Covered Bond Outlook 2023

Credit stability despite growing challenges

Covered Bonds, Scope Ratings GmbH, 23 January 2023

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| Bloomberg: RESP SCOP

Executive summary

The European banking sector emerged (more or less) unscathed from the Covid crisis and (so far) from the war in Ukraine. But 2023 will be another year of challenges. Once again, covered bonds will shine as the go-to product in stormy times.

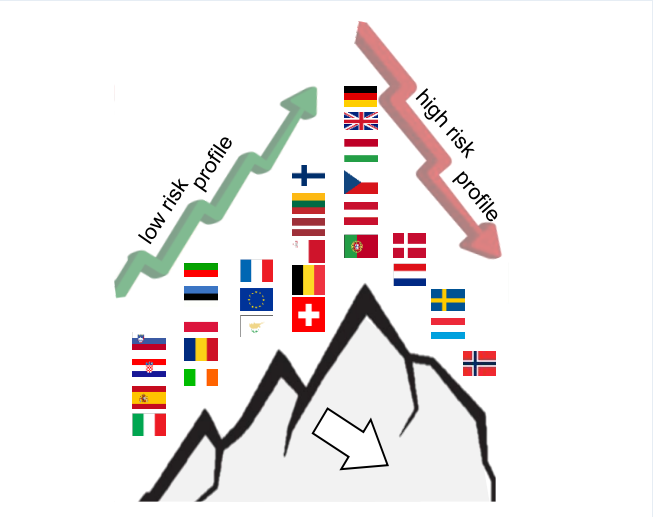
Close to EUR 30bn of benchmark issuance in the first three weeks of January marked the second-highest in a decade, exceeding the volumes for the same period of 2022, which turned out to be a record year. A key factor is the end of TLTRO and the extent to which it was needed (so needs to be replaced with market funding) or whether it was opportunistic. With the ECB phasing out its market activity and yields turning positive, real-money investors will return.

Cover-pool credit quality will remain stable. Even though mortgage borrowers face pressuresfrom higher interest rates and a higher cost of living, the risk of large-scale mortgage defaults is remote under our base case. Banks have the capacity and willingness to allow for payment deferrals or re-mortgaging, which will limit pressure on borrowers. Non-performing loans will remain moderate; issuers have the capacity to replace and maintain very low levels of NPLs in their cover pools.

The trend reversal in European house prices will continue in 2023, squeezed by higher mortgage rates. But we do not expect negative impacts from lower house prices on stressed recovery rates for covered bonds. Our rated universe is well protected against expected and stressed scenarios.

Several countries will see marked setbacks in house prices, although the extent will vary. Norway, Sweden and Luxembourg show the highest structural vulnerability to mortgage risks arising from affordability shocks and value declines. Denmark, the Netherlands and Portugal also show high structural risks. Spain, Italy and Greece look most resilient. Prices in Sweden and Norway also appear elevated comparing average annual house-price growth with long-term GDP growth, as do Austria, Luxembourg and the Czech Republic.

Risks to residential mortgage prices



Source: Eurostat, Scope Ratings

The market is prepared for a downturn. Borrowers are less exposed to rising interest rates as the share of floating-rate mortgages has decreased significantly in the last 10 years. Only 16% of new European mortgages were floating rate in 2022 and borrowers took advantage of ultra-low interest rates to switch into longer reset products. Banks did not dilute their underwriting standards despite much higher volumes of mortgage lending in the low-rate period. To some extent, this reflects macroprudential measures introduced by supervisors.

Regulators have not – for now – tightened their grip on ESG disclosures and standards, so ESG-themed covered bonds remain a small albeit growing niche. A gentle tug from the ECB could make them more mainstream. For issuer discipline around transparency, a similar wish proved to be the necessary catalyst.

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Key trends for 2023

Another year, another crisis. But covered bonds will shine in 2023 in their role as the go-to product in stormy times. The European banking sector emerged (more or less) unscathed from the Covid crisis as well as the ongoing war in Ukraine but 2023 will be another year of challenges.

With close to EUR 30bn of benchmark issuance in the first three weeks of January, 2023 got off to a strong start, exceeding the tally of 2022's (a record year) and marking the second highest month for issuance in a decade. With the ECB phasing out its activity in the market, public issuance will increase and real-money investors will return.

Russia's war in Ukraine has hit the European economy hard but we are far from the collapse some expected. We forecast a sharp slowdown in global growth to 2.6% in 2023 from around 3.3% this year, reflecting high inflation and significant monetary tightening. For the Euro Area economy, we anticipate near-stagnation (0.7%), with Germany contracting 0.2%.

Covered bond investors entered 2023 with reinforced defences for their credit quality.

The first line of defence – the credit quality of issuers – is stable and not expected to significantly deteriorate. Sound prudential capital levels, aided by the positive gearing of revenues to rising interest rates, will allow pre-provision profits to more than offset the likely increase in cost of risk.[1]

The second line of defence has also been ramped up. Implementation of the European Covered Bond Directive prompted necessary updates to some national frameworks. A raised bar means fewer headaches for investors as all European covered bonds now benefit from a robust foundation.

