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Scope Ratings

Covered Bond Quarterly: Q2 2021

Moderate house price growth expected; shedding a tear for missed harmonisation deadline; ESG theme evolving but sustainability factors not decisive in determining credit quality (otherwise unimpaired by Covid-19)

Covered Bond Ratings, Scope Ratings GmbH, 1 July 2021

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| Bloomberg: RESP SCOP

Executive summary

The credit quality of covered bonds remains unimpaired by the Covid crisis; there were no rating changes on covered bonds in the last quarter. Provided variants do not take centre stage, we see no credit-relevant topics for analysing covered bonds that could materially dampen the bright spots on the horizon.

Low interest rates and creeping inflation – both supporting stability of collateral prices and managable levels of unemployment – are not expected to weaken the credit quality of collateral pools. As the credit quality of covered bonds is already at the highest levels, the silver lining stemming from reduced infection and increased vacination rates coupled with a brighter economic outlook and strong GDP catch-up in most of Europe can not provide any further uplift.

House prices are expected to grow moderately, fuelled by low interest rates and economic recovery, but at a lower pace. However, in some countries the trend of moderating/declining house price growth observed prior to the pandemic may resume. Boosting growth during the pandemic will have aroused regulators and calls for further macroprudential measures to stem growth may be called for.

Maintenance of central bank purchase programmes offers issuers more attractive spreads in the primary markets, which remain subdued: new issuance is well below expectations. Investors continue to grind their teeth from a lack of supply but also benefit from spread stability. Spreads continue to tighten – at a much slower pace than before, however.

What investors are more focused on is the relative positioning of covered bonds against EU bonds. With the second helping of the Next Generation EU (NGEU) bonds, supply for rates investors has started increasing. At the current pace, it is likely that NGEU bonds will see larger issuance volumes than the total covered bond segment in 2021.

From a European covered bond harmonisation perspective, we will be shedding some tears on July 8. While there will be no market or regulatory impact yet, most have used the Covid “excuse” not to translate the proposals into national laws.

We applaud those Musterschüler that managed an ‘orderly’ directive translation (including some CEE countries such as Hungary and the Czech Republic). Traditional covered bond countries only saw regulators consulting bilaterally with issuers (France, Belgium) or remain totally opaque on the transition status (Italy). Spain has just broken cover with a drafted law transposing the directive published on 25 June.

With the publication of the EU Green Bond Standard, another ESG flavour was added to the ever growing number of ESG labels. Investors clearly appreciate the choice but decry the lack of standardisation. ESG aficionados need to love divergence, but this is increasingly becoming a concern. European supervisory authorities have reacted and implemented the Sustainable Finance Disclosure Regulation in March.

Following our recent webinar on ESG in covered bonds, we provide an overview of where ESG factors can play a role in Scope’s covered bond rating analysis – and why they are currently not decisive for determining credit quality.

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Market Developments in Q2/21

Investors have been starved of new covered bond issuance. The combination of the eighth TLTRO tender in June (in which banks took EUR 110bn vs EUR 330.5bn in its seventh iteration in March 2021) plus maintenance of the ECB's covered bond (and other) central bank purchase programmes means that public covered bond issuance remains subdued.

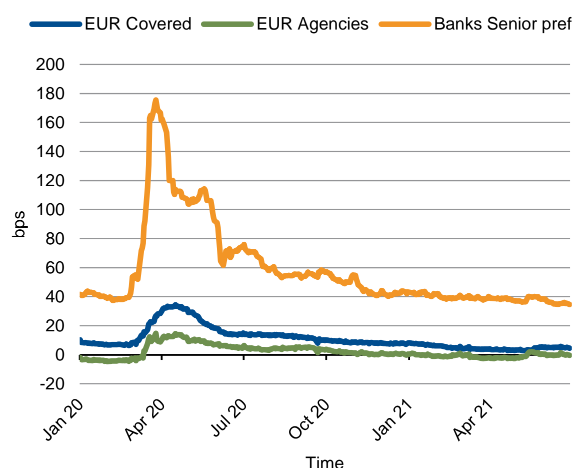
In the first half of 2021, the public covered bond market shrunk by approximately EUR 40bn as redemptions of about EUR 90bn were replenished with just EUR 50bn of new supply (of which roughly EUR 20bn was siphoned off by the ECB via CBPP3).

