more sensitive to physical climate risks.

The physical climate risk assessment differs widely among banks, with Finnish and Estonian banks at the extremes

Physical climate risk as % of real estate exposures

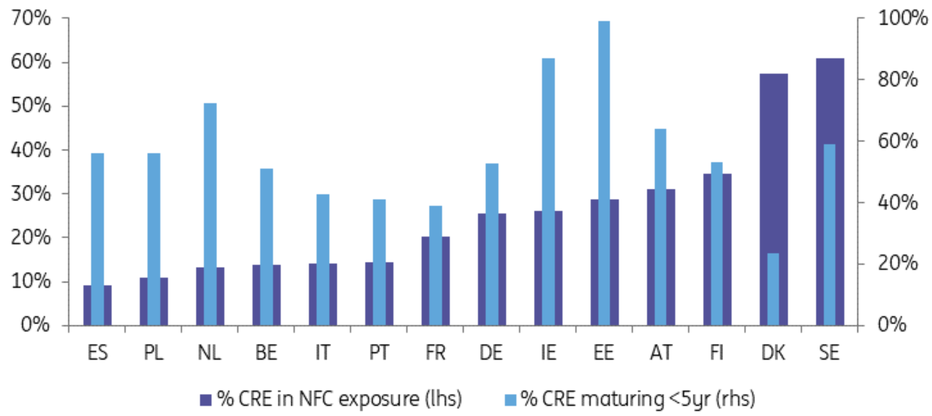


Issuer Pillar 3 disclosures, ING

The disclosures on **transition risks** confirm that a significant part of the CRE sector exposures of European banks will expire within five years' time. While this may exert unwanted pressure on these loans from a refinancing perspective, it is positive from a transition risk point of view. If the maturities of the CRE exposures are shorter, banks have an earlier opportunity to renegotiate the loan terms for stricter environmental requirements. This is supportive of the decarbonisation targets of banks. The commercial real estate exposures of Danish banks look somewhat more sensitive to transition risks, as the maturity of these loans mostly stretches beyond five years.

CRE sector important to transition risk exposures of the Nordic banks, but most CRE exposures mature within 5yr

Transition risk as measured by the maturity of CRE activities



Issuer Pillar 3 disclosures, ING

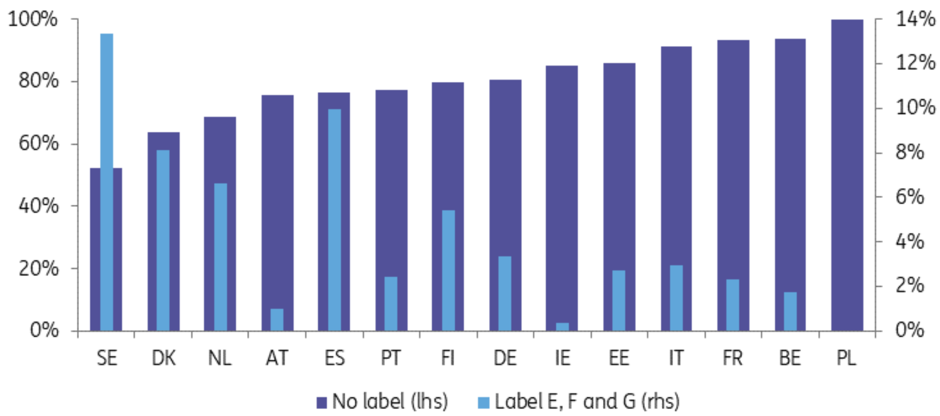
The energy performance disclosures by banks on their CRE collateralised loans offer further clues on the transition risks for the commercial real estate assets of banks. These disclosures use both energy performance certificate (EPC) labels and energy performance scores.

