SCOPE Scope Ratings

Covered Bond Quarterly

Reviving publicly guaranteed collateral for covered bonds could boost European competitiveness

Covered Bonds, Scope Ratings GmbH, 29 October 2024

Executive summary

With sovereign credit quality starting to reflect mounting fiscal and economic challenges, Mario Draghi's recent report on Europe's future competitiveness offered valuable insights into how to address some of the structural issues facing the euro area.

While the role of securitisation was discussed, the report is notably silent on the contribution of covered bonds, which could be material if public sector-guaranteed collateral can be developed for Classic European (Premium) covered bonds, or through European Secured Notes.

How would Frederick the Great, the King of Prussia who introduced an instrument in 1769 that developed into Germany's Pfandbrief, the forerunner of all covered bonds, have reacted to the Draghi report?

He might have pointed out that covered bonds can offer valuable funding support to three areas for action highlighted in Draghi's report: the innovation gap between Europe and the US/China; decarbonisation and competitiveness; and increasing security and reducing dependencies – the latter insofar as covered bonds provide financial stability as a European product mainly used by European issuers whose strength not only lies in the dual-recourse mechanism but mainly in its strong governance support).

The key challenge in targeting these three areas remains with funding, though. In that respect the existing toolkit of a European Covered Bond (Premium) is already fully equipped and ready to support – if the EU promotes necessary investments and accepts burden-sharing.

Elsewhere, rate cuts are expected to ease the economic environment, support a rebound in house prices, and reinvigorate sluggish euro area growth. Alongside strong bank fundamentals, this will help cushion the impacts of geopolitical turbulence. These factors ensured that covered bond issuance has been stable since our last Covered Bond Quarterly.

September lifted euro benchmark covered bond issuance to around EUR 141bn so our EUR 170bn forecast for the year is do-able even considering typically weaker Q4 activity. Spread variance this year has narrowed compared to 2023 with less issuance in very low (<10bp) or very high (>70bp) territory. However, on average, new issuance spreads increased to 42bp. This compares to 27bp in 2023 and 11bp in 2022.

Outliers above 50bp mainly come from Italy (37%), Germany (12%) and Austria (11%). Italian spreads reflect credit dispersion. Issuance from Germany >50bp came from CRE lenders. CRE uncertainties also drove spreads for some Austrian issuers. Covered bonds collateralised by CRE have become a rarity lately, however. While CRE exposure to German Pfandbriefe grew by 28% over the last 10 years, the total outstanding mortgage collateral increased by 65%. This reduced CRE exposure from 47% to 37%.

The residential property picture looks better. Since the beginning of the year, all but two EEA countries plus the UK have seen prices rise. On mortgage rates, the share of fixings at 10 or more years significantly increased during the ultra-low-rate environment between 2016 and 2022. In 2022, up to half of all households took out long-dated mortgages compared to only 25% in 2009. Adding fixed-rate period of more than five years, the share rises to 75%.

Following the pandemic and after inflation had put pressure on rates and ultimately on borrowing costs, households started to move into floating-rate products hoping for a reversal later. While this makes sense psychologically and economically, it appears a mystery as to why European households have adopted opposing strategies to optimise borrowing costs. In some cases, this is explained by who bears refinancing costs – the banks or the borrowers. But it is also about stickiness of household behaviour and market characteristics.

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What Frederick the Great might have told Mario Draghi

Source: Ideogram.ai, Scope Ratings

In 1769, Frederick the Great, King of Prussia, introduced the legal basis for an instrument that developed into Germany's Pfandbrief, the forerunner of all covered bonds. How would he have reacted to the Draghi report on European competitiveness?

The report emphasises the urgency of structural reforms to bolster Europe's growth and reverse its stagnating productivity. It estimates additional annual investment needs of around EUR 750bn-EUR 800bn, or about 4.5% of EU-27 GDP. While the role of securitisation was discussed, the report is notably silent on the contribution covered bonds could make.

