Covered Bond Quarterly: August 2022

2022 might turn into the year not just of covered bond harmonisation but of record issuance volumes too. Swedish house prices see biggest slump since GFC as price growth across Europe becomes uneven.

Covered Bond Ratings, Scope Ratings GmbH, 25 August 2022

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Executive summary

Covered bond issuance is well above expectations and in some cases has already exceeded forecasts for the full year. The summer lull has already ended: more than EUR 135bn in public placed benchmark issuance year-to-date is above the full-year issuance of the pandemic years and around the levels seen in 2018-19.

Economic headwinds are increasing but stable credit quality for issuing banks and their cover pools persists. Issuers have solid capitalisation and low provisioning levels. High issuance in the earlier part of the year reflected covered bonds' safe-haven status at the onset of war in Ukraine. Ease of placement while the ECB was still in purchase mode via its Covered Bond Purchase Programme also contributed. The shift to positive yields lured back real money investors, particularly at the long end. All of these factors have supported volumes and will make 2022 the year of highest public covered bond issuance for a very long time.

The European Covered Bond Directive (CBD) is no longer a fantasy but a reality. Updated legislation for all active issuance countries was passed (just) in time before the 8 July 2022 deadline. However, issuers now realise that many of the subtle details that will be found in secondary legislation – some of which is needed for issuance programme updates – are still missing. Issuers that cautiously frontloaded to gain time for these amendments will be able to sit back and wait. Others will need to wait for their regulators to be forthcoming and will in the meantime need to explore the limits of grandfathering while tapping existing bonds or even recycling retained bonds – provided significant changes to the terms and conditions do not void the grandfathering.

Economic headwinds, rising interest rates and wider spreads mean that in coming years, covered bonds will slowly but surely move away from being seen as a rates product towards a more differentiated credit product. Investors who are only accustomed to low spread differentials will need to brush up their knowledge and do some homework. In particular they will need to understand the CBD's finer details and implications i.e. whether they are buying into grandfathered old or new premium covered bonds, whether all boxes to meet preferential risk weightings have been ticked, and which LCR classification the bond will be given.

Cover pool complexity might also increase. Sovereign or sub-sovereign support packages to mitigate second-round effects such as higher inflation, rising energy bills as well as well as infrastructure could lead to a revival of public sector covered bond issuance.

This will eventually lead not only to plain-vanilla public-sector financing but increased PPPs or Export Credit Agency (ECA) backed financing. Ultimately this could help to restart discussions about SME or infrastructure as collateral for European Secured Notes – which the CBD has already pencilled in for 2024.

Headwinds for sure will also leave their mark on building activity as well as house prices. Sweden's house price index has reacted most strongly so far. From its high of 304 in March 2022, the HOX index dropped to 277 in July while the almost 4% month-on-month decline from May to June was the largest since October 2008. Nothing similar is yet visible in other markets, though. It simply might be that HPI indices are not as up to date as most are still posting further increases. The first cracks in the rally have become visible, though, as growth becomes uneven.

However, whether the changing trajectory becomes relevant for covered bond investors will mostly hinge on other factors: the extent to which unemployment creeps in and directly leads to defaults, and inflation significantly reduces affordability such that borrowers will need to enter loan restructurings. Both factors will prompt a reversal of current ultra-low NPL ratios.

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Market developments

Covered bond benchmark issuance has exceeded expectations and in some cases already exceeded forecasts for the full year. The summer lull has ended. More than EUR 135bn in public benchmark issuance year-to-date is well above the full-year issuance of the pandemic years and around the levels seen in 2018-19.

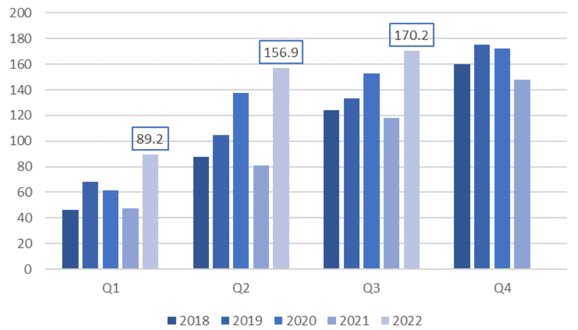
Economic headwinds are increasing but stable credit quality for issuing banks and their cover pools persists. Issuers present solid capitalisation and low provisioning levels.

High issuance in the earlier part of the year reflected covered bonds' safe-haven status at the onset of war in Ukraine.

The ease of placement while the ECB was still in purchase mode via its Covered Bond Purchase Programme also contributed.

Finally positive yields lured real-money investors back, particularly at the long end. All of these factors have supported volumes and will make 2022 the year of highest public covered bond issuance for a very long time.