In principle, growing house prices and larger mortgages mean higher refinancing volumes, but banks are not currently encumbering their balance sheets by issuing covered bonds. Rather, they deploy deposits (or use retained covered bonds used for TLTRO funding) to finance them.

As the ECB is currently ruling out a tapering of its loose monetary policy, we do not expect the dire situation for covered bond investors to change any time soon.

Similarly, looking at the development of covered bond and related agency and bank spreads, it seems that the summer lull has already started – about a year ago.

Figure 1: Secondary market spreads

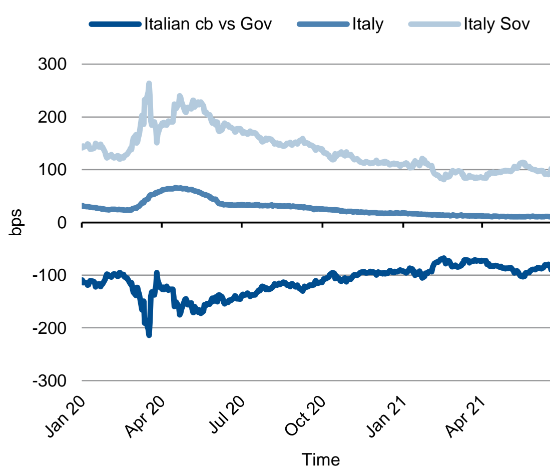


Source: Markit, Scope Ratings

Covered bond spreads only have moved sideways eventually grinding some 10bp lower year on year.

Even in Italy, where Covid hit first and hardest, has seen little spread movement and the spread differential between Italian covered bonds and its sovereign equivalent remained firmly negative.

Figure 2: Spreads of Italian OBGs vs BTPs

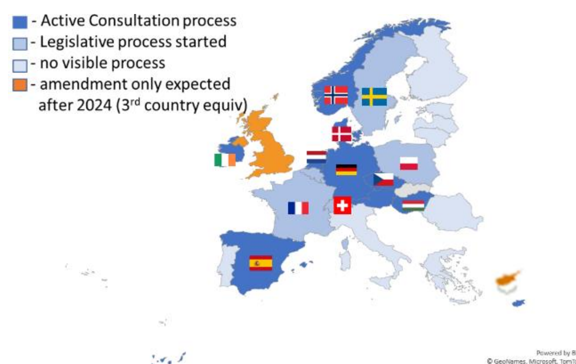


Source: Markit, Scope Ratings

European covered bond harmonisation – not yet there

The first half of 2021 finally saw a number of European countries pass required legislative acts. For those few Musterschüler (among them Germany, Denmark, Ireland but also Hungary and the Czech Republic) the covered bond directive was transposed and will be activated on 8 July.

Figure 3: Covered bond harmonisation – not yet there



Source: National regulators, Scope Ratings

Further, some countries have finally shown their cards:

The long-awaited consolidation of the three similar but diverging Austrian covered bonds types was finally dealt with (see Austria's covered bonds: transposing EU directive brings credit-positive consolidation). Going forward all Austrian issuers will be able to issue the same covered bond type under the same legal framework.

By contrast, harmonisation and European diversity could also result in a diverging development.

As small as Luxembourg is, it will have the highest number of covered bond types going forward.

