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Banks Outlook 2021

Julie Cichon
Sector Strategist, Financials
Amsterdam +31 20 563 8993
julie.cichon@ing.com

Suvi Platerink Kosonen
Senior Sector Strategist, Financials
Amsterdam +31 20 563 8029
suvi.platerink-kosonen@ing.com

Maureen Schuller
Head of Financials Sector Strategy
Amsterdam +31 20 563 8941
maureen.schuller@ing.com

Teunis Brosens
Head Economist, Digital Finance & Regulation
Amsterdam +31 20 563 6167
teunis.brosens@ing.com

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Teunis Brosens
Head Economist, Digital Finance & Regulation
Amsterdam +31 20 563 6167
teunis.brosens@ing.com

Julie Cichon
Sector Strategist, Financials
Amsterdam +31 20 563 8993
julie.cichon@ing.com

Maureen Schuller
Head of Financials Sector Strategy
Amsterdam +31 20 563 8941
maureen.schuller@ing.com

Suvi Platerink Kosonen
Senior Sector Strategist, Financials
Amsterdam +31 20 563 8029
suvi.platerink-kosonen@ing.com

Banks Outlook 2021: The delayed impact of Covid-19 will make itself felt

The pandemic brought banks a renewed sense of purpose in 2020: providing liquidity to the real economy. Helped along by accommodative monetary and government policies, banks have indeed played their part in the crisis response. Going into 2021, the delayed impact of the pandemic will make itself felt

Loan demand: weak, weaker, weakest?

In 2021, the recessionary environment will weigh on bank loan demand of corporates, as investment projects are shelved and businesses are struggling to survive. Borrowing rates are supportive, but cannot fall much further, and bond markets are an attractive alternative for larger corporates in many eurozone countries. Businesses seeking alternative sources of liquidity, once government-supplied liquidity has dried up, may stimulate demand for bank loans, but only to a limited extent. With southern European economies on average hit more strongly by lockdowns, having a higher share of Small and Medium-Sized Enterprises and consumer credit portfolios in those countries, and taking into account pre-corona trends, we expect bank loan demand to weaken mostly in southern Europe.

Margins: under increasing pressure

The clouded outlook for loan volumes is complemented by an ever-increasing pressure on margins, as eurozone banks continue to suffer from the negative rates environment in 2021. The 10-year EUR swap rate is hovering around -25bp, painting a dark picture of the European rates outlook with markets expecting short rates to stay, on average, at negative levels for the next decade. What is more, the yield curve has flattened considerably in the past few years, detrimental to banks deriving part of their income from maturity transformation.

The particular vulnerability of banks to negative rates depends on their loan book composition, including duration and funding mix. Deposits are no longer the safe and efficient means to generate interest income on maturity transformation that they once were. In fact, given difficulties imposing negative rates on deposits, a strong dependence on deposit funding may be turning into a weakness rather than a strength.

Non-performing loans: silence before the storm?

Helped by extensive government support measures and payment holidays, many businesses have been surviving in 2020. Default rates and NPL ratios have been deceptively quiet this year. Support measures are not forever though. A sharp increase in non-performing loans is a question of 'when, not if', but will hit some countries more than others. Factors driving those differences include the sectoral composition of corporate loan books, the share of SMEs in those loan books, and the size of legacy NPL portfolios. Taken together, a worrying picture emerges. Covid-19 may deal another blow to those countries and banking sectors that are worst positioned to deal with it.

Consolidation: a change in tune

Weak demand and digesting losses may drive banks into each other's arms. But even before Covid-19, several banking markets were already overbanked. 2020 will likely mark a year of change for bank consolidation in Europe with another hit to bank profitability in the form of Covid-19 and a change in tone from supervisors. This is likely to result in more consolidation.

We think domestic deals will continue to take the lead and consider in-market transactions to be more likely in certain areas. Cross-border deals are more likely to involve large banks that target new markets. Motivation could include increasing economies of scale, synergies, geographical and product diversification, acquiring better digital capabilities, or improving the asset and liability match by merging with a complementing entity. An important consideration for cross border mergers will probably continue to be the hunt for greater size and customer base, especially since banks are facing ever tougher competition from big-tech platforms. Cross-border deals have been hindered partly by a reluctance of domestic authorities. The tone may be changing though, with the ECB now seemingly pushing harder towards bank consolidation.

Bank bond supply: I'm good, thank you

Covid-19 has sharply reduced bank bond issuance this year. The fall in covered bond and preferred senior supply is a direct consequence of banks relying more on the ECB's TLTRO funding. Only subordinated supply has kept its head above water thanks to the ECB's measures and a rise in lending growth for some banks. With the global economy projected to recover from its severe growth relapse in 2021, bank supply is likely to follow a similar pace as we have seen this year.

Regulation: where were we?

Regulators have responded strongly to the Covid-19 pandemic in an effort to mitigate the impact of the crisis on households, corporates and banks. All these measures have guided banks well through the first storms of the Covid-19 crisis. To what extent banks will be able to rely on these temporary provisions in 2021, pretty much depends on how the coronavirus situation evolves. If renewed lockdowns and economic pressures are indeed the direction we are heading, governments and central banks will likely continue to do their utmost to navigate the crisis. That may include extending measures that were put in place temporarily to optimise the conditions for banks to deal with the Covid-19 crisis and the postponement of important measures such the Basel-III reforms.

Sustainability: next steps towards climate neutrality

The Covid-19 pandemic is underscoring and reinforcing the importance of sustainability. Bank sustainable bond issuance held its ground in 2020, quite an achievement given the general reduction in bank bond issuance. Sustainability is likely to remain a key topic in 2021 for banks in many different ways, ranging from disclosure requirements to the impact of the taxonomy regulation in the field of green loan and bond market developments, just to name a few. The follow-up developments in light of the European Green Deal will keep financial market participants engaged and so should the ECB's monetary policy review, which could include a pivot towards green lending. Bond markets will remain a vital reflection of this.

Teunis Brosens
Head Economist, Digital Finance & Regulation
Amsterdam +31 20 563 6167
teunis.brosens@ing.com

Bank lending in 2021: weak, weaker, weakest?

With weak economic growth, demand for bank loans will be muted in 2021. Banks in southern Europe tend to provide relatively more loans to small and medium-sized enterprises and consumer credit, and that's where we expect demand to be especially weak

Many French banks have their headquarters in La Defense in Paris

Overall weakness in business demand for bank loans

Bank lending to businesses surged in spring this year, as businesses scrambled for liquidity. Demand eased over the summer in most countries, though at different paces depending, among other things, on the availability and use of government guarantee schemes and the breadth of alternative government liquidity supply, for example in the form of tax deferrals and wage payments.

Bank lending demand by businesses in the quarters ahead will be chiefly driven by the following factors:

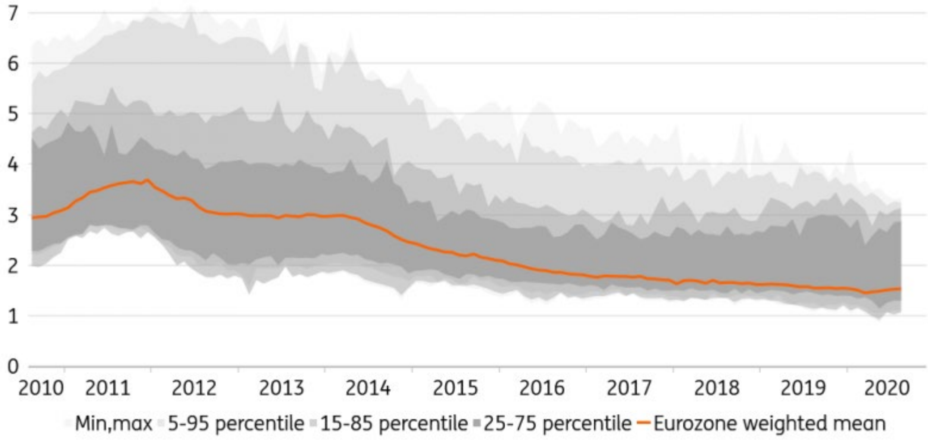
1 The recessionary environment weighs on bank loan demand

Our October baseline economic scenario assumes local lockdowns during the winter months and the rolling out of a vaccine in the first half of 2021. This would imply a continuation of the economic recovery in 2021. Given that the economic ground lost will not be recouped until 2023, and unemployment is set to increase, many businesses will struggle with lower demand, compared to pre-Covid-19 levels. This will also lead to investment plans being postponed or slimmed down. Therefore, bank lending demand will be only weakly supported by the economic recovery. Recent developments show that the probability of a more negative scenario, with more broad lockdowns and a much lengthier process for the rollout of a vaccine, is increasing. In such a scenario, GDP would not recover to pre-Covid-19 levels until 2024.

2 Borrowing rates are supportive, but cannot fall much further

Borrowing rates for non-financial businesses dipped slightly in March and April but have mostly moved back towards where they were at the start of 2020. While the European Central Bank may introduce additional easing measures before the end of the year, and despite the supporting effect of the ECB's long-term TLTRO loan operations, the effective lower bound on deposit funding will make it hard for banks to lower lending rates much further (see our companion piece " Negative rates to continue clouding the banking outlook in 2021"). This is especially true for banks in the South that on average are more reliant on deposit funding. We expect lower rates therefore to contribute only marginally to bank lending demand.

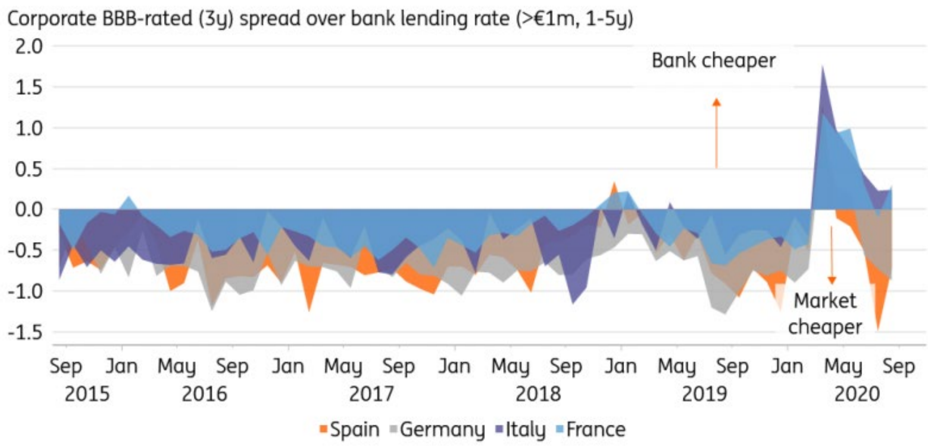
Borrowing costs for businesses (%, seasonally adjusted)



Source: ECB, ING

That said, bank lending rates are trending down in France and Italy. As a result, while most Eurozone BBB-rated corporates with access to bond markets are able to get better rates there than at their bank, Italian and French corporates now get cheaper bank funding. This may stimulate demand for bank loans in the latter countries.

Corporate BBB-rated (3y) spread over bank lending rate (>€1m, 1-5y)



Source: Macrobond, ING

3 Substitution from government-supplied liquidity towards banks

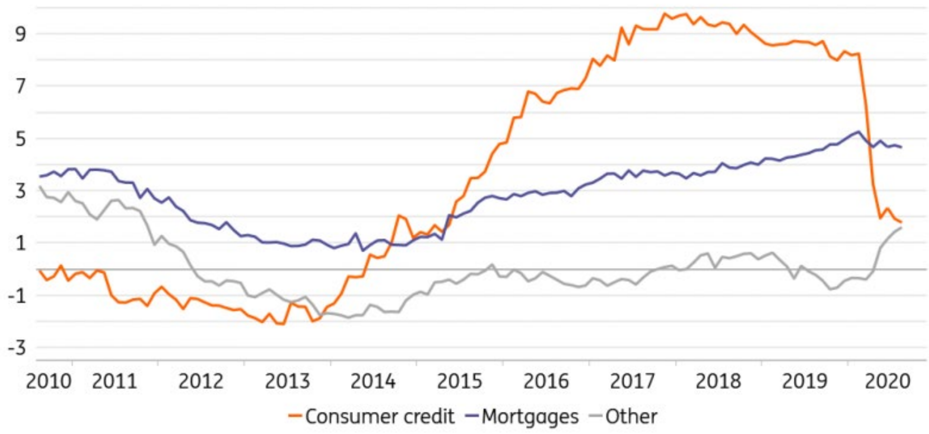
Otherwise healthy firms may turn toward their banks, if and when government-supplied liquidity is being phased out. This substitution effect will be stronger in countries which relied more on government-supplied liquidity in 2020. Roughly speaking this appears to apply more in Northern eurozone economies, than in Southern ones (we discussed this earlier here).

Bank loan demand by households: moving slowly

For households, the financial effects of the pandemic have remained muted so far. Though temporary workers and self-employed suffered, unemployment has not, yet, increased markedly, and governments have provided income support. That is bound to change however, as government support is already becoming less generous, and unemployment will inevitably start to rise more going into 2021.

Looking at types of household loans, growth of consumer credit has collapsed. Both prospective borrowers and lenders have likely become more cautious here. This loss in momentum is partly compensated for by a growth in the residual category of "other" types of household borrowing – the outstanding volume of which is comparable to consumer credit. Mortgage borrowing is keeping up relatively well, for now.

