SCOPE Scope Ratings

Covered Bond Quarterly

Steady sailing over the summer with few clouds on the horizon

Covered Bonds, Scope Ratings GmbH, 18 July 2024

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| Bloomberg: RESP SCOP

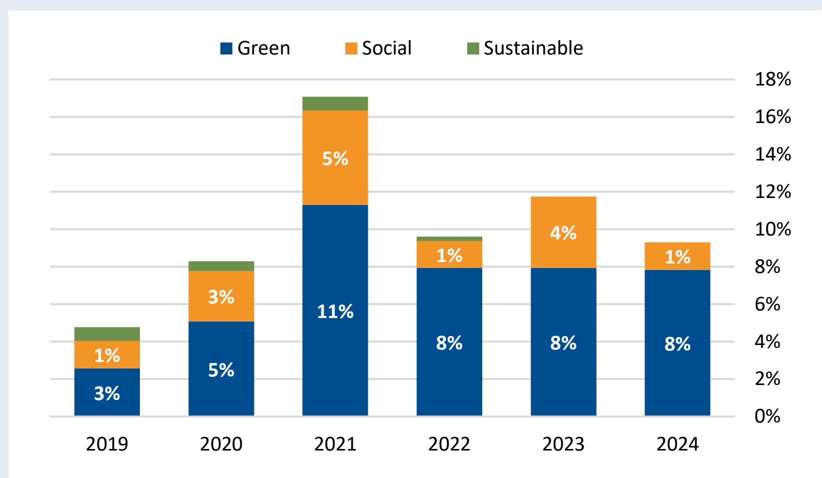
Executive summary

This year will not set any records for investor-placed covered bond issuance. After a strong start to the year and moderate-to-strong activity in April and May, issuance of EUR 3.75bn in June was the lowest in more than 10 years. But we still believe our projected volume of EUR 170bn for 2024 is feasible.

We expect stable credit quality for banks and covered bonds for the remainder of the year. At the same time, while our expectations that credit spreads would widen as a consequence of the expiry of the Eurosystem's purchase programmes materialised, the greater spread variance we expected is already looking like it is diminishing. The fact that banks are able to fund longer to better match their long-term assets is credit positive: 54% of new covered bond issues YTD had a seven-year-plus maturity. This compares to 23% in 2023, although it is still far from the 70%-80% between 2019-2021.

The EUR 9.5bn in ESG-themed covered bond issuance in H1 2024 stands at around half 2023 and 2022 volumes. Assuming no sudden shift, we will see a similar volume in 2024. In relative numbers, about 10% of all issuance has been labelled green or social, unchanged from the picture since 2022.

ESG covered bond issuance



Source: Bond Radar, Scope

The ECB, strongly committed to leading by example, has published climate-risk disclosures relating to its bond holdings (including covered bonds). For covered bonds it is not as easy to apply climate-risk considerations other than for the small share of ESG themed bonds. What is lacking is consistent reporting on what makes covered bonds the high quality go-to investment: ESG data on cover pools.

Meanwhile, there is less than six months to go before the updated 'property value' takes effect with CRR3 in January 2025. This could have a notable impact on covered bonds as market values are directly linked to the amount of bonds that can be issued. The property value cannot exceed the current market value or the average market value over the last six years for residential and eight years for commercial property. Our analysis demonstrates that the Commission's proposal to reduce the impact of cyclical effects on the valuation of property securing loans and to keep capital requirements for mortgages more stable works relatively well.

European house prices show a positive trend, on average. Variations remain high, though, with some markets still showing price depreciation – in particular in Central Europe. In the medium term, house prices in the south of Europe may outperform as indicated by strong GDP growth and moderate value increases since the financial crisis.

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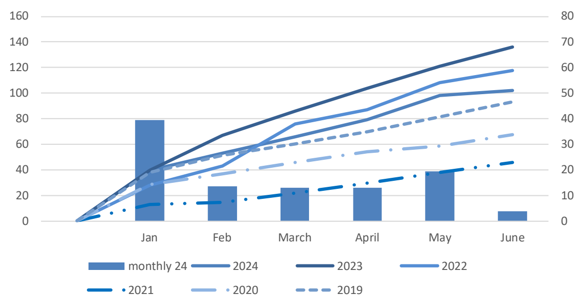
Issuance stalled in June but still strong

This year will not set a record for investor-placed covered bond issuance. After a strong start to the year and moderate to strong activity in April and May the market started to slow: June issuance of EUR 3.75bn was the lowest in 10 years. Slowing issuance was driven by uncertainty around the French parliamentary elections, but the rainy weather and the euro football championship might have contributed as well.