Figure 1: 2022 Covered bond issuance
(>EUR 500m/fixed rate)



Source: Refinitiv, Scope Ratings

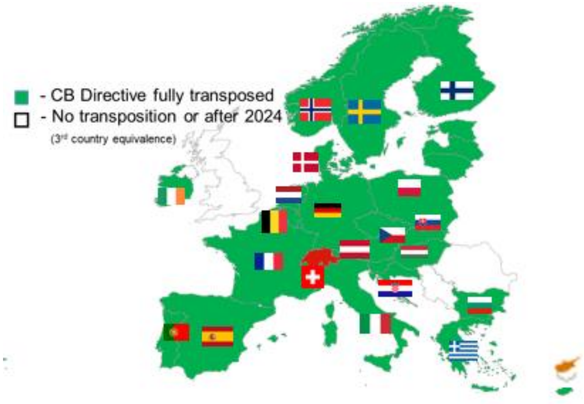
Headwinds, rising interest rates and wider spreads mean that in coming years covered bonds will slowly but surely move away from being seen as a rates product towards a more differentiated credit product. Investors who are only accustomed to low spread differentials will need to brush up their knowledge and do some homework.

In particular they will need to understand the CBD's finer details and implications i.e. whether they are buying into grandfathered old or new premium covered bonds, whether all boxes to meet preferential risk weightings have been ticked, and which LCR classification the bond will be given.

European harmonisation: mission not yet accomplished

On the positive side, all European countries made the 8 July 2022 CBD transposition cut – except for countries that lack active covered bond markets (Lithuania, Malta, Romania).

Figure 2: Covered bond harmonisation status



Source: National legislators, Scope Ratings

Missing secondary legislation might lead to creativity for grandfathering

Only German and Danish issuers were able to continue issuing directly after the deadline, since secondary legislation was available and necessary programme amendments were minor. After the summer break, Norwegian and Dutch issuers also seem to have found ways to overcome these hurdles.

This might not be the case in most other markets where regulators have not enacted secondary legislation and seem to be swamped with their new duties.

Even the easy public display of all covered bond programmes being given a "premium" designation has only been provided by German, Spanish and Dutch regulators.

Most issuers are not in dire need of new funding. However, further rising rates, better management of NSFR ratios and the ability to balance ECB funding with capital market funding are on the agenda of many treasurers. Some have already become creative and reopened and tapped existing grandfathered bonds.

While waiting for regulators to deliver, the holy grail might be recycling retained covered bonds currently used for TLTRO purposes. In the past, issuers converted retained programmes to public ones or changed the maturity of retained issues.

While waiting for regulatory input, lawyers will be exploring the extent to which terms and conditions can be amended without compromising the grandfathering.

We are still waiting to see how some of the finer details will be addressed. In the hands of local regulators, we expect continued diversity across Europe about the way maturity extensions will work and whether provisions for additional over-collateralisation (OC) will be static and part of minimum OC.

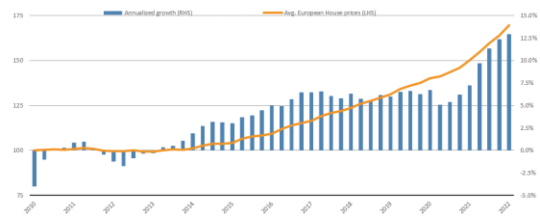
On the positive side, none of those details will have rating implications in the current environment as they can be incorporated into modelling while shortcomings can be remedied with OC: the magic wand of covered bonds.

Additional OC is voluntary. Differences in and willingness of issuers to preserve the highest credit quality will only come onto the radar screen of investors when credit conditions have significantly deteriorated and left their mark on banks' balance sheets and profit and loss accounts. This will take some time and by then, national regulators will eventually have started not only to harmonise primary but secondary legislation too.

European house prices: first cracks and rising divergence

Europe's house price rally broadly remains unscathed by economic and geopolitical events. Average annual growth still showed 12.9% for Q1 2022.

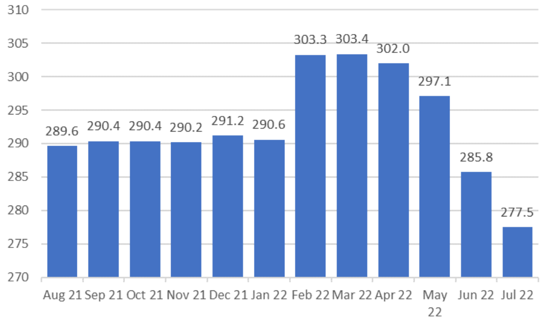
Figure 3: European house prices



Source: Eurostat, Scope Ratings

In Sweden however, the house price index has reacted most strongly. From its high of 304 in March 2022, the HOX index fell to 277 in July. The almost 4% month-on-month decline from May to June marked the largest drop since October 2008.