If Frederick the Great could talk to Mario Draghi about his report, he might have had some thoughts about how covered bonds could help to address the investment gap.

First area for action: the innovation gap

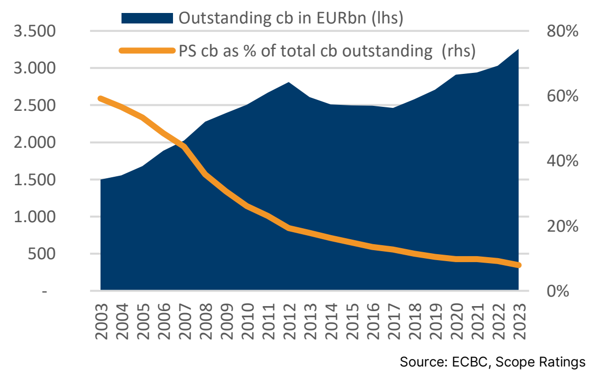
Covered bonds can offer valuable funding support to address Mario Draghi's first area for action: the innovation gap between Europe and the US and China. European Secured Notes (ESNs), introduced as part of the capital markets union project could, from a macro perspective, offer funding benefits to banks and SMEs, which form the backbone of the European economy.

ESNs can bolster financing for research and innovation (R&I). They will not, however, allow banks to increase the volume of SME financing if risk weights for SME portfolios increase and tie up capital. This compares unfavourably to securitisations, which can be used to free up capital and increase banks' SMEs lending capacity.

Classic European (Premium) covered bonds can also provide value. While alternative collateral is ineligible according to Article 129(1) of the Covered Bond Directive, exposures to or guaranteed by central governments, central banks, multilateral development banks, or international organisations that qualify for credit quality step one, do qualify for European premium covered bonds.

Using public sector-guaranteed collateral could boost public sector covered bonds, which have fallen somewhat from grace: the share of public-sector covered bonds has fallen to single digits compared to almost 60% in the early 2000s.

Figure 1: Covered bonds outstanding (EUR bn)



Source: ECBC, Scope Ratings

We have observed an increasing use of export credit-guaranteed corporate loans in public sector covered bonds. These instruments transfer part of the risk of payment default to sovereigns via their export credit agencies and are designed to promote foreign trade. Another example is the use of credit guarantee schemes to protect SMEs from COVID-19 impacts, which are emerging in some European covered bonds.

In the US, loans to SMEs via the US Small Business Administration (SBA) offer another proven example. The SBA, an independent government agency, provides support to entrepreneurs and small businesses through SBA (7a) loans, extended via banks, credit unions and other lenders. The SBA provides a government-backed guarantee on most of the loan, leaving some "skin in the game" for originators. We have seen these loans in public sector cover pools.

We believe that if adequately structured to meet eligibility criteria, a similar set-up sponsored by the EU, development banks, agencies or individual sovereigns could become a blueprint for sponsoring SMEs and R&I investment via (Premium) Covered Bonds.

Banks as intermediaries could benefit from low capital requirements for these loans, boosting their lending capacity while maintaining their role as points of contact and originators. There have already been several SME initiatives and transactions sponsored by European agencies where risk has been shared. Adding covered bonds would not only allow for lower risk weights but also provide SMEs with lower funding costs.

The second area for action - decarbonisation and competitiveness

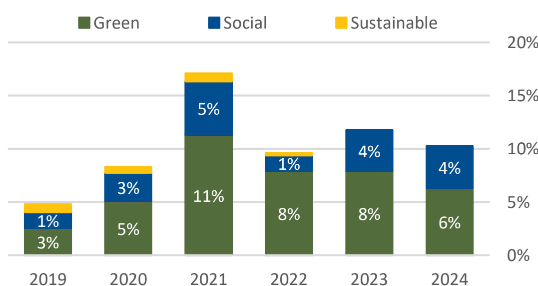
On Draghi's second focal point, we make a similar case as for innovation. Decarbonisation can be promoted through guarantees allowing for credit growth due to banks' minimal capital requirements plus affordable funding via covered bonds.