Eurozone bank lending to households, by type, year-on-year growth (%)

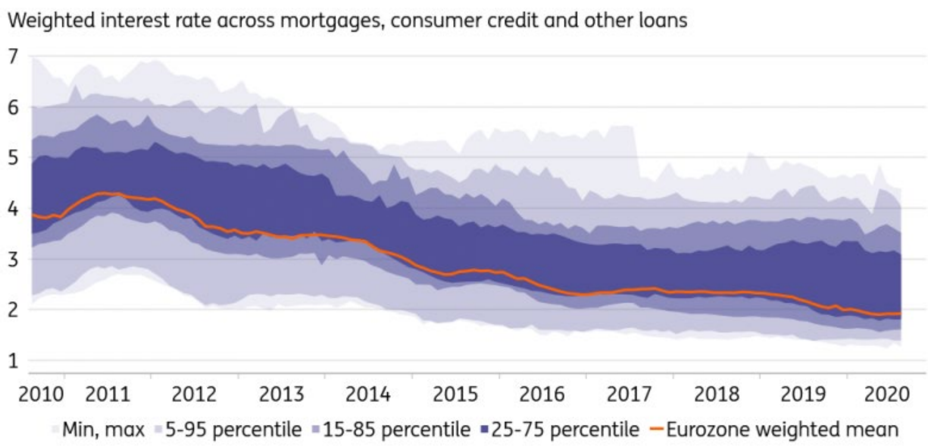


Source: ECB, ING

Moving into 2021, the **weak economic environment** makes it unlikely that consumer credit makes a strong recovery. For mortgage demand, we recall that in the 2012-2013 recession, net mortgage lending remained positive. It did dip briefly below zero in Summer 2009. Today's economic fallout is steeper and deeper than the one of 2008-9, but there is no financial crisis and our baseline scenario foresees a mild recovery in 2021. We, therefore, expect mortgage borrowing to continue growing, albeit at a slower pace.

Household **borrowing rates** remain very low and therefore supportive of demand, but rates have on average not fallen further since March this year. As with business rates, the scope for further rate decreases is limited.

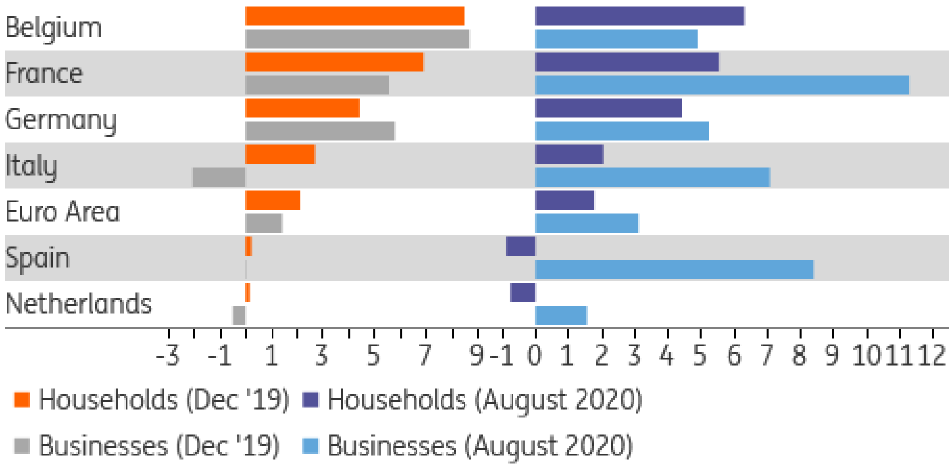
Composite borrowing rates for households



Source: ECB, ING

- Pre-corona, bank lending was growing modestly in the eurozone, driven mainly by Belgium, France and Germany. Growth was around zero in Spain and the Netherlands. Italy saw stable household borrowing growth, but net borrowing by businesses turned negative in 2019. While Covid-19 has lifted lending growth everywhere, pre-Covid-19 differences are likely to re-emerge at some point.

Bank lending growth (%YoY)



Source: ECB, ING

Bank lending supply: ample funding

- On the supply side, banks do not face a lack of funding. Deposit inflows spiked in spring 2020 as government liquidity flowed in while businesses and households reduced and postponed spending. The ECB's TLTRO and easing of collateral rules guarantee ample availability of central bank funding. The ECB wanted to make sure that lack of liquidity would not hold banks back, and they succeeded.
- At the same time, the margin pressure on banks remains unrelenting, as low and negative rates look set to stay with us for even longer. Some banks may be tempted to make up margin losses by trying to increase lending volumes. This may require them to increase their risk appetite. While this may help companies to return from the brink, there is a risk that the existence of "zombie firms", kept afloat initially by government support, is further prolonged. In the longer term, such firms may become a burden both for the economy, occupying resources that could be better deployed elsewhere, and for lending banks.

The outlook for bank lending demand

With economies in Southern Europe on average hit more strongly, a higher share of SME and consumer credit portfolios in those countries, and taking into account pre-corona trends, we expect most weakening of demand in the south, though Italian corporates may be tempted by low bank rates. French bank loan demand may be dampened by the fact that French businesses already borrowed heavily this year. German banks appear slightly better positioned to keep up lending growth, while bank lending growth in the Netherlands was already trending around zero before corona, which makes Dutch banks less well positioned to meet TLTRO benchmarks. This will be less of an issue in many other member states, that saw demand forbank

Suvi Platerink Kosonen
Senior Sector Strategist, Financials
Amsterdam +31 20 563 8029
suvi.platerink-kosonen@ing.com

Negative rates to continue clouding the banking outlook in 2021

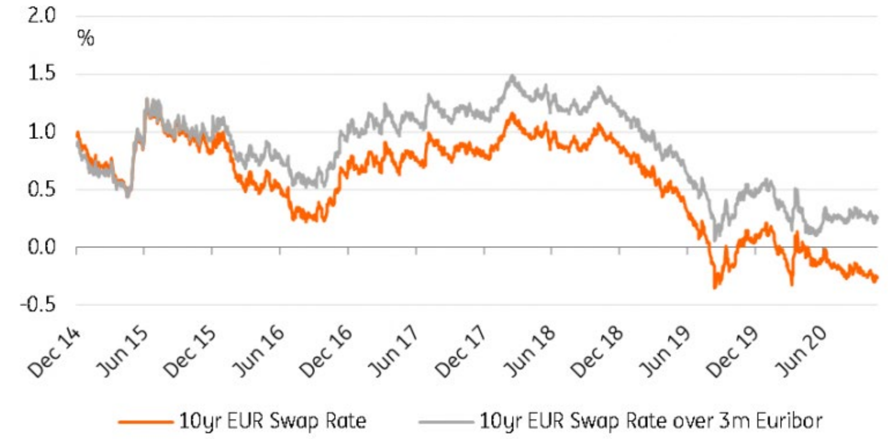
Eurozone banks will suffer from the negative rates environment in 2021, due to the easing monetary stance of the ECB. The vulnerability of banks to negative rates depends on their loan book composition including interest rate reset periods and their funding mix. Deposit rates have a natural lower bound, which makes them less attractive in a negative rates space

A cloudy day in Madrid

The Covid-19 crisis has resulted in a substantial weakening of the economic outlook in the eurozone with the European Central Bank responding with an extensive set of new measures in 2020. The low rates environment is by no means new, with the 3-month Euribor dipping below 1% in 2009 due to aggressive ECB reference rate cuts and slipping into negative territory in 2015 following the negative ECB deposit rate in 2014. As a consequence of the accommodative monetary policy stance, the 3-month Euribor has dropped below the ECB deposit rate, with the overnight index swap contracts pricing in an ECB rate cut in the next 12 months.

The 10-year EUR swap rate is hovering around -25 basis points and the low level paints a dark picture of the European rates outlook with markets expecting short rates to stay, on average, at negative levels for the next decade. The swap curve has flattened in the past years and the difference between the 10yr swap rate and 3m Euribor has shrank by 50bp since end-2014.

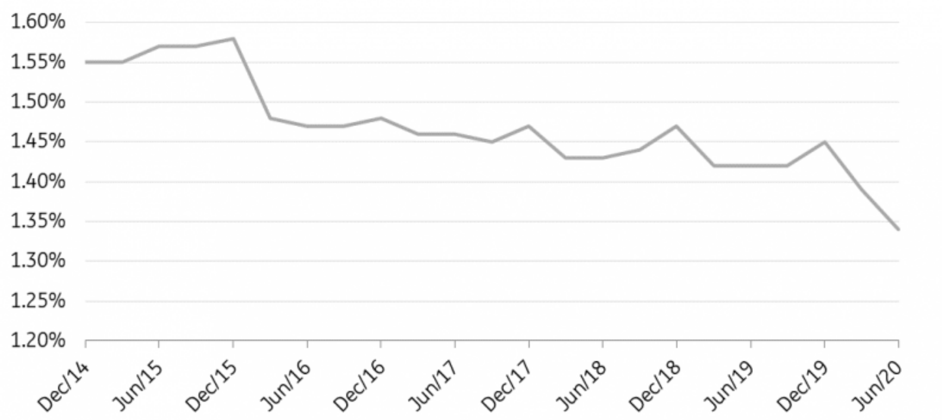
Swap curve has flattened since 2014



Source: ING, Refinitiv

The low or lately even negative rates environment will continue to take its toll on European banks and their revenue-generating possibilities. Low or even negative rates pressure the margins banks can realise on their interest-bearing assets.

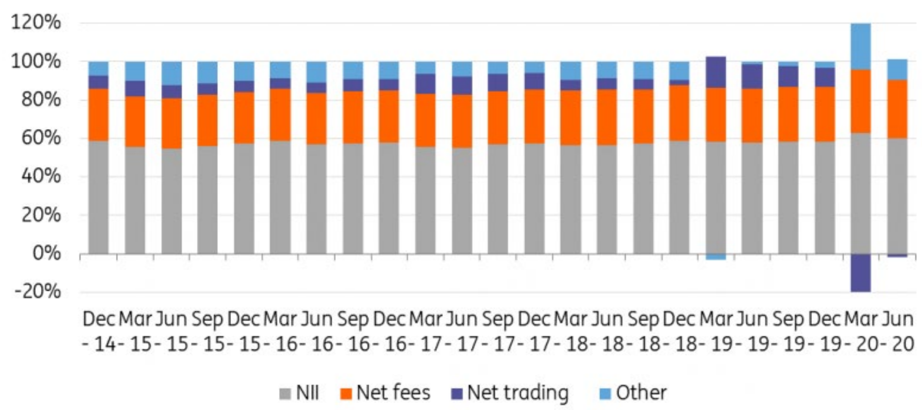
Net interest margin development for EU banks



Source: EBA, ING

That said, the effect is not similar for everybody. While the share of net interest income of total revenues has remained relatively stable over time for EU banks, country differences are substantial.

EU banks: Revenue split since 2014

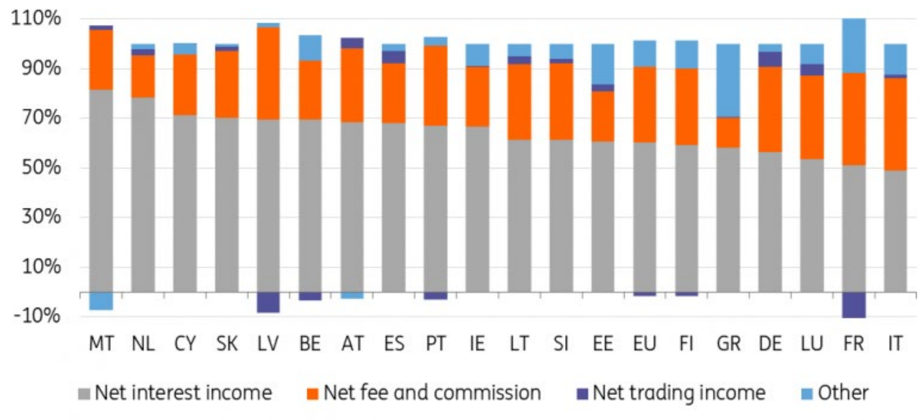


Source: EBA, ING

For banks in the Netherlands, Belgium, Austria or Spain the importance of net interest income as a total revenue driver is more significant than for banks in Italy, France or

Germany. The difference is likely driven by the latter banks' higher exposure to insurance and asset management businesses.

Importance of net interest income as a revenue driver per country



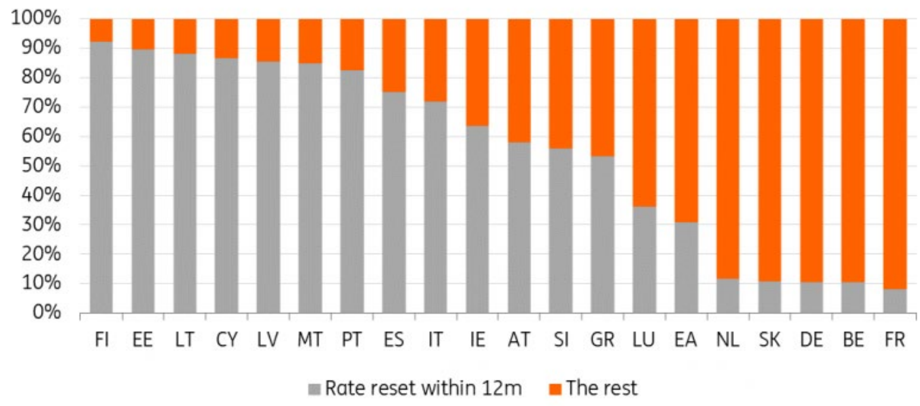
Source: EBA, ING

Furthermore, banks which have granted more loans tied to short-term rates as opposed to longer rates may be more sensitive to any changes in interest rates. Loan books with a larger share of long-term interest rate fixing periods instead are less sensitive to changes in rates.

