SCOPE Scope Ratings

Covered Bond Quarterly 2023

Look-across from US regional bank problems to covered bonds: vital importance of stable and matched long-term funding; falling European house prices signal party is over for homeowners, borrowers and lenders.

Covered Bond Ratings, Scope Ratings GmbH, 16 May 2023

info@scoperatings.com | www.scoperatings.com

| Bloomberg: RESP SCOP

Executive summary

Well over EUR 100bn of covered bond issuance year-to-date is a sign of health and confirms that weaning banks off the ECB's purchase programmes has not led to too many problems. Positive interest rates have lured back investors, long sidelined, and they have been ample substitutes for missing ECB take-up.

The Credit Suisse takeover and the US regional bank collapses forced European investors and regulators to hold their breath. But even though contagion in Europe is highly unlikely, what is common to these incidents – and which is directly relevant to covered bonds – is that it was not credit quality but liquidity problems that led to the banks' downfall, plus the crystallisation of market-value losses on high-quality assets.

The issue of maturity mismatches points the finger at covered bonds since this area is not well covered by the European Covered Bond Directive. But don't get us wrong; we consider everything in the CBD as positive. It raised and harmonised the bar for European covered bonds, ensuring better supervision, improved transparency, adequate asset segregation upon issuer insolvency and that sound asset quality is maintained. It also incorporates some short-term liquidity provisions.

But with the covered bond market moving to a soft-bullet format, the requirement to maintain decent liquidity protection has become a 'shark with no teeth' since legislation allows covered bonds' extended maturities to be used to calculate of the 180-day liquidity buffer. This makes this well thought through condition redundant as it shifts risk into the future. And it leaves European covered bond programmes with one flank open. Investors are fine for now and are happy to leave liquidity management in the hands of issuers. Should they be?

Meanwhile, the uncertain economic environment continues to push European house prices lower. Spoiled by years of growth, the party is over for homeowners, borrowers and lenders alike. Challenges are also crystallising in net residential mortgage lending, which nosedived to almost zero in the half year to February 2023, only slowly reverting in March. We do not see a swift recovery in the European housing market for most countries because affordability remains under pressure from rising interest rates, high inflation and general economic uncertainties. These factors are making house purchases unattainable.

The situation exposes mortgage covered bonds to several risks. First and most obviously, from weakening credit quality resulting from higher defaults and decreasing property values. Lower property values may reduce recovery and by definition increase expected loss. Lower property values can also affect the over-collateralisation of covered bond programmes.

Further OC constraints may be driven by lagging supply of eligible mortgages. After nine years of increasing mortgage stocks, declining new business is reducing the stock covered bond managers can dispose of.

Italy made the 8 July 2022 CBD transposition cut, but missing secondary legislation forced Italian covered bond issuers to miss out on record covered bond issuance. Italy's full transposition finally became effective on 31 March 2023, which has paved the way for Italian issuers to return to the covered bond market. This will ease their path to redeeming their EUR 320bn of maturing TLTRO funding and will once again give Italian covered bond issuers access to more predictable and less volatile funding.

We expect the Portuguese legislator to introduce final secondary legislation in the coming weeks after the public consultation period for the draft ended on 21 March.

Contents

Executive summary 2
US woes reveal where covered bonds are most vulnerable 4
Bank credit remains stable – for now 5
Party over for European homeowners 5
Covered bonds hit from several fronts 6
Italian and Portuguese legal frameworks get their final polish 6
Scope's covered bond universe 7
Scope covered bond rating actions and monitoring notes 9
Related bank and covered bond commentaries and research 9
House price commentaries 9
ESG in covered bond and banks 9

Scope Covered Bond Ratings

Karlo Fuchs
Managing Director
k.fuchs@scoperatings.com

Mathias Pleißner
Senior Director
m.pleissner@scoperatings.com

Reber Acar, CFA
Associate Director
r.acar@scoperatings.com

Fatemeh Torabi
Associate Analyst
f.torabi@scoperatings.com

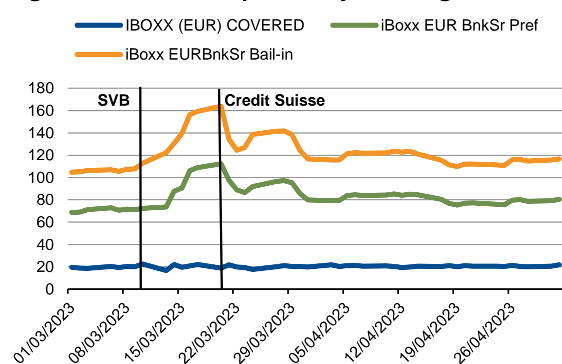
US woes reveal where covered bonds are most vulnerable

More than EUR 100bn of covered bond issuance year-to-date is a sign of health. Banks have been able to pre-fund in a rising interest-rate scenario and this might provide a gentle profitability benefit through improved interest-rate margins.

