



## European banks: Activities becoming ever greener



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The rapid growth in sustainable finance continues unabated. Banks have recently made a substantial contribution to this positive trend, with an increasing share of green bond issuance.

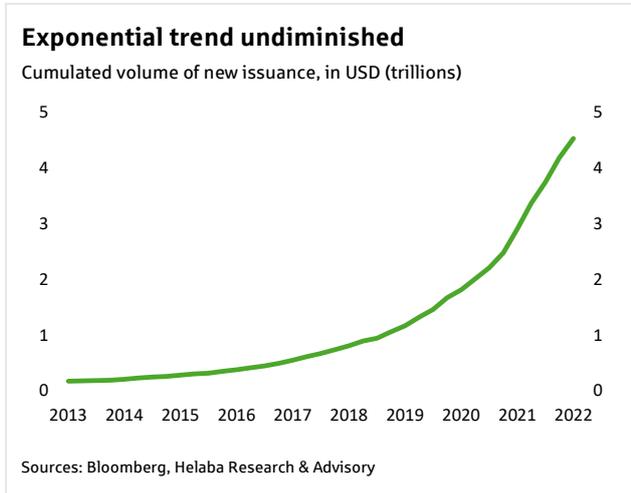
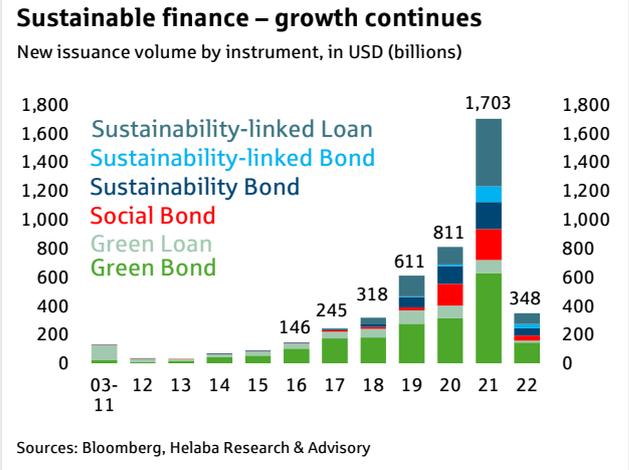
For supervisory and regulatory bodies, too, the focus is on steering capital flows towards sustainable investments. The main priority for 2022 is enhancing processes and disclosure practices for banks' climate-related risks. Another green label - the European Green Bond Standard - is currently awaiting parliamentary approval.

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# 1 Sustainable finance – a market update

## 1.1 Overall market remains extremely buoyant

Since we published our study entitled **"European bank bonds: Supervision wearing green-tinted spectacles"** on 8 December 2020, the relentless growth in sustainable finance has moved up a gear. In 2021, the global volume of new issuance across all asset classes and currencies hit a record high of USD 1.7 trillion, more than twice as much as the previous year. Financial institutions, which saw a 150 % jump in new issuance, were instrumental in driving this surge in activity. By the end of March 2022, the total volume of new funding with an ESG (environmental, social & governance) focus over the last few years had risen to USD 4.5 trillion.