Figure 1: Covered bond issuance (YTD)



Source: Bond Radar, Scope

The French election results calmed the market and as the euro championship reached its conclusion, there was some revival in activity, just before the market moved into its summer lull. We will see limited action until late August. But we still believe that our projected issuance volumes of EUR 170bn for 2024 is feasible, however. More than 60% has already materialised and the risks seem balanced enough for our projections to be hit.

In its recent Risk Assessment Report, the EBA is very bullish about secured funding, including covered bonds, for 2024 and beyond. It projects a doubling in 2024 with issuance to remain high in 2025 and 2026. We remain less bullish as the economic outlook is still clouded by geopolitical risk and euro-area growth remains subdued. Also new mortgage lending is yet to recover from sharply higher interest rates and the resulting affordability shock.

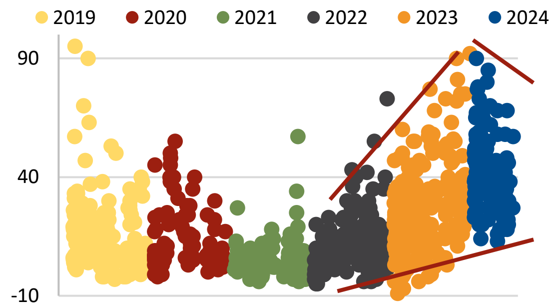
Nevertheless, we see some optimism on the horizon. The first central bank rate cuts have provided some relieve even though the pace and magnitude of further rate reductions have been massaged down.

Households have started to accept the higher-for-longer environment as the new normal. House prices are no longer falling. In fact, they have started rising again. The growth momentum around mortgage lending has started to change too. Momentum needs to strengthen, however, as it not yet sufficiently supportive. Also, growth in customer deposits at banks is outpacing lending. Still, refinancing maturing covered bonds amid revived investor interest will be helpful.

Liquidity stamps out credit dispersion

Our expectations that credit spreads would widen as a consequence of the expiry of the Eurosystem's purchase programmes in mid-2023 materialised, although the greater spread variance we expected (2024 Covered Bond Outlook: Back to a credit-driven buyer's market) is already looking like it is diminishing.

Figure 2: Spread variance EUR benchmark in bp



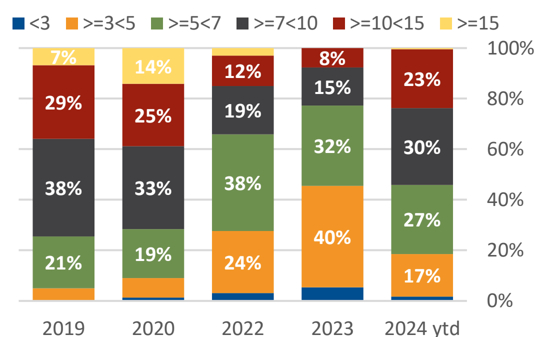
Source: Bond Radar, Scope

We do not expect spread variance to narrow any further, however, as spread tightening in EUR benchmarks in 2024 has been driven by relatively low secondary-market liquidity, which we do not believe is a systematic driver for credit. Facilitating factors are the ECB's holdings, which are keeping most of the bonds out of the reach of the secondary market, the volatile geopolitical and economic situation, or simply the fact that investors want to avoid booking losses on their legacy holdings.

Normalisation of maturities

With the rates environment and shape of yield curves normalising, it is credit positive that banks are able to fund longer to better match their long-term assets. Year-to-date, 54% of new covered bond issues have had a seven-year-plus maturity. This compares to 23% in 2023, although it is far from the 70%-80% between 2019-2021.

Figure 3: New issues by maturity bands

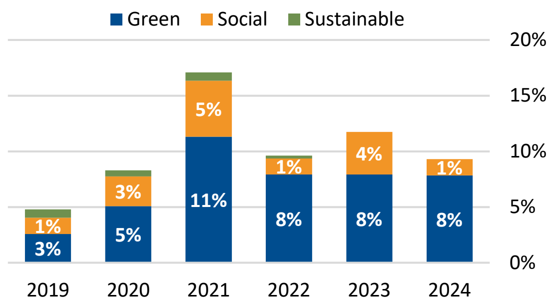


Source: Bond Radar, VDP

ESG on track

With the first half of the year now behind us, the EUR 9.5bn of ESG-themed covered bond issuance also stands at around half of 2023 and 2022 volumes. Assuming no sudden shift in ESG issuance, we will see a similar issuance volume in 2024. In relative numbers, about 10% of all issuance has been labelled green or social, unchanged from the picture since 2022.