With a dwindling number of specialised active covered bond issuers (down to one in 2021 from a high of six in 2012), Luxembourg legislators have opened up the menu. They will open up covered bond issuance to universal banks (with a novel 20% encumbrance limit). And the existing menu of five covered bond types – lettres de gage backed by public sector loans; mortgages, movables (aircraft, ships/boats and railway rolling stock); co-operative lending and renewable energy collateral – will see the addition of another two – harmonisation compliant – "*obligations garanties européennes* European covered bonds.

We wonder whether further blurring the Luxembourg version of covered bonds will revive the market or rather nail it as a nice theoretical option which is only randomly and arbitrarily used. To their benefit, the Luxembourg legislators have been open on how to translate the directive.

On 25 June, Spanish lawmakers published a draft law that is generally in line with the European Commission's Covered Bond Directive. With this, Spanish covered bonds will share most of the European positive standards with other EU covered bond issuers, but at the same time lose their high OC levels which was one of the unique selling points of Spanish covered bonds.

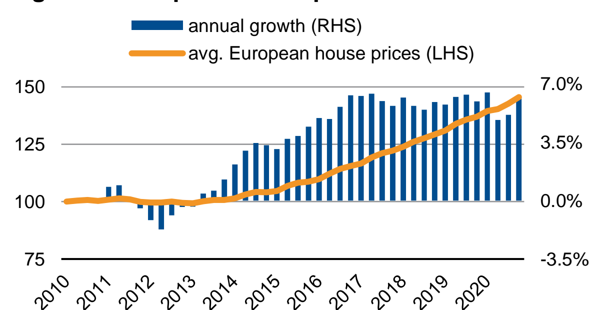
This is in stark contrast to their French peers. While it is well known that discussions started some time ago, we wonder why the regulator remain so opaque.

To our understanding, changes to the French set-up deal only with subtleties – at least from a rating perspective. As such changes should be neutral for issuers.

European house prices: rally over?

Growth in house prices across Europe peaked in 2020 at levels above 6%. On average, house prices went up by 6.2%. At the same time, real GDP went down by 6.1%. While most economists are clear about a strong GDP rebound in 2021/2022, views on house prices are divided.

Figure 4: European house prices



Source: Eurostat, Scope Ratings

The main factors that has boosted house prices in the last decade has been affordability. Low interest rates and benign economies in Europe supported a stronger demand for real estate in general. These two factors did not change during the pandemic. First, potential house buyers (high-income adults) were less impacted from the short-term impacts of the pandemic. Second, government subsidies offset immediate impacts on corporate bankruptcy.

What has changed however is building activity. Residential construction output in Europe contracted by 8.6% in 2020. In the second quarter of last year, the number of new building permits in Europe fell by 18.1% year-on-year. This has partly recovered, but as of end-2020 the number of permits was still 7.4% lower than in the previous year. As a consequence, this delayed the already tight supply of new housing in most European countries and put further pressure on prices.

With building activity catching up in 2021/2022, house price growth will lose momentum but a decline in prices is unlikely for most European countries. Interest rates will remain low and European households have accumulated record-high savings during the pandemic.

Still, house prices locally have reached levels at which most households will have trouble to get a bank loan without a material down-payment. This is most expressed in European metropoles where price growth has significantly decoupled from the country averages during the last decade. According to latest ECB analysis, residential property in metropoles however experienced lower growth compared to the average market. This has not been observed since 2006 and might be a sign of some cooling down in European metropolitan areas.

Difficulties obtaining a mortgage may become reinforced by macroprudential measures restricting new loans. All over Europe, regulators are huddling together to force down property demand. This could translate into new measures limiting credit growth and leverage.

Between 2014 and 2018, regulators had been relatively active in calming markets by introducing macroprudential measures. In some cases, this has been successful. However, since then regulators have remained relatively silent. Only in Norway and Sweden were measures to restrict credit growth and leverage introduced during the pandemic, but some eased existing measures as regulators feared a temporary payment shock among mortgage borrowers. That did not prove to be the case, however.