It also means that weaning the banks off the ECB's purchase programmes hasn't led to too many teething problems. Positive interest rates have lured back investors, long sidelined, and they have been ample substitutes for missing ECB take-up.

The year has seen noteworthy bank rescue operations so far. Credit Suisse is perdu and concern about the solvency of US regional banks continues unabated.

Figure 1: CBs not impacted by banking woes



Source: Scope Ratings

Names that were not well known at all in Europe forced investors and regulators to hold their breath. Contagion in Europe is unlikely and for a reason, as highlighted in our recent comment "Tight rules and strong oversight should buffer European banks against contagion". What is common to failures of SVB, Signature, First Republic and Credit Suisse is that it was not credit quality but liquidity problems that led to their downfall. Plus the crystallisation of market-value losses on high-quality assets.

The problem of maturity mismatches points the finger at covered bonds, since this area is not well covered by the European Covered Bond Directive.

When, in 2014, the EBA published its first report on "Covered bond frameworks and capital treatment", it had been more focused on liquidity, market risk and stress testing.

Risks received less prominence in the watered-down version of the recommendations for the harmonisation of covered bonds (see here), which became the blueprint for the CBD.

Don't get us wrong, we consider everything in the CBD as very positive. It raised and harmonised the bar for European covered bonds, ensuring better supervision, improved transparency, adequate asset segregation upon an issuer's insolvency and that sound asset quality is maintained. It also incorporates some short-term liquidity provisions. However, with the covered bond market moving to a soft-bullet format, the requirement to maintain decent liquidity protection has become a 'shark with no teeth' since legislation allows covered bonds' extended maturity to be used to calculate of the 180-day liquidity buffer. This effectively makes this well thought through condition redundant as it shifts risk into the future.

Except for Danish match-funded covered bonds, European covered bond programmes have one flank open. More permanent protection from liquidity risk such as conditional pass-through covered bonds has fallen from grace.

Also, more structural protections such as the duration-matching requirement in the Irish covered bond framework have not been used in other legislations. Investors are fine for now and are happy to leave liquidity management fully in the hands of issuers. Should they be that comfortable?

Indeed, issuers are highly rated, and still benefit from strong lines of defence. Capitalisation and credit quality remain sound and have not yet been impacted by slower growth or creeping insolvencies while rising interest rates are beneficial to profitability. We believe the risk of bank runs is less pronounced in Europe.

But let's visualise what the lesser focus on mismatches means. If covered bond programme is in rundown and assets need to be sold, the significantly changed interest-rate environment endangers the very viability of covered bonds.

When mismatches need to be cured, available over-collateralisation (OC) can become significantly and swiftly depleted or even could lead to the programme's insolvency.

By definition, cover assets are less liquid, long term and their market value is susceptible to the level of interest rates, in particular for fixed rate loans.

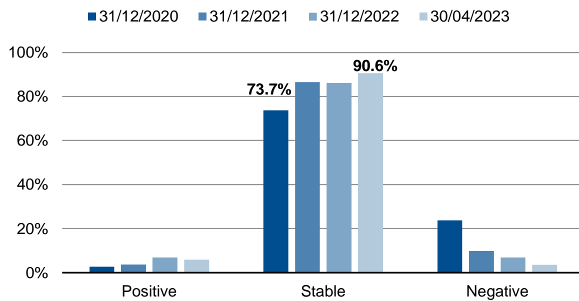
Let's assume a recently originated cover pool with an average fixed interest rate of 1.5% and a 20-year maturity. The recent ECB hike to 3.25% means the present value of this cover pool has already dropped by 25%. On the reverse, this means, for every euro that needs to be generated to cover a mismatch, EUR 1.33 of loans needs to be sold.