Figure 3: ESG covered bond issuance



Source: Bond Radar, Scope

However, there is a lot of spare capacity. A total of 40 issuers have issued green covered bonds since 2019. Half of those are frequent green issuers but only five of those have placed green covered bonds so far this year. That makes 15 issuers that may return to the market. Another positive message: on top of those five issuers, four celebrated their green debuts in the first half of 2024.

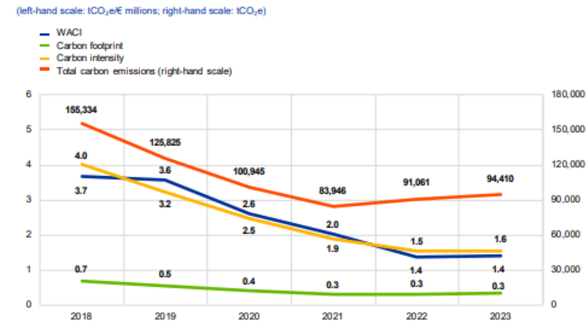
ECB climate risk disclosures – how long will they accept indifference?

The ECB is strongly committed to leading by example so has published climate risk disclosures relating to its bond holdings (including covered bonds) that are held for both monetary and non-monetary policy purposes. It will engage with its second climate-risk stress test in the course of 2024. For corporate bonds, CSPP and PEPP holdings are already subject to climate-risk consideration while primary market purchases are geared to issuers with better climate performance or green bonds. For covered bonds it is not as easy to apply climate-risk considerations when re-investing or for monetary operation other than through the relatively small share of ESG labelled bonds.

For covered bonds, the ECB needs to rely mainly on information coming from the first recourse: issuers. From a data-quality perspective, this is not perfect. Scope 1, 2 and 3 emissions are self-reported or approximated externally. Only large institutions are already obliged to publish information about their ESG risks biannually in their pillar 3 reports (CRR Article 449a). Smaller institutions will have to follow in their annual reports for 2025 only.

As the CRR is binding for banks, high-level and relative consistent portfolio-based information will help the ECB to consistently assess the first recourse. Indeed, such information has already allowed them to identify certain developments with regard to their covered bond holdings climate risk footprint.

Figure 4: ECB Climate risk metrices for covered bond holdings under the CBPP3 and PEPP



Sources: ISS, Carbon4 Finance, World Bank, Bloomberg and ECB calculations.
Notes: The chart shows historic values of the key metrics for the covered bond holdings held for monetary policy purposes under the CBPP3 and PEPP, based on issuers' scope 1 + 2 emissions. Metrics are calculated using bonds' nominal values. Emissions normalisation in the WACI and the carbon intensity metrics is based on revenue in € millions; in the carbon footprint metric, emissions normalisation is based on the investment amount in € millions. Underlying holdings refer to year-end values.

Source: ECB chart 16, Scope

What is lacking is consistent reporting on what makes covered bonds the high quality go-to investment: ESG information about the cover pool. We understand the data challenges issuers face in collecting and providing high quality even auditable ESG information on their cover-pool exposures. Only about a third of ECBC labelled covered bond issuers provide voluntary ESG related cover-pool information in their quarterly Harmonised Transparency Template (HTT) reports. Nonetheless, the quality and number of issuers reporting is increasing, which is positive. Comparisons are still not very meaningful, though, and from a credit perspective it is difficult to consistently identify credit-risk drivers.

The low share of issuers reporting information in their HTTs is somewhat surprising as the number of ESG issuers is much higher. ESG themed covered bonds also come with a regular reporting requirement but it is easier to dig out data for hand-picked collateral than for the whole pool.

Better transparency might only emerge with pressure

The ECB has investigated whether credit rating agencies can provide additional information, and it monitors and incentivises such developments (Disclosure of climate change risk in credit ratings). Further, the Bank fosters climate risk assessments at the Eurosystem level, establishing minimum standards that national central banks must abide by from 2025. The ECB repeatedly has tried to accelerate ESG disclosures – including its call for advice from the EBA and the joint ECB/ EBA statement – but the pace of disclosure improvements has been slow.