Banks in France, Belgium, Germany and the Netherlands are among those with the largest shares of household loans with the next rate reset in more than a year's time. Instead, banks in Finland, Spain and Italy are among those with a relatively higher share of household loans with the next interest rate reset within the upcoming 12 months.

Euro area periphery is also among those with a higher share of short-term household loans than the eurozone average.

Household loans' interest rate setting period



Source: ECB, ING

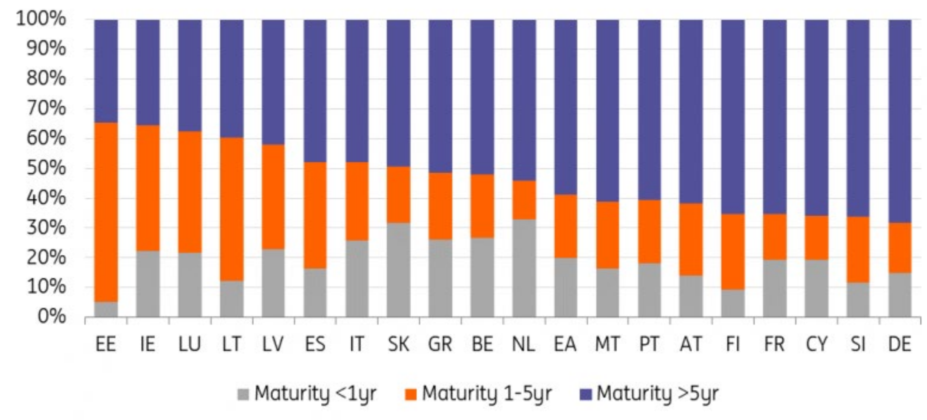
For corporates, the ECB instead reports maturity 'buckets' - splitting loans by loan maturities.

The share of corporate loans with a maturity of more than five years is among the highest in Germany, France, Finland and Austria. Italy and Spain are among countries that are positioned above the eurozone average in terms of the share of corporate loans with maturities below five years.

The statistics point towards German and French banks to be among the best positioned for a scenario with a longer period of low rates in terms of their loan books and also taking into account the relatively low importance of net interest income to their revenues. Banks in Spain and Italy are instead among those with a higher share of shorter loans on their books, with Spanish banks more reliant on net interest income than their Italian counterparts.

In addition to the effects on loan books, low rates make it more painful for banks to reinvest their maturing bond portfolios.

Maturity of non-financial corporate loans



Source: ECB, ING

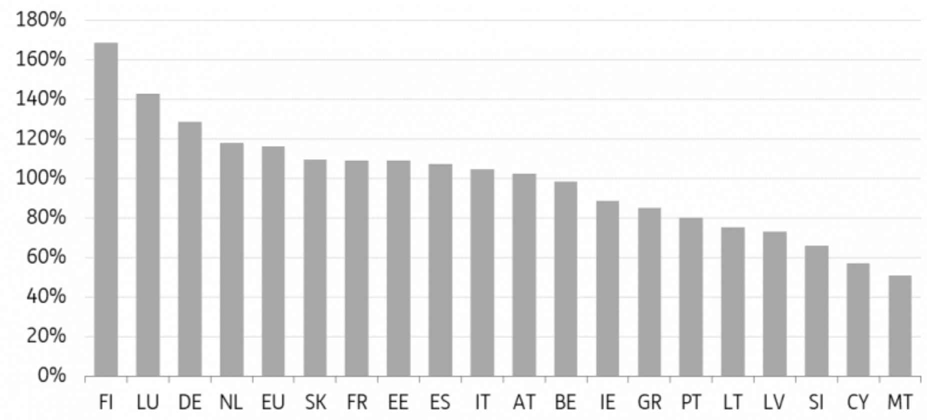
The funding mix

The loan book split is only part of the rates sensitivity picture; the funding mix is another important driver. Banks take part in maturity transformation by attracting short-term funding (mainly deposits) and granting longer-term loans, resulting in a shorter duration of their liabilities than their assets. Thus, their liabilities are likely to react faster to changes in rates than their assets.

Most banks' household and corporate businesses are, to a substantial part, deposit funded with the EU average of the loan to deposit ratio at 116%. Banks in the eurozone periphery have lower than average loan to deposit ratios with their loan books being particularly financed via deposits. The same can be said for Belgium and Austria.

Banks in Finland, Germany and the Netherlands have loan to deposit ratios which are higher than the EU average as these banks rely more heavily on other types of funding including bonds.

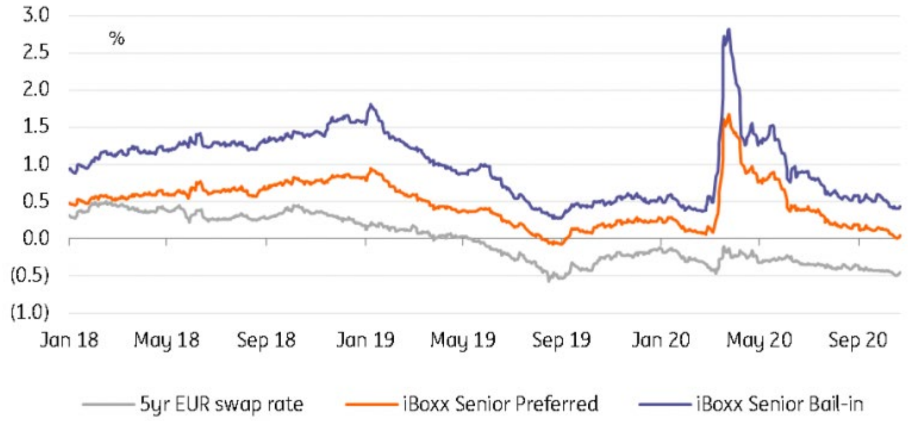
Loan to deposit ratios by country



Source: EBA, ING

Generally, deposits are considered a solid and sticky funding source limiting banks' exposure to volatile funding markets. However, in the current market environment with declining rates and senior bond yields, a larger share of bond market funding could actually act as a benefit for banks. Banks with higher loan to deposit ratios could benefit faster from lower funding costs as bond yields do not have a similar lower bound as deposit rates and bond yields are likely to fall in an environment of declining rates.

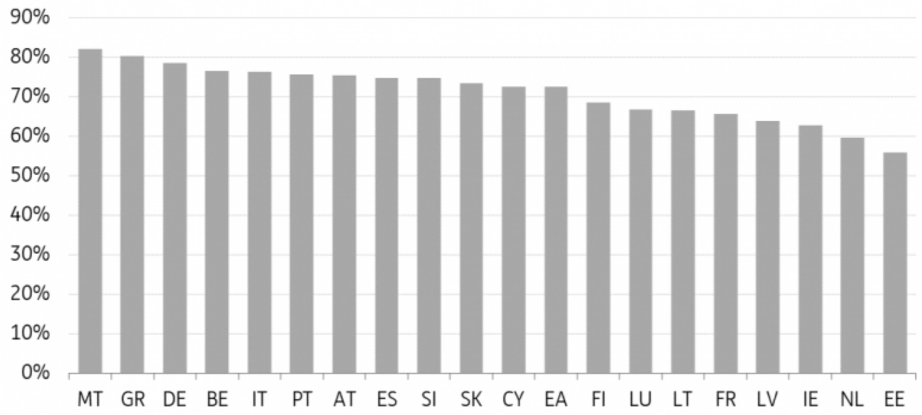
Bank bond yield development



Source: Markit, Refinitiv, ING

Deposit rates have a more natural lower bound than bond yields. Even if negative deposit rates are getting more common for wholesale clients and also lately for larger retail accounts, imposing them on smaller retail clients is still something that has been considered a no go area for most banks. The share of household deposits of the total deposits is substantial especially in countries such as Greece, Germany, Belgium and Italy, while corporate deposits play a somewhat larger role in the Netherlands and France.

Share of Households of total household and NFC deposits

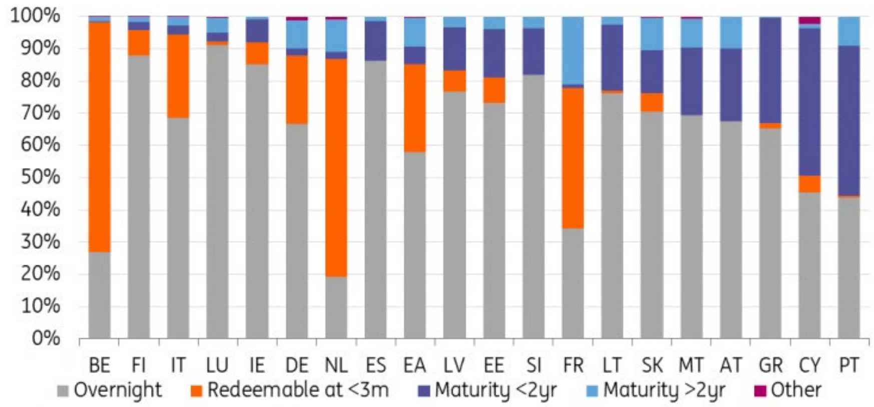


Source: ECB, ING

In the eurozone, 85% of household deposits are either overnight or redeemable with a notice of less than three months. Belgium, Finland and Italy especially have a high share of very short-term household deposits, while Greece, Austria and France have some more deposits with either a maturity of less than two years (GR, AT) or above 2 years (FR).

While we expect household deposits to remain one of the main funding sources for banks, the negative rates environment is likely to limit growth in this segment in certain areas.

Household deposits split



Source: ECB, ING

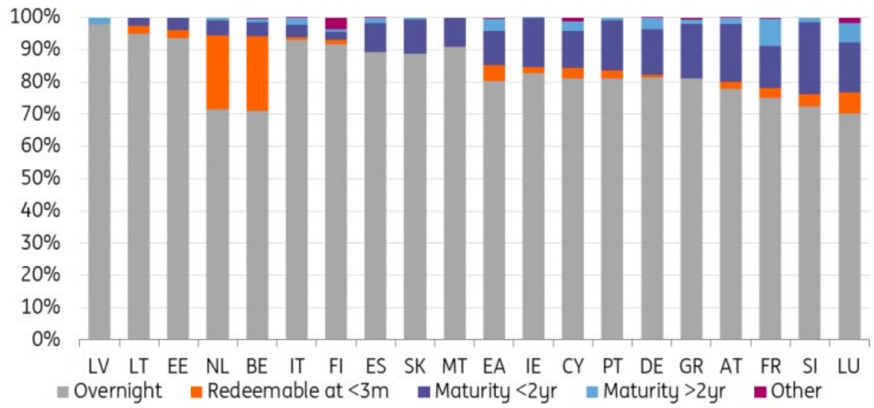
The share of overnight deposits for corporates is high

Also for corporate deposits, the share of overnight deposits is high with the eurozone average at 80%.

> *"From a funding angle, we consider banks in the Netherlands, Spain and Italy to be the best positioned to weather low or negative rates, with high loan to deposit ratios and relatively short deposit interest rate-setting periods"*

The Benelux countries have the highest shares of overnight deposits and deposits with a notice period of less than three months. Corporate deposits are somewhat longer in countries such as France, Austria, Greece and Germany. From a funding angle, we consider banks in the Netherlands, Spain and Italy to be the best positioned to weather low or negative rates, with high loan to deposit ratios and relatively short deposit interest rate-setting periods. Of these countries, Spain and Italy stand to benefit the most from the ECB targeted longer-term refinancing operations as compared to their bond market funding pricing.

Corporate deposit split



Source: ECB, ING

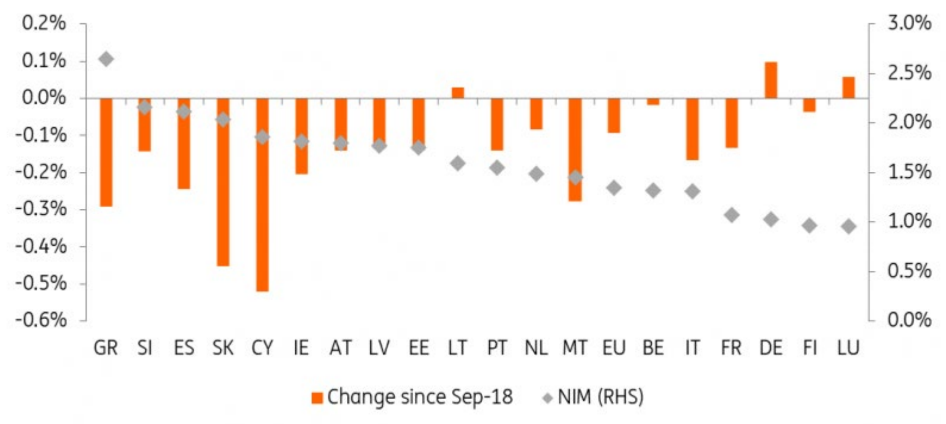
Net interest margins

Net interest margins have been under pressure for the whole sector within the EU tightening towards 1.3%, 20bp lower compared with September 2014 or 10bp lower than in September 2018. As a comparison, since September 2018 the 10-year EUR swap rate has declined by 125bp and since September 2014 by 140bp.

The net interest margin decline has been particularly faster than the EU average in Greece, Spain and Italy. Banks in these countries have relatively low loan to deposit ratios. In addition, they are less reliant on bond market funding than core banks. Furthermore, Italian and Spanish banks, in particular, have perhaps on average shorter interest rate resetting periods and shorter average maturities on their lending books. These factors may allow for lower rates dripping through at a quicker speed on the asset side with the liabilities side being perhaps slightly stickier, despite the obvious help from the TLTRO funding operation.