The statistics confirm the poor data availability of **EPC labels** in most countries. Swedish banks have a relatively decent 48% EPC label coverage for their CRE collateralised loans, but there is no EPC label coverage at all in Poland and only a 6% EPC label usage by Belgian banks. Banks with the ability to use EPC labels also tend to disclose a higher percentage of loans in the less energy-efficient EPC label E, F and G buckets which are the most exposed to transition risks. This likely reflects the broader EPC label coverage of commercial real estate in these countries, including for older dated and less energy-efficient properties.

Another well-known issue with the use of EPC labels is the lack of comparability of the definitions used. This makes it difficult to draw conclusions based on these statistics. Against this backdrop, it is a bit of a setback that the rescaling of EPC labels as per the initial revamp proposals to the Energy Performance of Buildings Directive (EPBD) seems to be off the table. The original proposals not only facilitated a better accessibility of labels but also a harmonisation of EPC label scales.

Banks from markets with better EPC label availability appear worse positioned on transition risk

Swedish and Spanish banks have the highest shares of E, F and G labelled properties

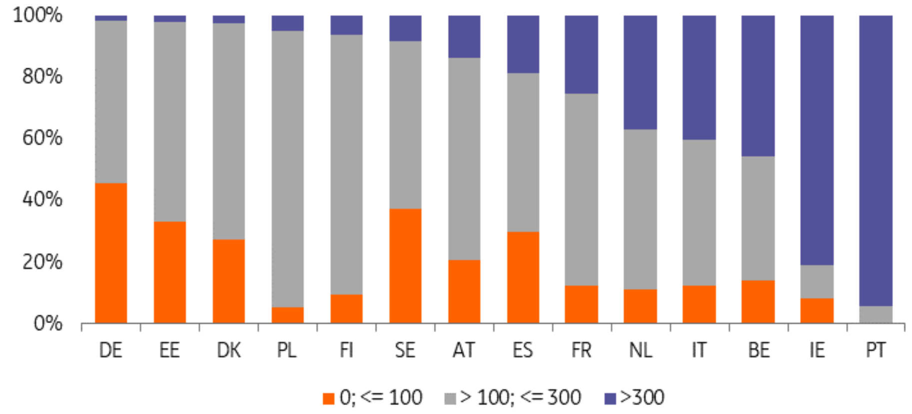


Issuer Pillar 3 disclosures, ING

The **energy performance** scores may give a better idea of the transition risk exposures of commercial real estate collateral. While these scores are still largely based on estimates, they do cover the full commercial real estate collateralised loan portfolio and are better comparable in terms of actual energy demand. These energy performance scores identify CRE properties in Portugal and Ireland to be most exposed to transition risks. German, Spanish and Nordic banks score best, with a higher share of their CRE collateralised loans included in the better <100 kWh/m2 energy performance bucket.

Energy performance scores of CRE collateral see least transition risks arise for German banks

Energy performance in kWh/m2 of collateral



Issuer Pillar 3 disclosures, ING

Based on this, we can draw the cautious conclusion that banking sectors with large commercial real estate exposures are probably not those most sensitive to climate transition risks.

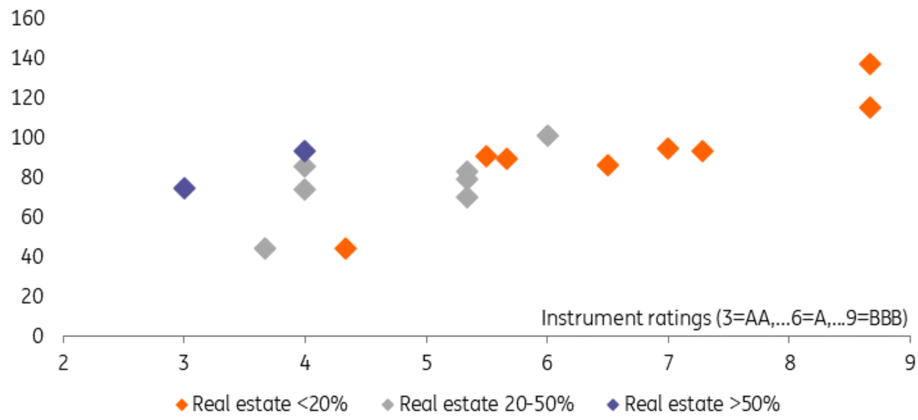
The spillover consequences of CRE concerns to funding costs

Higher exposure to companies in the CRE sector does come at a funding cost disadvantage. Credit spreads are currently wider for banks with more CRE loans on their balance sheet than for banks with less CRE exposure, which is even more so the case for bonds issued by banks further down the liability structure.

