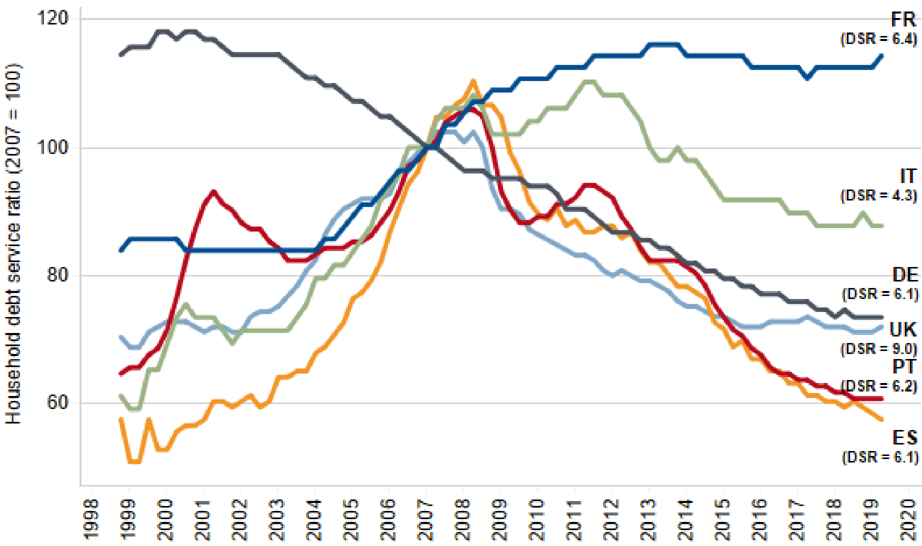
Covid-19: household financial resilience put to the test

Uncertainty around the length of shutdowns and the efficacy of support measures allow for a range of outcomes for consumer and mortgage credit. Scope's baseline scenario sees delinquencies nearly doubling in some peripheral euro area economies, while larger and more diversified economies like Germany and the UK will see mortgage and consumer credit delinquencies rise by between 20% and 50%, respectively. French delinquencies may surprise to the downside and suffer a steeper increase than during the global financial crisis due to higher leverage.

Executive summary

The Covid-19 pandemic has dealt European economies a blow of massive proportions at an unprecedented pace. The effects are most severe in peripheral euro area economies, but a near record share of households across the Continent is expecting a significant rise in unemployment over the next year. We expect such dislocations to flow to consumer credit and mortgage portfolios in the shape of a rise in delinquencies and defaults.

Figure 1: Evolution of household debt service ratios[1] in key European economies



Source: Bank for International Settlements, Scope Ratings

Some households are better prepared than others to weather gaps in their incomes and balance sheets, so we expect divergences between and within jurisdictions. While peripheral euro area economies are expected to be most vulnerable, some more robust economies may also face more severe shocks than during the global financial crisis. French households, for instance, have seen levels of debt rise more quickly than incomes since the crisis, making them more vulnerable to a sudden drop in incomes (see **Figure 1**).

In the following sections, we take account of the financial position of European households followed by a summary of government aid programmes. We also discuss how consumers view their economic situation and present a data-driven outlook for consumer and mortgage securitisations, which, given the uncertainty, is based on a range of scenarios.

[1] Households' debt service ratio is defined as the ratio of total required debt payments (interest and principal) to total disposable income.

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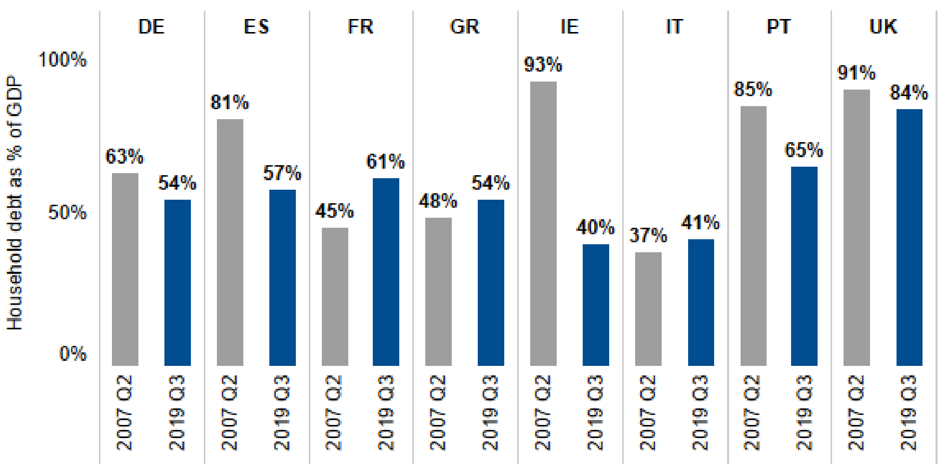
Some households better positioned to face the crisis

Differences between jurisdictions

Households in most European countries less leveraged than in 2007

At the outset of the current crisis, households in most major European economies were less indebted relative to GDP than they were heading into the global financial crisis of 2008-2009 (GFC), indicating generally healthier household balance sheets (see **Figure 2**. However, France, Greece and Italy are exceptions to that trend and are among those hardest hit by the pandemic. As GDP drops further and households take on additional credit to fill gaps in income, these ratios are expected to increase.