We consider these banks to continue to be especially sensitive to further declines in interest rates. One mitigating factor for banks is the other side-effect of low rates policies. Low rates support loan quality, and for banks such as these with larger relative NPL stocks, this is especially important.

Net interest margin and change since September 2018



Source: EBA, ING

The changes in the net interest margins have instead been smaller (or for some even positive) for among others, banks in Germany, Belgium, Finland and the Netherlands. The net interest margins in these countries are already quite compressed. In addition, with the exception of Belgium, banks in these countries have high loan to deposit ratios with a larger focus on market funding including bond markets.

With the exception of Finland, banks have relatively long term loan books slowing down the effects of declining interest rates. Net interest income is a very important revenue driver for banks in Belgium and the Netherlands, while banks in Finland and Germany have a larger share of other types of income.

We consider banks in these countries may be more vulnerable to flattening yield curves (excluding here any effects from interest rate hedging policies). That said, the effect of low rates may come through more slowly into their revenues, and eventually the longer the low or negative rates remain, the larger part of their longer-term books are being repriced at lower levels, locking in these low rates for a long time to come.

Teunis Brosens
Head Economist, Digital Finance & Regulation
Amsterdam +31 20 563 6167
teunis.brosens@ing.com

Bank non-performing loans in 2021: The calm before the storm

Helped by extensive government support measures and payment holidays, many businesses have been surviving in 2020. In fact, bankruptcy rates have dropped in most countries. Support measures are not forever though. A sharp increase in non-performing loans is a question of 'when, not if', but will hit some countries more than others

Frankfurt, Germany

Defaults and NPLs are deceptively quiet in 2020…

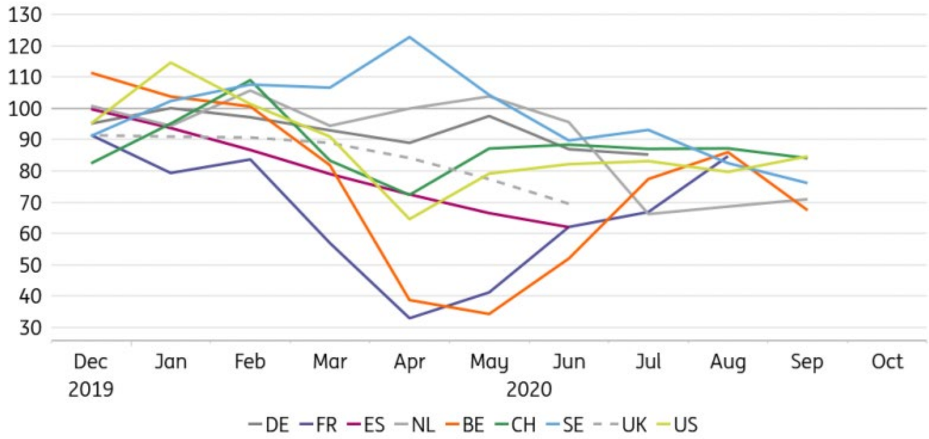
One lesson governments took from the 2008 and 2012 crisis response was: do not start increasing taxes and cutting expenditure too soon. That lesson was well heeded during the spring lockdown this year. Helped by accommodative monetary policy, governments indeed focused on supporting businesses and households. Austerity measures are nowhere on the agenda – yet.

Support for businesses took the form of tax deferrals and direct grants to compensate for lost turnover, and temporary employment benefits to allow businesses to keep their employees despite steep drops in revenues. Governments also devised loan guarantee schemes, allowing businesses with liquidity needs to borrow more easily from banks. Loan payment holidays were also implemented in many countries.

Regulatory measures were implemented to prevent banks from having to massively mark loans as problematic when a payment holiday was granted or a government guarantee was extended, which in turn would have impacted bank capital and discouraged bank lending. The ECB made sure there was ample liquidity in the financial system, providing TLTRO funding on generous terms.

As a result, bank lending sharply increased in the initial lockdown months. Though many businesses suffered, the number of defaults in many countries actually dropped, compared to a year earlier. In recent months, bankruptcies appear to stabilise at rates some 15-30% below what was "normal" just before Covid-19. This suggests that support packages, while helping businesses getting through the crisis, are also keeping alive a number of "zombie firms".

Number of business bankruptcies (seasonally adjusted, index, avg 2019 = 100)



Source: Macrobond, ING

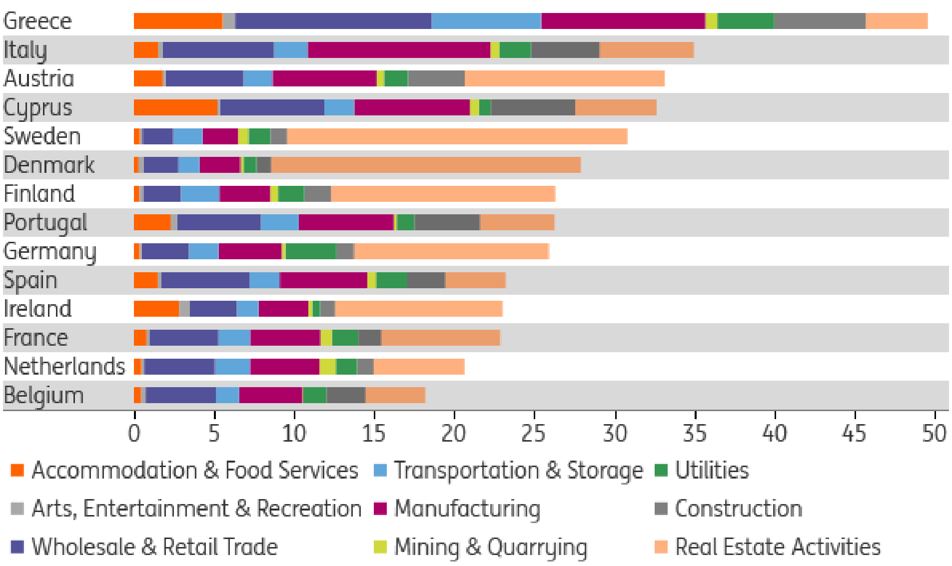
NPLs will rise everywhere in 2021, but some countries are more vulnerable

So what to expect for 2021? The Covid-induced recession will increase non-performing loans for banks when government support is phased out. "Zombie firms" that survived 2020 may further add to NPLs at that time. On the other hand, losses on loans that are covered by guarantee schemes will mainly accrue to government and less to banks. It appears that loan guarantee schemes were used more widely in countries in the south, mainly Spain and Italy but also France, than in northern countries. So, let's examine three factors that will drive NPL developments in 2021 and beyond:

1 Sectoral composition of corporate loan books

The sectoral composition of bank corporate loan books matters for NPL development. In the chart below, we show exposures to business sectors that are generally considered more vulnerable to the economic disturbances created by the pandemic response, as a share of the total loan portfolio (including exposures to households, government and financials).

Share of vulnerable sectors in total loan portfolio (%)



Source: ECB, ING

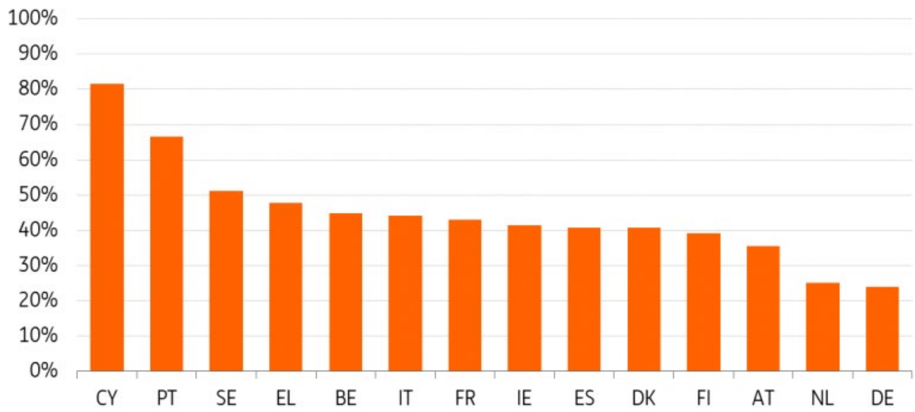
Generally speaking, banks headquartered in France, the Netherlands and Belgium have the lowest exposure to vulnerable business sectors. Vulnerable exposures in Scandinavia are mainly driven by commercial real estate loans. High exposures to the tourism sector can mainly be found in Greece, Cyprus, Ireland and Portugal, while Italian banks have relatively large exposure to manufacturing and trade.

It's important to consider that these sectors are normally impacted in different stages of the cycle, and a similar logic applies in the different stages of the Covid-19 crisis. Tourism, for example, is hit immediately and severely during lockdowns, but may also quickly recover. The same applies to transportation and storage. The initial hit to manufacturing was relatively less severe, but its recovery may also take more time. Real estate and construction may lag the most: initially, running construction projects are finished, while rents keep coming in as tenants survive on government support. As government liquidity is phased out, tenants may increasingly default. Meanwhile, a tepid economic recovery reduces demand for shopping space and a structural shift to working from home reduces office space demand. Construction companies will struggle with less well-filled new orders portfolios in the years ahead.

2 Share of SMEs in loan books

A second factor we consider for the NPL outlook is the share of SMEs in loan books. We assume that SMEs are hit relatively harder than larger companies, and may find it more difficult to recover. The share of SMEs in bank business loan books is highest in Cyprus, Portugal and Sweden, while the Netherlands and Germany score relatively low.

Share of SMEs in bank corporate loan books



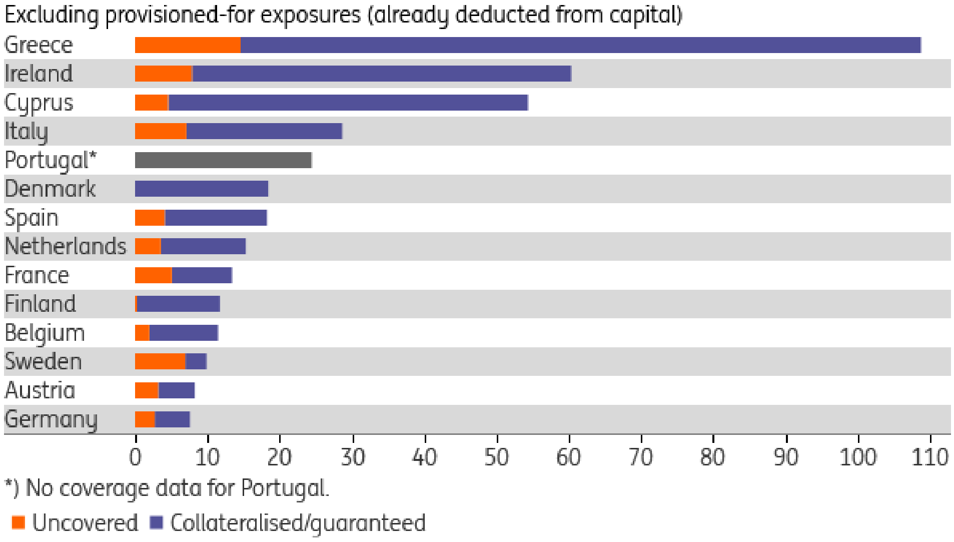
Note: EBA consolidates bank subsidiary loan data with the parent, but does not exclude it from host country data. This leads to inflated figures for countries with large presence of foreign banks.
Source: EBA, ING

3 Legacy NPL portfolios

To assess banks' ability to absorb NPLs, we look at the size of existing unprovisioned NPL portfolios as a share of bank capital. This is the pre-Covid legacy NPL luggage that banks bring into the Covid-19 crisis. Generally speaking, southern countries were already facing elevated NPL ratios before Covid-19, although in recent years a lot of progress has been made bringing those ratios down. Spanish NPL ratios (3.1% in 2020Q1) were converging to ratios in northern countries, while those in Italy and Portugal (slightly above 6%) more than halved between 2016 and 2020. The Italian banking sector has entered the Covid-19 crisis with NPL-ratios comparable to ratios before the 2008 financial crisis.

Unsurprisingly, Greece, Ireland and Cyprus top the list, while NPLs still comprise over 25% of bank equity in Italy and Portugal. Do note that in all countries, most of the non-performing exposures are collateralised or guaranteed yet the recoverability of such collateral varies. Of the southern countries, Spain is better positioned, both in terms of expected impact (in the eurozone loan book at least), and the ratio of existing NPLs over equity.

Non-performing exposures, % of bank equity

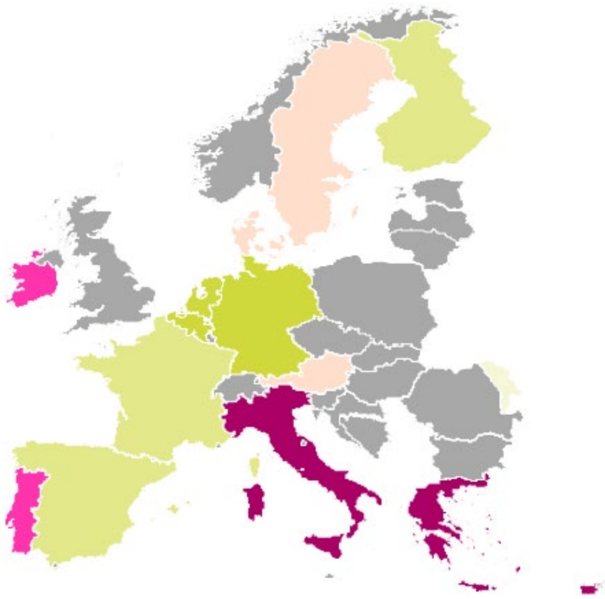


Source: ECB, ING

Taking it all together: where and when?