Cover-pool credit quality will remain stable as issuers will be able to mitigate increasing challenges. Mortgage borrowers are facing pressure from both higher interest rates and higher cost of living. Unless we see a surge in unemployment, non-performing loans will remain moderate. Even if we see selective increases, issuers have the capacity to replace and maintain very low levels of such loans in their cover pools.

We expect a trend reversal for European house prices in 2023. Following a decade-long rally where single markets recorded annual price increases in the double-digit area, several countries will see marked setbacks.

In contrast to the GFC, however, the market is better prepared for the downturn. Banks' back books are shielded as price appreciation has lowered average loan to value. Also, less seasoned loans seem less susceptible to decreases or even slumps in HPIs. Borrowers are less exposed to the rising interest-rate environment as the share of floating-rate mortgages in Europe has decreased significantly over the last 10 years, immunising them against sudden affordability shocks in most markets.

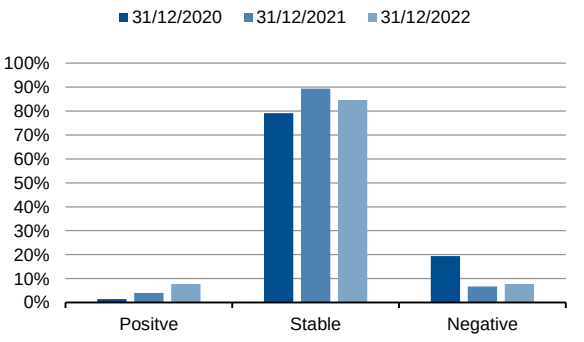
Banks have not significantly diluted their underwriting standards despite much higher volumes of mortgage lending during the low-rate environment.

While that is in banks' own interest, this also reflects an increased number of macroprudential measures promoted by the ECB and introduced by national regulators and supervisors. One lesson from the GFC is avoiding exuberance in residential real estate given its risk to financial stability. Lending and underwriting limits now prevent mortgage-book contagion among all banks.

Banks credit quality - strong ships in turbulent waters

The European banking sector exited the pandemic with little to no damage. Looking at Scope's rating universe – which spans more than 70, mostly European, banking groups – average ratings have remained broadly unchanged in recent years. We expect no major changes to this, with the vast majority of banks entering 2023 with a Stable Outlook, and the remainder equally distributed between Positive and Negative. This underlines the fact that central bank monetary tightening creates opportunities for banks. Asset quality will come under pressure, but banks can once again finally generate sizeable net interest rate margins.

Figure 1: Bank rating Outlooks as of end-2022



Source: Scope Ratings

The pandemic also highlighted a new role of the banking sector within the European economy. While banks can no longer be expected to be bailed out in case of idiosyncratic problems, they will still benefit from material support in case of systemic crises. In fact, given the key role they play in the transmission of economic policy, their health and well-being is often a consideration for politicians and central banks in the design of policy intervention.

Government support comes at a cost, however. As long as it does not jeopardise stability, banks are now

[1] See here for more details on our banking outlook

expected to act more in solidarity with their customers. We see initiatives like this in Poland, where banks have been forced to bear the cost of legal credit holidays for struggling mortgage borrowers, and in Spain, which implemented a relief scheme for vulnerable mortgage borrowers experiencing large increases in the cost of mortgage servicing.

We believe this step is credit positive, at least in the near term. At the same time, it is a trend that needs to be carefully monitored as to the ability of policymakers to strike the right balance and avoid making the sector un-investable.

Revenues will increase thanks to higher interest rates…

Our expectation is that banks' revenue growth will be in the high single-digit range in 2023, supported by continuing rate hikes and balance-sheet repricing. But growth will fade in 2024.

Net interest income, the principal source of bank revenues, will expand by double digits in 2023, driving the top line and more than compensating for the more difficult outlook for asset management fees and trading income.

Volumes will be less dynamic, reflecting the fading effect of the post-Covid economic rebound, lower affordability at higher rates, less support from public guarantees as well as a more cautious approach by banks and their customers. Structurally, we see limited upside for growth in leverage in Western Europe, while Central and Eastern Europe may still offer banks growth opportunities in the medium term.

… while asset quality will deteriorate and provisions will increase

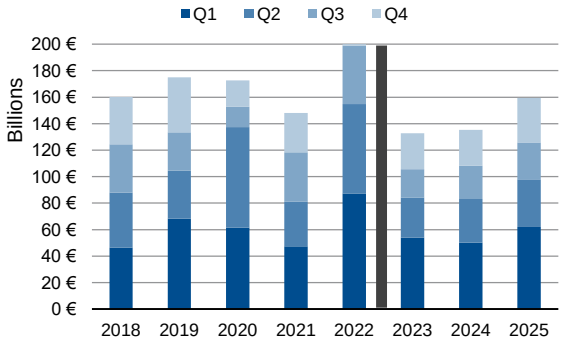
We believe that the stagflationary environment (weak growth, tightening monetary policy and high energy prices) will moderately drive up default rates. Governments may support asset quality as they did during the Covid pandemic but the monetary stance will make a difference. NPLs will increase from a median ratio of 2% to 2.5% by December 2024.