Figure 4: Swedish House Prices (HOX)



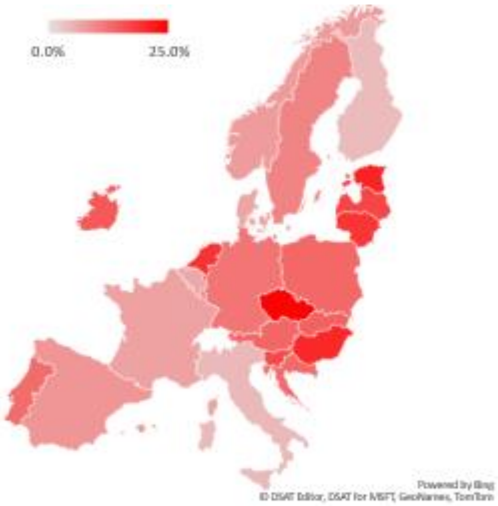
Source: Valuegard, Scope Ratings

Nothing similar is yet visible in other markets, although it simply might be that HPI indices are not as up-to-date as Sweden's. Still, the first cracks in the rally have become visible as growth falters and divergence in growth rates emerges.

In Eastern Europe especially, prices are skyrocketing, with the Czech Republic leading the pack with a massive 24.7%, followed by Hungary and the Baltic countries. Countries like Italy and Finland are displaying more moderate rates of below 5%.

We expect this development to continue in upcoming quarters as European housing markets will further fan out.

Figure 5: Annual increase in HPI as of Q1 2022



Source: Eurostat, Scope Ratings

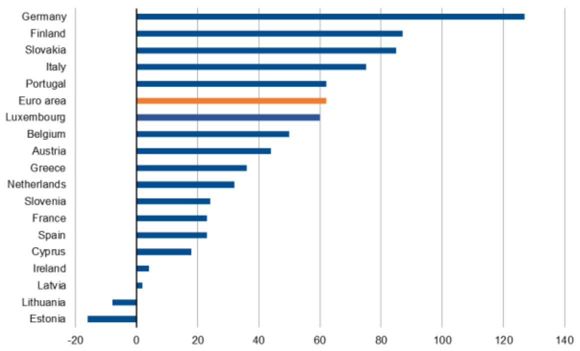
Following the ECB's first interest rate hike in more than a decade, monetary normalisation has finally reached the Euro Area. This will push mortgage rates up, cutting household affordability and dampening demand for house purchases. But house prices will be driven as much if not more by country-specific factors.

First, higher mortgage rates will not necessarily stop house prices from continuing to soar. The Czech Republic clearly demonstrates this. Czech mortgage rates stand at 4%, compared to a low of 2% in early

2021. Yet despite the doubling of mortgage rates, house prices have increased by more than 30%. The only thing that will cool the market will be further rates increases combined with the Czech National Bank's re-introduction of mortgage lending restrictions, including limits on loan to values and debt-servicing capacity.

Second, the development of mortgage rates is far from being homogenous across the continent. The latest information from the ECB shows that household borrowing costs for house purchases increased by 62bp annually in the Euro Area, strongly driven by +130bp in Germany. In the Baltic countries, though, borrowing costs are still lower than they were last year. Yet we see the opposite picture when looking at inflation, which is around 20% compared to around 9% for the Euro Area. Debt that is still cheap combined with soaring inflation are the best ingredients to fuel the local house-price boom.

Figure 6: YoY increase in costs of borrowing for house purchases as of June 2022 (in bps)



Source: ECB, Scope Ratings

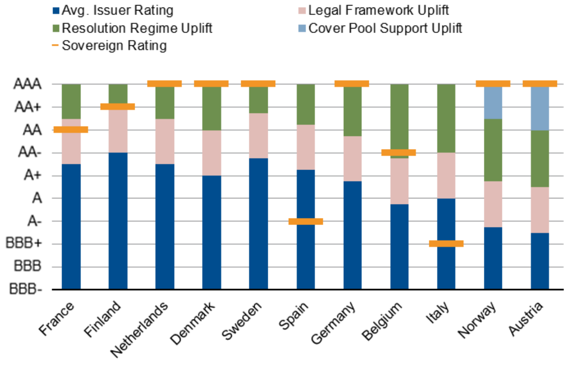
Third, housing is highly political, making government intervention more likely. This can be seen in Hungary, where the government massively subsidises the domestic mortgage market. After the central bank started to increase its base rate (now at 9.75%), the government froze mortgage rates at October 2021 levels. In addition, the central bank set up the 'Funding for growth – Green Home programme' in late-2021, allowing households to finance energy-efficient houses at a maximum interest rate of 2.5%, representing more than 40% of current new mortgage loans.

In Germany, Kevin Kühnert, Secretary General of the Social Democratic Party, wants to launch an initiative to help households raise equity for house purchases. This too has the potential to give house prices a further push.