Figure 2: Household debt as a percentage of GDP in 2007 versus late 2019

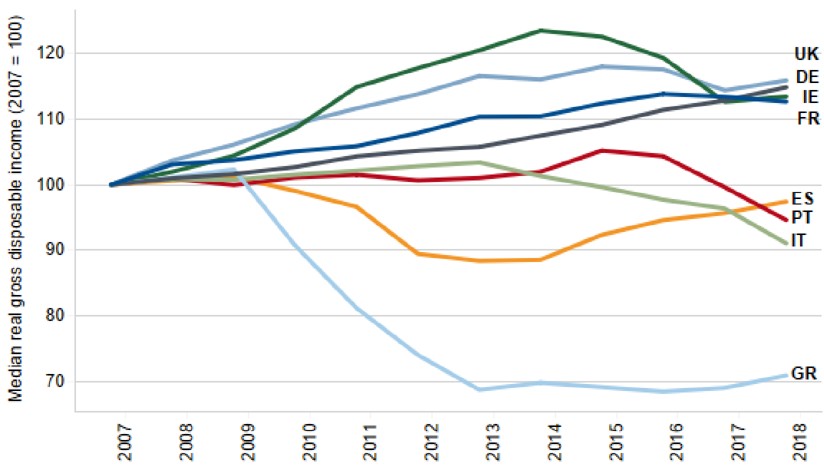


Source: Bank for International Settlements

Growth in real household incomes varies significantly

It is also important to note that while the level of indebtedness relative to GDP shows the health of household balance sheets, we must also take liquidity (i.e. income) into consideration when forming a view on household resilience through crises like the one we are in today. There are significant differences between European jurisdictions in this regard, deriving from two key factors: (i) divergence in national recoveries from the GFC/euro sovereign crisis, and (ii) secular trends in household credit, which vary between jurisdictions.

Figure 3: Recovery in disposable incomes has varied significantly across Europe



Source: EUROSTAT, Scope Ratings

In Greece, for instance, real incomes had only begun to recover as the Covid-19 pandemic hit Europe, having bottomed out at around 70% of pre-crisis levels in 2016 (see **Figure 3**), implying a significantly reduced ability to service liabilities through the current crisis. The trend has been similar, though much less drastic, in other peripheral economies like Italy, Portugal and Spain. In Germany, France and the UK, on the other hand, real incomes have continued to grow, allowing households much more leeway. Metrics on euro area household debt servicing capacity are shown in **Appendix I**.

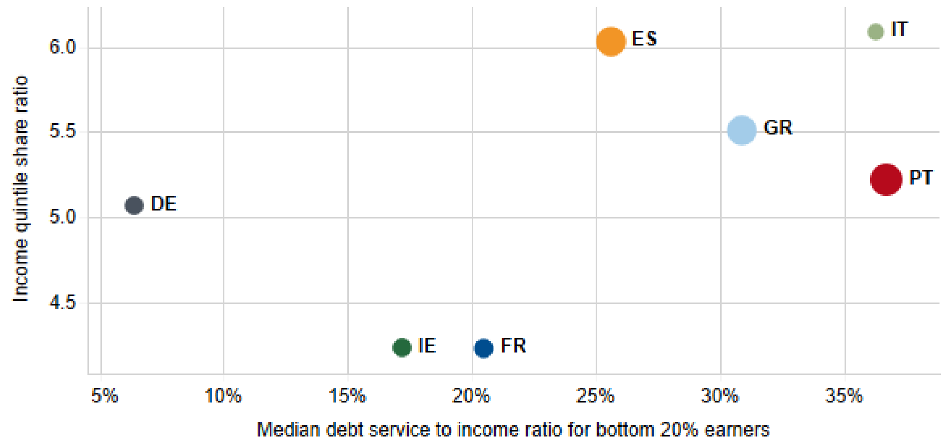
France has seen household credit grow faster than incomes

In France, the growth in credit to households has outpaced growth in disposable income. A substantial share of this credit expansion is in the form of residential mortgages, with outstanding mortgage stock growing by 300% between January 2000 and March 2020, as opposed to consumer loans, which doubled over the same period. Two important drivers of this trend are: (i) the growth in house prices, which led to an increase in the average size of mortgages, and (ii) banks' more aggressive use of mortgages to secure and retain customers. This has resulted in a higher strain on household disposable income and caused the aggregate debt service ratio[1] to rise by 15% since 2007, while households in all other countries in our sample saw material declines (see **Figure 1**)

This rise in household indebtedness led the French financial stability committee to set the countercyclical capital buffer at 0.25% in July 2019. This was scheduled to increase to 0.5% in April 2020, but in view of the current crisis, that decision has been reversed and the buffer is now set at 0%.