With no changes to the CBD on the horizon, planned changes in the Bank Recovery and Resolution Directive should not only cover the ranking of depositors in resolution but also how timely access to liquidity can be ensured after regulators have declared non-viability. It is not a given that covered bonds will always become part of the going-concern and worked-out institution.

Bank credit remains stable – for now

European banks continue to demonstrate solid capital and liquidity metrics. But in an ever more challenging economic environment, it becomes difficult to see positive rating drivers. As a result, most European banks we rate have now stable outlooks.

Figure 2: Bank rating Outlooks as of May-2023

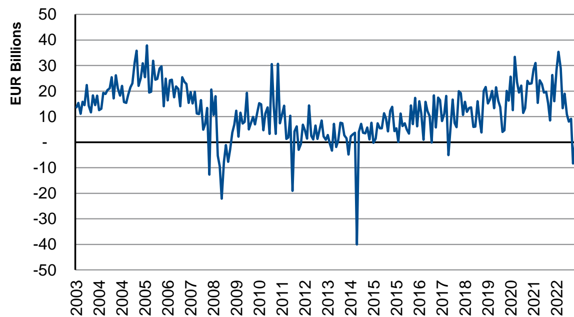


Source: Scope Ratings

Party over for European homeowners

The uncertain economic environment continues to push European house prices lower. But challenges are also crystallising in net residential mortgage lending, which nosedived to almost zero in the half year to February 2023, only slowly reverting in March.

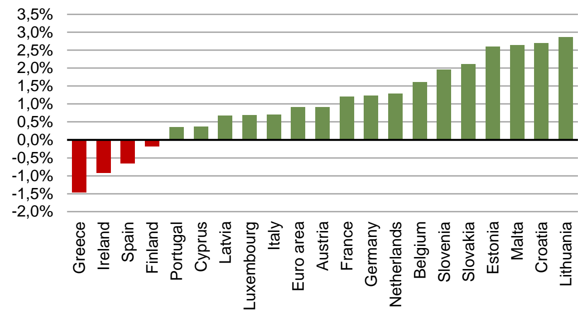
Figure 3: Monthly flows of housing loans to European households



Source: euro area statistics, Scope Ratings

The magnitude and duration of the lending pullback is stunning and brings back memories to 2008 when housing markets went into shock as the Global Financial Crisis erupted. Most of the negative net flows have been seen in countries that suffered most during the GFC. Relative to the total stock of outstanding housing loans to households, Greece lost 1.5% in the year to March 2023 followed by Ireland (-0.9%) and Spain (-0.7%).

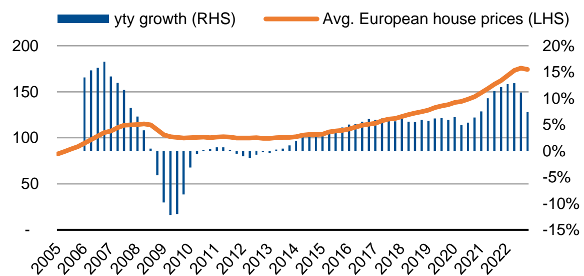
Figure 4: One-year growth in housing loans to European households



Source: euro area statistics, Scope Ratings

We do not see a swift recovery in the European housing market for most countries because affordability remains under pressure from rising interest rates, high inflation and general economic uncertainties. These factors are making house purchases unattainable for most European households.

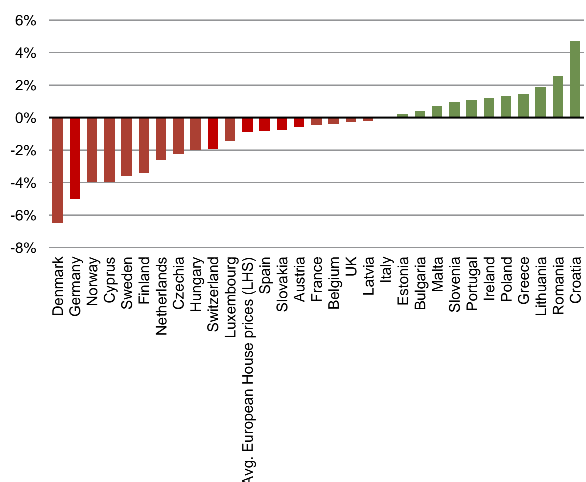
Figure 5: Average European house price growth



Source: Eurostat, Scope Ratings

Spoiled by years of growth, the party is over for homeowners, borrowers and lenders alike. Average prices across Europe fell 0.9% q-on-q in Q4 2022, the first time that had happened in eight years. Around 60% of European countries saw home values decline in the fourth quarter of 2022; although not all ended the year in negative territory.

