Covered Bond Quarterly: Q1 2022

Covered bonds saw record issuance activity amid Russia's invasion of Ukraine. Credit quality has not so far been harmed, but second-round effects will emerge to accelerate previous trends.

Covered Bond Ratings, Scope Ratings GmbH, 29 April 2022

info@scoperatings.com | www.scoperatings.com

| Bloomberg: RESP SCOP

Executive summary

More than EUR 85bn of covered bond issuance year-to-date marks the biggest public benchmark issuance volume for more than a decade. Some funding intially planned as unsecured was likely replaced with covered bonds. With Russia's invasion of Ukraine, covered bonds could again prove themselves as the 'go-to' funding instrument in times of crisis.

So far, the conflict has not harmed covered bond credit quality. European banks entered this latest crisis from a position of strength, while direct exposures to Russia and the Ukraine are not eligble under European covered legislation. Second-round effects, however, will result into lower economic growth and a faster increase in interest rates, ultimately hitting cover pools.

While the house price rally goes on, recent increases in mortgage rates are making home purchases a luxury. Declining affordability among European households will likely halt the rally for the time being.

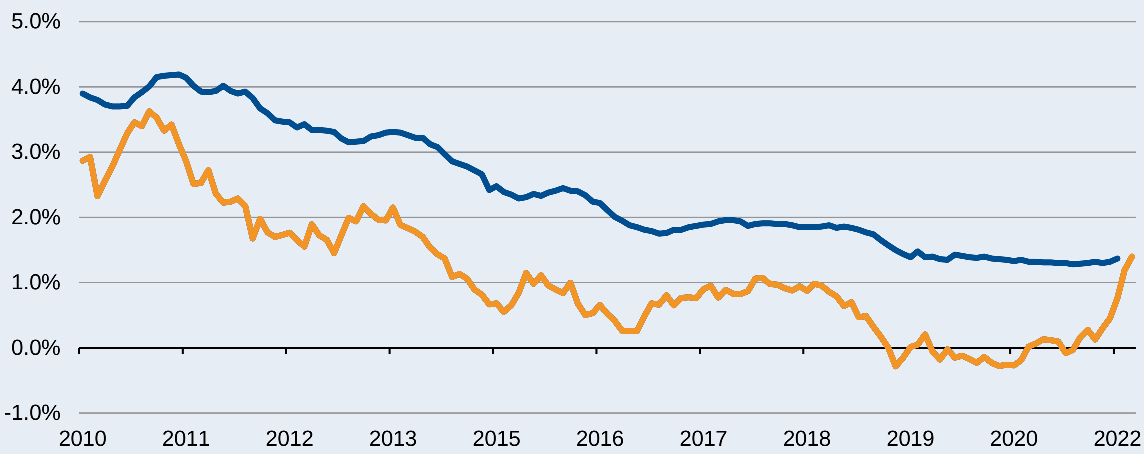
The mix of rising inflation and the impact of the war prompted higher European mortgage rates in March and April, mainly in fixed-rate markets. The rate on a 10-year mortgage in Germany has more than doubled to above 2.5%, a level not seen since 2014.

Ten-year euro swap rates have increased sharply and reached 1.65% on 27 April 2022. With an average lending margin of 1.35% on top of the bank's pricing base for 10-year mortgages, mortgage rates will likely reach over 3% within weeks.

Regulators have identified the risks in the residential mortage market and have increasingly used macroprudential measures to safeguard financial stability. Remaining white spots are now also being filled: Austria, which experienced one of the strongest house prices rallies among European peers, will activate lending restrictions from 1 July 2022.

On the harmonisation front, the 8 July deadline is now within reach. By then, harmonised covered bonds rules need to be transposed into national law. The good news: most legislators have already transposed the new rules, while the remainder are also close to the finish line. The bad news: there is still some way to go. As always, the devil is in the detail. Once regulations start being implemented, questions will arise from issuers and market participants. Secondary legislation and guidelines will then be needed to address those points.