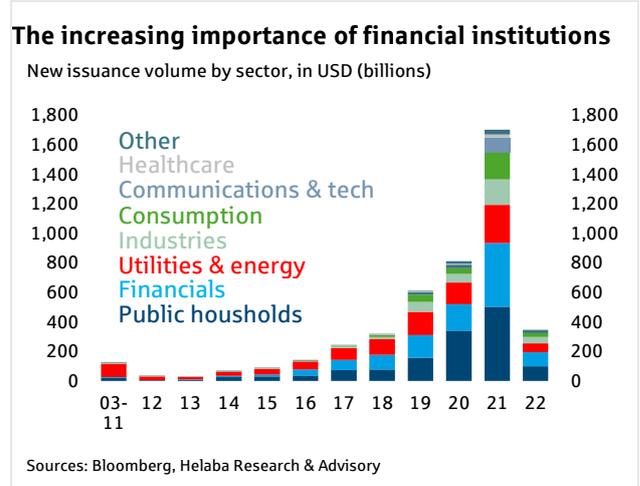


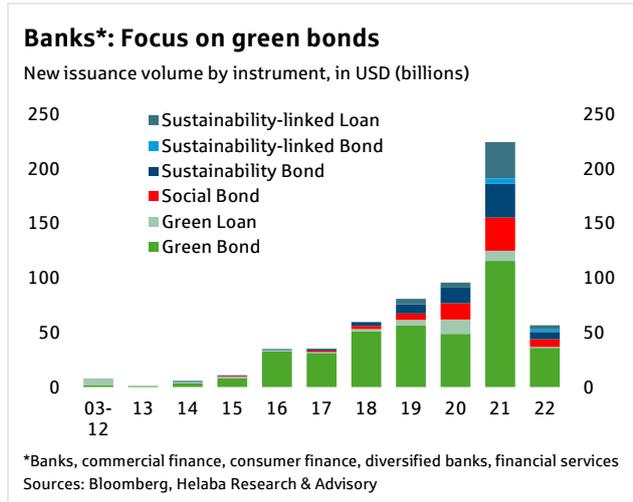
Lately, however, the primary market for ESG bonds has been taking a breather: In the first quarter of 2022, the volume of new issuance declined by 17 % on a year-on-year basis to around USD 348 billion. This was primarily due to public-sector issuers who, having already issued a significant volume of social bonds in 2021, recorded a 36 % drop in activity in the first quarter of this year. In contrast, new ESG issuance by banks in the opening quarter of 2022 rose by 5 % compared to the same period last year, reaching USD 56 billion.

## 1.2 ESG-related share of bank issuance rising

In the case of senior unsecured bank bonds, for example, sustainable issues recently accounted for 22 % of the total issuance volume (see also **"Primary Market Update EUR Benchmark Bank Bonds"** of 12 April 2022).

Green bonds have proven to be the most popular instrument, accounting for around half of new ESG issuance by banks in 2021. Although the market for sustainable finance was initially focused on green bonds in the early years, the "social" dimension and sustainability in general have also seen considerable growth of late. In our view, this reflects the fact that ESG-related topics have become firmly established within this asset class.

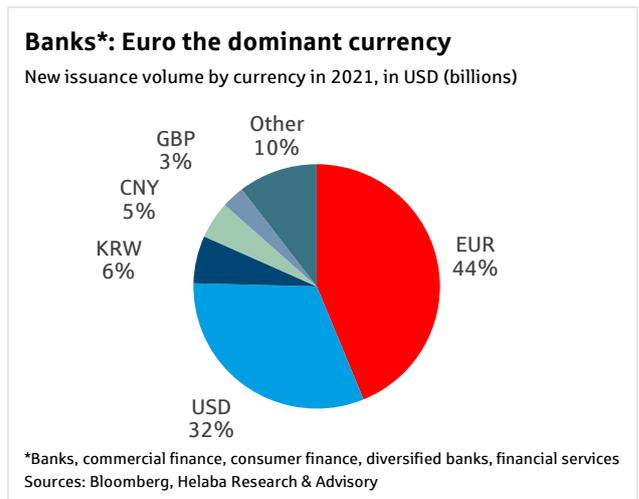
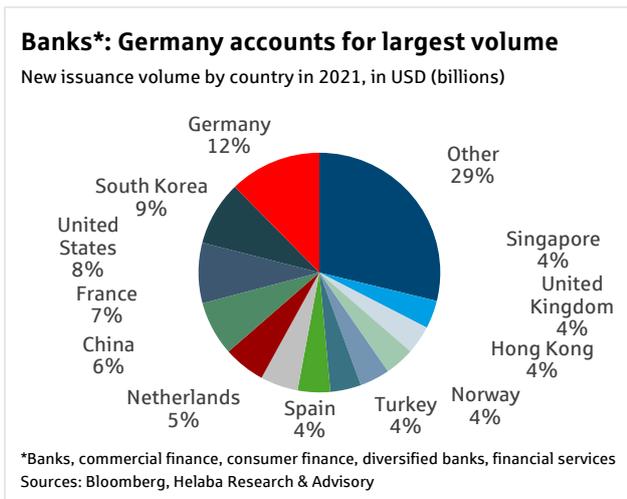




This development has been accompanied by further rapid progress in the legal framework, which is contributing to the more widespread adoption of green labels. For instance, the EU's Regulation on the establishment of a framework to facilitate sustainable investment has been in force since 1 January 2022. Since then, however, corresponding disclosure requirements have only applied to the two environmental goals of mitigating and adapting to climate change. They will not apply to the remaining goals<sup>1</sup> until 2023 at the earliest (for more detail, see ["European bank bonds: Supervision wearing green-tinted spectacles"](#) of 8 December 2020).

