SCOPE Scope Ratings

Covered Bond Quarterly

CRE risks looming but covered bonds well protected

Covered Bonds, Scope Ratings GmbH, 17 April 2024

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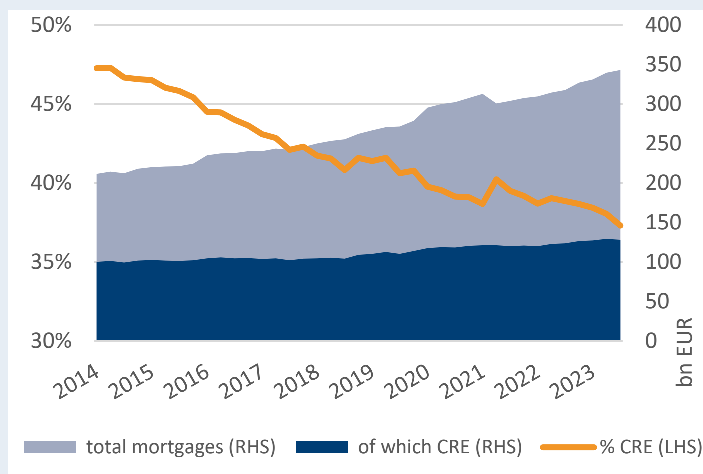
| Bloomberg: RESP SCOP

Executive summary

After a strong January, EUR benchmark covered bond issuance slowed in February and March. Some of the reluctance to issue may have been driven by Germany's specialised commercial mortgage lenders, given rising tensions in commercial real estate (CRE). Have German banks put Pfandbriefe at risk?

The proportion of German banks' CRE loans to total loans stands at 20%. That is in the upper range of European economies. However, the relative contribution of CRE loans to total mortgage exposure in Pfandbriefe has actually reduced significantly in the past 10 years, from 47% in 2014 to 37% today.

CRE exposure in German Pfandbriefe



Source: Scope, VDP

Not only has CRE exposure shrunk proportionally, the mortgage collateral of German Pfandbrief banks has been relatively stable over the last decade – not indicating overly bullish underwriting.

While 60% of German CRE Pfandbrief collateral is domestic, lending to US real estate doubled to 8% by the end of 2023 over the previous 10 years. The US now ranks third after German and French CRE loans in German covered bonds. By segment, office account for a 50% share, up from 40% ten years ago.

The focus now is on what happens with office properties. What we are observing today for office is what shopping centres and retail experienced in the last decade – a correction of values to lower, potentially more sustainable levels. This reflects a long-term shift and a challenge to real-estate investors and lenders.

Pfandbriefe investors are less affected as they not only benefit from the dual-recourse nature of covered bonds. In addition, Pfandbriefe benefit from very strong collateral, capped at a 60% loan-to-(lending)-value threshold. Most importantly, lending values are assessed using prudent, through-the-cycle valuation metrics providing a strong buffer to market values when the latter are inflated. At the end of 2023, the average buffer to market values in German mortgage Pfandbriefe was nearly 40% compared to less than 20% a decade ago.

While this accurately reflects higher market values, a feature of German Pfandbriefe that was deemed a competitive disadvantage when prices rose could become an advantage today as most other European covered bond laws fully rely on market values.

Our ratings outlook on covered bonds remains stable. French, Dutch, Danish and Finnish covered bond are the least sensitive to issuer downgrades thanks to the combination of their banks' higher average credit quality as well as the transaction-specific interplay between complexity and transparency.

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Issuance activity on track

After a strong January, EUR benchmark covered bond issuance slowed in February and March. Still, compared to our EUR benchmark issuance expectations of EUR 170bn for 2024, 41% has already been achieved, above the 40% YTD since 2019.

The main contributions have come from French issuers, accounting for 36% of total European issuance volumes. BPCE Société de Financement de l'Habitat (SFH) accounted for 7.6% on its own. France was followed by German benchmark issuance (18%) and a strong Italian presence (8%).

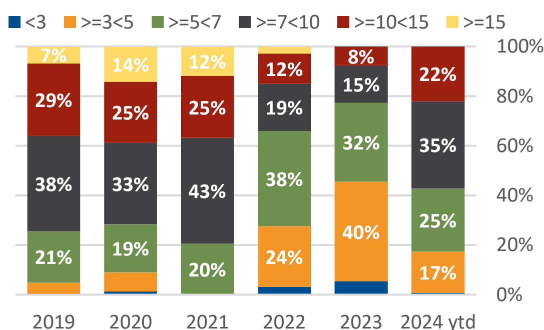
For now, the market has benefited from a "keep calm and carry on" attitude as even though the geopolitical and economic situations remain volatile, no additional calamity has emerged to roil the capital markets.