At the ECBCs 2024 spring plenary meeting in Reykjavik, the EBA shared some initial thoughts how cover-pool transparency could be formalised further. Transparency might become part of additional Pillar 3 disclosures or be included in the next update of the European Covered bond Directive (CBD), where the disclosure framework could be further improved. Ultimately the latter could mean that consistent and regular ESG disclosure becomes relevant for preferential risk weights and covered bond LCR treatment.

As seen with the CBD, political processes take time. In total, it took the CBD 10 years to materialise: The ESRB recommendation (2012) prompted an EBA report on best practices for covered bond frameworks (2014) which finally resulted in EBA recommendations on the harmonisation of covered bond frameworks in the EU (2016). Even with this blueprint, the CBD , including the regulatory requirement on more detailed and consistent cover pool disclosures, only became effective six years later in July 2022.

The ECB is unlikely to be willing to wait that long. As the single largest investor in covered bonds, it has the means to replicate for ESG and climate risk disclosure what it did back in 2015. The lack of comparable data on cover-pool transparency or in some cases the non-availability of data prompted the ECB to change the eligibility criteria for covered bonds used for monetary operations. Following a two-year phase-in period, only covered bonds that complied with requirements were eligible from 2017.

EBA reports CRE concerns

The latest EBA risk assessment report put special emphasis on elevated uncertainties from high geopolitical risk and low economic growth, with a special focus on CRE-related risks. We have commented on key elements. See Scope webinar Commercial real estate – how concerned should debt investors be? German and French banks have the highest CRE exposures, followed by the Netherlands. German, Spanish and Dutch banks reported the highest non-EEA exposures, mainly to the US. Office accounts for the banks' biggest exposure by property type hence raises the biggest concerns.

Despite elevated uncertainties in the CRE segment, the EBA notes that the asset quality of banks' CRE loans has so far remained solid. The authority highlighted that banks have set aside relative sizeable provisions to cover non-performing CRE. In total, banks had provisions of EUR 31bn against CRE loans, of which EUR 19bn were against NPLs.

In its special report on CRE, the EBA further highlighted that the loan-to-value (LTV) ratio is an important metric to assess the risk associated with CRE loans. LTVs indicates the cushion against property price declines. In this context, the authority also noted that risks may rise from cyclical volatility of collateral valuations and that this issue had become a priority for supervisors for a while.

CRR3 property value definitions could impact mortgage covered bonds

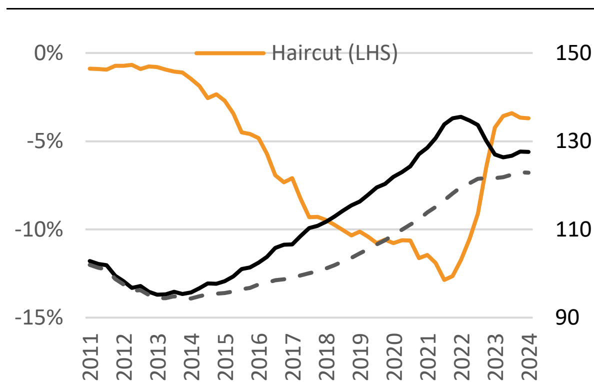
With regard to the 'property value' in CRR3, regulators have reached a first milestone in lowering volatility in property valuations. See previous Covered Bond Quarterly: CRE risks looming but covered bonds well protected.

But there is less than six months to go until the 'property value' in the updated Capital Requirements Regulation (CRR3) must be operationalised in all 27 EU member states (by 1 January 2025). Even though this is just one of many updates to the banking package and the final elements for the implementation of Basel III in the EU, it could have a notable impact on covered bonds because market values are directly linked to the maximum amount of covered bonds that can be issued.

Updated article 229(1) of the CRR matters because it will determine the valuation standards to be used for covered bonds backed by mortgages (129(3) CRR). Covered bonds will not be allowed to use the current market value of a property. The value must be one that "excludes expectations on price increases" and must be "sustainable over the life of the loan". As such the property value cannot exceed either the current market value or the average market value over the last six years for residential and eight years for commercial property.