Covered bonds are already adding to decarbonisation by refinancing sustainable collateral. Green covered bonds are still a niche within banks' total funding, but they add funding and investor diversification, providing a stabilising element in a bank's funding mix.

Direct incentives for issuing green covered bonds are low – for now. To the extent that there are any funding advantages in the form of a greenium, these are limited to less than 5bp. But at the same time the investor base and therefore the order books for green issues tend to be bigger. We believe this trend will grow. Large, globally active issuers will, over time, have no alternative to becoming active environmental or social labelled covered bond issuers.

Year-to-date, green covered bond activity is low at 6% of new issuance. This year has the potential to outperform 2023 and 2022 as Q4 green issuance is typically strong. The breakthrough has been a long time coming but could be fostered by political promotion, too.

Figure 2: ESG issuance



Source: Scope, Bond Radar

Third area for action: increasing security and reducing dependencies

It might be presumptuous to claim that covered bonds add to Draghi's third area of action: increasing security and reducing dependencies. While covered bonds will not prevent war or provide significant military financing (even though there is anecdotal evidence of some military funding in public sector cover pools), they do provide financial stability.

Because the covered bond is a European product mainly used by European issuers. Its strength not only lies in the dual-recourse mechanism but mainly in its strong governance support.

With that, Europe already has a strong and stable financial instrument that provides banks in Europe with refinancing sourced mainly from Europe. This provides independence against ^ppolitical and macroeconomic influences and support to Europe's sovereignty.

The European covered bond is a proven product that can be broadened with little need for amendments or softening of standards. Unlike other financial instruments, it has proven itself to be an evergreen issued and traded instrument, even in stressed economic environments.

Covered bonds do not benefit just from dual recourse but also from a super senior position in the capital structure, benefiting from a strong regulatory and legislative framework that together allow for the highest ratings.

European (Premium) covered bonds could support funding to address key areas of action highlighted by the Draghi report. However, this will only work, if issuers play an intermediate role without taking on the entire capital burden.

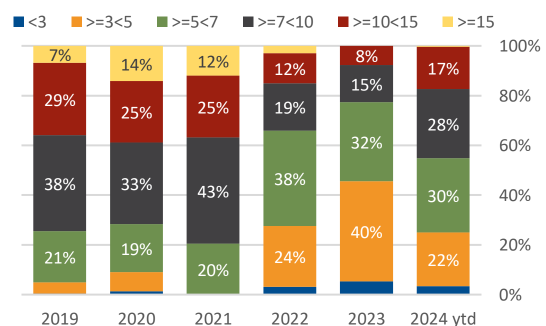
Without EU promotion and burden-sharing, it will remain challenging to motivate market participants to fund these goals.

Marked-out path for rate drops

Rate cuts were not unexpected either in their timing or magnitude. Still, weakening euro area growth of 0.8% (Scope forecast is 1.0%) expected by the ECB for 2024 add pressure to further rate cuts as early as December.

Given the current inverted forward curve and market expectations, issuers (and investors) have lowered maturities. In the first and second quarters, the average maturity of EUR benchmark covered bonds stood at around 6.7 years but dropped to 5.2 years in Q3. Bonds with 3-5 years maturities dominated, while only Deutsche Kreditbank issued in its typical 10+ bucket.