More challenging issuance conditions ahead

With close to EUR 30bn of benchmark issuance in the first three weeks of January, 2023 got off to a strong start, exceeding 2022's tally and marking the second highest month for issuance in a decade. With the ECB phasing out its activity in the market, public issuance will increase and real-money investors will return.

Last year's record issuance of EUR 200bn, supported by geopolitical instability and the ECB's interventions (TLTRO; siphoning off the market with its CBPP and the ultra-low interest-rate environment) will hopefully not repeat any time soon.

Figure 2: Covered bond issuance and redemptions (benchmarks)



Source: Macrobond, Scope Ratings

Compared to 2022, the volume of redemptions is lower in coming years. As most bonds simply refinance those maturing and the outlook for new mortgage origination is weak, this infers lower issuance volumes in 2023. However, the ultimate verdict on new-issuance volumes will come from the ECB: the end of its supportive TLTROs and the extent to which this funding was needed (so needs to be replaced with market-based funding) or whether it was taken out opportunistically.

Only EUR 1.3trn of the originally EUR 2.3trn of TLTRO III drawdowns still remain with the ECB. While the exact amount of own-use or retained covered bonds used for the TLTRO is unclear, it was significant (see our comment in the 2022 Covered Bond Outlook on the lack of transparency regarding retained covered bonds and the impact of wind-downs).

On the positive side, when retained covered bonds are cancelled out they will free up collateral that can be used for covered bonds issued publicly. Similarly, many retained covered bonds were issued in significant size, cancelling them will reduce imbalances in the cash flow profiles of covered bond programmes.

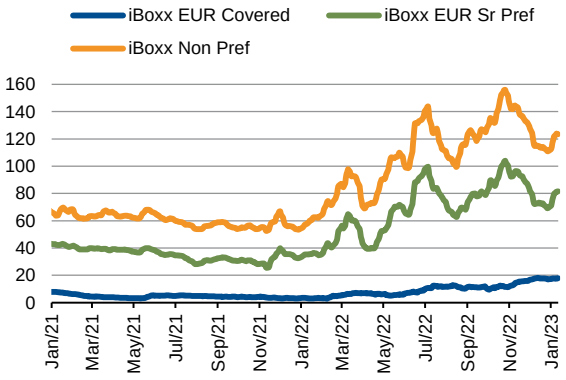
But going back to the public markets will create a wake-up call for some issuers. During the active phase of the ECB's CBPP, covered bond execution was a no brainer. With take-up rates of close to 40%, the ECB ensured slam-dunk issuance.

In today's new normal, issuers have to be more cautious. We have already observed that placements have become more difficult and issuers need to offer investors higher spread premiums, especially, in the first two weeks of January, at longer tenors. The end of the active phase of the CBPP and some pre-funding in late 2022 already indicated more choppy waters and wider spreads.

This is in contrast to 2021 and until the end of H1 2022 when covered bond spreads flatlined. Even when spreads on senior preferreds and bail-inable senior non preferreds started to increase, the save-haven status kept covered bond spreads stable. The increase from the H1 median of about 6bp towards 18bp is nothing

against the volatility seen for senior preferred on non-preferred instruments.

Figure 3: Spread developments in bank funding



Source: Macrobond, , Scope Ratings

More notably, the average spread curve will no longer be the fixing point for all issuers. In recent years and thanks to the ECB hoover, spread differences between countries and individual issuers was limited. The altered macroeconomic environment will not uniformly impact countries and issuers. We expect greater credit and spread differentiation to creep in. Investors will have to re-establish their (hopefully not forgotten) credit skills.

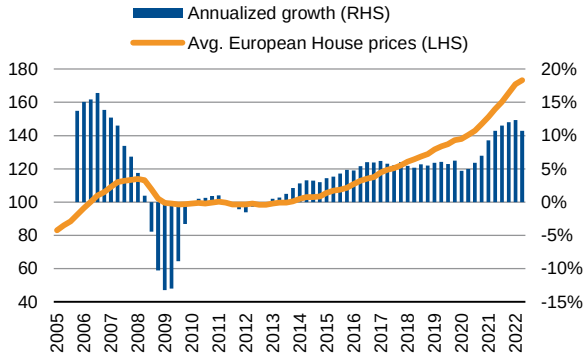
Normalisation also will mean that we will finally see activity from real-money investors and not just banks or asset managers managing banks LCR portfolios. Yields and coupons are back in positive territory. The average coupon this year is around 3% compared to almost zero and they have once again become attractive for classic long-term investors: insurance companies.