The two graphics below illustrate the 5yr equivalent asset swap spread levels for the preferred senior unsecured and bail-in senior unsecured bonds of a sample of European banks. The charts distinguish banks with less than 20% exposure to CRE firms, from banks with 20-50% CRE exposure and banks with more than 50% CRE exposure. The spread levels are plotted against the average ratings of the bond instruments.

The funding cost impact of higher CRE exposures is modest in preferred senior

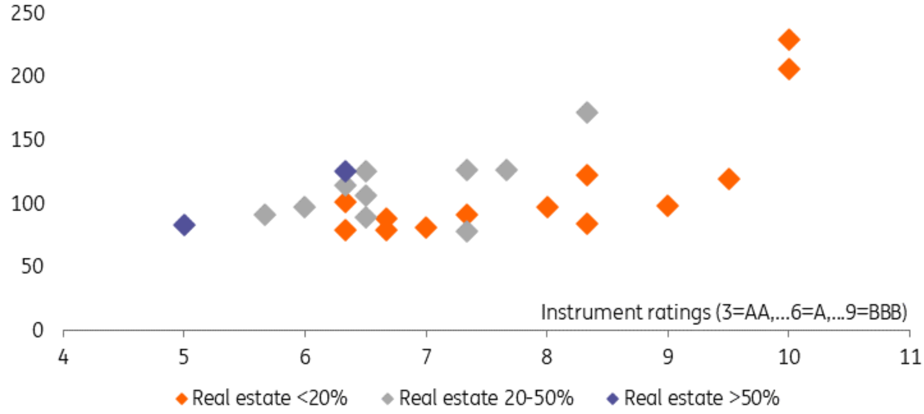
5yr equivalent preferred senior unsecured asset swap spreads, in basis points



IHS Markit, Refinitiv, ING

There is more funding cost disadvantage to higher CRE exposures in bail-in senior

5yr equivalent bail-in senior unsecured asset swap spreads, in basis points



IHS Markit, Refinitiv, ING

The charts confirm the wider asset swap spread levels for banks with more than 50% CRE exposure in both the preferred and bail-in senior unsecured bond markets. Banks within the 20-50% CRE bucket also have in most cases higher credit risk premiums on their bail-in senior liabilities than banks with less than 20% CRE exposure.

This shows that commercial real estate-related risks are already partially reflected in bond market funding levels. That said, we do believe that spreads will widen more if the credit metrics of the banks come under stronger pressure from CRE-related problems. If CRE concerns were to ease convincingly, banks with more CRE exposures should benefit from a decline in the CRE risk premium.

Conclusion

While the worst price declines in commercial real estate are levelling off, supervisors and market participants stay vigilant regarding the developments in the CRE market. Nordic banks are among the most exposed to turmoil in the CRE sector, but the performance of their CRE loan books remains solid so far. These banks also do not appear to be among those most exposed to CRE-related climate risks. The bond market already prices in a certain CRE risk premium, offering some cushion if commercial real estate were to become a more serious concern for bank fundamentals. That said, this risk premium is unlikely to be enough to prevent credit spreads from widening further if stresses in the CRE sector build up.

Five factors driving bank bond supply next year

2023 has been a very significant year for bank bond supply, but we don't expect supply to turn lower in 2024. Here are five factors driving issuance

Suvi Platerink Kosonen
Senior Sector Strategist, Financials
suvi.platerink-kosonen@ing.com

The European Central Bank is set to end its cheap funding for banks in 2024

1 At best sluggish lending volumes

The banking sector has felt the impact of a slowing economy and higher rates in 2023. Private sector lending has been sluggish, and lending books have declined to slightly below the levels seen at the end of the year, both for households and corporates. Consumer credit has held up better, offsetting part of the decline in loans for house purchases.