Figure 3: New issues by maturity bands

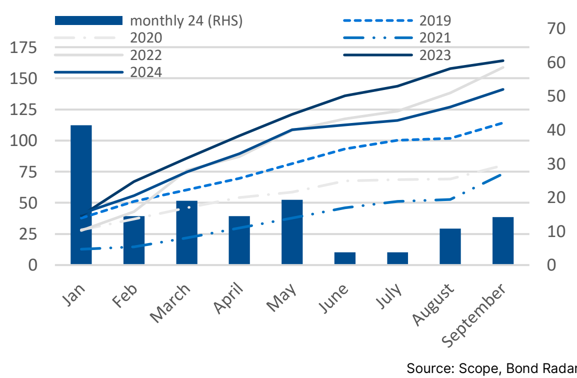


Source: Scope, Bond Radar

Issuance keeping pace with our 2024 outlook

Solid issuance in September lifted euro benchmark covered bond issuance to around EUR 141bn. Our EUR 170bn forecast for the year is do-able even considering typically weaker fourth quarter activity. This year will not set any records, though. After a strong start to the year and moderate to strong activity in April and May, the market slowed: June issuance of EUR 3.75bn was the lowest in 10 years. July was poor as well, but August and September marked a comeback, with around EUR 25bn only exceeded by 2022 (EUR 35bn).

Figure 4: Covered bond issuance (YTD)



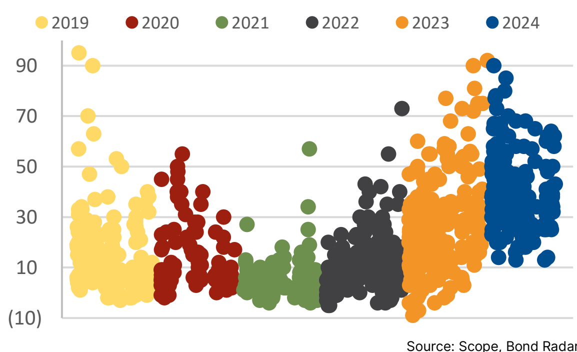
Source: Scope, Bond Radar

Some credit-driven spread widening

Spread variance narrowed compared to 2023 with less issuance in very low (<10bp) or very high (>70bp) territory. However, on average, new issuance spreads increased to 42bp. This compares to 27bp in 2023 and 11bp in 2022. Most covered bonds in 2024 have been issued within a 30bp-50bp range.

Outliers above 50bp mainly come from Italy (37%), Germany (12%) and Austria (11%). Italian spreads reflect credit dispersion, which we forecast would return following the ECB's retreat as the market's principal investor. Issuance from Germany exceeding 50bp came from CRE lenders such as Pfandbriefbank, Aareal or Hamburg Commercial (although issuance since Q1 has been limited). CRE uncertainties also drove spreads for some Austrian issuers higher, showing that despite narrowing spreads, credit remains relevant following the ECB's retreat.

Figure 5: Spread variance EUR benchmark in bp



Source: Scope, Bond Radar

German Pfandbriefe less exposed to CRE

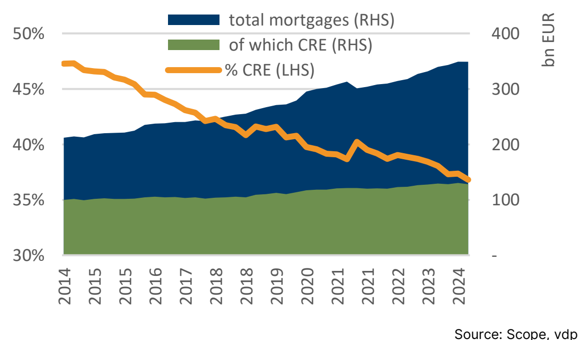
Covered bonds collateralised by CRE have become a rarity lately, while news flow from the sector has quietened in recent months. But that is not a sign of easing tensions, as Deutsche Pfandbriefbank's (pbb) profit cut shows.

The European Banking Authority published a special topic in its July risk assessment report on CRE highlighting the sector's structural and cyclical risk factors. The EBA mainly focused on outdated valuations but also highlighted that EU/EEA banks' CRE related exposures increased by more than 40% over the last 10 years to EUR 1.4trn, outpacing total mortgage growth.