Figure 1: European fixed (+10y) rates* vs EUR10y swap



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Scope Covered Bond Ratings

Karlo Fuchs,
Managing Director
Head of Covered Bonds
k.fuchs@scoperatings.com

Mathias Pleißner
Senior Director
Deputy Head of Covered Bonds
m.pleissner@scoperatings.com

Reber Acar
Associate Director
Covered Bonds
r.acar@scoperatings.com

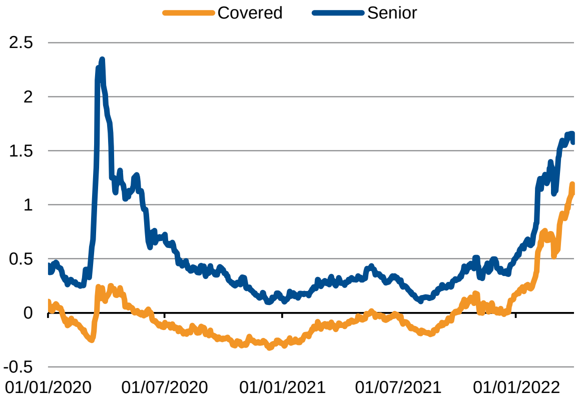
Market Developments in Q1/22

Covered bonds could again prove themselves as the 'go-to' bank funding instrument in times of crisis. Two weeks after the start of the Russian invasion, the covered bond market had already re-opened, with benchmark issues from CFF and Commerbank on 8 March.

In Q1 2022, euro-denominated covered bond issuance amounted to around EUR 70bn. By the end of April, issuance had exceeded EUR 85bn. This is the strongest issuance activity of the last 10 years, reflecting the fact that some funding intially planned as unsecured was replaced with covered bonds – also owing to the unsecured funding market being closed for banks following Russia's invasion of Ukraine.

Yields surge across the board in the first quarter of 2022. Compared to unsecured funding, the yield differential to covereds widened by around 30bp in February – supporting covered bond issuance.

Figure 1: Yield development



Source: Refinitiv, Scope Ratings

In and of itself, Russia's invasion of Ukraine does not alter our general expectation for the market in 2022. Instead, the war is acting as an accelerator for already existing themes: surging inflation, a normalisation of monetary policy and the increasing sovereign debt pile.

As the ECB is slowly but steadily pulling back from the market, positive yields are once again attracting real-money investors. Credit factors, in particular the credit quality of banks and cover assets, will become a more relevant factor in the remaining year.

Credit quality so far not harmed by Russian invasion

So far, the war in Ukraine has not harmed covered bond credit quality. European banks entered this latest crisis from a position of strength. Financial fundamentals are solid, including capital, asset quality and liquidity, while profitability has rebounded from the depths of the Covid-19 crisis.

For banks with local subsidiaries in CEE and Ukraine in particular, the crisis could result in structurally lower profitability. The remainder will be affected by lower growth due to spillover effects. However, under the assumption that there will be no sudden and complete embargo on Russian oil and gas, the impacts will be managable.

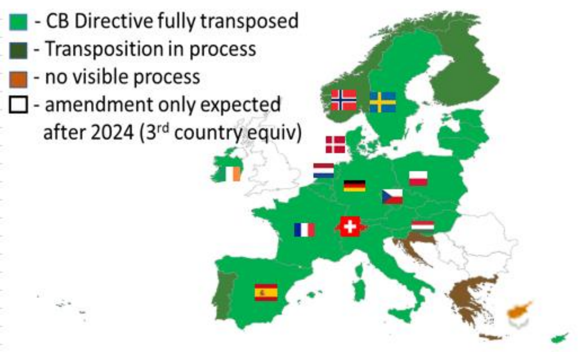
For cover pools, there are no strong signs of a severe credit-quality deterioration. Direct exposures to public entities in Russia and the Ukraine are not eligible under European covered legislations, though there might be a small share of export loans in public-sector cover pools benefiting from guarantees provided by European export credit agencies. However, due to the explicit guarantees, non-performance of these exposures has no impact on cover pools other than a potential timing delay or lower over-collateralisation.

Indirectly, however, war in Ukraine may squeeze mortgage affordability as inflation and higher energy prices drive up living expenses, while higher mortgage rates are eating into free cash flows (see below).

Covered bond harmonisation – still some way to go

About half EU Member States have announced full transposition of the European Covered Bond Directive, as reported by the EU Comission. In 13 Member States, four of which have reported a partial implementation, translation into national law is still in the making.