With the (very) limited economic growth pencilled in for 2024, we expect lending to remain subdued in 2024. This will set a cap on balance sheet growth and limit additional bank funding needs.

2 Less reliable deposit developments

Deposit balances have been more harshly hit than lending balances in 2023 in the eurozone, particularly in Italy, Spain and France. In 2024, alongside less impressive lending, we also expect deposits to remain under pressure.

Furthermore, higher interest rates continue to drive depositors into better yielding alternatives, reflected as an ongoing shift from current accounts into term deposits. More active depositors and more competition for deposits mean it is less straightforward for banks to rely increasingly on deposits for funding.

Eurozone banks have increased their share of deposit funding in the past couple of years, supported by the generally stable nature of deposits and their beneficial regulatory treatment. We would not take it for granted that this trend will continue as it has in the current environment.

3 End of the ECB funding support for banks

Bank funding needs are likely to remain substantially impacted by the runoff of European Central Bank funding. Another €450bn in Targeted Longer-Term Refinancing Operations mature in 2024.

A substantial share of the excess Liquidity Coverage Ratio liquidity buffers have already been exhausted. While there is still further headroom to absorb the additional impact, we see a higher risk for refinancing maturing LTROs, in particular for banks in Italy and Germany. Part of the refinancing is likely to continue to head to bond markets, subject to market circumstances remaining accommodative. We wrote about the LCR impact of the LTRO runoff here.

As the ECB is seeking to bring down the excess liquidity in the system, it would be highly controversial for it to offer banks the option to lengthen these drawings into a new longer-term refinancing operation, in our view. We do, however, expect part of these funds to end up being rolled over in the shorter operations including the three-month Longer-Term Refinancing Operations and Main Refinancing Operations. However, we think some stigma may be attached to this and as such, the bulk of banks would likely seek to find other sources of funding to replace their central bank drawings.

4 Bond redemptions remain broadly stable

Bank bond redemptions are set to remain broadly stable year-on-year in 2024 reaching just above €290bn. Of these, €121bn are in covered bonds, €145bn in senior debt and €27bn in bank subordinated paper.

The largest changes in redemptions are seen in bail-in senior debt, where redemptions could increase by €15bn YoY. Preferred senior debt maturities are seen c.€15bn lower YoY, and covered bonds could see lower redemptions of €5bn YoY. Subordinated debt redemptions could increase slightly YoY, driven by higher Tier 2 redemptions and calls and a stable amount of AT1 debt with first call dates in 2024.

5 Bail-in senior markets reach a more mature stage

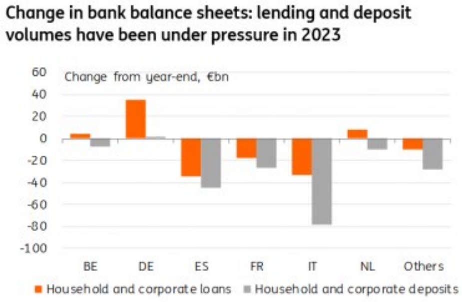
Bail-in senior issuance in 2024 will be driven by a combination of potential risk-weighted asset changes that may impact the total MREL (minimum requirement for own funds and eligible liabilities) eligible debt needs and redemptions.

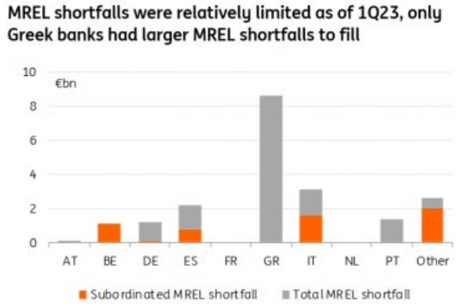
We see that the bail-in senior market is reaching a more mature stage. Larger banks are already meeting their loss absorption requirements.