German banks, most of them covered bond issuers, account for most of this exposure. The EBA also pointed out that while half the banks signalled that their CRE portfolios would remain stable, 30% intend to increase their portfolios.

This is not exactly the picture we have observed on German Pfandbriefe, though. While CRE exposure to total German Pfandbriefe grew by 28% over the last 10 years (2.8% annually) the total outstanding mortgage collateral increased by 65%. This effectively reduced the share of CRE exposure in German Pfandbriefe from 47% to 37%.

Figure 6: CRE exposure in German Pfandbriefe



Source: Scope, vdp

One trend we have recently observed is that German covered bond issuers have reduced their exposure in markets that are deemed to be at risk, such as the US office sector.

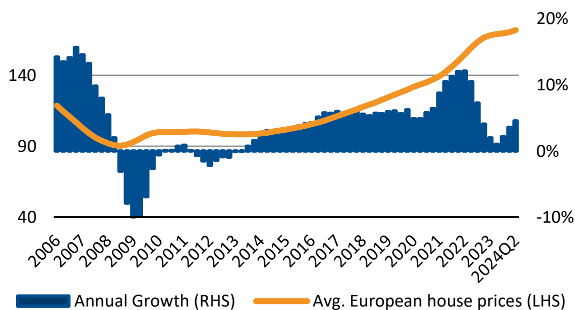
Since peaking in Q3 2022, US CRE exposure in German cover pools has fallen to 7% from 9.3%. The office portfolio in German Pfandbriefe has decreased since the beginning of the year by 60bp.

That is not significant, but it is nonetheless a divergence from the earlier trend and is backed up by pbb stating its intention to lower its office exposure in favour of data centres, hotels and retirement homes.

European residential property back on track

For residential property, the picture looks better. Since the beginning of the year, all but two EEA countries plus the UK have seen prices rise. Annual average growth to the second quarter stood at 2.5%, in line with our expectations on headline inflation for 2024. As a consequence, average real property prices in Europe have stagnated although this can be seen as a sign of stabilisation following two years of declining real values in many countries.

Figure 7: European house prices growth (yoy)

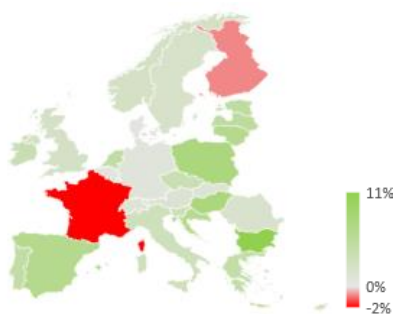


Source: Scope, eurostat

Since the beginning of the year, we see negative nominal house-prices growth only in France (-2.4%) and Finland (-1.0%). French households have suffered from a combination of political, regulatory and macroeconomic changes that have caused and are still causing negative effects on housing.

Macroeconomic effects following the pandemic, and Russia's invasion of Ukraine have hit other European mortgage markets, but political turbulence and regulatory action arguably hit French households even more strongly.

Figure 8: European house prices (nominal, year to date)



Source: Scope, eurostat

Regulatory changes together with rising inflation have hit French households twice, impacting affordability for new mortgages. First, at the beginning of 2022, the French government introduced a law that restricted new mortgage terms to a maximum of 25 years from 35 years, effectively increasing instalments to cover for increased amortisation plus interest. Second, the amount that can be borrowed was capped at 35% of borrowers' income. Borrowers have also had to deal with the political intent to raise the retirement age to 64 from 62, increasing uncertainty and discontent about political leadership. Political uncertainty, growing pressure on households, and faltering economic growth have fuelled support for right-wing parties and have not helped stabilise the French property market.