Figure 2: Covered bond harmonisation



Source: National legislators, Scope Ratings

But the reality looks brigther than that. Most countries listed by the Comission as current "non-achievers" are more advanced than it might appear. Some countries may simply not yet have reported their implementation; others have published draft laws and are in the final stages of their legal consultations. So can legislators pat themselves on the back and enjoy the spring?

Secondary legislation needed to clarify outstanding points

As always, the devil is in the detail and there is still some work to do. Once regulations start being implemented, questions will arise from issuers and market participants. Secondary legislation and guidelines will be needed to address those points.

One example relates to the extendable maturities in Germany and Austria. In both jurisdictions, there is no automatic extension of bonds after an issuer has defaulted, but the alternative manager has the right to extend maturities by up to 12 months if deemed necessary. Austrian law requires that the alternative manager be convinced that the maturity extension will ensure timely payment of the covered bonds. German law only requires “reason to believe”. In both cases, it is unclear on what basis the decision has to be made.

Minimum over-collateralisation is another area that needs to be clarified in some countries. While most countries agreed on the 5% standards, others are still thinking about lower levels: 2% in Norway or even the bare minimum in Italy, which surely will need further clarification.

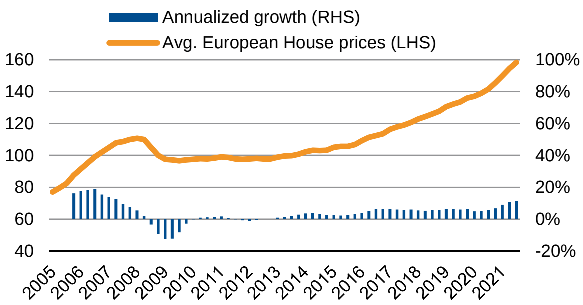
European house prices: mortgages becoming a luxury

The house price rally goes on, but recent rate increases are making mortgages a luxury. This is affecting demand and, by extension, house prices. Declining affordability among European households will likely halt the rally for the time being.

We do not expect a sudden or sharp decline in nominal house prices, however, as inflation in building materials prices will keep them buoyant. But by the same token, it will add pressure on top of a rising interest burden. Demand and real house prices are expected to suffer.

Average quarterly growth in European house prices (including the UK, Norway and Switzerland) stood at 2.5% in the last quarter of 2021. This is slightly down compared to Q2 and Q3, when growth hit the 3% mark. However, despite the slightly lower quarter-on-quarter growth, annual average house-price appreciation hit 11.3%. The last time annual growth in Europe was in double digits was back in 2006 but they found a sudden reversion in the guise of the global financial crisis.

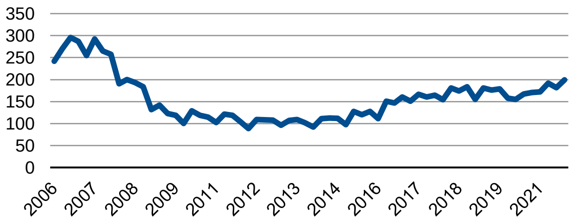
Figure 3: European house prices



Source: Eurostat, Scope Ratings

The situation today is different. We do not expect a slump as seen back in 2008. Under-supply of housing is prevailing in many European countries, particular in metropolitan areas. Over-supply driven by speculation, which contributed most to the severe slump in house prices and wasa most pronounced in Ireland and the European periphery, is not visible today.

Figure 3: European building activity (indexed)



Source: Eurostat, Scope Ratings

As such, it comes as no surprise that banks reported a continued increase in demand for mortgages, according to the ECB lending study from February 2022. Ultra-low interest rates at the time of the survey still made mortgages a giveaway, fostering demand from households and real estate investors. Also, the pandemic continues to fuel the desire to move into more spacious homes, adding to demand to own real estate.

