Covered Bond Quarterly

Cautious tone in primary market; inflation fuels real-term house-price decline; legal amendments could boost Spanish supply; developments in CEE

Covered Bond Ratings, Scope Ratings GmbH, 24 July 2023

Executive summary

The international covered bond market saw more than USD 188bn-equivalent of public issuance in benchmark and sub-benchmark size YTD to 24 July. But because of the sheer pace of issuance, the market showed signs of strain towards the end of the second quarter as buyers succumbed to fatigue. This was evident as some deals failed to capture the robust order books that had underpinned issuance for most of the year while pricing shifted north (moderately) and aftermarket performance turned a little flat.

The market tone improved into July, largely because issuers took a more cautious approach to pricing to get deals over the line in shape. Market participants expect the market to slow in the second half, given tighter credit standards and lower credit demand on the back of higher mortgage rates and faltering house prices.

House prices fell in real terms in all but two countries of the EEA in the year to Q1 2023, led by Sweden with a 15.2% decline and Germany with 14%. Across Europe, there was a real weighted average fall of 8.4%. In real terms, we are back on average to 2020 levels. For Sweden, though, house prices in Q1 2023 had fallen to 2016 levels. Germany fell back to 2019 levels. The most severe impacts are in Finland, where deflated house prices are at levels not seen for more than 20 years.

While deflated house prices reveal real value loss, they may on the plus side help to push some European mortgage markets into recovery mode more quickly than expected. And if employees can benefit from inflationary wage increases, even marginally, low real-term house prices may help to boost affordability more quickly than expected, despite higher mortgage rates.

For most covered bond markets, the translation of the European Covered Bond Directive is a done deal. Digging into the legislative details, however, what becomes apparent is that they can often be interpreted in unintended ways. This became apparent in Spain, where the first amendment of the covered bond law has now been finalised. Ambiguity regarding when a covered bond programme can ultimately be accelerated was removed, and cover-pool management was clarified: collateral can now be taken out of the cover pool as long as legal or contractual over-collateralisation tests are not breached. This is relevant for both primary collateral but for liquid assets that are only needed as a buffer when significant maturities are rolling in, activating 180 day coverage requirements.

The ability to use updated, automated valuations when registering mortgages for the first time in the cover pool has also been clarified. Effectively it allows the use of collateral from the banks' back books for mortgages where a full valuation was done when the loan was first granted. This will significantly ease cover pool management.

In the aftermath of the Poland's mini-banking crisis, the adequacy of asset- liability management is back on the regulator's table. Polish regulators have presented their ideas about how to place refinancing residential mortgages on a more stable footing. They will likely open up to a funding mix, although a minimum ratio has not yet been determined yet.

Polish banks will be free to choose whether to back mortgages with senior unsecured debt, equity or covered bonds. They still need to ramp up their MREL funding but the introduction of quotas could boost covered bond issuance.

Meanwhile, Croatia solved its problems with CHF-denominated mortgages loans some years ago. Now that it has joined the euro area, the Covered Bond Directive has been transposed into local law although for now, covered bonds remain a theoretical funding option.

Croatian mortgages are mostly long term and granted at fixed rates – the perfect collateral for covered bonds. We expect housing finance to grow and covered bond funding to become the natural choice, although Croatian regulators might need to give a gentle nudge to kickstart the market.

Contents

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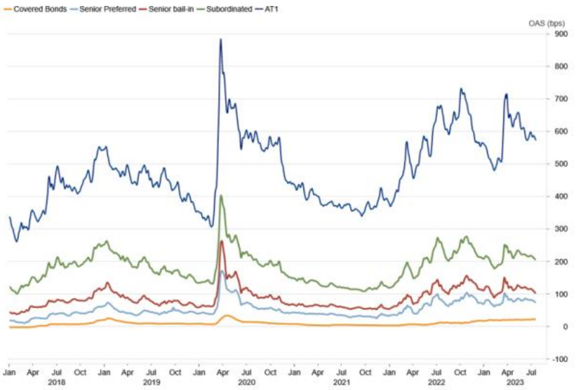
Primary markets turns cautious

The international covered bond market saw more than USD 188bn-equivalent of public issuance in benchmark and sub-benchmark size YTD to 24 July, according to Bond Radar data, from around 120 issuers from 24 countries. Issuance was predominantly in euros (85%) and three quarters of primary volumes came from European issuers, driven by the long telegraphed TLTRO replacement narrative in the case of euro area borrowers.