To gauge the effects of the new property-value definitions, we calculated the haircut on residential values assuming the directive had been transposed and that no country exceptions or transitions were granted. We then factored in European house-price indices since 2005 and calculated the floating average over six years to compare it to the respective market value index. Our analysis demonstrates that the Commission's aim to reduce the impact of cyclical effects on the valuation of property securing loans and to keep capital requirements for mortgages more stable works relatively well.

Figure 5: Haircut to market value (residential)



Source: Eurostat, Scope Ratings

It comes as no surprise that the discount negatively correlates to property-price increases over the same period. Neither is it a surprise that the discount peaked in 2022 following a period of double-digit growth for residential property. The discounts have obviously decreased since then, reflecting the price corrections observed in many European countries.

The definitions in the CRR do leave some room for interpretation, however. Our analysis was based on real house prices rather than nominal values. If we were to consider nominal house prices i.e. not adjusting for inflation, today's haircut would be 14%, versus 4% considering nominal values.

Market value will not become redundant, as it will remain a key determinant of the property value, but it does set a cap on the calculation basis under the CRR and potentially also for the loan-to-value criteria of covered bonds.

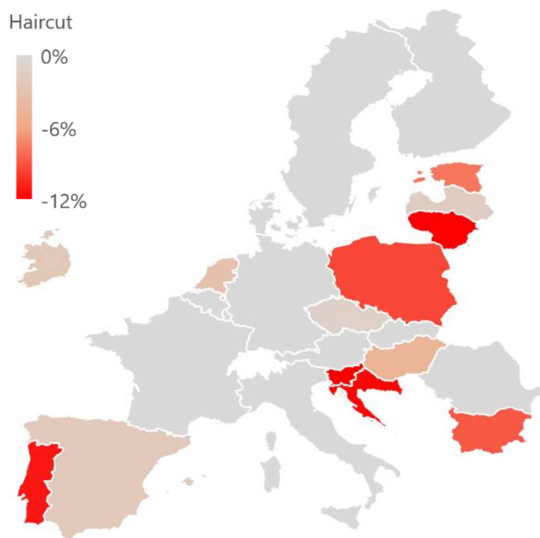
Also, national regulatory bodies may allow institutions to use market value or mortgage lending value without

limiting increases in property value. Silence will not mean the status quo has been maintained, though, as the Directive will enter into force from 2025. But a transition period may be possible for exposures created before January 2025 (until next revaluation) and to member states already applying a 'rigorous' lending value concept. This transition may be applicable until December 2027.

Diversified value haircuts to European countries

At country level, Europe is once again showing how diverse it is and here there is something of a vertical split. For most central European countries, no haircut would have to be applied to market values as of Q1 2024. But Southwestern and Eastern European countries show a haircut of up to 12%. This reflects market values well above the medium-term average. This is where LTVs may go up quite substantially having an effect on asset eligibility and finally on over-collateralisation.

Figure 6: Implied haircuts in Europe (Q1 2024)



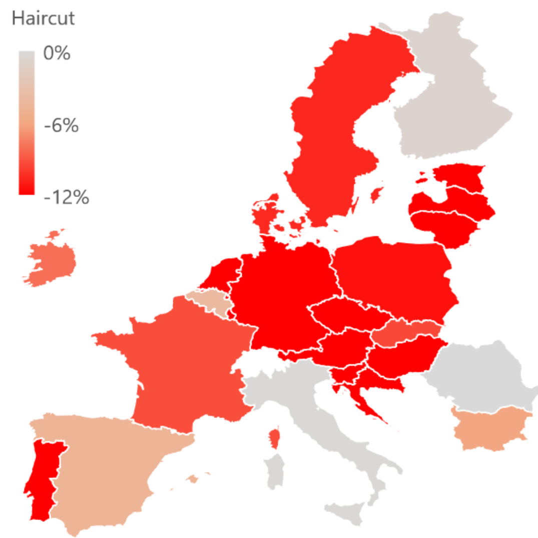
Source: Eurostat, Scope Ratings

However, despite a potential transition period to implement the property value or potential exceptions, not all of the above countries will have to significantly adjust their value downwards from 2025. Hence, we do not expect to see rising LTVs in mortgage covered bonds across the board.

This is also because in some countries the value basis for determining issuance volumes of covered bonds already follows a prudent or sustainable approach. Austria, Germany, France and Spain, for example, take into account prudent or long-term considerations when assessing the values relevant for collateralising covered bonds.

However, only two years ago, the implied haircut would have led to a quite significant market value correction in most European countries.