While lending is likely to remain pressured, we expect that regulatory changes will continue to impact risk density and may push RWA higher.

On top of this, there are limited MREL shortfalls in smaller institutions. Banks in jurisdictions with a longer MREL transitioning time have some further work to do to meet their MREL requirements. Greek banks are among those that have some further work to do with another c.€8bn to meet their MREL requirements.

Balance sheet changes and MREL shortfalls as supply drivers





Source: ING, ECB, SRB

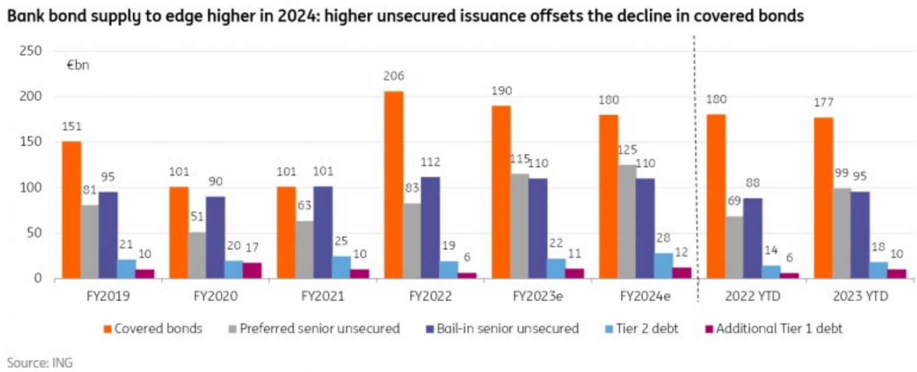
What to expect in terms of bank bond supply in 2024

We expect bank bond supply to remain high in 2024, reaching €455bn. And bank net supply remains elevated.

While the increase in the overall funding needs is perhaps limited by sluggish lending volumes, we don't expect the share of deposits to continue to head higher and banks will continue to refinance part of their maturing LTROs via the bond markets.

We expect the LTRO refinancing wave to result in heavier supply landing in the first quarter of 2024.

We expect unsecured bank bond supply to remain elevated in 2024, offsetting the impact from lower covered bond supply



Source: ING

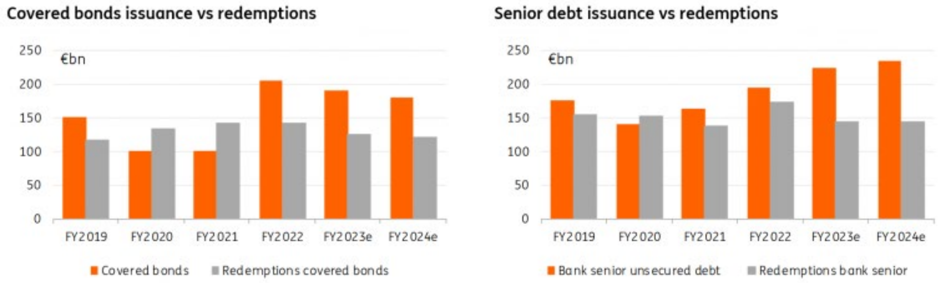
Senior unsecured supply to offset the slump in covered bonds in 2024

We forecast higher senior unsecured issuance to offset the slightly lower covered bond reading that we pencil in for 2024. Preferred senior debt issuance will likely remain solid at €125bn, while covered bond issuance will edge lower to €180bn. We think preferred senior debt and covered bonds will be the most fitting longer-maturity funding alternatives for banks seeking to refinance their LTROs.

The share of bail-in senior to total senior issuance has declined year-to-date to 49% from 57% in 2022. The change has been driven by the substantial increase in preferred senior debt issuance. We expect the share of bail-in senior debt to total senior debt to slightly decrease further next year. We forecast bail-in senior supply to reach €110bn in 2024.