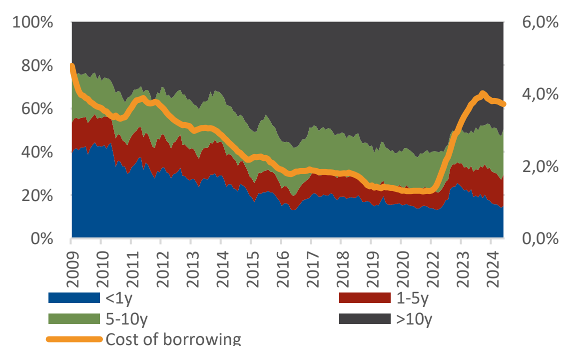
As a positive, though, most French mortgages are fixed for life, which does not expose French households to refinancing risk. By contrast, in Finland, 96% of residential mortgages are floating, which immediately exposes households to rising rates.

We argue that falling house prices in Finland reflect the housing oversupply built up over the last eight years where building activity has been well above the historical average and has not been met by supply. Immigration has increased significantly in Finland, but it has not compensated for low housing demand. We expect Finland's real GDP to contract in 2024 by 0.3%, which means any bottoming out may have to come from improved affordability following the recent rate cuts.

Europe is as diverse as the choice of mortgage interest-rate fixes …

The share of mortgage fixings at 10 or more years significantly increased during the ultra-low-rate environment between 2016 and 2022. Households took the chance to lock in low rates for longer and insulated themselves against affordability shocks from rising rates. In 2022, up to half of all households took out long-dated mortgages compared to only 25% in 2009. Adding fixed-rate period of more than five years, the share rises to 75%.

Figure 9: Interest-rate fixes for new EU mortgages

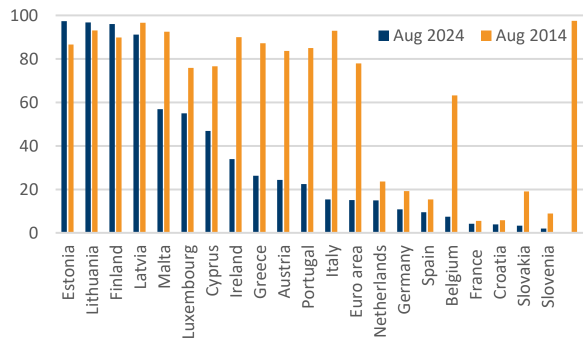


Source: Scope, ECB

Following the pandemic and after inflation had put pressure on rates and ultimately on borrowing costs, households started to move into floating-rate products hoping for a reversal later.

While this makes sense psychologically and economically, it is a mystery why European households adopted opposing strategies to optimise borrowing costs. The share of floating-rate mortgages is diverse, which at first glance is counterintuitive as they are all referenced to the same base rate as determined by the European Central Bank.

Figure 10: Share of floating rate mortgage for selected European markets



Source: Scope, ECB

…which is mainly driven by prepayment costs

A key explanation lies with the question of who bears pre-payment risk. When a fixed-rate loan is prepaid, one party bears a present-value loss as the cash repaid needs to be invested at prevailing rates (refinancing risk). For a bank, this can be problematic as borrower behaviour is typically driven by a common factor: the interest-rate environment.

Borrowers are expected to pre-pay fixed rate mortgage loans and take out new mortgages if interest rates have fallen. This can lead to severe and sudden financial losses to the banks if pre-payment risks are not hedged or transferred. For banks, an easy answer to this problem is to offer floating-rate loans, which transfers refinancing risk to the borrower.

In the US, mortgage agencies Fannie Mae and Freddie Mac typically handle this risk mainly by transferring it to investors. In Europe, apart from Denmark no such agencies exist, so this risk is either left with the borrower, the bank or split between both. (In Denmark, the risk is transferred to external investors).

In Germany, borrowers bear most pre-payment risk. Lenders are compensated for the loss of interest and even the loss of margin. By contrast, in Belgium, France, Spain and Austria, the borrowers' contribution is typically limited to a one-off payment equivalent to a few basis points or some months of interest payments. In Italy, borrowers have no prepayment penalties at all, hence the banks take present-value losses.