Three quite high-level indicators do not do justice to the nuanced and complicated nature of national NPL developments. That said, a worrying picture emerges. Covid-19 may deal another blow to those countries and banking sectors that are worst positioned to deal with it. Averaging the factors, NPLs are likely to continue to pose most challenges in Greece, Cyprus, Italy, Portugal and Ireland. Countries where we expect the smallest problems are Germany, Belgium, the Netherlands and Finland.

NPL heatmap



Source: Bucketing based on three factors above.

An important question is when NPLs will start to rise. Everything depends on the development of Covid-19 and government responses. Many businesses may currently depend on government support, for example, in the form of tax deferrals or wage payments, and may run into trouble once government support is phased out. This is currently expected to happen in the course of 2021. NPLs may further increase in 2022.

Suvi Platerink Kosonen
Senior Sector Strategist, Financials
Amsterdam +31 20 563 8029
suvi.platerink-kosonen@ing.com

Bank consolidation to continue picking up in 2021

Several banking markets in the eurozone are overbanked. Covid-19 is now impacting the resulting low profitability. Those profitability pressures, together with a change in tone from supervisors, are likely to result in more consolidation led by in-market transactions. And cross-border activity may get a boost.

The lights from bank buildings are reflected in the river Main in Frankfurt, Germany

Europe's over-banking problem

Several banking markets in the eurozone are over-banked, pressuring profitability.

As of June 2020, EU banks reported an average Return on Assets of 0.03%. Looking at the euro- area banking systems, more than half reported return on assets (ROA) of at or below 0.1%. This already low profitability is now being hit by increasing credit costs and pressure on the revenue side with rates staying lower for even longer because of the Covid-19 crisis.

One possible solution here may be increasing the sheer size of operations. Bank mergers and acquisitions may target synergies especially on the cost side but also in revenues. We could also see better geographical or product diversification or perhaps still larger organisations to better absorb the increasing regulatory and compliance costs. In our view, 2020 will likely mark a year of change for bank consolidation in Europe with another hit to bank profitability in the form of Covid-19 and a change in tone from supervisors.

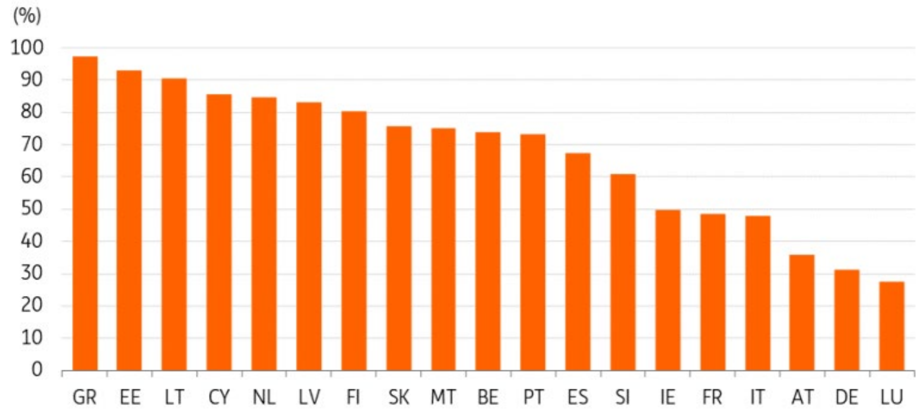
> *"Low profitability is now being hit by increasing credit costs and pressure on the revenue side"*

We've already seen several larger-scale deals going through this year, including Intesa Sanpaolo acquiring its smaller rival UBI Banca in Italy, and CaixaBank merging with Bankia in Spain. Press reports also suggest Crédit Agricole could be interested in Banco BPM in Italy, while the heads of Swiss banks UBS and Credit Suisse are said to have discussed their options according to press sources. Deutsche Bank and Commerzbank merger talks collapsed early 2019 as the banks concluded that the "transaction would not have created sufficient benefits to offset the additional execution risks, restructuring costs and capital requirements associated with such a large-scale integration". What all these deals have in common is that they are all largely domestic.

We think domestic deals will continue to take the lead and consider in-market transactions to be more likely in certain areas. In the past decade, the market share of the five largest banks has increased, notably in Greece, Spain, Cyprus and Italy. These are areas that have either experienced a full-blown banking crisis or at least substantial issues for parts of the banking sector. In 2019, the five largest banks in 14 Euro area countries represented more than half of the domestic banking market share, as you can see in the chart below. Furthermore, in nine countries, these five largest institutions hold at least 75% of that market.

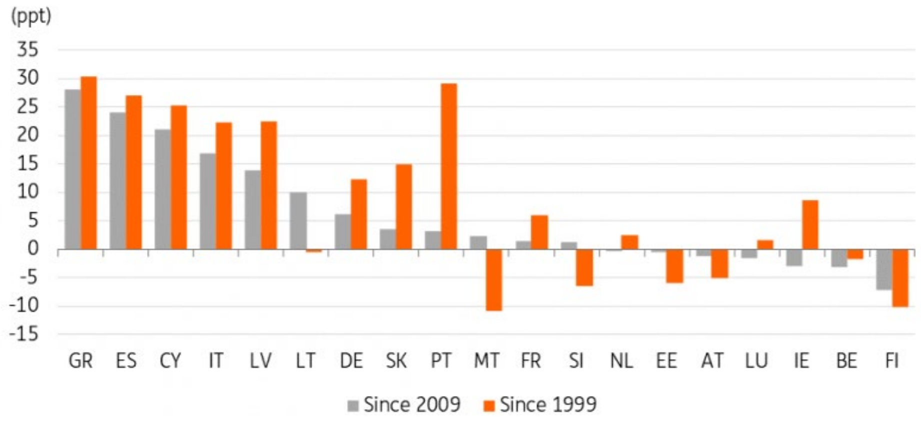
The larger the combined share of the five largest banks in a given country, the less likely we consider domestic M&A to be. The lowest sector concentration is in countries such as Luxembourg, Germany, Austria, Italy, France and Ireland. So in our view, in these markets' banks would stand to benefit the most from domestic M&A activity.

Combined market share of 5 largest credit institutions in each country as of 2019



Source: ECB, ING

Combined market share change for five largest institutions

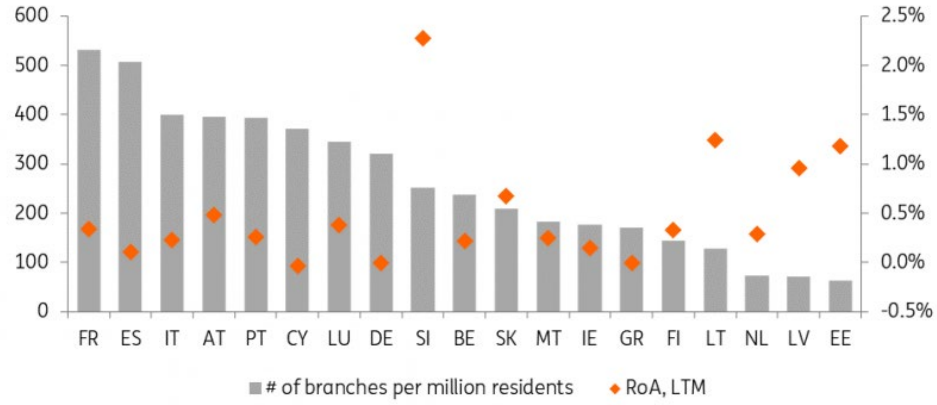


Source: ECB, ING

A move to domestic consolidation

Domestic consolidation may reduce the number of bank branches, which could support bank profitability in the country. As we show in the chart below, the number of bank branches per number of residents is among the highest in France, Spain, Italy and Austria. Germany ranks closer to the middle compared with the rest of the eurozone. The Netherlands, being a small country geographically, has a concentrated banking sector and this goes some way to explain its position towards the end of the table as a country with the fewest bank branches per person.

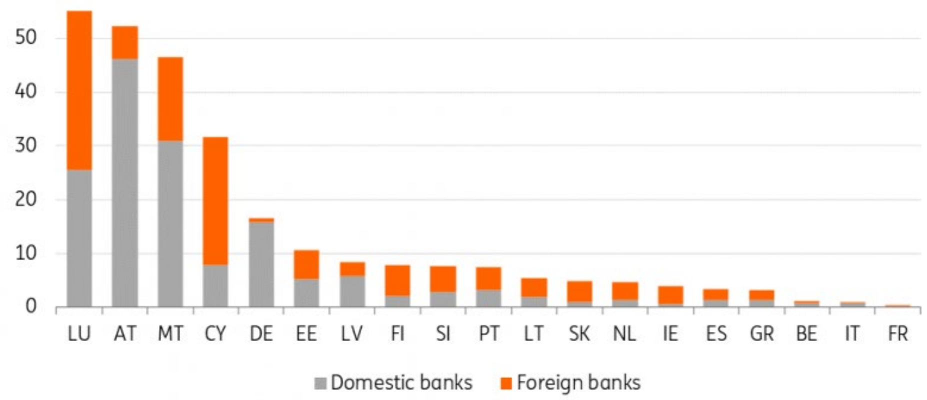
Number of bank branches per residents vs RoA



Source: ECB, Eurostat, EBA, ING

Eurozone banking systems are also split by the number of banks per country and the presence of foreign banks. Not surprisingly, Luxembourg tops the charts here; the number of banks per person in Austria is also relatively high. Of the larger players, Germany stands out as having a high number of banks per person with the majority of those being domestic. From a banking efficiency point of view, Germany and Austria could well benefit from consolidation which would result in fewer banks and branches.

Number of banks per person



The column for Luxembourg is cut and the total number for Luxembourg is c196
Source: ECB, ING

Cross-border deals

Cross-border deals are more likely to involve large banks that target new markets. A bank could acquire an existing player with a strong enough market position in a given country to increase economies of scale and geographical diversification, among other things. Or perhaps banks with matching geographical profiles could merge to increase their combined market share, find synergies and improve efficiency. Acquiring better digital capabilities, extending customer base, improving product diversification or perhaps improving the asset and liability match by merging with a complementing entity are other cross-border merger drivers. An important consideration for cross border mergers will probably continue to be the hunt for greater size, especially since banks are now facing tougher competition from big tech platforms.

"Banks face tougher competition from large big tech platforms"

Cross-border deals have been hindered by the difficulty in finding necessary synergies. This may have been driven by an expectation of (too) high capital requirements for the combined entity and the difficulty of moving liquidity and capital between countries in larger banking groups due to local rules. Perhaps low equity valuations also have a dampening effect on activity.

The Banking Union has not been finalised. The particular reluctance of domestic authorities to support M&A activities from a regulatory and supervisory angle may also be playing a role here.

The tone may be changing though. The ECB published a draft guide on the supervisory approach to the banking sector's consolidation in July this year. The central bank indicated that well-designed and well-executed consolidation can help address the overcapacity and low profitability problems that have been damaging Europe's banking sector since the financial crisis. The guide outlines the ECB's expectations on three important areas in relation to bank consolidation: the setting of capital requirements and guidance, the treatment of 'badwill' and the use of internal models by newly formed entities.

Andrea Enria, Chair of the ECB's Supervisory Board
Source: Shutterstock

A change in tone

So, let's take a look at those three things:.

1) Firstly, the starting point of setting capital requirements for the new entity will be a weighted average of the current requirements, possibly adjusted on a case-by-case basis. This could prevent banks assuming that a larger size would automatically lead to higher capital requirements, which could mean that large scale mergers may look more attractive.

2) Secondly, the ECB indicates to recognise from a prudential perspective 'badwill' that can be used for booking higher provisions, transaction or integration costs or perhaps investments. This is an important consideration as most Western European bank shares are currently trading well below their book values, making the treatment of 'badwill' an important consideration. Support from the regulator for banks for recognising 'badwill' makes conducting acquisitions substantially more attractive in the current market circumstances.

3) Thirdly, the existing internal models can be temporarily used also in the new entity subject to certain conditions. This should reduce unwanted volatility in capital requirements in case of consolidation.

Separately, Andrea Enria, who's the Chair of the ECB's Supervisory Board, and Edouard Fernandez-Bollo, a Board member, wrote early in October about the importance of focusing on actions needed to foster the integration of banking activities within the banking union. They highlight that around €200bn of high-quality liquid assets are not transferable in cross-border subsidiaries of significant credit institutions due to the liquidity coverage ratio at the subsidiary level, reducing the effectiveness of centralised liquidity management.

> *"The ECB now seems to be pushing harder towards bank consolidation"*

In essence, they propose that banks could incorporate as part of their resolution planning clear group support agreements for subsidiaries in terms of liquidity. In exchange, they would receive a cross border liquidity waiver. This could result in more efficient liquidity management at the parent entity level as liquidity could be moved easier between the subsidiaries and the parent entity if that were needed.

In our view these general principles laid out in the ECB's draft document and Enria's blog post point towards the same thing: the ECB now seems to be pushing harder towards bank consolidation in Europe with the aim of improving banking system profitability. For those banks considering such consolidation, the message is encouraging even if only in a draft form.

That said, we consider the most important consideration behind bank M&A to remain whether the entities are a good match and the combination adds value. Now perhaps on top, the supervisor seems to be more accommodative.