Because of the sheer pace of issuance, the market showed signs of strain towards the end of the second quarter because the relentless pace of issuance since the start of the year had caused investor fatigue. Unsurprising in the circumstances even if Q2 flow was already slower than the torrid Q1.

Buyer fatigue was evident as some of the deals coming to market prior to the end of Q2 failed to capture the robust order books that had underpinned issuance for most of the year while pricing shifted north (moderately) and aftermarket performance turned a little flat.

Figure 1: European bank spreads



The decision by Bausparkasse Schwäbisch Hall (BSH) on 20 June to shelve its EUR 500m Hypotheken-pfandbrief owing to lack of demand after it had put the deal into the market and set pricing caused a sharp intake of breath as it is a highly unusual step. But other covered bonds that came to market in that same period looked rather anaemic as they approached the finish line.

The market tone improved into July, to a large extent because issuers took a more cautious approach to pricing to get deals over the line in shape. Market participants expect the market to slow in the second half, given tighter credit standards and lower credit demand on the back of higher mortgage rates and faltering house prices.

The general dislocation that some market observers had feared following the withdrawal of ECB covered-bond liquidity and whether it would be replaced in sufficient size by real-money buyers of first resort failed to materialise. Until the latter part of June, the market had barely missed a beat all year, thanks in large part to covered bonds' better return profile driven by higher benchmark bond yields. Ultra-safe covered bonds offer a reasonable pick-up to government paper.

Towards the end of Q1, the covered bond market had demonstrated yet again that it can function in all weathers. In the eye of the market storm and the extreme volatility at the time of the US bank collapses and the Credit Suisse takeover, the FIG debt capital market shut for around 10 days. The reopening in the last week of March tracked a tried-and-tested formula: short-dated covered bonds were put into the market to test the waters.

A regular flow resumed promptly in euros, initiated by non-European issuers and non-euro-area Nordic issuers.

Italian issuers in pole position in June

For the first half of the year, French and German issuers accounted for 20% and 16.5% of aggregate global supply, respectively with USD 36.5bn and USD 29.5bn-equivalent in issuance. But with EUR 6.5bn of aggregate issuance in June, Italian issuers took pole position in terms of country issuance of covered bonds, issuing substantially more than German, UK, Canadian and French issuers.

The return of OBG supply after a year of zero Italian issuance was a market highlight and had been foreshadowed by Scope in May in the wake of Italy's full transposition of the EU Covered Bond Directive (see Italy paves the way for revived covered bond issuance).

UniCredit was first Italian issuer to tap the market, followed by Credit Agricole Italia, Banco BPM, Intesa Sanpaolo and ICCREA Banca.

Spanish issuers front-loaded covered bond supply into the first few weeks of the year and have been absent from the covered bond market since late February. But they will eventually resume the pace of issuance following some clarifications in the Spanish covered bond framework (see below).

Meanwhile, CEE issuers also showed some small shoots. UniCredit Bank Czech Republic and Slovakia issued its inaugural green covered bond (EUR 500m) while Slovakian issuers (Slovenska Sporitelna, Tatra Bank and Vseobecna uverova Banka) also tapped the euro market, putting the country back onto investors' radar screens. PKO Bank Hipoteczny tapped its native PLN market. More structural changes might be needed to put Poland back into focus (see below also).

Inflation fuels real house-price declines across Europe

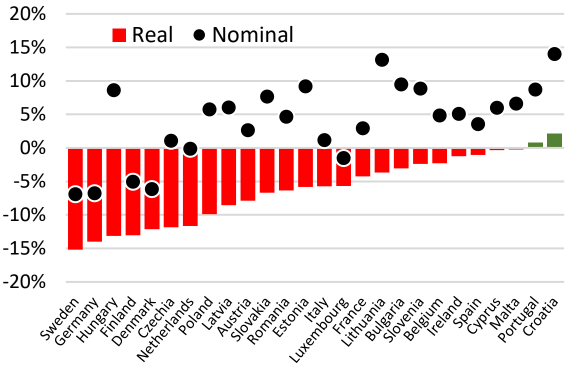
House prices fell in real terms in all but two countries of the EEA in the year to Q1 2023, led by Sweden with a 15.2% decline and Germany with 14%. Across Europe, there was a real weighted average fall of 8.4%.

Only seven out of 30 European countries saw nominal house price reductions over this period. Taking into account the decades of rich property price increases fuelled by ultra-low interest rates, the latest developments are tolerable. In nominal terms, average European house prices are back to 2022 levels. Only Finland has seen house prices fall to 2020 levels.