Consequently, where banks offer fixed-rate loans, they need to hedge themselves, with the costs typically passed on to borrowers.

There is a general tendency where markets are more exposed to floating-rate loans where banks bear pre-payment risk, because hedging it is a sophisticated exercise and may become expensive, particularly for smaller banks. From Figure 10, we can see that among the countries mainly exposed to floating rates, most have small mortgage markets.

In mature markets, this tendency alone no longer holds, although Sweden is an exception. Sweden is not a euro area member but its economy and fiscal policies are closely linked. Sweden is a predominantly floating-rate market but benefits from a well-established and mature mortgage market.

Stickiness of household behaviour and other market characteristics, where for instance borrowing caps help limit the financial burden, play an important role in the divergence of European markets.

We believe that in a long run, fixed-for-life mortgages with some pre-payment flexibility should prevail as they improve a country's financial stability. They give households some flexibility paired with stability and they have proven to be manageable by banks.

Fixed mortgage loans will ensure that borrowers are not exposed to risks that they will not be able to handle. A typical household does not have the means or know-how to hedge against sudden market risks.

This is putting pressure on markets exposed to floating-rate mortgages. In its financial stability report from May 2024 the Swedish Riksbank stated that high household indebtedness and short interest-rate fixes have a major impact, including on consumption, which has clearly declined.

Another example comes from the "Household Budget Survey" produced by Statistics Finland at the end of 2023, which showed that families with variable-rate mortgages and significant outgoings have faced the most difficulties when rates were going up. Adding inflation pushed young families into a corner with long-term consequences. This is something national regulators need to be concerned about.

Income based measures on track

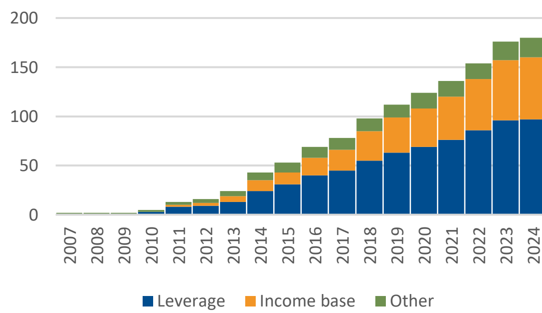
European regulators, most prominently the European Systemic Risk Board (ESRB) as well as national regulators closely monitor mortgage markets, given their importance for financial stability. Across Europe, macroprudential measures, particularly borrower-based metrics, can mitigate potential instability risks arising from housing market developments.

Income-based measures such as debt service to income have become the preferred and most effective choice over time.

This is in line with a study released in December 2023 by the Committee on the Global Financial System under the sponsorship of the BIS. It identified that ratios related to a loan's leverage (e.g. loan-to-value ratios) are not very effective in mitigating a borrower's resilience against shocks.

Tools based on borrowers' income, like debt-service-to-income ratios, have been shown to be a more effective way of enhancing a borrower's resilience.

Figure 11: Number of borrower-based measures in Europe



Source: Scope, ECB

With residential real estate markets less at risk, we see increasing hesitancy to introduce additional measures that could stop borrowers entering the housing market. This also becomes evident when looking at the limited or even relaxing actions during 2024. The hope that Germany would finally introduce borrower and income-based measures to improve household resilience seems to have shattered. This is despite the “Ampel” coalition having agreed to such measures in its agreement in December 2021.

With federal elections coming up in 2025, other topics have moved to the top of the agenda. Another missed opportunity to enhance the German market’s resilience.

The Finnish Financial Supervisory Authority did not touch LTV-based mortgage caps, keeping them at the standard level of 95% for first-time buyers and 90% for other mortgages.

The Latvian FSA even relaxed some measures but introduced an interesting twist: it increased the debt service to income (DSTI) limit from 40% to 45%. But the higher cap is only applicable to mortgages that are used to buy energy-efficient housing. It is restricted to housing that meets Energy Efficiency Certificates of classes A+, A, B or C.