More stringent measures are expected to limit the ability of average households to receive mortgage financing any time soon. This in turn will reduce demand and as a consequence soften house price growth.

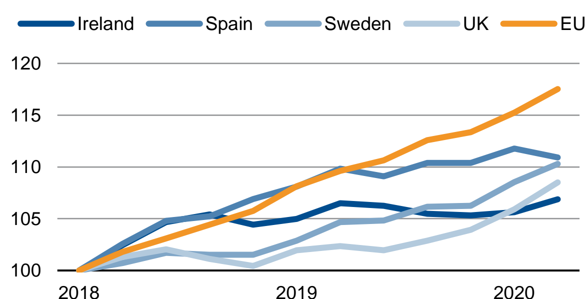
On 29 June, Finland's financial supervisory authority (Finanssilvalvonta Finansinspektionen) re-introduced cap on housing loans for residential mortgage loans financing second or holiday homes, effective from

1 October. Thanks to strong amortisation, average LTVs in Finland are moderate by comparison to European peers (especially the Nordics), Limiting the maximum LTV to 85% marks the first step to further tightening.

On average, we do not think that European house prices will decline in the medium term as the market remains fuelled by the low interest-rate environment, inflation has started to creep in and the economy remains benign. And not all areas are heating up.

In some countries, however, the trend of moderating/declining house price growth already seen before the pandemic may resume. The UK, Sweden, Ireland and Spain have under-performed the European average.

Figure 5: Selected house price trends



Source: Eurostat, Scope Ratings

For Ireland and the UK, prices have mainly been driven by uncertainties around Brexit. This started to affect house prices from 2018 onwards. To what extent this continues affecting house prices will depend on how well the UK can recover from the pandemic and how trade restrictions and duties, in particular with the EU, impacts the local economy.

In Sweden, house prices did not experience a material revaluation around the time of the GFC so they are relatively inflated in a European context. Concerns around a potential housing bubble have been addressed by a series of macroprudential measures since then. Those have made buying real estate less attractive and kept house prices relatively stable between 2017 and 2020. However, the coronavirus-driven house price run did not spare Sweden with a nationwide house price index surge of 10.1% in 2020 and 11.5% in greater Stockholm. This is roughly double the European average. Together with expected new macroprudential measure to be introduced, this growth is likely to be corrected in the short term with below average growth or even a moderate decline.

Spanish house prices started to recover after the global financial crisis, but this was halted in the third quarter of 2019. In some Spanish regions, this reflects an already overheated market prompting price corrections. This correction may have been only interrupted by the pandemic-driven house price rally and may continue.

For most of the remaining countries, we expect house price growth roughly in line with inflation and mostly in positive territory if the economic outlook brightens together with a strong GDP catch up in most European countries.

Covered bonds – a long-standing history

When the covered bond was created more than 250 years ago by Frederick The Great, it overflowed with ‘Governance’. The ‘G’ was the guiding principle from the first day when “Pfandbriefe” were born in Prussia back in 1769.

Based on a royal decree, Frederick set up “Landschaften”. These legally secured the ownership of property and allowed the owner to grant debentures over it. If the obligations under the debt were not met, regulation allowed for public foreclosure of the real estate.

The First “Social” covered bonds were issued in Denmark back in 1795. The Great Fire of Copenhagen burnt a quarter of the city to the ground. After the fire, a great need arose for an organised credit market because a large number of new buildings had to be built in a short space of time. Danish covered bonds were thus born with a strong social element.

“Sustainable” or “Green” covered bonds took longer to emerge. Münchener Hypothekenbank issuing a covered bond in 2014 with collateral based on sustainable ecological, social and governance criteria. In 2015, Berlin Hyp issued the first covered bond to be labeled green with issuing proceeds used to refinance green buildings.

In 2020 social or green labelled benchmark covered bond issuance accounted for 13% of overall issuance. 2021 has shown lower sustainable activities to-date but the trend is clear and remains strong.