Figure 7: Implied haircuts in Europe (Q1 2022)

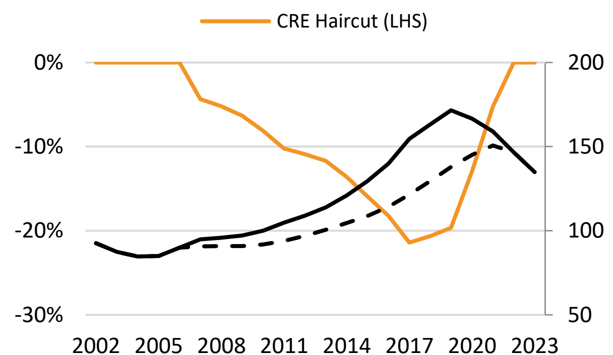


Source: Eurostat, Scope Ratings

Bespoke haircuts to commercial real estate

Applying the 'property value' for large-scale commercial real estate will typically not be based on market indices but from individually updated valuations. To visualise its impact, we illustrated the haircut based on German CRE indices.

Figure 8: Haircut to market value German commercial property

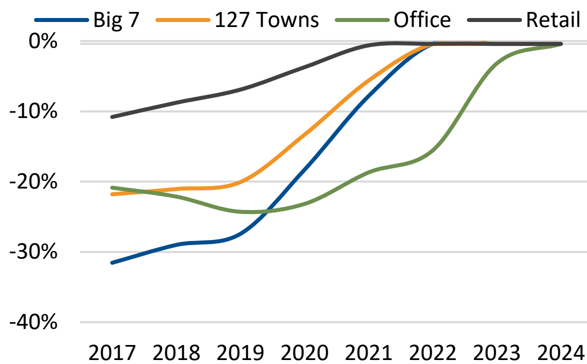


Source: Eurostat, Scope Ratings

Generally, the haircut flattens the nominal price index we used for the commercial illustration. Hence it shows lower volatility but also an imminent conversion to lower (capped) current market values. We can also show differences within certain regional or property-type clusters.

Prime properties in the largest cities in Germany (the Big 7) tend to show higher haircuts than the more diversified sample of 127 German cities and towns. The latter also did not benefit from super-low yields of around or even below 3% during the period of ultra-low interest rates. Hence a parallel shift reflecting the higher interest-rate environment had fewer effects on updated valuations.

Figure 9: Haircut by type and region (German commercial properties)



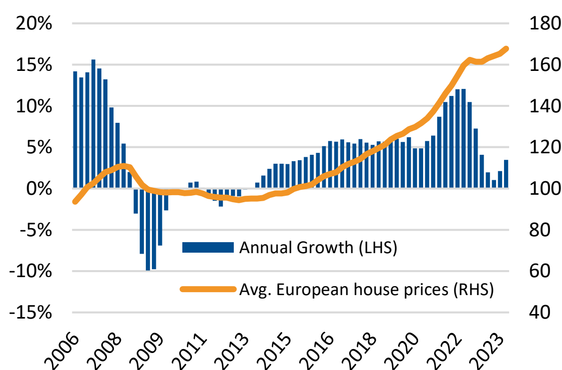
Source: Deutsche Bundesbank, Scope Ratings

Since 2017 retail properties have had a materially lower haircut compared to office properties as retail properties already went through phases of strong value corrections driven by e-commerce penetration and the pandemic. Consequently, retail has not observed the same growth rates as some other property types. What all segments have in common, however, is that today no haircut would have been applicable to their market values as the current market value is lower than their eight-year average. It should be noted, though, that CRE is a highly bespoke asset class where an index does not reflect the individual CRE valuation and implicit haircuts accordingly.

European property prices in line with inflation target

Where are property values today?, Eurostat's residential house price indices for the euro area confirmed the trend of moderate nominal price increases. Average annual growth stands at around 2% over the last 12 months, in line with the ECB's inflation target. This is reassuring as on average property prices did not have to undergo the same kind of correction they suffered after the Global Financial Crisis of 2008-2010. This is also because the conditions are completely different, with demand typically well above local real-estate supply. The current trend even supports signs of steadily increasing average growth rates.