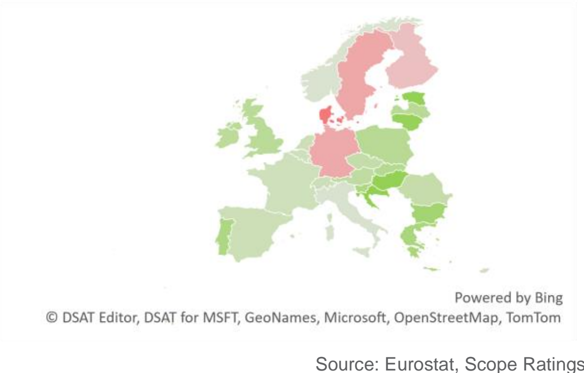
Figure 6: European Q4 2022 quarterly house price change



Source: Eurostat, Scope Ratings

In fact, only four countries saw full-year declines: the most severe in Denmark, followed by Germany, Norway and Sweden. While Nordic households are the most exposed to value corrections (see Structural mortgage risks expose European households to value corrections) because they are vulnerable to mortgage risks arising from affordability shocks and value declines, Germany's position as the second worst performer was more of a surprise.

Figure 7: 2022 house price change



Source: Eurostat, Scope Ratings

This may have been partially driven by high uncertainties around utilities costs ahead of the heating season and in the face of the country's dependency on Russian gas.

Fears around escalating utilities costs impacted even more on households, which were already hesitant, to invest in property. Italy and the Netherlands also observed above-average declines in house prices, for the same reason.

Covered bonds hit from several fronts

The situation exposes mortgage covered bonds to several risks. First and most obviously, from weakening credit quality resulting from higher defaults and decreasing property values.

Lower property values may reduce recovery and by definition increase expected loss. Lower property values can also affect the over-collateralisation (OC) of covered bond programmes.

In most legislation, mortgages are only eligible to provide cover to mortgage covered bonds up to a loan-to-value of 80%. If the LTV rises about the cap, that portion of the mortgage securing the covered bond becomes ineligible. Issuers may have to provide additional cover in the form of new mortgages or substitute assets if they want to maintain OC constant.

Further OC constraints may be driven by lagging supply of eligible mortgages. After nine years of increasing mortgage stocks, declining new business is reducing the stock covered bond managers can dispose of.

Italian and Portuguese legal frameworks get their final polish

Italy made the 8 July 2022 CBD transposition cut, but missing secondary legislation forced Italian covered bond issuers to step aside amid record covered bond issuance volumes in 2022 and so far in 2023. Italy's full transposition of the EU Covered Bond Directive finally became effective on 31 March 2023, which has paved the way for Italian issuers to return to the covered bond market. See Italy paves the way for revived covered bond issuance.

Before Italian banks can start issuing under the new framework, they first have to confirm to the Bank of Italy that programme documentation has been updated and only after the 30-day minimum notification period they can restart issuance activity.

Reinstating covered bond issuance will ease the path of Italian banks to redeem their EUR 320bn of maturing TLTRO funding and will once again give issuers access to more predictable and less volatile funding. Ever since the European sovereign crisis, OBGs have been trading at lower spreads than BTPs and investor appetite remains strong as OBG's provide a spread pick-up to other European covered bonds.

The legal framework for OBGs remains strong and robust and the legal update is credit neutral to our assessment of the legal framework-driven uplift. Our governance support assessment confirms that Italian covered bonds can receive the maximum possible support uplift.

In combination with our cover-pool assessment, Italian covered bonds can achieve the highest ratings and benefit from up to nine notches of credit differentiation between the issuer rating and the covered bond rating.

In itself, the update provided only limited changes to the existing framework. Market standards such as the requirement to provide regular investor information have been codified and regulatory oversight has been strengthened. Unlike most other European covered bond regimes, Italian covered bonds have a zero over-collateralisation requirement on a nominal and net present value basis.

Just complying with the Italian law therefore means they cannot be labelled as "European covered bond (premium)". Preferential regulatory treatment for investors hinges on the issuer committing to an OC of at least 5%.