The 26<sup>th</sup> UN Climate Change Conference (COP26), held in Glasgow from 31 October to 13 November 2021, was another important milestone which, at the very least, shone a renewed spotlight on the urgency of taking action to achieve the goals of the Paris climate agreement.

Germany was the country with the largest share of new ESG issues by banks in 2021 (12 %). In addition to its economic might, we believe this also reflects the immense importance of transitioning to a sustainable economy.



<sup>1</sup> The sustainable use and protection of water and marine resources, the transition to a circular economy, pollution prevention and control as well as the protection and restoration of biodiversity and ecosystems.

## 2 Regulatory framework gaining ground

### 2.1 Regulatory measures to bring greater transparency and more information

Regulators have also prioritised the transition to a sustainable economy, having identified ESG<sup>2</sup> risks as a source of financial risk (for more detail, see "[European bank bonds: Supervision wearing green-tinted spectacles](#)" of 8 December 2020). Based on our observations, the key issue in 2022 will be to increase the transparency and understanding of underlying risks. In addition to the climate stress test, several other regulatory initiatives in Europe will address various aspects of sustainability and complement each other.

From 31 December 2022, large institutions<sup>3</sup> will be required to **disclose information<sup>4</sup> on their ESG risks** and requirements will steadily rise after this date.

Furthermore, under the new Corporate Sustainability Reporting Directive (CSRD; previously the Corporate Social Responsibility and Non-Financial Reporting Directive, NFRD)<sup>5</sup>, the aim is to revise the **general disclosure requirements** on ESG aspects. Trilogue negotiations are currently underway as part of the legislative process and transposition, which was originally planned for 2024, is likely to be postponed by at least one year. The final requirements are expected to be published in Q2 or Q3 of 2022 (see also the Helaba/BDO publication "[Nachhaltigkeit – künftig Standard in Reporting und Finanzierung](#)").

Starting with the 2023 financial year disclosure, institutions will be subject to full prudential reporting requirements in the form of a "**green asset ratio**", which will show the ratio of a bank's loans and securities that comply with the **EU taxonomy** in relation to its total banking book assets.<sup>6</sup> Institutions have already been obliged to report their taxonomy-eligible exposures for the 2021 financial year, although we consider its informational value to be relatively limited. Among other things, banks have complained that it is difficult to obtain relevant data from their corporate clients.<sup>7</sup>

### 2.2 ECB supervisors acknowledge banks' progress towards ESG disclosure

**Supervisory authorities recently examined the disclosure of climate-related and environmental risks by banks.** The ECB banking supervision published its [final report](#) on this exercise on 14 March 2022, in which it acknowledged the progress that has already been made. Overall, however, supervisors concluded that banks still fall short of fully meeting expectations regarding the disclosure of climate-related and environmental risks.<sup>8</sup>

Nevertheless, more than 70 % of the banks covered by the assessment explained how their senior management monitors climate-related and environmental risks - this share was roughly 50 % in the previous year. Around 75 % of banks did not provide any details on whether climate-related and environmental risks have any significant impact on their risk profiles, despite the fact that approximately half of these institutions have stated to the ECB that they consider themselves vulnerable to such risks. In addition, the key indicators disclosed by the banks did not sufficiently meet supervisory expectations. For example, only around half of institutions publish key performance or risk indicators on climate-related and environmental risks. Furthermore, many banks do not appear to report their climate-related and environmental risks in sufficient detail. For instance, nearly 30 % of banks that have

<sup>2</sup> Environmental, social & governance

<sup>3</sup> Listed companies with more than 500 employees

<sup>4</sup> Articles 449a CRR II and 434a CRR require the [EBA](#) to develop draft implementing technical standards that specify uniform disclosure formats and related instructions according to which banks must disclose information required under part eight of the Capital Requirements Regulation (CRR)

<sup>5</sup> The revised regulations are primarily aimed at expanding the scope of application, requiring sustainability information to be included in the management report, mandating an audit of disclosure information and the digitising of sustainability information (iXBRL tagging)

<sup>6</sup> In accordance with the Taxonomy Regulation and Delegated Acts

<sup>7</sup> As of 31 December 2021 and 31 December 2022, banks are only required to report their taxonomy eligibility. From 31 December 2023, they will have to disclose their taxonomy alignment to environmental goals 1 and 2, while goals 3 to 6 are currently under discussion (this would require the final criteria for environmental goals 3 to 6 to be published before 31 December 2022)

<sup>8</sup> For more information, see also the [November 2020 report](#)

committed themselves to aligning their risk positions to the 2015 Paris climate agreement (COP21) did not provide any information to substantiate this commitment.