No big news regarding the ECB either, which had been driving covered bond issuance, profiles and spreads for five years. Rates have remained untouched since September 2023.

On 13 of March, the ECB published changes to the operational framework for implementing monetary policy without major implications expected for covered bonds. Key measures were left untouched. More expected from 2026, when the ECB plans to review its key framework parameters.

From this stable environment, investors have shown increased appetite for duration. Year to date, 57% of new issues have carried a seven-year-plus maturity. This compares to 23% in 2023, although it is still far from the 70%-80% between 2019-2021.

Figure 1: New issues by maturity bands

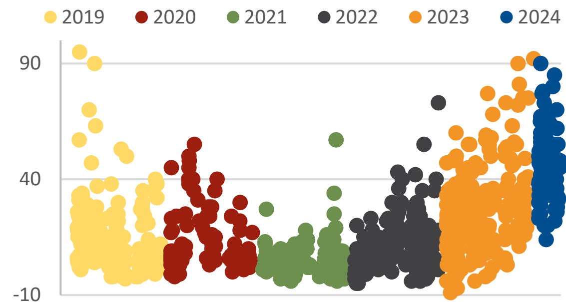


Source: Bond Radar, VDP

Credit dispersion ongoing

The expiry of the Eurosystem's purchase programmes in mid-2023 is reflected in covered-bond spread widening and variance, which has continued into 2024. This supports our view that the focus is back on credit, where issuers' quality, cover pools and market risks will drive spreads and greater differentiation between programmes than in recent years. This trend is expected to continue, fuelled by strong and concentrated supply.

Figure 2: Spread variance EUR benchmark in bp

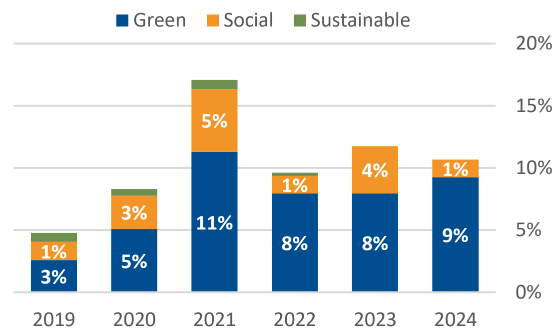


Source: Bond Radar, VDP

We do not expect to see many records broken for covered bonds in 2024, but this may be the year with the highest amount of ESG benchmark issuance in EUR. On a relative basis, the 9% of green and social covered bonds that have been issued year-to-date has exceeded the shares of 2022 and 2023.

However, on a nominal basis there is still a long way to go, with a total of EUR 7.5bn YTD compared with EUR 16bn in the record ESG year of 2022. Also, it is worth noting that all but two green benchmarks were issued in January, marking a poor performance for the rest of the quarter.

Figure 3: ESG issuance



Source: Bond Radar, VDP

While issuance activity is typically low in February and March, some of the reluctance to issue may also have been driven by Germany's specialised commercial mortgage lenders, bearing in mind headwinds from the US real estate market.

While all the major German banks sold covered bonds early in the year, the tensions in commercial real estate (CRE) may have led to some resistance from some of these issuers.

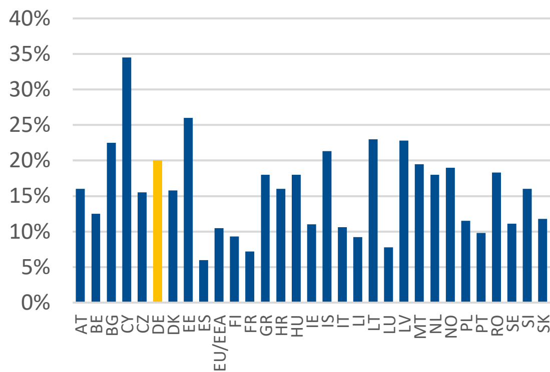
It remains to be seen how news around CRE will affect some banks as some of the German covered bond issuers have substantial exposure. See also Scope's Webinar on Commercial real estate – how concerned should debt investors be.

Looming storm for CRE coverage?

EU/EEA banks reported exposure to CRE loans of EUR 1.4rtn, according to the EBA's risk assessment report , as of July 2023. Exposure to small and medium-sized enterprises (SMEs) was EUR 2.5trn.

Most of this is concentrated in the larger European economies but the relative share of CRE loans to total loans differs substantially. In Germany, for instance, the share is 20%, which is in the upper range compared to major European economies. At the same time, EBA's risks assessment does not take into account German savings and co-operative banks, which account for around 30% of the German banking sector, although this segment typically contributes less to large-sized CRE.