EU Taxonomy, a blessing or a curse?

The governance of covered bonds is bespoke for each legal system. While the EU Covered Bond Directive was a great move to standardise certain relevant governance principles, there is still room for national discretion. The same issue applies to the EU taxonomy for environmental principles. Its reference to Energy Performance Certificates (EPCs) defies direct comparison as national EPC scores differ. Further the share of eligible buildings in the highest categories (EPC A and B) is very small.

However, the taxonomy allows for an alternative: buildings financed/refinanced by a green bond must be within the top 15% of national or regional building stock.

But even this is not a ‘one size fits all’. For instance, the Danes may have challenges in generating sufficient green collateral because of the balance principle applicable to Danish mortgage banks. They cannot simply select a sub portfolio of eligible green loans to synthetically back a dedicated green covered bond. And they cannot easily use proceeds of a green bond to invest in loans funding sustainable assets.

This is because a Danish mortgage loan is directly linked to its covered bond (match funding). To issue a benchmark covered bond, it may require bundling loans with the same maturity and interest reset profile that are all subject to refinancing. This is challenging and may only be possible for the large players as long as eligible green loans reflect only a fraction of the overall market.

Market players are looking for solutions, but this will not improve transparency in a European (green) covered bond market claiming to be harmonised.

Scope’s covered bond ESG risk assessment

We consider ESG principles throughout our full rating process for covered bonds, starting with the anchor point – the issuer rating – and complemented by all building blocks determining the covered bond rating.

Figure 6: ESG in Scope’s covered bond ratings

Source: Scope Ratings

Long-term business sustainability is an important factor in the credit analysis of a bank. In our analysis, we provide transparency on how the issuer is addressing ESG factors but also how they are positioned to benefit from or potentially fail to address the digital transition (combined in the ESG-D assessment).

As with the proposed green asset ratio and impact of climate risk, we expect the preparedness and inclusion of this factor in a bank’s strategy and underwriting to become an integral part of the regulatory focus.

The ESG-D assessment can therefore result in positive or negative adjustments to a bank’s rating anchor and is integral to the assessment of the issuer’s business in the context of a changing operating environment. When establishing the additional covered bond uplift, governance considerations (such as strength of supervision as well as the prudent management of the risk and protection structure of a covered bond programme) may lead to additional adjustments of both fundamental and cover-pool support analysis. Our fundamental support analysis reflects factors such as the stringency of internal and external governance. Our resolution analysis reflects the governance impact of regulatory oversight and an active stakeholder community.

Governance factors such as a potential imbalance between complexity and risk vs. transparency as well as management support can further constrain the maximum uplift. Beside qualitative factors, ESG can also impact our cover-pool support analysis from a more quantitative angle.

ESG and credit risk: causation or correlation?

Neither market participants nor scientists have focused on the past on finding evidence around the relation between credit risk and sustainability. Not only because sustainability has only recently emerged as such a vital topic but because energy efficiency data was not stored or even requested for newly originated mortgage loans. Moreover, only a few countries benefit from a centralised data repository that might allow a broader picture to be formed and most importantly to yield significant results in regard to ESG and credit risk.

We looked into several studies that all highlighted a relation between ESG Scores or energy efficiency of buildings and the likelihood to default. The most promising studies were published by Nationwide (Energy efficiency vs. default probability 03/2021) and Ca' Foscari University of Venice (Buildings’ Energy Efficiency and the Probability of Mortgage Default: The Dutch Case 05/2020). Both are based on relatively large samples of mortgages that were tested against energy efficiency measures.

The studies provided significant results and support what the market is craving– correlation between sustainability and credit risk. However, from our point of view whether the relationship is really causation or just correlation remains unanswered.

For instance, ‘the Dutch case’ can show that low energy efficiency buildings explain much of the default likelihood of loans to low-income households. On the other hand, there is no impact/correlation if income is high. The question arises whether low-income households really can afford high energy efficient buildings. Other income or factors are likely not taken into consideration based on the dataset available.