In 2023, banks have issued €194bn in senior debt of which €99bn was in preferred/OpCo debt and €95bn was in bail-in senior debt (NPS/HoldCo) on a year-to-date basis. The supply is running substantially ahead of last year at this time when senior issuance reached €157bn split between €69bn in preferred and €88bn in bail-in senior debt.

We expect covered and senior issuance to remain ahead of redemptions again in 2024



Source: ING, IGM

In bank capital, banks start to gear up for higher redemptions to come

We forecast that 2024 should see solid bank capital supply. We forecast that bank capital issuance will reach €40bn in 2024 split between €12bn in AT1 and €28bn in T2. This is a step higher from 2023, for which we forecast €33bn total, with the YTD levels running currently at €29bn.

Redemptions will drive capital supply higher in 2024, in our view. Alongside the 2024 redemptions, we think issuers will be getting ready for the higher redemption burden approaching in 2025. Euro-denominated bank capital redemptions will increase by €3bn YoY to €27bn in 2024 and further to €43bn in 2025.

We believe that the timing of capital issuance is largely impacted by market conditions. If market conditions were to remain volatile, banks would be more likely to jump on any issuance window on a more proactive basis. If, instead, the market views of 2025 turn out to be more upbeat, banks may feel more comfortable waiting to refinance their early 2025 redemptions closer to the actual call dates. We think banks will generally seek to call their capital at the first call date instead of extending the notes.

Bank capital issuance to remain ahead of redemptions in 2024

Source: ING, IGM

In euro-denominated AT1, €5bn in (originally) benchmark size AT1 debt outstanding has the first call date in 2024. This includes c.€400m for the two deals that have been tendered in 2023 ahead of the 2024 calls. On top of this, €1.8bn in sub-benchmark debt is callable in 2024.

AT1 redemptions will substantially increase in 2025 to €15bn of which €12bn is in benchmark size. Part of the 1H25 calls may be refinanced already in 2024.

Redemptions will also increase in Tier 2 debt. A further €18bn is set to reach its first call date in 2024 in callable Tier 2 debt, of which €14bn is in benchmark size, while €1.9bn bullet T2 matures. T2 bullet redemptions increase to €10bn in 2025 and callable T2 repayments remain stable at €18bn in 2025. Due to the limited remaining capital recognition of outstanding bullet T2 debt one year prior to the maturity, these deals may be partly replaced by bail-in senior as here, regulatory capital recognition is likely less of a driver.

We forecast bank bond supply to reach €455bn in 2024

ING's bank bond issuance estimates

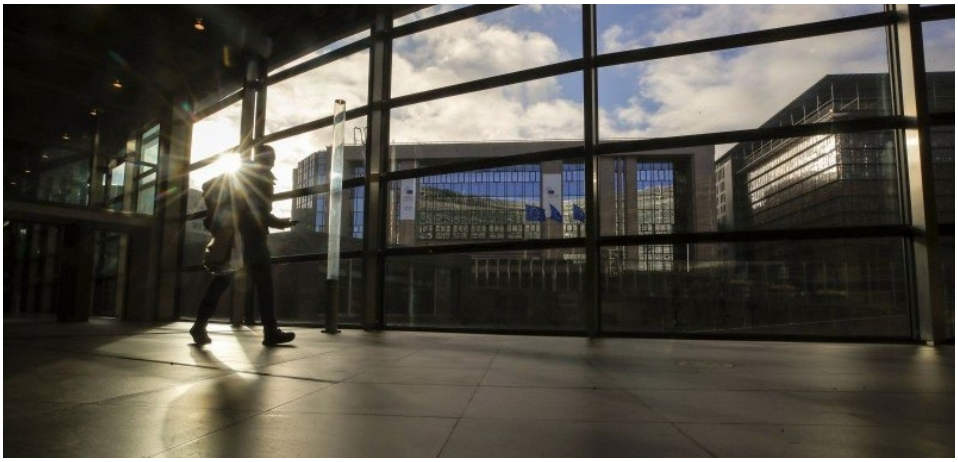
	FY2019	FY2020	FY2021	FY2022	FY2023e	FY2024e
Covered bonds	**151**	**101**	**101**	**206**	**190**	**180**
Covered redemptions	*118*	*134*	*143*	*143*	*126*	*121*
Bank senior unsecured debt	**176**	**141**	**164**	**194**	**225**	**235**
of which Preferred senior unsecured	81	51	63	83	115	125
or which Bail-in senior unsecured	95	90	101	112	110	110
Bank senior redemptions	*155*	*154*	*138*	*175*	*144*	*144*
Bank subordinated	**31**	**37**	**35**	**25**	**33**	**40**
of which Tier 2 debt	21	20	25	19	22	28
of which Additional Tier 1 debt	10	17	10	6	11	12
Bank capital redemptions	*41*	*34*	*33*	*31*	*24*	*27*
Total Unsecured bank bond supply	**207**	**178**	**199**	**220**	**258**	**275**
Total Bank bond supply	**358**	**278**	**300**	**426**	**448**	**455**