Regardless, households in Continental Europe maintain relatively modest debt service ratios in absolute terms. This is in sharp contrast to Anglo-Saxon countries including the United Kingdom, where the ratio was the highest of all jurisdictions in our sample at the end of Q3 2019, even exceeding that of US households.

Figure 4: Income equality is accompanied by higher strain on income for low-income households[2,3]



Source: European Central Bank, EUROSTAT

[2] Size of the bubbles represents median debt owed by bottom 20% earners in the jurisdiction.

Differences within jurisdictions

Households at lower end of the income distribution face higher debt-servicing burdens

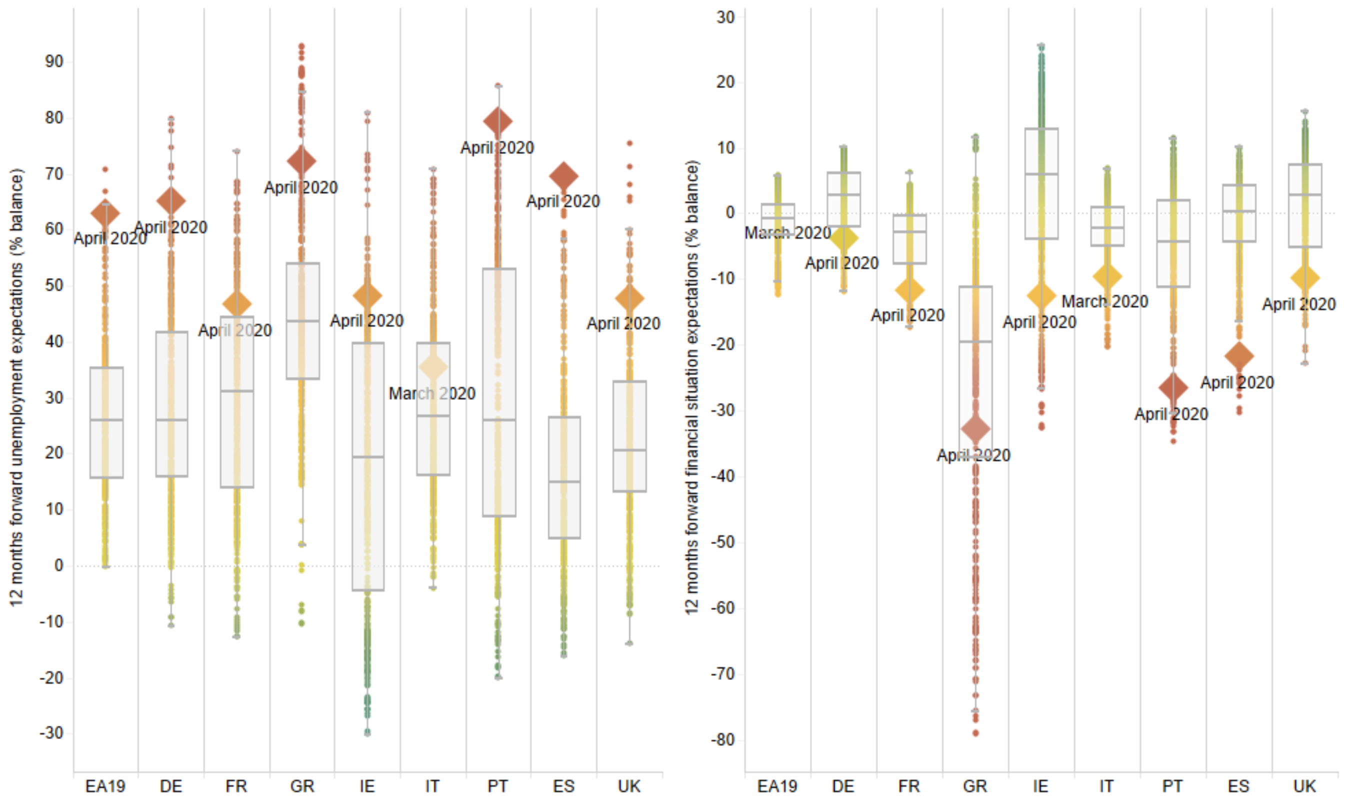
Within jurisdictions, some households are significantly better positioned. In Italy, where income inequality (measured by the income quintile share ratio[3]) is the highest of all jurisdictions in our sample, households in the bottom 20% spend 36% of their income on debt service, more than four times that of the top 20% of earners (see **Figure 4**). This is worth noting as low-income households will likely be the most vulnerable in a downturn, and their share of outstanding debt may not always be a negligible share of total outstanding debt. In Greece, for instance, the median amount of debt owed by the lowest 20% earning households is EUR 9,300 – higher than that owed by the corresponding bucket of German households, which have significantly higher income, but almost a quarter of the median debt owed by the top 10% earners in the country.