On a positive note, an increasing number of banks have pledged to achieve the goal of climate neutrality by 2050 in line with the Paris agreement. Banking supervisors have identified good practices and acknowledge the industry's capacity to adapt. According to the report, several banks provide regular information on their credit exposure to industries that are particularly impacted by the transition towards net zero, such as the electricity, oil, gas and automotive sectors.

### 2.3 For the first time, focus of banking stress test on climate-related risks

What is more, the ECB banking supervision has decided to put climate-related risks at the heart of this year's **stress test**. The European supervisors regard this first climate stress test as a learning process, both for themselves and the banks. The aim is to identify vulnerabilities, modelling processes and the challenges faced by banks. In addition, the test is intended to enhance the availability and quality of data. Overall, the central bank's supervisors want to gain a more thorough understanding of how banks themselves evaluate their climate-related risks. The results of the stress test are initially expected to be used in the scope of banks' capital planning processes on a qualitative level; it is unlikely that there will be any significant quantitative impact for the time being.

The stress test commenced on 27 January 2022 and is due to be conducted in the first half of 2022, after which the ECB will publish the aggregated findings. We assume that banks will publish their own comments on the results.

### 2.4 ECB banking supervision monitoring banks' handling of climate-related risks

Essentially, the ECB banking supervision wants to conduct a more wide-ranging audit of banks they supervise on how they manage their climate-related and environmental risks. It had previously published **guidance** for banks on climate-related and environmental risks in November 2020, which set out its expectations regarding the management of such risks.

In November 2021, ECB supervisors published their first **large-scale assessment** of how banks within their remit are adapting their risk management processes to climate-related and environmental risks. Although the report concluded that institutions had taken some preliminary steps, none of them came anywhere close to meeting the expectations laid out in the guidance document. As stated above, the ECB banking supervision has recently issued a more detailed report on the disclosure of climate-related and environmental risks.

At the same time as the stress test in the first half of 2022, **ECB supervisors will also be carrying out an audit of banks to determine the extent to which systems and processes for managing climate-related and environmental risks have been implemented and integrated** into their overall risk strategy and governance practices.

Ahead of the ECB banking supervision's climate stress test in 2022, the ECB (Eurosystème) undertook an **economy-wide climate stress test**, the **results** of which were made available in September 2021. This test examined the resilience of companies and banks in a variety of climate scenarios from a macroeconomic perspective. In addition to the ECB's supervisory climate stress test, it also forms the basis for the climate stress test of the Eurosystème's aggregate balance sheet, which is also scheduled for 2022.

### 2.5 EBA to integrate ESG into banking supervision

Meanwhile, the European Banking Authority (EBA) has been tasked with **integrating ESG into banking supervisory processes**<sup>9</sup> and published guidelines for banks on the management and supervision of ESG risks in June 2021. In its May 2021 pilot study on the scope of climate risks, it stressed the need to address gaps in data to ensure a smooth transition towards low-carbon activities. Furthermore, the EBA also highlighted major discrepancies

<sup>9</sup> CRR/CRD V

between institutions on their implementation of the EU taxonomy (see our publication "[EBA publishes pilot exercise on climate risk](#)" of 25 May 2021).

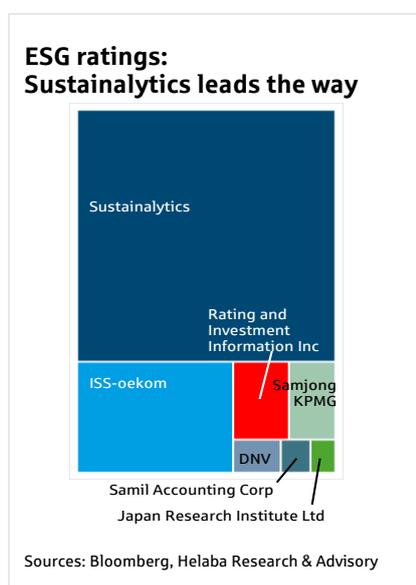
## 2.6 As yet no quantitative minimum requirement to cover ESG risks

The **legislative proposals on the final implementation of the EU Commission's Basel III amendments** also contain draft ESG-related provisions. The latter are largely based on the results of the above-mentioned initiatives and aim to ensure that banks systematically identify, disclose and manage ESG risks within the scope of their overall risk management framework. This includes regular climate stress testing by both supervisory authorities and the institutions themselves.