If more efficient collateral impacts default probability, it should be irrespective of household income. The hypothesis requires further study to support the assumption (or hope) that ESG is a positive driver of default and may consequently even convince regulators to make it a driver of regulatory capital as well.

Our own studies based on data available on Norwegian covered bonds did not show any significant dependency between PD, LGD and energy efficiency.

While green funding has convinced

ESG-compliant bonds attract more investors and may lead to investor diversity. This will, first of all, become highly relevant if market liquidity tightens and the central bank starts signing off from absorbing most of the newly issued covered bonds.

ESG issuance can also reduce average refinancing costs. Even though covered bonds only provide minuscule 'greenium' of 2-3bp compared to non ESG compliant covered bonds, this gap may increase if rates and spreads widen again.

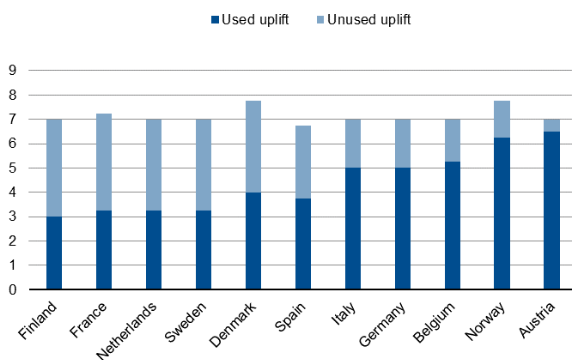
Analytically, issuers with a more diversified funding profile and access to a broad group of investors may be less exposed to refinancing risk, which could be addressed by lower stresses on our refinancing spreads.

Q2 2021: credit quality of covered bonds remains stable

Stable bank ratings continue to be supportive of the stability of Scope's covered bond ratings, all of which are rated AAA with stable outlooks. The most resilient covered bond ratings remain those in Finland, France, Netherlands, Sweden, and Denmark. This primarily reflects the fact that this is where average bank ratings within Scope's coverage are highest. Consequently, the covered bonds rated in those countries have the highest resilience to changes of the issuer rating (see Figure 7 below). The highest covered bond ratings in those countries are achieved by taking into account fundamental credit support.

Only 16% of Scope rated covered bond programmes are reliant on additional cover pool uplift to achieve the highest rating. The buffer against issuer downgrades is lower for such programmes, but strong cover-pool support can in most cases can still mitigate a downgrade of the issuer rating.

Figure 7: Covered bond rating stability

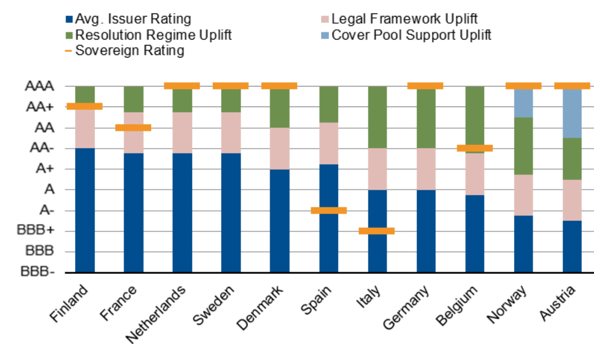


Source: Scope Ratings

At the same time, the dual recourse of covered bonds also allows issuers 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 rating driver.

High bank ratings coupled with supportive legal and resolution frameworks (see Figure 8) provide 84% of covered bond programmes rated by Scope with sufficient support to reach the highest ratings. Most of these ratings are very resilient to issuer downgrades. Cover-pool support is only a secondary rating driver, but the strength of the cover pool can provide additional rating stability.

Figure 8: Covered bond rating composition



Source: Scope Ratings

Rating overview in detail

As of Q2 2021, Scope rates 38 programmes from 25 issuers in 11 countries. We provide a comprehensive overview including: i) key rating metrices and ii) references to commentaries on the issuer and its covered bonds in an easy-to-use Excel format that can be downloaded here.