Julie Cichon
Sector Strategist, Financials
Amsterdam +31 20 563 8993
julie.cichon@ing.com

Bank supply hurdles to rise further in 2021

Banks have relied far less on bond market funding this year than in 2019 due to the Covid-19 crisis. Solely subordinated supply has kept its head above water thanks to the ECB's measures. With the global economy in the process of recovering from its severe growth relapse, 2021 bank supply is likely to follow a similar pace we've seen this year

Frankfurt's banking district

Primary market activity

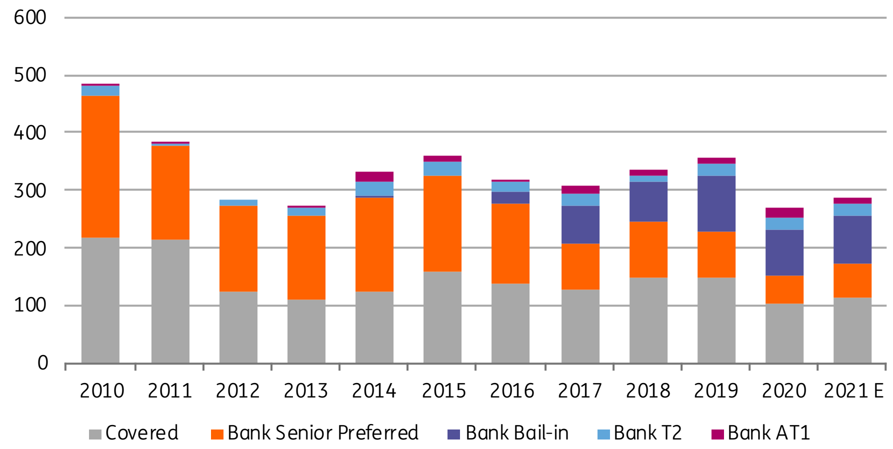
The primary market activity in bank bonds has been very slow this year from a historical point of view. While last year's supply reached €357bn, all debt categories included, only €237bn has been issued by mid-October in 2020 and we forecast supply to reach €272bn by the end of the year, as you can see in the chart below. Considering our 2020 forecast, we estimate the overall supply in 2020 to decrease by around 25% compared to what has been issued by banks in 2019. The drop is particularly noticeable within the covered and preferred senior bond categories. As a matter of fact, €91bn had been issued by mid-October in covered bonds and €41bn in preferred senior. We forecast covered bond supply to reach €105bn by the end of the year, a substantial decrease compared to €151bn in 2019. We expect preferred senior supply to total to €47bn at the end of 2020 while €81bn was issued last year.

"Primary market activity in bank bonds has been very slow this year"

€72bn had been issued in bail-in senior bonds up until mid-October, leading us to estimate this supply to rise to €83bn by the end of the year, still lagging the €95bn issued in 2019. Only the subordinated segment seems to be slightly running ahead of last year with a total of €33bn issued up to mid-October, comprised of €16bn of Tier 2 and €16bn of AT1 bonds, versus €31bn for the whole year 2019 (€21bn of Tier 2 and €10bn of AT1 bonds).

These supply dynamics can be explained by different factors. Firstly, the decision of the ECB in March allowed banks to meet part of the Pillar 2 requirement with AT1 and Tier 2 instruments on top of covering 56% of the P2 requirement with CET1 instruments. This could be one factor supporting a rise in AT1 supply compared to last year. Secondly, subordinated issuance may have been supported by a rise in lending growth for some banks. Eventually, the combination of ample liquidity, negative underlying yields and tight spread levels created a supportive environment for banks to print capital. All in all, we estimate subordinated supply to reach €37bn in 2020 (€19bn of T2 and €18bn of AT1).

Bank supply and estimates

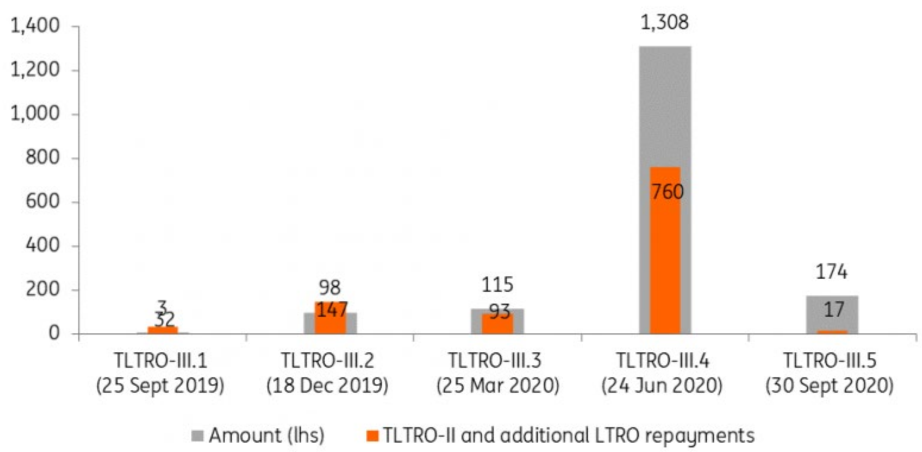


Source: Dealogic, ING

Bank redemptions amount to €291bn in 2021, of which €143bn is in covered bonds, €103bn in preferred senior, €13bn in bail-in senior, €25bn in Tier 2 and €7bn in AT1. The 2021 redemptions are slightly higher than in 2020 (€291bn versus €289bn), and we do see a rise in covered bond redemptions (€134bn in 2020 versus €143bn in 2021) and in bail-in senior redemptions (€2bn to €13bn). Within the subordinated bonds bucket (bonds with a first call date or a maturity date), Tier 2 and AT1's redemptions total €32bn in 2021 versus €36bn in 2020. Tier 2 redemptions decrease from €27bn in 2020 to €25bn in 2021 and AT1 redemptions from €9bn to €7bn.

Although not graphically shown here, French banks have widely dominated the supply by banks in EUR this year. The French banks had issued a total €64bn, all debt categories included, until mid-October. Germany takes second place with €25bn, followed by Spain (€22bn) and Italy (€21bn). Banks in these four countries are also the largest users of the Targeted Longer-Term Financing Operations (TLTRO). France and Italy drew respectively €350bn and €345bn in June, while German and Spanish banks drew €248bn and €257bn respectively from the fourth tranche, which was the largest TLTRO tranche to date.

TLTRO-III allotments vs TLTRO-II repayments (€bn)



Source: ECB, ING

The role of the European Central Bank

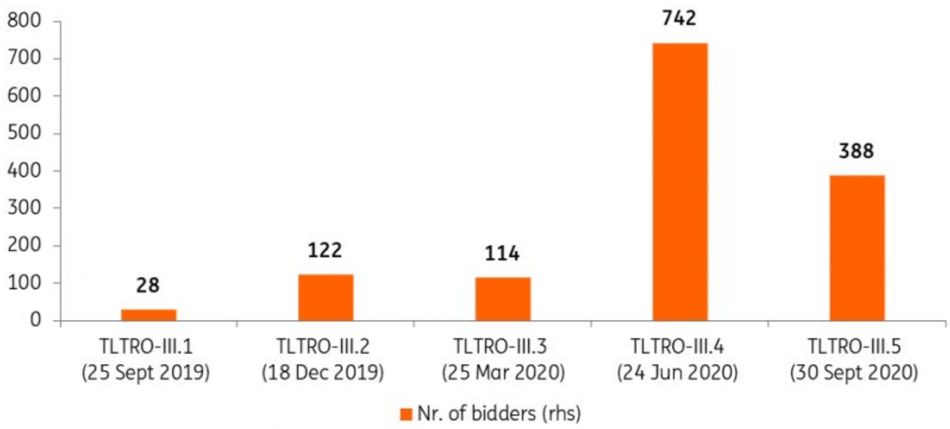
The fall in covered bond and preferred senior supply is a direct consequence of banks relying more on the ECB. European banks have in effect attracted a sizeable €1,308bn under the fourth tranche of the ECB's TLTRO-III operations in June and €175bn under the fifth one in September, as we show above, totalling to a substantial €1,699bn central bank funding so far. A large number of banks participated in the fourth tranche (742) while a little more than half of this amount of bidders drew funds under the fifth tranche, as shown in the chart below

> *"The fall in covered bond and preferred senior supply is a direct consequence of banks relying more on the ECB"*

This also suggests that still many banks participated in that tranche, but drew a substantially lower amount. If banks meet the lending requirement set by the ECB, they can obtain the TLTRO funding at a rate of -1% for one year and at -0.50% for the rest of the time. The banks still have two more opportunities to draw funds under the TLTRO-III operations on 16 December 2020 and 24 March 2021. The last date is also likely to see some large withdrawals as it is the final opportunity.

September 2021 brings the first early repayment opportunity for the first five tranches. The sixth and seventh tranches have their first early repayment date on 22 December 2021 and 30 March 2022 respectively. As we mentioned earlier in our European banks, Do they have what it takes? report, the willingness for early repayment may depend on the lending development of the bank, the secondary bond trading levels, the tiering effects and the economic outlook.

TLTRO-III number of bidders



Source: ECB, ING

Early repayment considerations

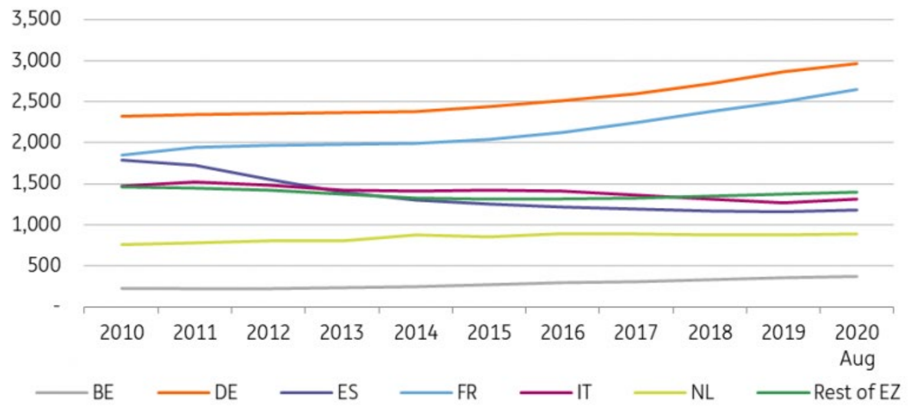
Furthermore, the measures taken to ease the leverage ratio calculation, the ECB's temporarily eased collateral rules and the net stable funding ratio (NSFR) are also important for banks to consider should they wish to repay their TLTRO-III debt earlier.

The first one relates to whether the ECB will decide in June 2021 that central bank reserves will remain exempted from the leverage ratio for another year. If central bank reserves remain exempted, banks will have less incentive to repay their TLTRO-III borrowings as the (partially) related higher central bank reserves will not weigh in the leverage ratio calculation. Another thing to bear in mind is the temporary nature of the eased ECB collateral rules in response to the Covid-19 pandemic. Last April, the ECB announced a temporary easing of the collateral measures linked to the duration of its Pandemic Emergency Purchase Programme. The PEPP is set to last until the Covid-19 crisis is over but should, in any event under its current terms, not be terminated before June 2021. The measures will also be reassessed before the end of the year. If the period of the eased collateral rules expires, banks will have less eligible collateral available vis-a-vis their sizeable TLTRO drawings. Eventually, the Net Stable Funding Ratio will become binding by 28 June 2021, meaning that banks will have to comply with the requirements. TLTRO funding is fully eligible as stable funding up to one year ahead of their maturity. Hence the fact that the NSFR will be binding in Europe as of next year will likely weigh more heavily in the decision by banks to repay their TLTRO fund early than it has before.

Corporates and households

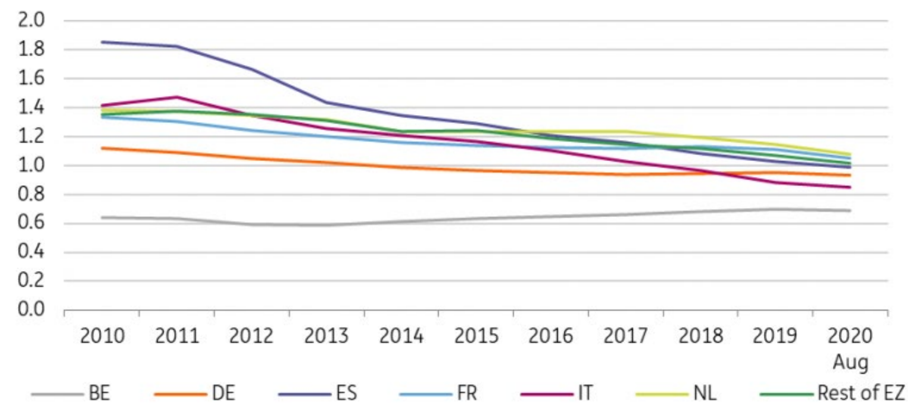
The chart below shows that bank lending growth is stronger in some countries than others: Germany and France take the lead, with comfortably rising loan books. Italy and Spain record both a slight recovery after years of decreasing loan books. The rest of the eurozone banking sectors have flatter lending growth curves.

Bank lending growth (€bn)



Source: ECB, ING

Loan to deposit ratio



Source: ECB, ING

That being said, for the corporates and household segments alone, the loan to deposit ratio has plunged over the years, as you can see in the chart above. This illustrates that banks accumulate deposits at a higher pace than their lending. Especially this year, with the Covid-19 outbreak, the drop in consumption and the lockdowns have resulted in households saving more money than usual. Corporate deposits also recorded strong growth across all eurozone jurisdictions, thanks to borrowings that companies have put in as deposits for future use. This has mitigated the need for banks to finance their lending growth with the issuance of new bonds.