Average growth across the euro area was still a positive 4.1%, according to data released by Eurostat. The picture does not change much if extended to Europe including Norway, UK and Switzerland.

House prices across Europe reveal how much diversity there is in inflation in Europe: euro area inflation for the second quarter ranged from 1.6% to 11.3%. Viewing house-price developments in inflation-adjusted terms paints a different picture. Inflation in Europe has been well above nominal house-price growth (if any) so there was a real weighted average decline of 8.4% in the year to end Q1 2023. This can be seen most clearly in countries that have suffered both declines in nominal house prices and high inflation.

Figure 2: Annual house price growth to Q1 2023: real vs nominal



Source: Eurostat, Scope Ratings

In real terms, we are back on average to 2020 levels, before the economic effects of the pandemic boosted house prices. For Sweden, though, Q1 house prices had fallen to 2016 levels; for Germany, to 2019 levels. The most severe impacts are Finland, where deflated house prices are at levels not seen for over 20 years.

While deflated house prices reveal real value loss, they may on the plus side also help to push some European mortgage markets in recovery mode more quickly than expected. And if employees can benefit from inflationary wage increases, even marginally, low real-term house prices may help to boost affordability more quickly than expected, despite higher mortgage rates.

Covered Bond Directive – Spanish amendment paves the way for more issuance

For most covered bond markets, the translation of the European Covered Bond Directive is a done deal. Secondary legislation is available and most issuers have updated their prospectuses to fuel the rapid flow of issuance.

Digging into the legislative details, however, what becomes apparent is that they can often be interpreted in unintended ways. This became apparent in Spain, where the first amendment of the covered bond law has now been finalised.

Ambiguity regarding when a covered bond programme can ultimately be accelerated was removed, and cover-pool management was clarified: collateral can now be taken out of the cover pool as long as legal or contractual over-collateralisation tests are not breached. This is relevant for both primary collateral but for liquid assets that are only needed as a buffer when significant maturities are rolling in, activating 180 day coverage requirements.

The ability to use updated, automated valuations when registering mortgages for the first time in the cover pool has also been clarified. Effectively it allows the use of collateral from the banks' back books for mortgages where a full valuation was done when the loan was first granted. This will significantly ease cover pool management.

Polish issuers to become more active if supervisors have a say…

In the aftermath of Poland's mini-banking crisis, the adequacy of asset-liability management is back on the table. Polish regulators have presented their ideas as to how to place longer-term refinancing for residential mortgage loans on a more stable footing.

Unlike the Hungarian case, where covered bond refinancing has become a must (see Hungarian covered bonds: better credit fundamentals support euro market comeback), the polish regulator (KNF) will likely open up to a funding mix although a minimum ratio has not yet been determined.

Polish banks will be free to choose whether to back mortgages with senior unsecured debt (MREL and non MREL)), equity or covered bonds, with minimum quotas ranging from 20% to 60%.

Whereas Polish banks still need to ramp up their MREL funding, the introduction of such quotas could provide a boost to covered bond issuance in the medium term and increase the number of covered bond issuers.

…while Croatia awaits its inaugural issuance?

Similar to Hungary and more recently Poland, Croatia solved its problems with CHF-denominated mortgages some years ago. It joined the euro area in 2023 and the Covered Bond Directive was transposed into local law early 2022. However, for now covered bonds remain a theoretical funding option.

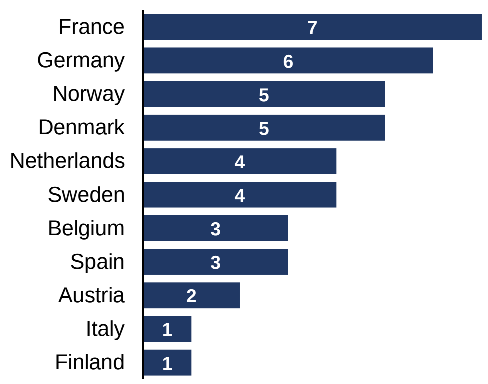
Banks are focused on building up their MREL cushions and are not yet interested in making use of covered bonds. Croatian banks are mostly deposit funded (70%) and can draw funding support from their parent groups if needed – s 90% are foreign owned.

A 91% homeownership rate puts Croatia among the countries with the highest homeownership rates worldwide. Mortgages are mostly long term and granted at fixed rates – the perfect collateral for covered bonds. We expect housing finance ng to grow and covered bond funding to become the natural choice. Croatian regulators might need to give a gentle nudge to kickstart the market.

Scope's covered bond universe

As of June 2023, Scope rates 41 covered bond programmes in 11 countries across Europe. This accounts for 1,145 Scope-rated bonds and a total outstanding volume of EUR 659bn equivalent.