Figure 4: CRE loans at amortised cost to total loans to NFCs and households – June 2023



Source: Risk Assessment report of the European Banking Authority – December 2023

However, some of Germany's specialist mortgage lenders and Landesbanken do have large commercial real estate portfolios (see German banks: systemic crisis unlikely amid persistent concerns about real estate slump).

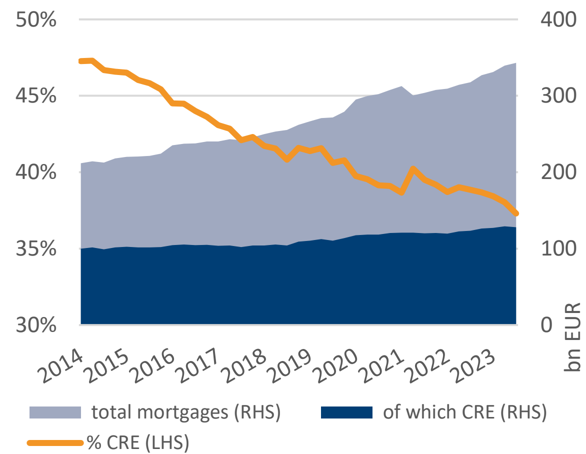
Most of these banks are also issuers of Pfandbriefe, which have been considered a safe haven and remained resilient even during the global financial crisis when other sources of capital drained away.

Have German Pfandbrief banks put at risk this reliable and cheap funding channel? German specialist mortgage lenders and Landesbanken have been active internationally, seeking to diversify their asset portfolios around the globe in particular, where margins appeared attractive against the supposed quality and location of the property.

Have German banks put Pfandbriefe at risk?

German Pfandbrief banks have always been active in CRE. But the relative contribution of commercial real estate loans to total mortgage exposure in German Pfandbriefe has reduced significantly, according to data from the Association of German Pfandbrief Banks (VDP, Verband Deutscher Pfandbriefbanken). In 2014, close to half of all mortgages were on commercial real estate. The number today is down to 37%. In nominal terms, CRE loans have increased slightly but by no means at the same speed as total mortgage lending in Germany over the same period.

Figure 5: CRE exposure in German Pfandbriefe

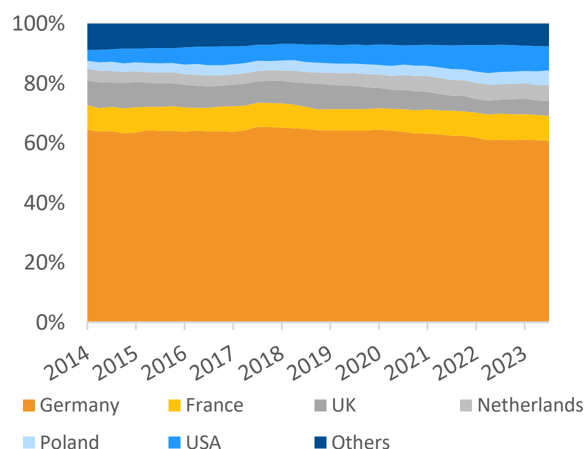


Source: Scope, VDP

Not only has relative CRE exposure shrunk, the mortgage collateral of German Pfandbrief banks has also been stable over the last decade. The banks have not shown significant signs of increased appetite for riskier assets or markets.

Commercial mortgages have a stable share of around 60% of domestic CRE loans. Most other country exposures have also remained stable in the last 10 years with the exception of the US, where exposure had doubled to 8% as of the end of 2023. In fact, the US ranks third today after German and French CRE loans in German covered bonds.

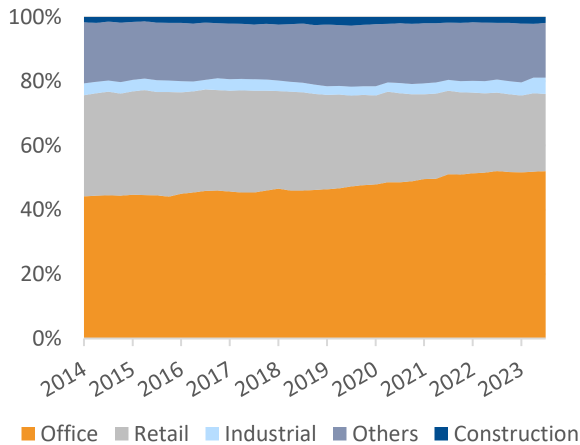
Figure 6: Share of CRE loans split by property location



Source: Scope, VDP

This stability is also reflected in exposure to certain asset types. Together, office and retail properties account for a relatively stable 80%. Over the last 10 years, retail exposure has shrunk, mainly driven by the banks' lower risk appetite for this segment. As opposed to office, retail properties have already had their own watershed moment, fuelled by upcoming "new" trading channels from online penetration.