The proposals do not yet make any provision for factoring ESG aspects into minimum capital requirements (the so-called Green Supporting Factor), which the Commission attributes to a lack of data. However, the Commission has instructed the EBA to examine whether and how the impact of ESG factors should be reflected in capital requirements for the respective assets. The findings of this study are expected to be available in 2023. We anticipate that the first consultation document should be published in the near future (for more information, see our study "[Implementation of Basel III imposes uneven burden on banks](#)" of 2 November 2021).

## 2.7 European green bond label awaiting passage into law

Yet another initiative of the EU Commission is the establishment of a so-called "**European Green Bond Standard (EuGB)**". In a similar vein to the development of a taxonomy for classifying sustainable activities, it stems from the EU Commission's Action Plan on Financing Sustainable Growth of March 2018, the overarching goal of which is to steer capital flows towards more sustainable investments (for more detailed information, see our publication "[Europäische Banken: Nachhaltigkeit rückt in den Fokus](#)" of 4 July 2019).<sup>10</sup>



Along with its Sustainable Finance strategy, the European Commission published a draft [regulation on the introduction of EuGBs](#) on 6 July 2021. Under this proposal, the EuGB will be a voluntary standard and will complement existing standards (e.g. the ICMA Green Bond Principles and the CBI Climate Bond Standard). According to the explanatory memorandum, the aim is to increase market efficiency by applying uniform rules and, in turn, to reduce the costs of pricing these bonds for investors. At the same time, the new standard is designed to ensure the application of the Taxonomy Regulation.

At the moment, the regulation is still at the legislative stage and trilogue negotiations between the European Council, Parliament and Commission are underway. We do not expect the final regulation to come into force until sometime in 2023 at the earliest. When it is finally ratified, issuers will have to establish suitable programmes and comply with the extensive requirements of the taxonomy. In addition, it is likely that a second party option will be necessary and, for that reason, it may well be some time before the first bonds with the new label are issued.

## 2.8 Senior unsecured bank bonds getting greener

To date, we have not observed any significant spread differentials between green and non-green bonds of issuers, at least not on the secondary market. Although proceeds are earmarked in the case of bonds with a green label,

<sup>10</sup> The Commission has additionally revisited the introduction of a standard for environmentally sustainable bonds as part of its "European Green Deal Investment Plan" of January 2020, with a view to further boosting investment opportunities and facilitating the identification of environmentally sustainable investments with a clear labelling scheme.

bondholders have no legal recourse to certain assets in the event of insolvency (no securitisation). They rank pari passu with creditors of bonds without a green label.

However, issuers are increasingly integrating ESG factors into their corporate strategies and we believe this may have a positive overall impact on their credit quality. In our view, a sustainable approach has a disciplining effect and contributes to greater transparency, more efficient processes within a company and a more rigorous management of risks. At the very least, it should compensate for the transition and physical risks associated with climate change. Meanwhile, rating agencies also take ESG aspects into account when assessing the creditworthiness of issuers.

### **2.9 Conclusion: 2022 will see the key groundwork being laid for the banking industry's ongoing ESG alignment**

Sustainability has long since become a major factor for competitiveness in the banking sector. On the upside, the transition towards a low-carbon economy offers vast business opportunities for banks. Issues around sustainability additionally play an important role in banks' reputation management. However, this will also mean that "brown" business activities will be discontinued. What is more, the green transformation will incur immense costs and effort in developing the relevant processes as well as systems for risk management and disclosure.

Institutions will be faced with huge challenges in collecting and evaluating data on the alignment of their activities towards sustainability. In our opinion, the quantification of climate change risks is still in its infancy. For institutions and supervisors alike, the main priorities in 2022 will be to enhance relevant risk modelling systems and processes as well as the availability of data, while simultaneously improving transparency and disclosure mechanisms.

Any immediate impact on credit quality from ESG issues should be relatively low in 2022. However, important foundations are being laid for the medium-term ESG strategy of banks and their risk management and disclosure practices.



## News from Research & Advisory

Links to recently published analyses

- [Primary Market Update EUR benchmark bank bonds](#) of 14 April 2022
- [European banks: War in Ukraine clouds outlook - mainly due to indirect effects](#) of 4 March 2022



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