What is missing to complete the normalisation process and from a ratings perspective are covered bond tenors that better match long-term mortgages. From a peak of about 10 years at the end of 2020, the average maturity of new issuance had halved by the end of 2022. With the current, flat yield curve at the longer end, investors cannot really be attracted to longer-dated funding as the commensurate reward is missing.

Structural mortgage risks expose households to value corrections

Annualised European average house-price growth in the last four quarters remains in double digits. But the trend is reverting. Some countries, mainly the Nordics, experienced q-on-q declines in the third quarter and the trend strengthened in the last quarter of 2022.

Figure 4: Average European house price growth

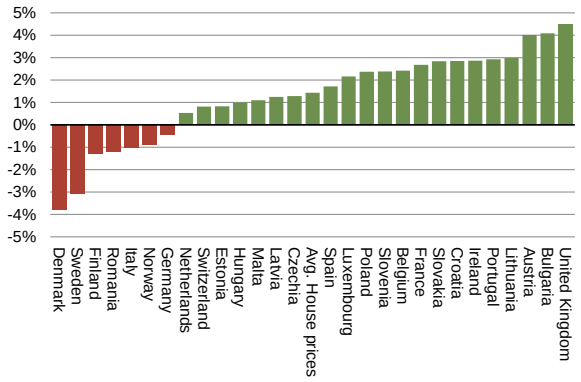


Source: Eurostat, Scope Ratings

The main culprit is clear: "housing market dynamics are very sensitive to mortgage rates", according to a study in the ECB's Economic Bulletin of September 2022. The study found that a one percentage point increase in mortgage rates leads to a decline of around 5% in house prices (after two years) and a drop in housing investment of 8%. This historical trend is even stronger in a low interest-rate environment. This means we can expect a 9% drop in average values within two years because that's where we are: mortgage rates are coming from historical lows and, according to the ECB, they increased more strongly than ever recorded in the first half of 2022.

The actual effect of mortgage rates on house prices throughout Europe is mixed, however. While Swedish State-owned mortgage lender SBAB Bank reported a market-wide transaction-based decline of 17% between the market peak of early 2022 and January 2023, prices in Spain grew by about 7.1% in 2022 according to a report by Sociedad de Tasación, the property valuation firm.

Figure 5: European Q3 2022 quarterly house price change



Source: Eurostat, Scope Ratings

This is because housing is also affected by structural elements within a local mortgage market, not just mortgage rates. Some markets are more vulnerable to rising rates. Key drivers are above-average household debt, share of floating interest rates and whether house-price growth has been sustainable or not.

Nordic households principally exposed to value corrections

Combining these drivers, Norway, Sweden and Luxembourg show the highest structural vulnerability to mortgage risks arising from affordability shocks and value declines. To some extent, this risk has already materialised. Denmark, the Netherlands and Portugal also show higher structural risks compared to other European countries.

The housing sector in Eastern Europe is showing moderate structural risks. This is mainly driven by moderate household indebtedness despite some unsustainable growth. By contrast, the Euro Area periphery (Spain, Italy and Greece), which have only slowly recovered from the very high value corrections during the GFC, seem most resilient.

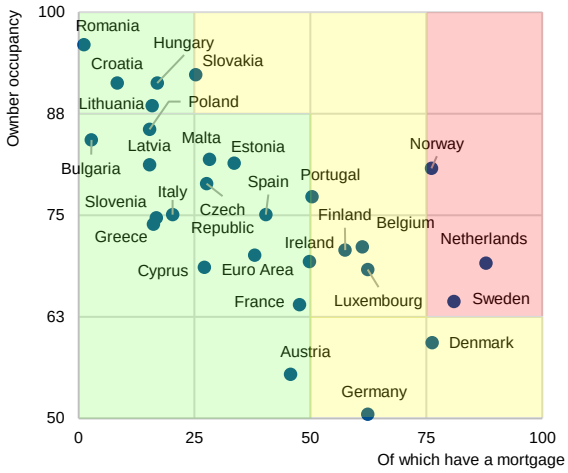
Figure 6: Risks to residential mortgage prices?

Source: Eurostat, Scope Ratings

Pressure highest for homeowners with mortgages

Europe's mortgage market is very diverse. Most households in Eastern and Southern Europe own property but without a mortgage attached. This contrasts with Northern European countries such as Norway, Netherlands Sweden and Denmark, where more than 75% of owner occupiers have encumbered property.

Figure 7: Risk plot, Owner occupancy vs mortgage



Source: Eurostat, Scope Ratings

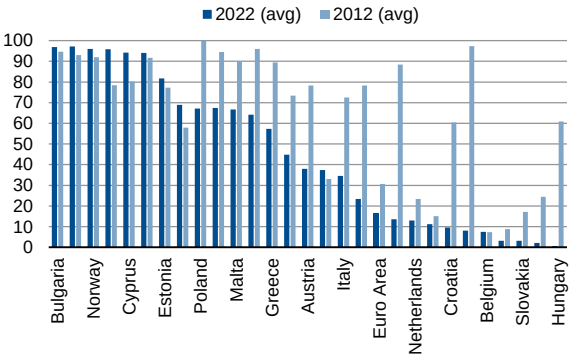
As a consequence, households in these countries also have the highest indebtedness in Europe. But even here, the picture is mixed. While Danish and Dutch households where able to reduce their debt-to-income profile in the last decade in line with the European average, Norwegians became even more leveraged.