Figure 7: Share of CRE loans split by property type



Source: Scope, VDP

After the onset of online penetration, the pandemic turned the retail market upside down. But, the aftermath of the pandemic also had some abrupt and longer-term effects on office properties. What we are observing today for office is what shopping centres and retail experienced over the last decade – a correction of values to lower, potentially more sustainable levels. This reflects a long-term shift, maybe reaching a new normal and a challenge to real estate investors and lenders.

Will office exposure be fatal to Pfandriefe?

It is hardly surprising that lease take-up for office properties has suffered. We have raised our concerns with a negative outlook on the real estate sector in general but in particular to the office sector (see Real estate outlook and European CRE/CMBS outlook).

According to Savills, European office take-up in 2023 fell by 17% against pre-pandemic average compared to 2022. For major office locations in Germany, Colliers has stated a drop of between -3% (Frankfurt) to -30% (Berlin), within the same period.

In Manhattan, one of the world's largest office markets, leasing activity in 2023 was more than 20% down compared to 2022. The New York City comptroller has calculated how this may affect medium-term tax revenues by assuming a 40% drop in office values due to a shift from a 5-day office presence to a 3-day office working week.

While this is specific to New York it may become a blueprint for prime office markets globally. Part of this effect is already priced in but it also demonstrates one of the key problems for commercial real estate: volatility in the value of the security for loans.

By design, a CRE loan is typically a medium-term loan product that carries refinancing risk, since term-amortisation is low, if there is any. This makes reliance on property values at a specific date material. But volatility in property values does not just matter at refinancing. It also matters during the term of a loan as financial and default covenants often rely on loan-to-value thresholds. This clearly matters to Pfandbriefe issuers as indicated by higher NPL ratios and increased forbearance (see German banks: systemic crisis unlikely amid persistent concerns about real estate slump).

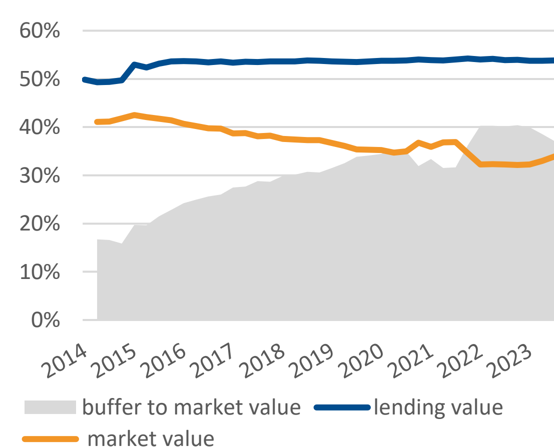
German Pfandbriefe investors are less affected as they benefit from dual recourse where performance only falls on the cover pool if the issuer defaults following a failed resolution. In this case, Pfandbriefe benefit from very strong collateral that will only indirectly be exposed to fluctuations in market value.

This is because

i) the loan amount eligible for covered bond coverage is capped at a 60% loan-to-(lending)-value threshold and
ii) the lending value must be assessed using prudent, through-the-cycle valuation principles. Hence, none of the German covered bond issuers can use market values as references for covered bond coverage eligibility.

There is a material difference, in particular where properties appear to be overvalued. At the end of 2023, the average buffer to market values in German mortgage Pfandbriefe was nearly 40% compared to less than 20% ten years ago. This accurately reflects the trajectory of market-value increases over the period.

Figure 8: Loan-to-lending vs. loan-to-market value



Source: Scope, VDP

Hence, a feature of German Pfandbriefe that has been deemed a competitive disadvantage when prices rose (and covered bond funding was constrained) might become an advantage today as most other European covered bond laws fully rely on market values.

Where such buffers may still be seen as inappropriate, additional enhancement is available to German Pfandbriefe. On average, German Pfandbriefe benefit from 30%-plus over-collateralisation and strong excess spread.

From our perspective, however, credit risk is not necessarily the key risk driver of German covered bonds due to the prudent valuation principles supporting strong value coverage – despite the obvious turmoil. It is often rather maturity and interest rate mismatches that prevail and drive programmes' supporting over-collateralisation.

Regulation on track

Valuation volatility is certainly food for through for regulators. In fact, they have already taken it into account through proposed Art. 229 (1) of the Capital Requirements Regulation (CRR III), which has introduced a "Property Value".