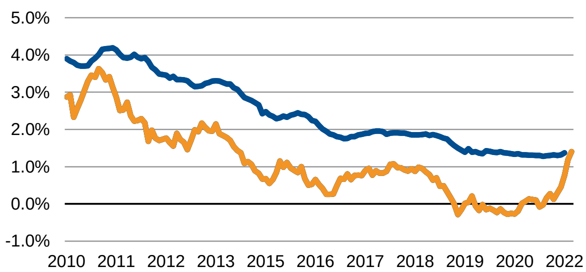
Households today face the highest debt-to-income and leverage seen in the last decade, increasingly stretching affordability. European house prices have grown more than 5% per annum for eight consecutive years, while average wage growth has hobbled along at around 2%. Stretched affordability is increasingly becoming a factor for banks underwriting mortgages, as highly-geared households are failing affordability tests –particularly when including potential rate hikes.

Floating-rate mortgage markets on the inside track – for now

The mix of rising inflation and the impact of the war in Ukraine prompted higher European mortgage rates in March and April this year, mainly in fixed-rate markets. For instance, the rate on a 10-year mortgage in Germany has more than doubled to about 2.5%, a level not seen since 2014. More is to come.

Ten-year euro swap rates have increased sharply and reached 1.65% on 27 April 2022. With an average lending margin of 1.35% on top of the bank’s pricing base for 10-year mortgages, mortgage rates will likely reach 3% within weeks.

Figure 4: European fixed (+10y) rates* vs EUR10y swap



Source: ECB, Bloomberg, Scope Ratings

A EUR350.000 10-year fixed-rate mortgage taken out six months ago and assuming 2% annual amortisation required a monthly payment of around EUR 1,000. If today's 10- year swap is fully reflected in lending rates, this would lead to a 45% increase to EUR 1,450 per month. On top of that, borrowers will also have to pay for the increased cost of living.

Borrowers who have not yet locked into low fixed rates will see their financing packages for home purchases challenged. They will either have to postpone home purchases or, if they are lured by lower floating rates, they will become exposed to rate increases at the next re-fixing.

Banks may be hesitant to directly pass through long-term refinancing rates, as residential mortgages remain attractive and highly competitive at the same time. But earnings pressures keep pushing. According to the ECB lending survey, risk tolerance and cost of funds had a slight net tightening effect on mortgages, and we expect this to have tightened even further in first quarter 2022 data.

For now, short-term floating-rate mortgages, which still account for the majority of European mortgages, look appealing given the ECB's hesitation to raise rates. But this will change in late 2022 or early 2023. Not even the ECB can push back against general inflation hikes.

To recap, a central bank's principal objective is maintaining price stability. According to the ECB, this represents the most important contribution to monetary policy. It is hard to argue in favour of staying hesitant to move on rates with inflation way above 5% – inflation that is not a temporary phenomenon driven by "special" effects from the pandemic or war in Ukraine.

While rising interest rates and general inflation will be a European phenomenon, any correction within European real estate markets may be more country-specific. This is because some markets have experienced an exceptional rally since 2010 while others have remained relatively steady. For instance, house prices in the UK, Germany, Austria (see below) and Sweden have doubled but prices in Spain and Italy have remained stable.

We see stressed interest rates as a necessary part of the underwriting toolkit. A new analysis provided by the Swedish financial supervisory authority recently showed that more than 10% of households receiving a mortgage in 2021 would face financial trouble, assuming mortgage rates of 7%. What seems like an extraordinarily high rate today was the norm in 2008.

Austrian lending limits at the door

Austria's Financial Market Authority (FMA) has proposed legally-binding borrower-based macroprudential measures to take effect on 1 July 2022. The measures adequately address the risks built up in the housing market, while providing enough flexibility to finance growing demand for home ownership.

The regulator is limiting loan-to-value (LTV) at 90%, debt servicing capacity (DSTI) at 40% and loan terms at 35 years, following the recommendation of Financial Market Stability Board (FMSB) earlier this year. Twenty per cent of banks' new mortgage lending will be exempt from the rules.

Through these measures, the regulator is addressing growing concerns about a housing bubble, as house price appreciation has out-performed economic fundamentals for more than a decade. Since the beginning of the pandemic prices and fundamentals have further decoupled, with price increases by around 25%; not only in metropoles like Vienna; in fact, even more so in other urban areas.

Concerns were further underlined by the debt-fuelled nature of the boom and loosening mortgage lending standards. According to authorities, more than half of newly-granted mortgages had an LTV above 90%.