Figure 3: Number of CB programmes rated

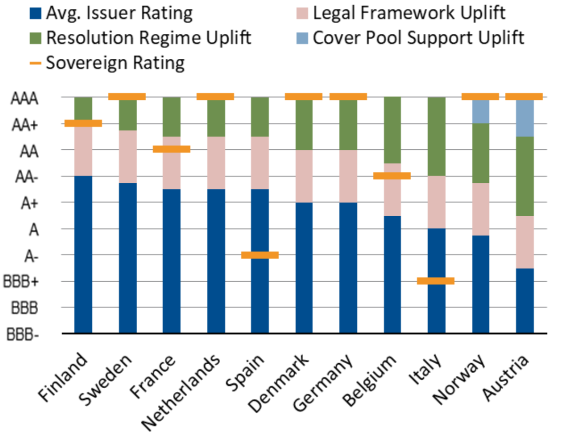


Source: Scope Ratings

All of Scope's covered bonds are rated AAA with a stable outlook (see here).

Because bank ratings are still strong and have very supportive legal and resolution frameworks, 83% of the covered bond programmes rated by Scope do not rely on cover-pool support to reach the highest ratings. At the same time, the dual recourse of covered bonds allows the other 17% of covered bond programmes to reach the highest ratings based on cover-pool support; notably, in Austria and Norway.

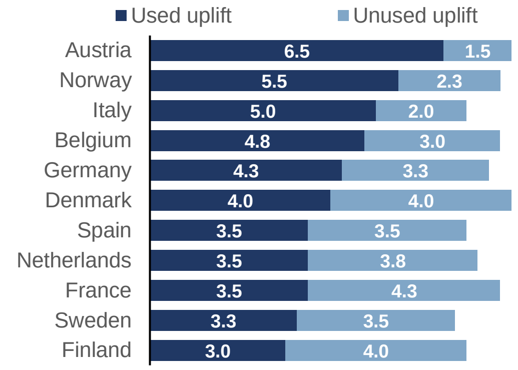
Figure 4: Covered bond rating de-composition



Source: Scope Ratings

Unused notches from both governance and cover pool support can provide additional rating stability. On average, covered bond programmes rated by Scope can withstand issuer downgrades of up to three notches, on condition that the programmes' risk characteristics and protection provided through OC do not materially change.

Figure 5: Covered bond rating stability



Source: Scope Ratings

French, Danish and Finnish covered bonds are the least sensitive to issuer downgrades with four or more unused notches that are not required to support the highest ratings. This is due to the combination of their banks' higher average credit quality as well as the transaction-specific interplay between complexity and transparency provided for the covered bond programmes.

For all programmes except two, the combination of governance and strong cover-pool support can mitigate a rating action on the covered bonds if the issuer is downgraded by at least one notch. We also see that current OC exceeds the levels needed to support the AAA ratings by around 34% on average.

We do not expect rating-supporting OC to constrain ratings in the short to medium term, either through increased issuance activity or through a deterioration in cover-pool quality, including a decline in the value of eligible assets through depreciation.

Scope covered bond rating actions and monitoring notes

Scope affirms AAA rating of Wüstenrot's Austrian mortgage-covered bonds, with Stable Outlook, published 10 May 2023

Scope Ratings GmbH (Scope) has affirmed its AAA/Stable ratings on the Austrian covered bonds (Hypothekenpfandbriefe) issued by Salzburg-based Bausparkasse Wüstenrot AG (Wüstenrot). The Outlook remains Stable.

Click here to access the rating affirmation.

New analysis on covered bonds issued out of Realkredit's capital centre S and capital centre T, published 26 June 2023

Scope Ratings has updated its report on the Danish mortgage covered bonds (særligt dækkede realobligationer – SDRO) issued by Realkredit Danmark A/S out of capital centre S and capital centre T.

Click here to access the monitoring.

Related bank and covered bond commentaries and research

US woes reveal where covered bonds are most vulnerable, *published 15 May 2023 available here*

Italy paves the way for revived covered bond issuance, *published 3 May 2023* available here

2023 Covered Bond Outlook: credit stability despite growing challenges, *published 23 January 2023 available here*

Italian banks: solid funding and liquidity against challenging backdrop, published 5 April 2023 available here

Scope updates its covered bond rating methodology and calls for comments, *published 29 March 2023 available here*

Tight rules and strong oversight should buffer European banks against contagion, *published 14 March 2023 available here*

House price commentaries

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