The CRR generally addresses the amount of capital and liquidity that banks and investment firms must hold, while "eligible collateral" can mitigate credit risk. As such, volatility in collateral values will also affect capital, which is certainly not in the interest of regulators.

The "Property Value" refers to "prudent and conservative valuation criteria", excluding expectations of price increases and adjustments to non-sustainable value components over the life of the loan.

While the proposal allows for wide interpretation, it is clear that the market value must not be the reference in the future. At the same time, there is some consensus that German lending values will be fully in line with the criteria described for the newly-introduced property value.

Credit positive, where markets adopt

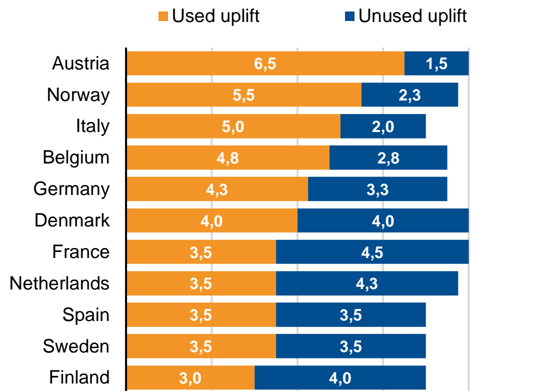
While we appreciate a wider acceptance of sustainable, through-the-cycle valuation methods, CRE lending will likely only become less exposed to credit cycles where loan documentation relies on less cyclical measures. In particular, where (tight) LTV covenants may trigger a loan default due to short-run market turbulence.

At the same time, this may not fully mitigate a turning point driven by technical achievements or social and/or cultural changes impacting a specific asset class. Commercial real estate is an asset class that must adapt to fluctuating market changes and will typically bear higher risks than residential mortgages.

Scope's covered bond universe

All of Scope's covered bonds are rated AAA with a stable outlook (see here). French, Dutch, Danish and Finnish covered bond are the least sensitive to issuer downgrades thanks to the combination of their banks' higher average credit quality as well as the transaction-specific interplay between complexity and transparency.

Figure 9: Downgrade sensitivity Scope rated Covered bonds

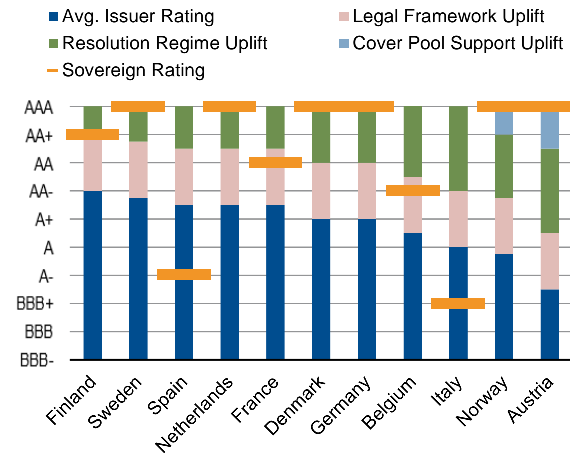


Source: Scope Ratings

Strong bank ratings and very supportive legal and resolution frameworks allow 85% of our rated covered bond programmes to achieve highest ratings without additional cover pool support. The strength of the cover pool does provide additional rating stability, however.

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 over-collateralisation do not materially change.

Figure 10: Covered bond rating composition



Source: Scope Ratings

At the same time, the dual recourse of covered bonds allows the other 15% of covered bond programmes to support the highest ratings on the basis of cover-pool support. Notably, covered bonds in Austria and Norway achieve AAA ratings with the help of this credit support.

The buffer against issuer downgrades is lower for such programmes. For all, except two, strong cover-pool support can mitigate a downgrade of the issuer rating of at least one notch. We also see that the OC currently provided exceeds the OC needed to support AAA ratings by around 23% 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 drop in eligible assets from value depreciation).

Annex I: 2024 Outlooks and Research

Related outlooks

Real estate outlook: negative credit prospects in sector where scale, diversification crucial, February 2024

Covered Bond Outlook: Back to a credit-driven buyer's market, January 2024

European CRE/CMBS outlook: stormy seas to continue, January 2024

European Banking Outlook: sound fundamentals support credit profiles but profitability will decline, January 2024

Sovereign Outlook: Soft landing, turn of the global rate cycle balance fiscal and geopolitical risks, December 2023

Related research

One year on: European banks in good shape, March 2024

German savings and co-operative banks well positioned to face challenges, March 2024

German banks: systemic crisis unlikely amid persistent concerns about real estate slump, March 2024

Systemic risk remains high in European housing market, January 2024

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