As is typical for most covered bond jurisdictions, derivatives in the cover pool will not terminate upon the issuer's insolvency but will remain available to service the covered bond programme.

In contrast to most European countries where such counterparties are rated Single A minus and above, Italian legislators allow for derivative counterparties and volumes of up to 8% provided they comply with credit quality Step 3 (BBB rating category). The new regulations have clarified that covered bond issuers must provide a liquidity buffer that corresponds at least to net liquidity outflows in the OBG programme over 180 days. The beneficial impact for investors is limited as the regulation allows the calculation to be based on the extended maturity of covered bonds (if applicable).

With 12-month extendable soft bullet covered bonds being market standard, this effectively means that most issuers do not need to provide additional collateral for the liquidity buffer. See here our updated assessment on the Italian legal framework and further governance considerations.

Portuguese secondary legislation at the door

We expect the Portuguese legislator to introduce final secondary legislation in the coming weeks after the public consultation period for the draft ended on 21 March.

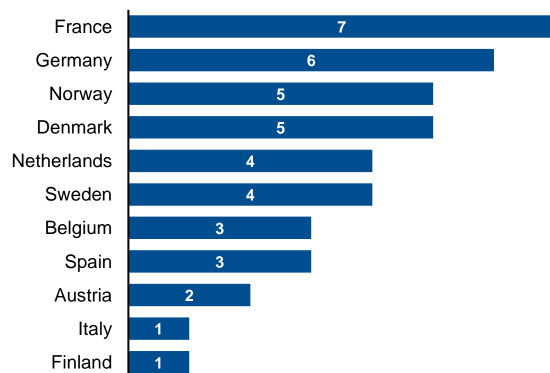
Just like in Italy, we expect changes to the existing framework to be limited, based on the draft legislation. The impact of the new 180-day liquidity buffer will be limited for typically soft-bullet covered bond programmes. Also, the minimum OC remains at 0%, but issuers typically commit to OC levels of 5% and above.

Most of the Portuguese covered bond issuers have been absent from the primary market since 2020 and similar to Italy, only when programmes have been updated covered bond issuance activity might revive.

Scope's covered bond universe

As of May 2023, Scope rates 41 covered bond programmes in 11 countries across Europe. This accounts for 1,159 rated bonds and a total outstanding volume of EUR 663bn equivalent.

Figure 8: Number of CB programmes rated

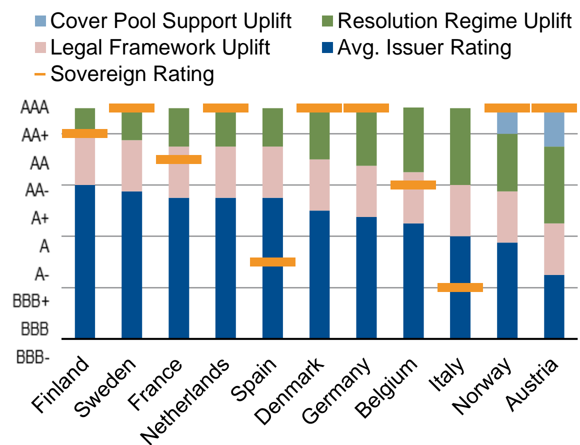


Source: Scope Ratings

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

Thanks to bank ratings that are still strong and with 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.

Figure 9: Covered bond rating de-composition

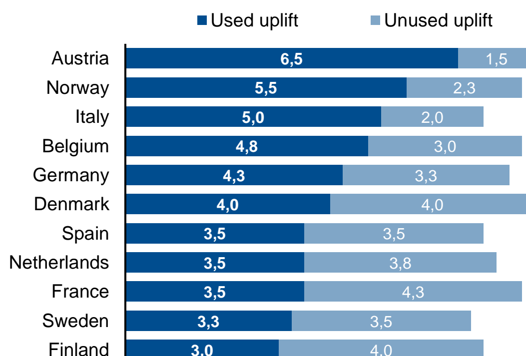


Source: Scope Ratings

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, covered bonds in Austria and Norway.

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 10: 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 currently provided OC exceeds the OC 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.

See **page 9** for list of Scope covered bond rating actions, monitoring notes, research and commentaries.

Scope covered bond rating actions and monitoring notes

Scope affirms AAA rating of Wüstenrot's Austrian mortgage-covered bonds, with Stable Outlook, published 19 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.