Credit quality of covered bonds remains stable

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

Figure 7: Covered bond rating composition



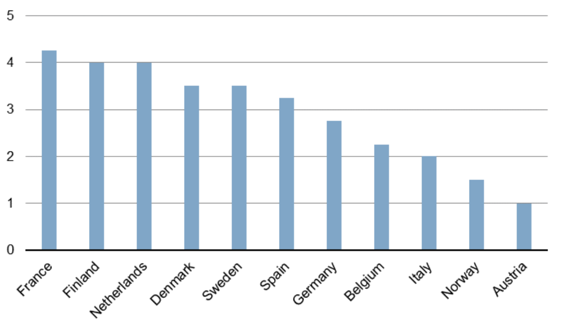
Source: Scope Ratings

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; 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 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 8: Covered bond rating stability



Source: Scope Ratings

Updated Green Bond Principles contradict covered bonds' core feature

The June 2022 update of the Green Bond Principles (GBP) introduced a new type of green bond. The proceeds of so-called Secured Green Standard Bonds can be used to refinance assets that may or may not be used as collateral for the green bonds. This contrasts with Secured Green Collateral Bonds, where the financed assets must be used as collateral.

A core feature of covered bonds is the fact that proceeds are used to refinance cover assets (typically mortgage and public sector loans). This naturally limits potential market risks for covered bonds as issuers have an interest in limiting asset-liability mismatches.

The Secured Green Standard Bond breaks with this tradition and opens the door for potential mismatch risks. Refinancing ultra-long green infrastructure projects denominated in a foreign currency, for example, could erode an otherwise well balanced asset-liability profile if it is not hedged.

In addition, Secured Green Standard Bonds remove the key advantage of green covered bonds compared to unsecured green bonds: the green cover pool.

While pure-green cover pools are still in the making, using green covered bonds to refinance energy-efficient mortgages is leading to a gradual greening of cover pools, ultimately benefiting covered bond investors. Refinancing assets outside the scope of the cover pool removes this benefit.

Investors need to keep an eye on the small print of different green bond frameworks. Currently, most green covered bond frameworks still limit the use of proceeds to cover pool-related green financings. The green bond landscape is rapidly changing, but this should ideally not be at the cost of investors.

Scope covered bond rating actions and monitoring notes

30 June 2022 – Scope affirms at AAA/Stable the covered bonds issued out of Realkredit's capital centres S and T

On 30 June, Scope affirmed the AAA rating assigned to the Danish mortgage covered bonds issued by Realkredit Danmark A/S out of capital centres S and T. The issuer rating of A+ combined with governance support results in the highest achievable ratings for the mortgage covered bonds. The cover pool provides additional rating stability.

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

13 June 2022 – Scope affirms at AAA/Stable the Austrian mortgage-covered bonds issued by Wüstenrot

On 13 June, Scope affirmed its AAA/Stable rating on the Austrian covered bonds issued by Salzburg-based Bausparkasse Wüstenrot AG. Lower stressed maturity mismatches result in lower over-collateralisation needed to support the rating. The credit quality of the domestic residential cover pool remains sound. High stakeholder cohesiveness increases the rating floor.

Click here to access the rating affirmation.

21 April 2022 – Scope affirms AAA rating on SSB Boligkreditt’s Norwegian mortgage-covered bonds

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 and here to download the performance update with key programme information.

Related bank and covered bond research

German housing bubble unlikely to burst; prices could swing either way depending on banks, economy: German mortgage rates have risen to levels not seen in a decade. We discount a collapse in house prices though this will depend on the economy. If banks allow buyers to max out their debt capacity with riskier debt, prices could even be further stretched. Click here to access the commentary.

Governance support for Austrian covered bonds now allows for up to six-notch uplift: Austrian covered bonds can be rated up to nine notches above issuer ratings, six notches of which stems from better governance support, which is driven by higher systemic importance, stronger cohesiveness and the new legal framework taking effect in July. Click here to access the commentary.

Austrian lending limits will not ensure financial stability if interest-rate-risk is excluded: Exemptions included in the set of macroprudential measures proposed by Austria's Financial Market Authority to address risks in the housing market are too generous and do not tackle the risk of higher interest rates. Legislative adjustments are needed. Click here to access the commentary.

European house prices: stretched affordability makes mortgages a luxury, dampens demand: 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. Click here to access the commentary.

ECB 2022 climate risk stress test: a sense of urgency but a long way to go: The ECB's 2022 climate risk stress test performed on a sample of large European banks is a landmark achievement. This exercise matters from a credit standpoint because it informs on the resilience of European banks. But the results are disappointing. Click here to access the commentary.

European banks can cope with significant credit deterioration: Takeaways from profitability and capital calculations conducted by Scope on 50 large European banks in its rated universe show that 44 institutions will remain profitable even if they had to triple their credit provisions. Click here to access the commentary.

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