Source: ING

ESG supply by banks set to stay strong in 2024

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

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



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

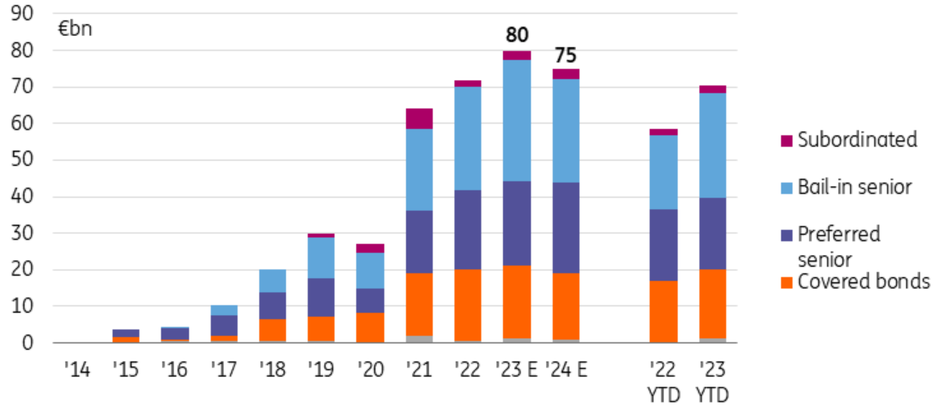
Sustainable bank bond supply on track to reach new highs in 2023

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

€75bn In ESG supply by banks

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

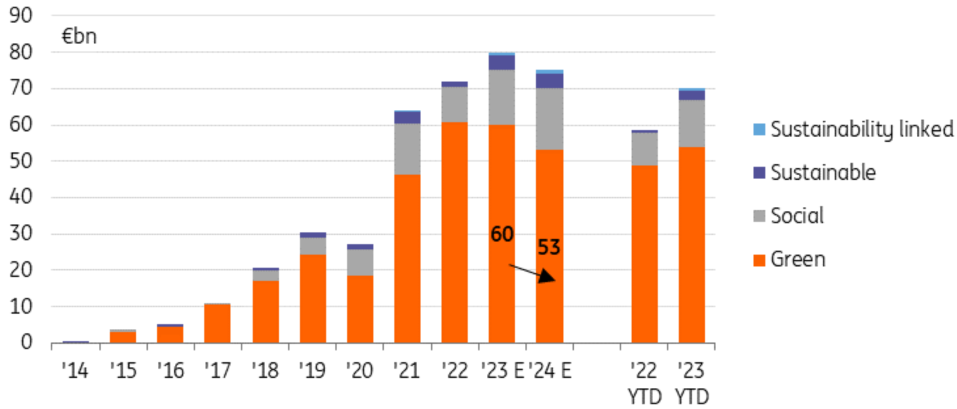
Sustainable issuance in bank bonds continues to rise