Stretched affordability will crystallise at interest resets…

Looking into origination of new European housing loans, only 16% were in the form of floating-rate loans in 2022. The remainder have reset periods of one year or above – in most cases fixings are every five to 15 years. That means rate increases to levels seen last in 2013 will only hit a minority immediately. This is reassuring, taking into account that core inflation is poling extra pressure on European households.

In that respect, it is good to see that most European mortgage borrowers took advantage of the ultra-low interest-rate environment to switch into a longer reset products, as evidenced by the fact that the aggregate percentage of floating-rate mortgages has halved in the last 10 years.

Figure 8: Floating rate new mortgage loans



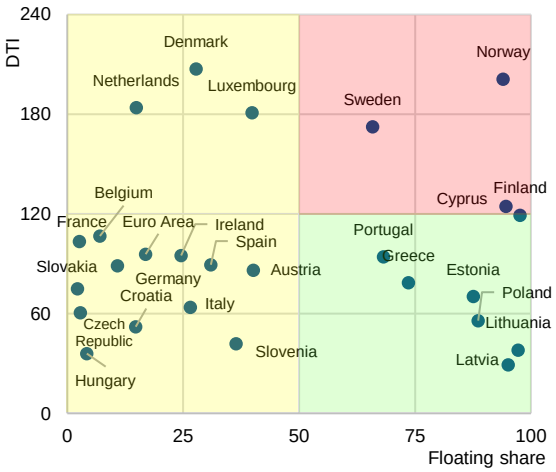
Source: ECB DW, Scope Ratings

But speaking to the diversity of housing finance in Europe, the share of floating-rate loans even increased

in some countries in the last decade. This chiefly concerns the Nordics, which continue to be floating-rate mortgage markets. Fixed-rate loans remain a niche product.

Consequently, among the four countries most exposed to a combination of high indebtedness and floating interest rates, three are Nordic. Denmark is not part of this group: the country has historically had the highest household indebtedness but otherwise benefits from a comparatively low share of floating-rate loans.

Figure 9: Risk plot, DTI vs. floating rates

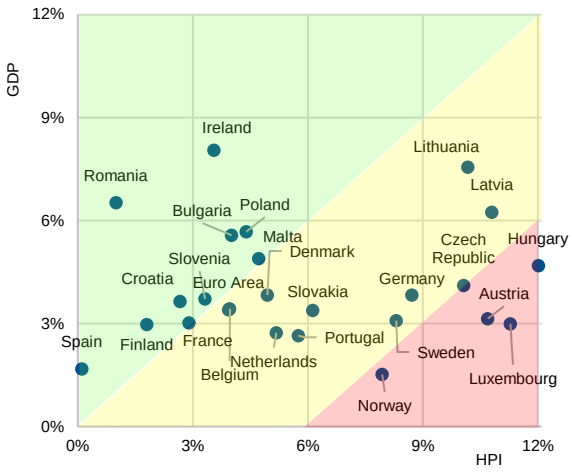


Source: Eurostat, SSB, ECB DW, Scope Ratings

Unsustainable growth will prompt house price declines …

Vulnerability to significant corrections in house prices has to be seen in context of each country's relative long-term economic growth. Comparing average annual house-price growth since 2010 against long-term GDP growth, Swedish and Norwegian markets appear elevated. The same can be observed in Austria, Luxembourg and the Czech Republic. Annual house prices often increased in double digits compared to a very moderate average nominal GDP growth. Growth in Denmark and even more so Finland is relatively sustainable – mitigating risks arising from high indebtedness and/or floating-rate loans.

Figure 10: Risk plot, annual GDP vs HPI growth



Source: Eurostat, OECD, Scope Ratings

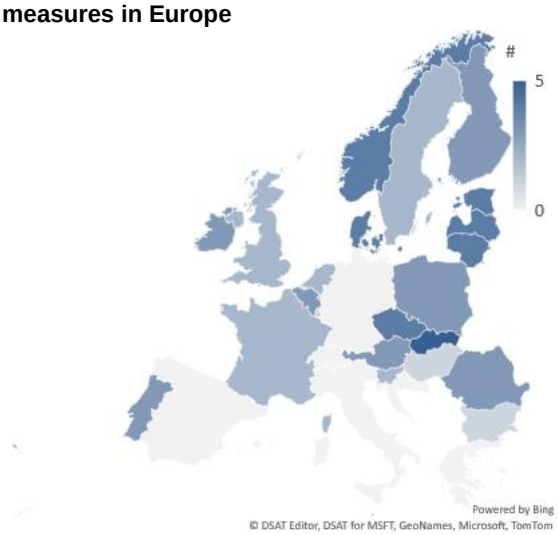
UK and Switzerland rank moderate

While some data constraints limit this analysis to the EU, the same analysis can be done for the UK and Switzerland. Both show moderate exposure to strong value depreciation. Switzerland ranks top 3 on household indebtedness even though it has a very low owner occupancy of only 42%. At the same time, most mortgages are fixed rate so do not expose households to immediate affordability shocks. Finally, long-term house-price increases were moderate at around 3% and well in line with GDP growth.