Figure10: European house prices



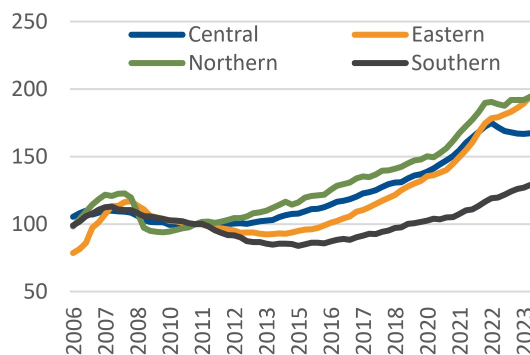
Source: Eurostat, Scope Ratings

However, variations in European countries remains high. Relatively unchanged from our earlier analysis, house prices in some countries have fallen on a nominal basis. Among those are Luxembourg, Germany, Finland, France and Sweden, and several other countries in Central Europe.

By rebasing European property prices to the beginning of 2011, after the financial crisis affected southern European economies, we see, that Central, Eastern and Northern European countries have shown a similar, long-term property price growth path. This coincides with each sub-region's GDP, each of which has stood at around 2%-3% during the last 11 years.

Also in common to those regions is that they all observed a boost during the pandemic. Where these groups differ is what happened from 2022. Inflation and rising rates mostly affected Central European countries, which are the only ones hit by a nominal value decline. Both Northern and Eastern European countries were left relatively unimpressed by rising rates and still show nominal price increases.

Figure 11: European sub-region house price index



Source: Eurostat, Scope Ratings

Potential from Southern European countries

The outliers are Southern European countries with a large gap to their European neighbours and experiencing the lowest economic growth, with an annual average of 2.1% in the last 11 years.

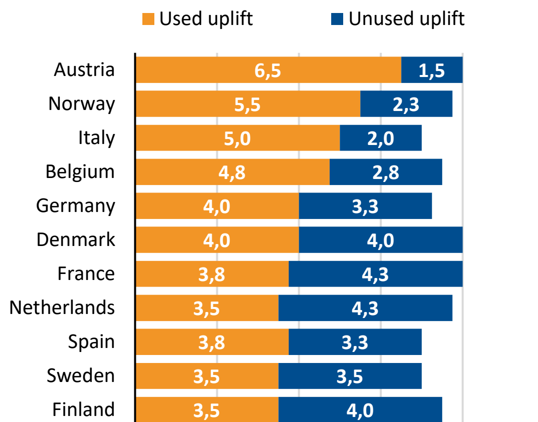
But taking into consideration the countries' growth rates since the pandemic, southern European countries have been boosted, also by a rebound in tourism following the lifting of pandemic restrictions.

Likewise, their economies were less affected by the loss of cheap gas and the downturn in manufacturing. As a consequence, house prices in the southern periphery may benefit from the general positive economic environment and outperform the rest of Europe in the medium term. Also, demand remains high in many cities and towns in the European periphery too.

Scope's covered bond universe: Rating stability and high buffer against issuer downgrades

All of Scope's covered bonds are currently rated AAA with a stable outlook (see here). French, Dutch, Danish 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.

Figure 13: Downgrade sensitivity Scope rated Covered bonds

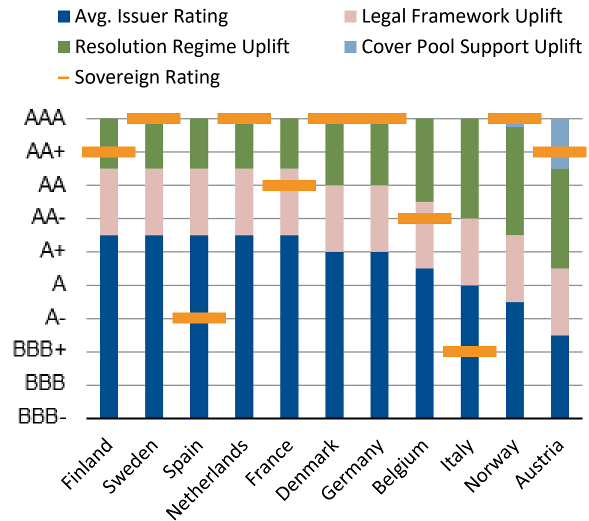


Source: Scope Ratings

Strong bank ratings and very supportive legal and resolution frameworks allow 85% of our rated covered bond programmes to achieve 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 do not materially change.

Figure 14: Covered bond rating composition



Source: Scope Ratings

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, 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 over-collateralisation (OC)currently provided exceeds the OC 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 drop in eligible assets from value depreciation).

Annex I: 2024 Outlooks and Research

Related outlooks

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

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Related research

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