Our economic scenarios

Different economic scenarios have been assessed by our economists in their Monthly Economic Update of October. Scenario 1 assumptions, which is also our base case scenarios, focus on local lockdowns, mild national restrictions and several vaccines being available in 2021. Scenario 2 depicts a darker picture with restrictions tightened, a handful of viable vaccines but with a different roll-out in 2021 across economies. Scenario 3 portrays a gloomy economic environment resulting from national lockdowns in which the vaccine development takes longer.

> *"The 2021 bank supply should not be that different from what we have seen this year"*

Whichever scenario we face next year, the 2021 bank supply should not be that different from what we have seen this year. That said, if we are looking at scenario 1 or 2, 2021 supply may run slightly ahead of 2020. If scenario 3 appears to be the reality next year, supply is more likely to be fairly in line with this year and we would expect heavier ECB support and more TLTRO drawings with the possibility of the ECB extending the period during which banks may benefit from the currently applicable -1% TLTRO funding rate. A prolonged duration of scenario 2 could also lead to the same assumptions as explained in scenario 3.

€290bn Bank supply in 2021

Overall bank supply

Following our base case scenario, we believe the 2021 overall bank supply will run ahead of 2020 but we expect it to remain modest and certainly not to exceed 2019. Covered bond supply is expected to rise from €105bn to €120bn and preferred senior issuance from €47bn to €58bn. For covered bonds, the rise can in part be explained by the €16bn increase in redemption payments in 2021. Since the supply in covered bonds and preferred senior paper has seen the strongest decline in 2020 on the back of the ECB's TLTRO-III operations, we expect this issuance to pick up again as we believe that at least some banks will decide to repay their TLTRO drawings earlier in September next year after the interest rate on those drawings has been reduced from 100bp to 50bp. This will free up encumbered assets in support of the issuance of covered bonds. Besides, covered bonds and preferred senior will remain the most favourably priced instruments to replace the shorter maturity TLTRO funds with longer maturity bonds.

Bail-in senior issuance is expected to be roughly in line with this year's issuance, at €85bn. A couple of factors are to be considered here: the rise in redemptions and the fact that some banks are already well advanced in terms of meeting their Minimum Required Eligible Liabilities requirements, while other banks are still in the process with their MREL build-up.

The favourable market conditions, the decision of the ECB to meet part of the P2 requirement with Tier 2 and AT1 bonds and the fact that banks may replace their grandfathered Tier 1 by 31 December 2021 will all remain supportive factors to the issuance of subordinated paper. Nonetheless, we do expect subordinated supply to fall slightly compared to this year's forecast as banks will have less subordinated debt to refinance in 2021 (€36bn repaid this year versus €32bn in 2021). Hence, banks will ultimately also make an economic decision regarding their need to attract subordinated debt versus cheaper alternatives. Should the ECB decide to continue to restrict dividend payments, the net subordinated issuance should not be expected to rise that much compared to this year. Considering all these factors, we estimate Tier 2 supply to remain relatively stable at €20bn and AT1 supply to fall to €12bn.

Fig 1 Bank supply and redemptions and ING forecasts (€bn)

	2019	Mid-October 2020	ING end of 2020 forecast	2020 redemptions	ING forecast 2021	2021 redemptions
Total	**357**	**237**	**272**	**289**	**290**	**291**
Covered bonds	151	91	105	134	115	143
Bank senior unsecured	**176**	**113**	**130**	**119**	**143**	**116**
o/w Preferred senior unsecured	81	41	47	117	58	103
o/w Bail-in senior unsecured	95	72	83	2	85	13
Bank subordinated debt	**31**	**33**	**37**	**36**	**32**	**32**
o/w Tier 2 debt	21	16	19	27	20	25
o/w Additional Tier 1 debt	10	16	18	9	12	7

Source: ING, Dealogic

Maureen Schuller
Head of Financials Sector Strategy
Amsterdam +31 20 563 8941
maureen.schuller@ing.com

Teunis Brosens
Head Economist, Digital Finance & Regulation
Amsterdam +31 20 563 6167
teunis.brosens@ing.com

Suvi Platerink Kosonen
Senior Sector Strategist, Financials
Amsterdam +31 20 563 8029
suvi.platerink-kosonen@ing.com

Covid-19 uncertainties to weigh on bank regulation in 2021

The Covid-19 pandemic has led to a flood of regulatory responses in order to mitigate the impact of the crisis on households, corporates and banks. All these measures have guided banks well through the first storms of the Covid-19 crisis. The major question now is to what extent banks will still be able to rely on these temporary provisions in 2021

The Covid-19 regulatory backdrop

To what degree banks would still be able to reap the benefits from the current constructive regulatory backdrop in 2021, should pretty much depend on how the Covid-19 situation evolves. If the virus rears its head again with a vengeance, resulting in renewed lockdowns and economic pressures, the odds are high that governments and central banks will continue to do their utmost to navigate the crisis.

In the recent October communiqué, G20 finance ministers and central bank governors even confirmed their "determination to continue to use all available policy tools as long as required to safeguard people's lives, jobs and incomes, support the economic recovery, and enhance the resilience of the financial system, while safeguarding against the downside risks."

Major policy responses in light of the Covid-19 crisis

The European Banking Authority postponed the EU-wide bank stress test to 2021 to alleviate the operational burden for banks in 2020 considering the Covid-19 challenges.

In March 2020, global banking regulators decided to postpone the Basel-III reforms until January 2023, also to give banks and regulators access to sufficient resources to adequately respond to the coronavirus pandemic.

The Capital Requirement Regulation quick fix which came into force in June 2020 moved forward certain capital benefits that would otherwise apply as of 28 June 2021. This included the revised treatment of software assets, provisions on loans backed by pensions or salaries, the revised supporting factor for SME exposures and the new supporting factor for infrastructure finance.

The CRR quick fix also temporarily, for a period of seven years, exempts Covid-19 loan guarantees from CET1 NPE adjustment. Besides, it also extends the transitional eriod related to expected credit loss provisioning under IFRS9 by two years. Meanwhile, the derogation to exempt central bank reserves from the leverage ratio exposure measure was moved forward by a year, while adjustments were made to the offsetting mechanism to make the use of the exemption less penalizing in terms of additional leverage ratio requirements.

The EBA issued guidelines ensuring that Covid-19 related payment holidays would not automatically result in a reclassification of exposures as forbearance or defaulted. In September, the EBA announced plans to phase out its guidelines in accordance with the end of September 2020 deadline. The regulatory treatment set out in the guidelines will continue to apply however to all eligible payment holidays granted prior to 30 September 2020.

That aside, the ECB has implemented several measures to soften the burden on banks related to the Covid-19 crisis. These include measures to ease the capital requirements for banks by allowing them to temporarily operate below the level of capital defined by the pillar 2 guidance (P2G), the capital conservation buffer (CCB) and the liquidity coverage ratio (LCR). The ECB also recommended banks not to pay dividends at least until the end of this year, and the liquidity support offered to banks against very favourable terms under the TLTRO-III operations. The use of the latter has among others been facilitated by several collateral easing measures.

This means that next year's focus will largely be on those measures that were put in place temporarily to optimise the conditions for banks to deal with the Covid-19 crisis. Part of these temporary measures, such as the exemption of central bank reserves from the leverage ratio, will end next year. This raises the question as to whether a deterioration of the coronavirus situation would prompt central banks to keep them in place for a longer period of time than initially intended. Besides, some important regulations such as the Basel-III reforms have been postponed to give banks the extra time and resources to cope with the pandemic. If the regulatory pipeline isn't further moved forward, 2021 should remain a very active year as far as banking sector regulation is concerned. In the remainder of this section, we touch upon a few examples.

Stress testing the Covid-19 fallout

The yearly stress testing exercise by the EBA was not organized in 2020 in the middle of the Covid-19 pandemic. Instead, the EBA indicated that the next round of bank stress testing will be organized in 2021. The exercise should be launched at the end of January 2021, with the results scheduled to be published at the end of July 2021. The exercise will entail 51 banks across the European Union covering 70% of the sector, in line with the plan for the 2020 testing round. The 2021 stress test will be based on the methodology and design put together for the 2020 test exercise, but adjusted for certain factors including debt moratoria, public guarantees and changes in regulation.

The EBA bank stress tests entail a substantial amount of valuable information allowing market participants to assess the viability of the banking sector and individual banks. We consider the stress testing exercise an important addition to the financial reporting of banks, even though the availability of comparable data on a bank-to-bank basis has increased substantially since the financial crisis. The EBA transparency exercises particularly allow markets to stress bank financials in their own scenarios already. With the 2021 stress testing exercise, the market interest will likely be especially focussed on the possibility of obtaining comparable debt moratoria and guarantee data across the EU.

MREL – What's in store for banks?

While the effects of Covid-19 have hit European economies, the impact on the banking sector has so far been limited by the substantial measures taken by central banks and governments. As we expect the loan quality of banks to weaken with the expiring moratoria, banks with already poor profitability and limited capital buffers are most at risk. The longer the stress on the economies and banks lasts, the harsher the effects will be. Resolvability of the weakest links may yet be tested.

MREL requirements (Minimum Requirements for own funds and Eligible Liabilities) were created to ensure that banks maintain sufficient eligible instruments to allow for the implementation of the applicable resolution strategy in case of need. On top of the subordination requirement, the location of eligible liabilities also plays a role here. The aim is to prevent the need for utilising public funds for a bailout.

> *"The impact on the banking sector has so far been limited by the substantial measures taken by central banks and governments"*

The Single Resolution Board (SRB) is expected to communicate to banks in early 2021 the level of MREL they are expected to hold in line with the 2020 resolution planning cycle. That planning cycle communication is expected to include two binding MREL targets, an intermediate one to be met by 1 January 2022, and the final one to be met by 1 January 2024.

The MREL decisions are expected to reflect the changed capital requirements and to take into account the effect of Covid-19 on the banking system. The SRB has indicated that it will use the flexibility in the regulatory framework, such that short term MREL constraints will not prevent banks from lending to businesses and households. Therefore, if the Covid-19 situation and the economic outlook were to substantially weaken, we would expect this to be reflected in the resolution planning as a longer transitioning time given to banks.

Postponement of the Basel-III reforms – giving banks a one-year breather

The Covid-19 outbreak has prompted global banking regulators on 27 March 2020 to postpone the Basel-III reforms (often dubbed as Basel IV) from January 2022 until January 2023, to spare banks and regulators the resources to adequately respond to the coronavirus pandemic. The transitional arrangements for the much-debated output floor were also extended by a year to 1 January 2028. This means that the standardised **output floors will now be phased in from 50% in 2023 to 72.5% by 2028.**

> *"Meeting the January 2022 deadline was always seen as challenging"*

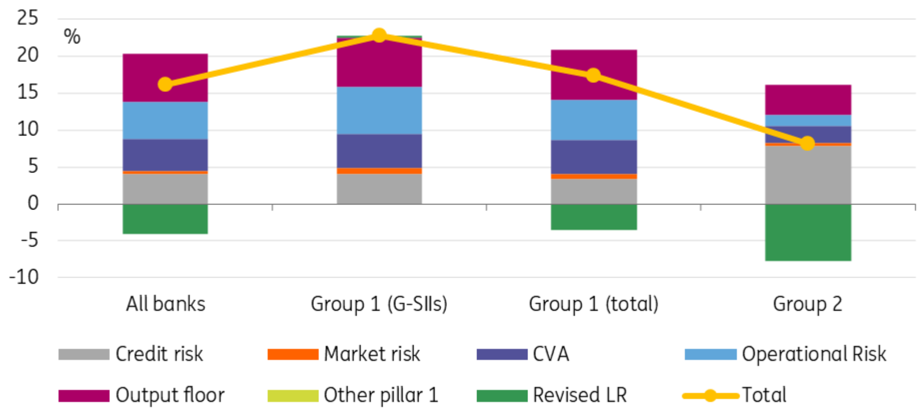
For Europe, meeting the January 2022 deadline with the CRD6/CRR3 package implementing Basel IV was already always seen as challenging, given the importance and far-reaching impact of the reforms for European banks. However, instead of publishing its CRD6/CRR3 proposals in June 2020, the European Commission should now probably publish them in the first half of 2021. This raises the question of whether this could delay the CRD6/CRR3 package even until 1 January 2024 instead of 1 January 2023.

The beneficial side effect of such a delay would be that European banks will be granted more time to meet the stricter capital requirements. The European Banking Authority (EBA) estimated in April this year that European banks would need €21.1bn of additional Tier 1 capital to comply with the new Basel framework. A further delay would give banks more time to attract or free up the additional capital.

The increase in the capital requirements that banks face under Basel IV is among others the result of the introduction of the output floor for banks using internal models, which is set at 72.5% of the capital requirements based on the standardized approach. The output floor is particularly penalising in conjunction with the stricter risk weight requirements under Basel IV for specialised lending, unrated corporate exposures or higher LTV mortgage loans under the standardised approach. In addition, banks are also no longer allowed to use the advanced Internal Ratings-Based approach for all exposures. For instance, for exposures to large corporates and banks, banks would have to apply the foundation IRB.

According to EBA estimates particularly the largest European banks are impacted by the increased capital requirements, meaning these banks will also be the ones benefitting the most from the extra time granted by the postponement of Basel IV.