UK's household debt is moderate. Also, roughly three quarters of UK mortgages are fixed rate and almost all new mortgages taken out since 2019 have been fixed-rate, albeit with mainly two or five-year fixes. However, the long-term increase in house prices was around 6%, more than double GDP growth over the same period.

Macroprudential measures: time for a test

Figure 11: Borrower-based macroprudential measures in Europe



Source: ESRB, Scope Ratings

Despite the challenges European housing markets and mortgage borrowers face in 2023, there is good news: the market is prepared. Exuberance in European residential real estate has been a key theme for national regulators, macroprudential authorities and for the supervisory side of the ECB in recent years.

Regulators face a dilemma, however. Some banks are already calling for looser regulation that will allow them better manoeuvre around the downtrend in their mortgage business. Such policies would be detrimental to the central bank's monetary tightening. Norway, for example, just removed its 60% LTV limit for mortgages in Oslo, but at the same time has proposed to reduce maximum indebtedness to x4.5 from x5.

Figure 7 shows that measures are not evenly distributed across Europe. Also, not all countries we believe will be susceptible to corrections have implemented the same measures. A common thread is they only impact new origination and it will take time to insulate the back book.

European mortgage markets can be divided into three groups.

The Nordics and CEE countries have been very active in limiting the origination of risky mortgages given strong house-price appreciation and the typically floating-rate nature of mortgages.

The Slovakian regulator has been the most diligent, using the full slate of borrower-based macroprudential measures: limits on maximum loan to value (LTV), debt-service-to-income as well as debt-to-income thresholds, limiting loan terms while also stress-testing interest-rate sensitivities.

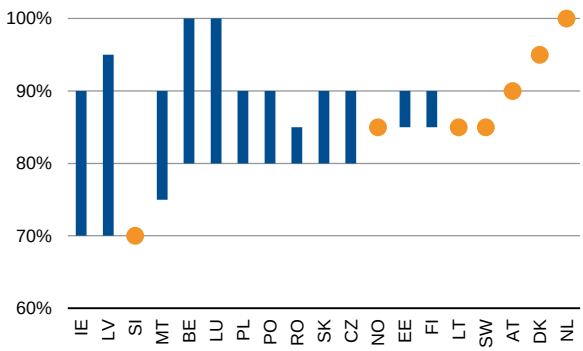
Western European regulators have been less active and late. Most prominently, the German authority chose not to opt for targeted borrower-based measures but for general bank focused ones instead.

Spain, Italy and Greece have been rather passive, as their housing markets are still recovering from the previous crisis, making another severe downturn rather unlikely.

LTV limits are the most common measure in Europe, being activated in around 70% of countries (see Figure 8). LTV limits typically range between 80% and 90%. LTVs above 90% are usually reserved for young, first-time buyers to avoid squeezing them out of the market.

Danish and Dutch measures are weak. Regulators likely feared that they would too strongly curtail new lending in those markets, that show elevated LTVs as well as high household indebtedness.

Figure 12: Macroprudential LTV limits in Europe



Source: ESRB, Scope Ratings

More than half of European regulators limit the maximum debt-service-to-income ratio at origination and half of those specify mandatory interest-rate stresses when assessing a borrower's debt-service capacity.

There are differences in magnitude. Mandatory stresses in Norway, Finland and Lithuania are still sizeable, with assumed mortgage rates between 5% and 7%. Mortgage borrowers in these countries have been well prepared for the recent hike in interest rates. As such, payment arrears are unlikely, even if rates continue to increase.

For the remaining countries, testing for a shock rise in mortgage rates by 150- 300 bp was too optimistic, in retrospect. In the current situation of higher interest rates and higher cost of living, the capacity of borrowers to service their debt declined rapidly. Luckily, inflation rates have started going down and further, major interest-rate increases are not expected – but the air is getting thin.

Cover pool credit performance expected to deteriorate moderately only…

Other factors will also play a relevant role to mitigate stresses to borrower affordability. European governments are able and to some extent willing to buffer negative repercussions from worsening economics as they did during the Covid pandemic, but the monetary stance will make a difference. Public debt will not be spared from the higher interest rates so governments must be more selective in how they support their economies.

We see the risk of large-scale mortgage defaults as remote under our base-case expectation that mortgage rates will start flattening out soon and a deep economic recession will be avoided. Still, vulnerable mortgage borrowers will feel the pinch from higher interest rates, higher energy costs, and general cost inflation. Because banks have the capacity and willingness to allow for payment deferrals or re-mortgaging, pressure on mortgage borrowers can be limited.