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

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

Social issuance will continue to become more dominant



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

Factors driving sustainable bank bond supply in 2024

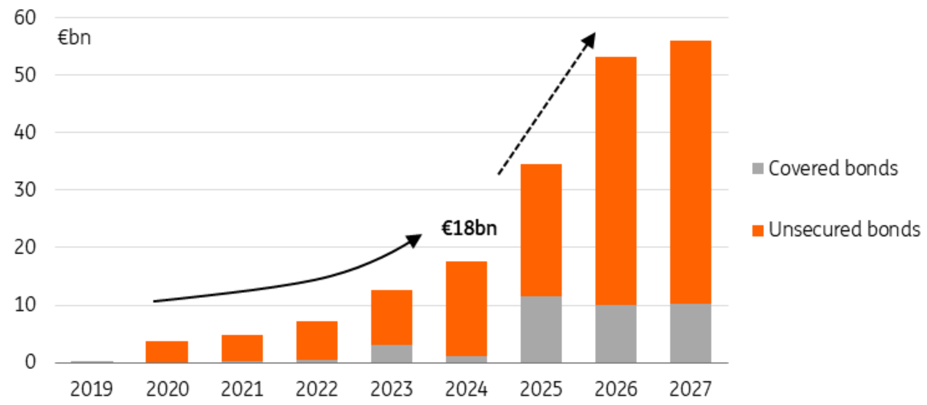
Slower lending growth (-)

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

Few sustainable bond repayments (-)

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

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

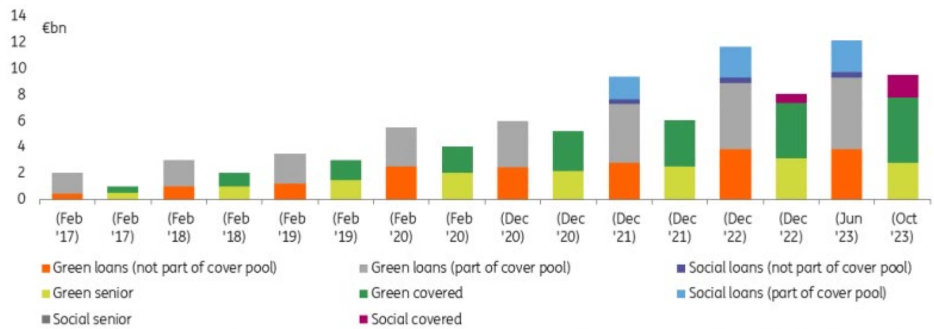


Only EUR bank bonds with a minimum size of €250m included
Source: ING

Identification of new assets (+)

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

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



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

Financing of other environmental objectives (+)

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

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

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

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

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

What to expect from the European Green Bond Standard

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

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

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

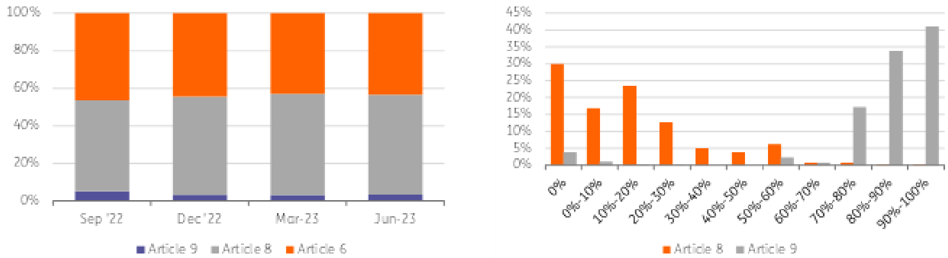
The European green bond regulation provides for a so-called **flexibility pocket**. Up to 15% of the proceeds can be allocated to economic activities that comply with the EU taxonomy apart from the technical screening criteria, for instance because these criteria have not entered into force yet. The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

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

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

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

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



Morningstar Direct, ING

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

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

The applicable do no significant harm criteria per real estate activity

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

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

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

In summary

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

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