Change in T1 minimum required capital due to Basel- III reforms by 2028



Group 1 banks are large and internationally active banks, Group 2 banks are the other banks
Source: EBA (April 2020, based on June 2019 data), ING

Knock-on effects for banks

The postponement of the Basel-III reforms also has certain side effects for banks on the bond market funding side. For example, the reforms provide for a more favourable risk weight treatment for covered bonds on a global level if the bonds meet certain minimum requirements. This will now be delayed until 1 January 2023. Within the EU, covered bonds already benefit from a more favourable risk weight treatment under the Capital Requirments Directive, but this applies only to covered bonds issued by banks located within the EEA. The third-country equivalence discussion was also left outside the scope of the European Covered Bond Directive that entered into force in January this year. Instead, the European Commission will publish a report on third-country equivalence, potentially together with a legislative proposal on how it should be introduced, by 8 July 2024 at the latest. As such, the delay of the Basel-III reforms is of more importance to the introduction of a favourable risk weight treatment for covered bonds for banks outside the EU, than it is for the treatment of third-country covered bonds within the EU.

Other changes to the capital requirements of bank bonds that will be delayed by a year include, for example, the change in capital requirements for banks under the standardised approach for preferred senior unsecured bonds issued by other financial institutions. Namely credit quality step (CQS) 2 bonds (i.e. those with a second-best A- to A+ rating) will get a 30% risk weight under the standardised approach instead of the current 50%. For bail-in senior unsecured and T2 instruments the risk weight treatment would become 150% and for AT1 instruments basically 250%, where under the current CRR the risk weight treatment is a similar 100% (non-significant investment) as for AT1 instruments to the extent that they fall below the 10% CET1 threshold for non-significant investments. T2 and AT1 instruments have a 250% risk weight where they are significant investments but fall below the applicable CET1 threshold. Holdings above the applicable CET1 thresholds would also under Basel IV still have to be deducted correspondingly from the own issued eligible liabilities and capital instruments.

Digital and data regulation: Many initiatives, but limited impact in 2021

On the digital and data front, a lot is going on that will influence banks in the future. The European Commission is preparing its Digital Services Act. Regulation of digital platforms with a "gatekeeper" function is to be intensified. For banks, this may be some welcome support in their increasing competition with big-tech platforms. The problem for banks is that what is core business for them, may only be a peripheral service offering for big-tech platforms, helping to make those platform more attractive for end-users. The growing dominance of platforms increases their market power. Policymakers are considering tools to safeguard the diversity of digital services, so customers retain a choice. This should help banks as well, though the main risk for them in the digital era remains that they lose primary access to customers, becoming dependent on third-party platforms for that.

Furthermore, European Commission proposals are expected in 2021 moving from open banking (PSD2) towards open finance. In other words, a broadening of portability for financial data. This would enhance opportunities to build one-stop-shop financial platforms, thus intensifying competition, and putting the most digital-savvy banks and fintechs at a further advantage.

It should be noted that both on the digital regulation and data front, Brussels will still be in the proposal discussion phase in 2021. The impact of these initiatives will not be felt until (well) after 2021. They are important though for the medium to long term strategic direction banks can take.

"The political will to create a central bank digital currency seems strong"

A third relevant item is the exploration of a digital euro by the ECB. While the advantages of a retail central bank digital currency from a user perspective in a European context appear limited, the political will to create one nonetheless seems strong, mainly for geopolitical reasons. For banks, it may mean a partial loss of deposit funding and intensified competition by non-bank providers of digital euro wallets. But this too is a long-term project. Remember that the People's Bank of China started studying CBDC in 2014, and only moved to pilot a digital currency this year. Surely other central banks can move faster now, building on research and experience that has already built up, but tinkering with the fundaments of the monetary and financial system is not something central banks do lightly. The ECB will decide on further exploration in mid-2021, so it may well be 2024 or later before a digital euro is widely available, if at all.

Leverage ratio requirements – what to expect from the CB reserve exemption?

On 28 June 2021 the leverage ratio requirements for banks will become binding. Around that time the ECB will also decide if the temporary exemption of central bank reserves from the leverage ratio exposure measure is extended by another year. This could have consequences for the TLTRO-III repayment behaviour of banks as of September next year, albeit probably only to a limited extent as most banks are well-positioned to meet the leverage ratio requirements.

The CRR leverage ratio provisions provide a discretion to temporarily exclude central bank reserves from a bank's leverage ratio calculation under exceptional circumstances.

This exemption can be granted by the supervisory authority for a period of maximum one year, under the condition that the exclusion is fully offset by a mechanism that proportionately increases the bank's leverage ratio requirement (the offsetting mechanism).

Under the CRR quick fix of 24 June 2020, banks were already given the option to exclude central bank exposures (ie coins and banknotes and deposits held with the central bank) from their total exposure measure until 27 June 2021. The offsetting mechanism was also modified to ensure the effectiveness of the use of this exclusion option. Banks using the discretion would still be required to calculate an adjusted leverage ratio, but now only at the moment that the discretion is exercised. The adjusted leverage ratio would then not change anymore for the period during which the discretion is effective.

These measures were taken to ensure that leverage ratio considerations wouldn't stand in the way of banks from using the ECB longer-term refinancing operations (ie the TLTRO-III) as a consequence of a parallel rise in their central bank reserves. The option was granted however, subject to the condition that the competent authority would first confirm the existence of exceptional circumstances justifying such an exclusion in light of monetary policy implementation. On 17 September 2020, the ECB acknowledged the existence of exceptional circumstances for the whole euro area, allowing for the temporary exclusion of central bank reserves from the leverage ratio.

While the 3% leverage ratio requirement only becomes binding on 28 June 2021, banks already disclose their current leverage ratio. Hence, the measures taken by the CRR quick fix this year already served to signal an improvement in the current leverage ratio of the banks. The ECB estimated that based on data from the end of March 2020, the exclusion would lift the aggregate leverage ratio of 5.36% by 0.3ppt. Besides, in its September 2020 press release, the ECB also pointed out that for globally systemically important banks (G-SIBs) the measure provides relief under their already binding total loss-absorbing capacity (TLAC) requirements.

The exemption from the exposure measure is currently applicable until 27 June 2021. The ECB will then decide if it wishes to extend the exclusion beyond June 2021, ie once the 3% leverage ratio will become binding. This would require a certain upward recalibration of the leverage ratio requirement though. That said, besides the implications of such a decision on the reported level of the leverage ratio, or in terms of any loss-absorption relief, this decision could also be of relevance for the TLTRO-III.

Namely, banks have the first opportunity to repay part of their TLTRO-III drawings early as of September next year. If the ECB decides not to extend the measure by another year, this might impact their TLTRO prepayment behaviour. For some banks, this could be a reason to reduce their excess liquidity, particularly considering that the favourable -1% interest rate term under the TLTRO-III operations will have ended by then.

The ECB's decision to use the discretion by another year will obviously depend on the duration of the exceptional circumstances as a result of the coronavirus pandemic. If a phase of new lockdowns would result in renewed pressure on European economies and banks, the odds indeed become higher that the ECB will extend the leverage ratio exemption.

NSFR - A more important consideration for banks as of mid-2021

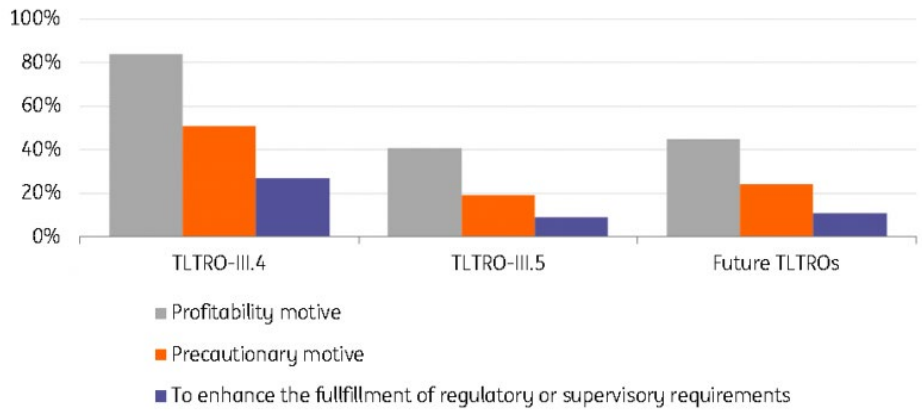
In June 2021 the Net Stable Funding Ratio (NSFR) will become binding to banks. This means that banks need to have sufficient stable funding available to cover their stable funding requirements over a one year period. Once binding, the NSFR will probably become a more important factor for banks to consider in their (re)financing decisions.

This means that the NSFR will also have a greater weight in the decision by banks to repay or refinance their TLTRO drawings. The drawings by banks under the 3yr TLTRO-III operations do count as stable funding until one year ahead of their expiration date. However, in the event of the previous TLTRO-II operations, the (partial) loss of NSFR recognition of the applicable tranches a year ahead of maturity, was by some banks not deemed that important as the NSFR was still not binding in Europe. Other banks did already take the impact of the expiration date of the TLTRO-II tranches on the reported NSFR into account in the decision to early repay or refinance their drawings.

"Banks may also feel more pressure to refinance their bonds at least a year ahead of maturity"

Once the NSFR becomes binding, banks may also feel more pressure to refinance their bonds at least a year ahead of maturity. Besides, the NSFR regulation explicitly states that institutions have to take into account existing options in determining the residual maturity of a liability. For options exercisable at the discretion of the institution, the reputational consequences of not exercising the option have to be considered. For AT1 and T2 bonds with embedded call options, the NSFR regulation is explicit that the bonds would lose their 100% NSFR recognition one year ahead of the call date.

The reasons for banks to participate in the TLTRO operations



Source: ECB, ING

However, banks nowadays also regularly use call dates one year ahead of maturity for their bail-in senior bonds to be able to repay the bonds once they are no longer MREL eligible. One could argue that if the bank is determined to use the call option, the bond should lose (part of) its NSFR recognition in the year before the call date (ie potentially resulting in a refinancing need two years ahead of the bond's final maturity date).

The same should arguably apply to a bank's TLTRO drawings should the bank decide to early repay part of its TLTRO drawings on any of the relevant early repayment dates. The ultimate impact of NSFR considerations on the TLTRO-III repayments may ultimately prove to be modest though, as meeting regulatory or supervisory requirements was never the most important reason for banks to participate in the TLTRO operations.

Maureen Schuller
Head of Financials Sector Strategy
Amsterdam +31 20 563 8941
maureen.schuller@ing.com

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

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

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

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

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

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

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

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

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

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

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

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

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

The renewed sustainable finance strategy and green bond standard

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

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

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

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

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

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

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

Bank sustainability issuance - Holding up well despite soft bank supply

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

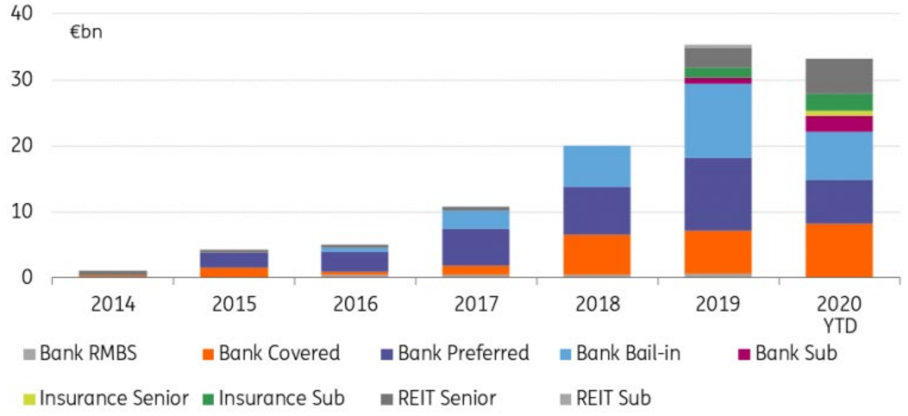
Over the first ten months of 2020, €33bn in sustainable bonds have been issued in the financials segment, of which €25bn was by banks alone. This amount covers only EUR-denominated instruments with a minimum size of €250m and marketed with dedicated sustainable use of proceeds. Hence, the year-to-date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

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

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

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

Sustainable EUR financials supply across different products



*Based on EUR denominated bonds with a minimum size of €250m
Source: ING

Sustainable issuance to rise in covered and senior bonds in 2021

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

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

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

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

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

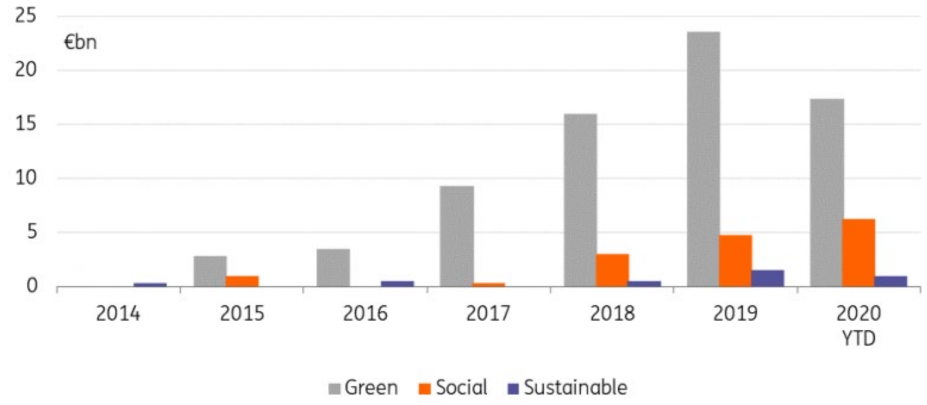
Supply is making a modest shift to social

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

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

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

Social issuance by banks gains momentum where green supply falls



*Based on EUR denominated bonds with a minimum size of €250m
Source: ING

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

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

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

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

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

What about sustainability linked issuance?

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

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

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

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

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

The ECB's monetary policy review

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

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

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

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

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

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

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