However, the downside risk remains elevated. Even if mortgage defaults can be avoided in the near term,

increased interest payments and higher cost of living will negatively affect the overall economy and ultimately the creditworthiness of mortgage borrowers too.

Covered bond credit quality could be impacted by second-order effects

The abrupt turnaround in the European residential real estate markets will not be without consequences for issuers and investors.

Competition for new mortgages among covered bond issuers will become more intense in 2023 as demand for new real estate loans will significantly cool down.

The number of housing transactions is already trending down. According to Eurostat, the number of housing transactions fell in nine out of the 14 Member States covered in the second quarter of 2022 (yoy).

Aggregate new mortgage lending volumes on a European basis do not yet exhibit such trends. But this will surely come. The Bundesbank has already reported that new private mortgage lending more than halved in October 2022 compared to peak volumes in March 2022 when rates were still low.

We do not expect cover pools to become impacted and shrink any time soon. Most of the stock will be re-mortgaged and most banks still have sizeable eligible assets not registered in the cover pools.

Average LTVs will increase upon HPI depreciation

Unlike in the past, investors will now become aware of the impact of HPI changes early on as there is a mandatory revaluation requirement according to the Covered Bond Directive (CBD).

A price deterioration of 20% or more will limit the share of eligible assets but in case a loan becomes ineligible in full, this does not typically require a de-registration as generally only the excess portion can no longer be accounted for.

This is due to LTV limits, which stand at 80% for countries that have adopted the CBD.

Depending on the LTV distribution of cover pools, a 20% HPI reduction may either call for additional unencumbered eligible assets to be registered (if available) or the addition of substitute assets. If not, investors will see reductions in over-collateralisation.

In any case, observed and expected price corrections will test covered bond issuers in managing their programme in line with the rules set out according to legislation as well as market expectations.

Stressed recovery assumptions immune against value depreciation…

We do not expect negative impacts from a fall in house prices on stressed recovery rates for covered bonds. Scope's stressed recoveries are calculated by applying Market Value Decline assumptions on property values. These are a function of sustainable long-term growth and current valuations.

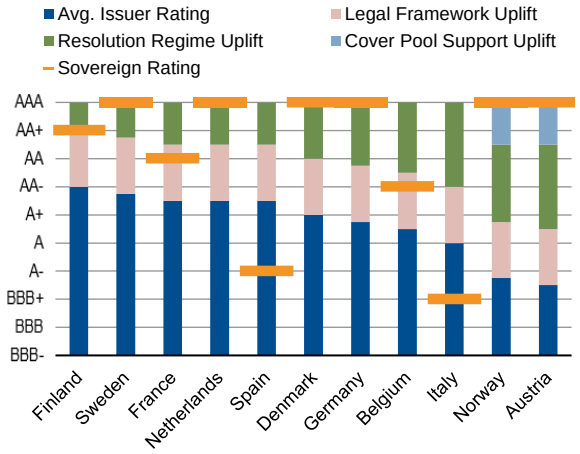
As a consequence, Scope's value decline assumptions increase when prices grow above our sustainable long-term growth assumptions but also decline when values drop. This offsets most of the market-driven volatility and makes our recovery rates fairly immune to house-price shocks occurring through the cycle.

As a result, our rated universe is well protected against expected and stressed scenarios.

Scope's covered bond universe

All of Scope's covered bonds are rated AAA with a stable outlook (see here). Finnish, French and Dutch 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 13: Covered bond rating composition



Source: Scope Ratings

Thanks to bank ratings that are still strong and very supportive legal and resolution frameworks, 78% of the covered bond programmes rated by Scope do not rely on cover-pool support to reach the highest ratings. For those, the strength of the cover pool can provide additional rating stability.

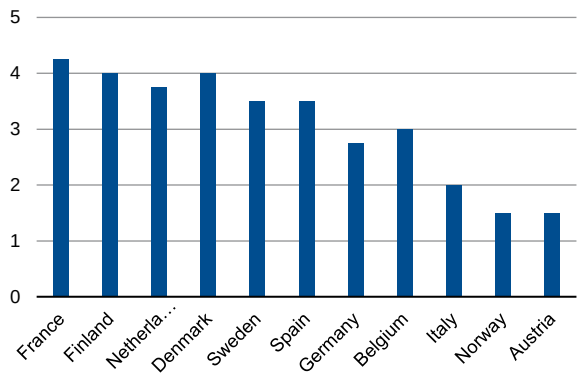
On average, covered bond programmes rated by Scope can withstand issuer downgrades of up to three notches, on condition that the programmes' risk characteristics and protection provided through over-collateralisation (OC) do not materially change.

At the same time, the dual recourse of covered bonds allows the other 22% 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 currently provided OC exceeds the OC needed to support the AAA ratings by around 27% 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).