The intervention comes at the right time as the surge in house prices is not abating. Building materials costs are further increasing, demand is continuing as the structural housing shortage persists and potential buyers are rushing in over fears that they will not be able to buy when interest rates rise further.

Despite the concerns on the increasing bubble, we believe that most mortgage markets remain healthy. Ultra-low mortgage rates fixed for longer periods, low household indebtedness largely allocated to more resilient, high-income households, and a functioning rental sector make an abrupt price correction rather unlikely.

In Austria, we view positively the exemption for 20% of new loans, which is needed to bring up the Austrian owner-occupation rate of 55% closer to the EU average of 65%.

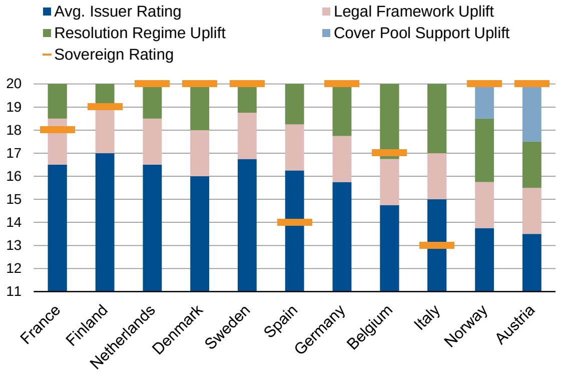
Although not legally binding, the board has further nuanced its definition for sustainable mortgage lending. Banks are now being encouraged to limit the DSTI at 30%, while a DSTI of up to 40% is now only recommended for fixed-rate mortgages where the fixed-rate period covers at least half of the loan term. For a standard mortgage of 30 years, this means a fixed-rate period of at least 15 years.

The share of fixed-rate mortgages in Austria today accounts for around 60% of new lending, significantly higher than the 20% in 2015.

Q1 2022: credit quality of covered bonds remains stable

All of Scope's covered bonds are rated AAA and have a stable outlook (click here for list). Finnish, French and Dutch covered bonds are the least sensitive to issuer downgrades thanks to their banks' on-average higher credit quality.

Figure 10: Covered bond rating composition



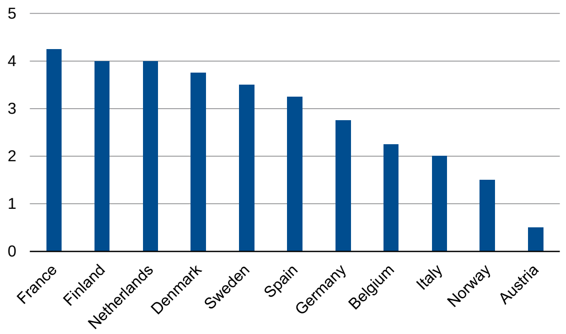
Source: Scope Ratings

This is not unique to covered bonds from those countries. Thanks to sound bank ratings and very supportive legal and resolution frameworks, 85% of the covered bond programmes rated by Scope are not reliant on cover-pool support to reach the highest ratings. Cover-pool support is only a secondary rating driver, and the strength of the cover pool 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 over-collateralisation (OC) do not materially change.

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, we see that covered bonds in Austria and Norway achieve AAA ratings with the help of this rating driver.

Figure 11: Covered bond rating stability (average)



Source: Scope Ratings

Governance: the most relevant ESG pillar for covered bonds

Governance support is the most relevant credit factor for covered bonds, as highlighted in our recently updated Covered Bond Rating Methodology (see here). Besides editorial changes and clarifications, we have renamed the fundamental credit support 'governance support' as this explicitly describes the most relevant factors supporting a covered bond rating above that of its issuer.

Our governance support analysis comprises the legal framework, the resolution regime and the systemic importance of a dedicated covered bond programme. Combined, these factors determine the boundaries within which a covered bond is established. Governance starts with the legal framework setting the conditions under which a covered bond may be issued – nationally but even on a wider level such as the EU Covered Bond Directive.

Governance rules who is accepted to issue covered bonds. It sets the conditions for regulatory treatments for covered bond investments. Governance regulates intervention in case of an issuer default declaring resolution tools widely in favour of covered bonds.

An active domestic stakeholder community (regulators, issuers and investors) proactively monitor market developments, maintaining confidence in the product and encouraging improvements in the relevant regulations.