Scope affirms AAA rating on SSB Boligkreditt's Norwegian mortgage-covered bonds, Outlook Stable, published 18 April 2023

Scope Ratings GmbH (Scope) has affirmed the AAA/Stable rating on the Norwegian covered bonds (obligasjoner med fortrinnsrett) issued by the specialised mortgage bank SSB Boligkreditt AS (SSBB), the fully owned subsidiary of Sandnes Sparebank.

Click here to access the rating affirmation and here to download the performance update with key programme information

Scope assigns AAA rating to DNB Boligkreditt's NOK 50bn issue (NO0012427055), Outlook Stable, published 26 January 2023

On 26 January 2023, Scope assigned a first-time AAA rating to the NOK 50bn Norwegian covered bond (obligasjoner med fortrinnsrett), ISIN: NO0012427055 issued by specialised mortgage bank DNB Boligkreditt (DNBB). DNBB is fully owned by DNB Bank ASA. The Outlook on the rating is Stable.

Click here to access the rating assignment and here to download the rating report with key programme information.

New analysis on mortgage covered bonds issued by Verd Boligkreditt AS

Scope Ratings has updated its rating report on the Obligasjoner med fortrinnsrett (Norwegian mortgage-covered bonds) issued by Verd Boligkreditt AS

Click here to access the rating affirmation and here to download the performance update with key programme information

Related bank and covered bond commentaries and research

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

Legal framework analysis: Italy Obbligazioni Bancarie Garantite (OBG), published 3 May 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

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

House price commentaries

Party over for European homeowners, published 9 May 2023 available here

Structural mortgage risks expose European households to value corrections, published 11 January 2023 available here

ESG in covered bond and banks

Macroeconomic Climate Stress Test: climate-change risk management in action, published 30 March 2023 available here

Scope Ratings GmbH

Headquarters Berlin
Lennéstraße 5
D-10785 Berlin

Phone +49 30 27891 0

Frankfurt am Main
Neue Mainzer Straße 66-68
D-60311 Frankfurt am Main

Phone +49 69 66 77 389 0

Paris
10 avenue de Messine
FR-75008 Paris

Phone +33 6 6289 3512

Oslo
Karenslyst allé 53
N-0279 Oslo

Phone +47 21 09 38 35

Madrid
Paseo de la Castellana 141
E-28046 Madrid

Phone +34 91 572 67 11

Milan
Via Nino Bixio, 31
20129 Milano MI

Phone +39 02 30315 814

Scope Ratings UK Limited

London
52 Grosvenor Gardens
London SW1W 0AU

Phone +44 20 7824 5180

info@scoperatings.com
www.scoperatings.com

Disclaimer

© 2023 Scope SE & Co. KGaA and all its subsidiaries including Scope Ratings GmbH, Scope Ratings UK Limited, Scope Fund Analysis GmbH, Scope Investor Services GmbH, and Scope ESG Analysis GmbH (collectively, Scope). All rights reserved. The information and data supporting Scope's ratings, rating reports, rating opinions and related research and credit opinions originate from sources Scope considers to be reliable and accurate. Scope does not, however, independently verify the reliability and accuracy of the information and data. Scope's ratings, rating reports, rating opinions, or related research and credit opinions are provided 'as is' without any representation or warranty of any kind. In no circumstance shall Scope or its directors, officers, employees and other representatives be liable to any party for any direct, indirect, incidental or other damages, expenses of any kind, or losses arising from any use of Scope's ratings, rating reports, rating opinions, related research or credit opinions. Ratings and other related credit opinions issued by Scope are, and have to be viewed by any party as, opinions on relative credit risk and not a statement of fact or recommendation to purchase, hold or sell securities. Past performance does not necessarily predict future results. Any report issued by Scope is not a prospectus or similar document related to a debt security or issuing entity. Scope issues credit ratings and related research and opinions with the understanding and expectation that parties using them will assess independently the suitability of each security for investment or transaction purposes. Scope's credit ratings address relative credit risk, they do not address other risks such as market, liquidity, legal, or volatility. The information and data included herein is protected by copyright and other laws. To reproduce, transmit, transfer, disseminate, translate, resell, or store for subsequent use for any such purpose the information and data contained herein, contact Scope Ratings GmbH at Lennéstraße 5 D-10785 Berlin.