Figure 14: Covered bond rating stability



Source: Scope Ratings

Appendix I: ESG – what's new

Green funding not yet mainstream, reporting needs more consistency

ESG covered bonds have continued to increase; EUR 18bn of issuance in 2022 marks another record year. In a year with EUR 200bn in total issuance, though, this record amounts to a mere 9% thus the ESG segment remains a niche. Momentum towards ESG covered bonds appears even to have slowed. After 13 inaugural ESG-themed issuers in 2021, only nine issuers tapped the market in 2022. Unlike the traditional market, issuers are not active each year and formats as well frameworks have not yet been standardised. As activity in 2022 was thwarted by the Russian war in Ukraine, inflation, rising interest rates and a recession on the horizon, we hope that issuers will be able to refocus on ESG in 2023.

We acknowledge the progress made on the EU taxonomy and the European Green Bond Standards as well as on the Green Bond Principles; the latter updated in June 2022 introducing a distinction between Standard Green Use of Proceeds Bonds (unsecured debt obligations) and Secured Green Bonds (see Secured Green Bonds incentivise covered bond issuers to increase market risk),.

At the same time green covered bond activity will only experience a real boost if regulators or the central bank do even more acknowledge green or social criteria in their frameworks.

Since 2022, the ECB has focused more actively on the carbon footprint for its direct and indirect investments. Based on its published framework to establish a climate score, the Bank will actively reposition its APP holdings, in particular corporate bond portfolios, towards greener issuers. Further, the ECB will limit the share of assets issued by entities with a high carbon footprint that can be pledged as collateral and is considering the introduction of climate-related risks when determining haircuts for corporate bonds.

For both ABS and covered bonds, a corresponding framework to identify green issuers is still lacking - mainly because of the lack of sufficient and consistent data. We expect this to change soon. The ECB has in the past shown in the covered bond space that it is unwilling to wait for issuers to come forward by themselves. Only after the introduction of the ECB's mandatory quarterly cover pool reporting – which put issuers at risk of losing their repo eligibility – did issuers become more diligent and timely in their cover-pool risk reporting.

As before, the covered bond industry organisation, the European Covered Bond Council (ECBC) has provided a blueprint by amending the Harmonised Transparency Template (HTT) seeking additional ESG information. We expect the ECB to build on this emerging industry standard as it provides the main characteristics it is looking for in its assessments: high quality of disclosures and focus on emissions. Hopefully, this time the ECB will put the onus not on the credit rating agencies , which ultimately only re-report what they receive from the issuers –but on the banks themselves.

Similarly the EBA has started testing the waters and is recommending in its supervisory assessment that banks provide more comprehensive coverage of ESG risks when it comes to capital and liquidity risk assessments. Still, this is in early stages and they need to develop methodologies and get access to reliable data to ensure a consistent application.

Reliable data remains a key problem and we do not see this being solved in the blink of the eye. And it is not only about the relationship between ESG and credit risk. When it comes to the main asset type for covered bonds, residential mortgages, their ESG criteria needs to be harmonised so that EU-wide measures or criteria are applied. Energy Performance Certificates (EPCs), even if available, do not qualify as they differ within the EU. Other initiatives such as the energy efficiency mortgage label, trying to maximise regulatory alignment with the main legal and policy developments at international level with additional standardised disclosure (via HTT) are welcome.

Without additional harmonised and potentially forced transparency, the ability to consistently include ESG factors in credit analysis remains limited.

Annex I: Related research

House price commentaries

"Germany falls into line on raising macroprudential buffers", published 12 Jan 2022 available here.

"European house prices reaching their climax?", published 20 Jan 2022 available here

"Germany: systemic risk buffer well intended but won't stop problems emerging", published 16 Feb 2022 available here

"European house prices: stretched affordability makes mortgages a luxury, dampens demand", published 12 Apr 2022 available here

"Austrian lending limits will not ensure financial stability if interest rate-risk is excluded", published 13 May 2022 available here

"German housing bubble unlikely to burst; prices could swing either way depending on banks, economy", published 15 Jun 2022 available here

"European house prices: rising divergence in growth across Europe", published 3 Aug 2022 available here

"Swedish residential property correcting but mortgage market to remain resilient", published 24 Aug 2022 available here

"Norway's residential housing boom is over: prices starting to fall", published 4 Nov 2022 available here

ESG in covered bonds and banks

"Secured Green Bonds incentivise covered bond issuers to increase market risk", published 20 Sep 2022 available here

"Climate risk disclosure requirements not without challenges for European banks", published 17 Feb 2022 available here

Framework reports

"Legal framework analysis: Spain (Spanish Covered Bonds)", published 1 Nov 2022, available here

"Legal framework analysis: Norway (Obligasjoner med fortrinnsrett/OMF)", published 1 Sep 2022, available here

"Governance support in Austria's new covered bond framework allows for six-notch uplift", published 13 June 2022, available here

Scopes Covered Bond Quarterlies

"Q3 2022 Covered Bond Quarterly: strong issuance volumes as cracks appear in house-price rally", published 25 Aug 2022, available here

"Q2 2022 Covered Bond Quarterly: record issuance amid Russia's invasion of Ukraine", published 2 May 2022, available here

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