Scope rating actions and monitoring notes

28 May 2021 – Scope affirms AAA rating on SSB Boligkreditt's Norwegian mortgage-covered bonds – Outlook Stable

On 28 May, Scope affirmed the AAA rating with a Stable Outlook on the Norwegian covered bonds (obligasjoner med fortrinnsrett) issued by SSB Boligkreditt AS, the fully owned mortgage subsidiary of Sandnes Sparebank. The A- issuer rating combined with fundamental credit and cover pool support results in the highest achievable ratings for the bonds. The cover pool consists of fully domestic, owner-occupied residential assets and benefits from a low LTV.

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

Q2: Related bank and covered bond research

Webinar: Prospects and outlook for ESG covered bonds. Click here for the recording of the session.

European house prices: time for regulators to hit the brakes? Growth in house prices across Europe was stronger in 2020 than it has been at any time in the last decade. The economic outlook and pressure on housing affordability and profitability point to a moderation in growth. That said, with ultra-low interest rates, housing shortages in metropolitan areas and high-income mid agers being spared income losses, growth could even accelerate. This may be the right time for regulators to become proactive and introduce stricter macroprudential measures, else banks and borrowers might be caught on the wrong foot when the tide turns. Click here to download the full research report.

Austria's covered bonds: transposing EU directive brings credit-positive consolidation: Austria's covered bonds are among the oldest in Europe, yet the country's legislation is also among the most fragmented: three different covered-bond regimes exist in parallel. The 8 July 2021 deadline to transpose the European Covered Bond Directive will consolidate existing legislation, both modernising it and bringing it into line with that of other EU members. Click here to download the full research report.

Austrian house prices: little risk of an abrupt price correction, at least for now: The pandemic has fuelled Austrian house price growth. With price increases running at more than twice the growth of disposable income in the past decade, a slowdown in growth is justified. We see little risk of an abrupt price correction, though, reflecting reduced market risk for mortgage lenders, moderate household indebtedness, a functioning rental sector, and a regulator actively promoting sustainable lending standards. Click here to download the full research report.

Will safety of financial assets prevail over debt risk in Denmark? Danish households are the wealthiest in Europe. But they are also the most indebted. This significantly exposes their wealth to interest and house-price revaluation risk and makes them susceptible to income shocks. Financial assets serve as a safety net against risks stemming from mortgage debt, but risk appetite is gaining momentum. This may call for regulatory action. Click here to download the full research report.

Charging negative rates on retail deposits is not without risk for banks: Corporate customers have been on the receiving end of negative deposit rates for years, but some European banks have recently started to charge individuals; a practice that carries a different set of commercial, reputational and legal risks. Click here to access the full research report.

Norwegian banks: adoption of EU Creditor Hierarchy Directive facilitates MREL issuance: Upcoming adoption of the EU Creditor Hierarchy Directive will allow Norwegian banks to issue senior non-preferred debt on a statutory basis for the first time. The country's banking supervisor has consistently said there is a basis for most banks in Norway to be subject to an MREL requirement. Click here to download the full research report.

French banks: supervisory pilot test reveals moderate exposure to climate risks: French banks display moderate exposure to climate risks, according to a pilot exercise performed by the ACPR, the French financial supervisory authority, between July 2020 and April 2021. This is the first assessment of financial risks stemming from climate change performed by the French authorities. Click here to download the full research report.

Italian banks: significant room to optimise capital structures: Smaller Italian banks have not optimised their capital structures. Eight out of 10 banks sampled had room to do so at the end of 2020 through issuance of capital securities. The acceleration in the pace of balance sheet de-risking at medium-sized banks in 2019 and 2020, alongside the compression of yields in credit markets may make these deals more attractive to Italian banks. Click here to download the full research report.

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