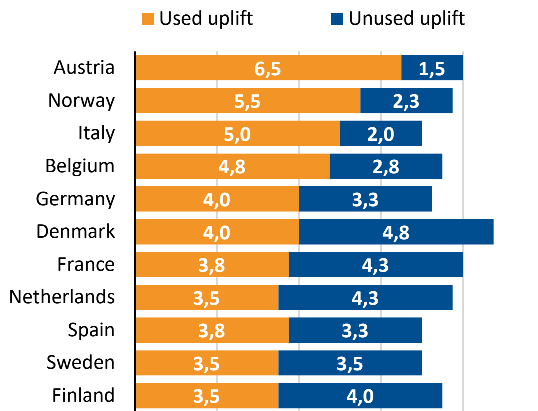
Overall, this increases affordability risk although from an expected-loss basis this might be balanced out by green collateral. If expectations hold true and all things being equal, green collateral should be less exposed to declines in market value compared to collateral with lower energy-efficiency scores.

High rating stability and strong buffer against issuer downgrades

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

Compared to last quarter, Danish transactions have gained additional downgrade buffers as the improved transparency on Danske's Pool C and D has shifted our Cover Pool Complexity assessment from high risk to low risk. This translated into up to three notches of additional cover-pool support.

Figure 12: Downgrade sensitivity to Scope rated covered bonds



Source: Scope Ratings

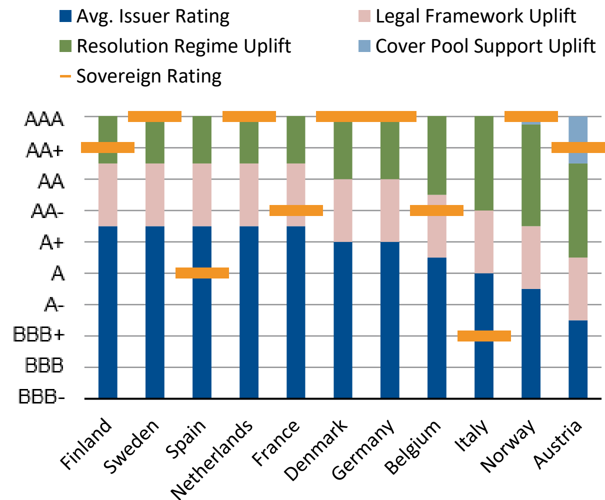
Strong bank ratings and very supportive legal and resolution frameworks allow 85% of our rated covered bond programmes to achieve the highest ratings without additional cover-pool support. The strength of the cover pool does provide additional rating stability, however.

On average, covered bond programmes rated by Scope can withstand issuer downgrades of up to three notches, on condition that the programmes' risk characteristics and protection provided through over-collateralisation (OC) do not materially change. At the same time, the dual recourse of covered bonds allows the remaining 15% of covered bond programmes to support the highest ratings on the basis of cover-pool support. Notably, covered bonds in Austria and Norway achieve AAA ratings with the help of this credit support.

The buffer against issuer downgrades is lower for such programmes. For all except two, strong cover-pool support can mitigate a downgrade of the issuer rating of at least one notch. We also see that the OC currently provided exceeds what is needed to support AAA ratings.

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 fall in eligible assets from value depreciation).

Figure 13: Covered bond rating composition



Annex I: 2024 Outlooks and Research

Outlooks

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

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

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

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

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

Related research

Covered Bond Directive: Policymakers solicit views on outstanding items. Are ESNs the next frontier?, September 2024

Covered Bond Quarterly: Steady sailing over the summer with clouds on the horizon, July 2024

New property value definitions in CRR3; notable impact on mortgage covered bonds, July 2024

Covered Bond Quarterly: Have German banks put Pfandbriefe at risk?, April 2024

Systemic risk remains high in European housing market, January 2024

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