Those governance factors make regulatory action on the issuer a rather unlikely event, so that a covered bond becomes a going-concern instrument. This results in a significantly reduced likelihood of default, and thus a lower expected loss, translating into up to six additional notches of rating uplift for the covered bonds.

The governance support uplift on top of the issuer rating forms the covered bond's rating floor. For highly rated issuers, governance support can be the primary rating driver, allowing highest ratings without relying on additional cover-pool support.

Likewise covered bonds have social and environmental aspects. They have an essential role in society as it is a relevant pillar within the funding profile of financial institutions to refinance residential mortgages. Green bonds are becoming more and more important for issuers, attracting a wider investor group especially when the ECB departs from being the one and only covered bond investor.

Scope covered bond rating actions and monitoring notes

21 April 2022 – Scope affirms AAA rating on SSB Boligkreditt's Norwegian mortgage-covered bonds, Outlook Stable

On 21 April, Scope affirmed the AAA rating with a Stable Outlook on the Norwegian covered bonds issued by the specialised mortgage bank SSB Boligkreditt AS, the wholly-owned subsidiary of Sandnes Sparebank. The issuer's credit strength combined with fundamental and cover-pool support result in the highest rating. The soft-bullet profile and over-collateralisation reduce risks from maturity mismatches and low-LTV cover assets are resilient to high stresses.

Click here to access the rating affirmation.

08 February 2022 – Scope affirms AAA rating on Verd Boligkreditt's Norwegian mortgage-covered bonds, Outlook Stable

On 8 February, Scope affirmed the AAA rating with a Stable Outlook on the Norwegian covered bonds issued by the specialised mortgage bank Verd Boligkreditt AS, which is jointly owned by 19 independent savings banks. The issuer's credit strength combined with fundamental and cover pool support results in highest rating. The soft-bullet profile and over-collateralisation reduce risks from maturity mismatches and low-LTV cover assets are resilient to high stresses.

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

25 January 2022 – Scope affirms Landkreditt Boligkreditt AS's mortgage-covered bonds at AAA/Stable

On 25 January, Scope. affirmed the AAA rating with a Stable Outlook on the Norwegian covered bonds (obligasjoner med fortrinnsrett) issued by Landkreditt Boligkreditt AS, the wholly-owned mortgage subsidiary of Landkreditt Bank AS (both banks are rated A-/Stable). The A- issuer rating combined with fundamental and cover-pool support results in the highest possible rating. The low-LTV cover assets are resilient to high stresses. The soft-bullet profile and over-collateralisation reduce risks from maturity mismatches.

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

Related bank and covered bond research

Scope publishes update of its Covered Bond Rating Methodology: The methodology update contains only editorial changes and minor modifications.

Click here to access the methodology.

Germany: systemic risk buffer well intended but won't stop problems emerging: Bafin's introduction of a systemic risk buffer highlights risks in the German housing market and was a step in the right direction. However, direct, borrower-based measures are better suited to avoiding risks crystalising when interest rates rise. Click here to access the commentary.

European house prices reaching their climax?: European house prices may have reached their climax during the pandemic. The 10.6% growth in rolling 12-month prices to Q3 2021 may have been the final sprint. The last time prices grew in double digits was in 2017, a year before they collapsed by 15%. Click here to access the commentary.

Conflict in the east raises risks to European bank outlook: War Ukraine has overtaken sentiment around European banks. However, strong financial fundamentals should help the sector weather this crisis. Click here to access the commentary.

Climate risk disclosure requirements not without challenges for European banks: European banks will be kept busy in 2022 meeting stakeholder demands for improved ESG disclosure. Priorities will be shaped by two regulatory initiatives: the ECB climate stress test and expanded Pillar 3 prudential disclosures for ESG risk indicators. Click here to access the commentary.

Phasing out of ECB capital support measures poses no concerns for banks: The phasing out of some of the ECB's supervisory measures introduced to increase banks' ability to support the economy during the pandemic will have no material impact. The banking sector remains well capitalised. Click here to access the commentary.

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
23 Boulevard des Capucines
F-75002 Paris

Phone +33 6 62 89 35 12

Oslo
Karenslyst allé 53
N-0279 Oslo

Phone +47 21 62 31 42

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

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