Households' expectations among worst on record

Consumer confidence declines at the sharpest rate on record

The depth of this crisis is summarised by the fact that the euro area experienced its sharpest month-over-month (March to April) drop in consumer confidence on record and has bottomed to a level nearly on a par with the worst level seen during the GFC. It took 19 months – August 2007 to March 2009 – for sentiment to experience the equivalent decrease to what we've seen since February 2020. For the time being, this is a liquidity shock for consumers that will disproportionally impact those with limited financial resources.

Figure 5: Unemployment and financial situation expectations for the next year slide to near record lows across Europe



Source: European Commission

3 Income quintile share ratio is defined as the ratio of total income received by the 20% of the population with the highest income (top quintile) to that received by the 20% of the population with the lowest income (lowest quintile).

Financial situation and unemployment expectations

Unemployment expectations for next year among the worst ever

Forward-looking expectations are equally dramatic, with the financial situation over the next 12 months matching an all-time low since the metric came into being in 1984. Dovetailing this are unemployment expectations, which are approaching the historic peak from March 2009. The rate of decline is also unrivalled.

The outlook for consumers over the next 12 months with respect to their financial situation and unemployment expectations are more telling indicators for investors in consumer credit. These measures can hint at how consumers are planning financially. If worst-case scenarios play out, how will borrowers prioritise debt obligations against day-to-day obligations? Will consumers prioritise certain debt obligations over others, perhaps favouring short-term liquidity from forms of unsecured debt vs servicing mortgages, for example?

The nature of uncertainties during the pandemic (finding a vaccine, treatments to manage symptoms, government policies, etc.) will continue to pressure consumers to scale back spending and may require debt prioritisation in the event of wage reductions or unemployment. Relief in the form of a vaccine is not likely a reality until early 2021, and treatments are still in testing stages. Until we see substantial progress, consumers with limited savings/liquidity and high levels of debt will be forced to make tough choices that may have implications in certain consumer ABS deals.

Government response

Governments take several steps to help borrowers

Rising debt service ratios, especially when they are at relatively modest absolute levels, are not necessarily of concern during an economic boom, but they become increasingly relevant as economies enter periods of high uncertainty, falling demand and loss of productivity, even if temporary. Anticipating the financial stress faced by the millions now filing for unemployment benefits across Europe, governments proactively stepped up to support consumers through the crisis with unprecedented relief packages, including payment moratoriums, tax deferrals/waivers and direct transfers. We have summarised key measures taken to support households across major European countries in the table below.

Figure 6: Government measures to support households in eight European countries

Jurisdiction	Payment Moratoria	Direct Support
France	- No national policy.	- EUR 1bn earmarked for aid to more than four million households. - EUR 24bn allocated for those who lose employment due to closures during the pandemic.
Germany	- No national policy.	- Expanded short-term work scheme allowance to prevent lay-offs.
Greece	- No national policy.	- EUR 800 direct payment to 1.7 million employees.
Ireland	- No national policy.	- Wage subsidy scheme extended to businesses to ensure salary security for employees. - Unemployment payments increased to EUR 350.
Italy	- Subject to certain conditions, those who lose employment due to closures during the pandemic or suffer health issues can request payment holidays of up to 18 months. - Broader moratoriums guarantee schemes under consideration.	- EUR 600 direct payment to self-employed. - EUR 4.3bn funding to municipal governments for further programmes.

Portugal	- Payment holiday of six months for homeowners (excluding buy-to-let loans)	- Macroprudential regulation lifts debt service-to-income ratio limits on consumer credit with less than two years to maturity and classified as intended to mitigate 'households' temporary liquidity shortage situations'.
Spain	- Those who lose employment due to closures during the pandemic can request payment holiday of three months.	- Expanding the social security net to support households whose incomes are impacted by the shutdown.
United Kingdom	- Up to three months in payment holidays to all homeowners. - Repossession proceedings to be halted temporarily. - Payment holiday of up to three months on credit cards, personal loans and overdrafts.	- Wage subsidy scheme extended to businesses to ensure salary security up to 80% of wages for all employees (capped at GBP 2,500 per month).

Banks offer borrowers voluntary payment holidays part of the solution

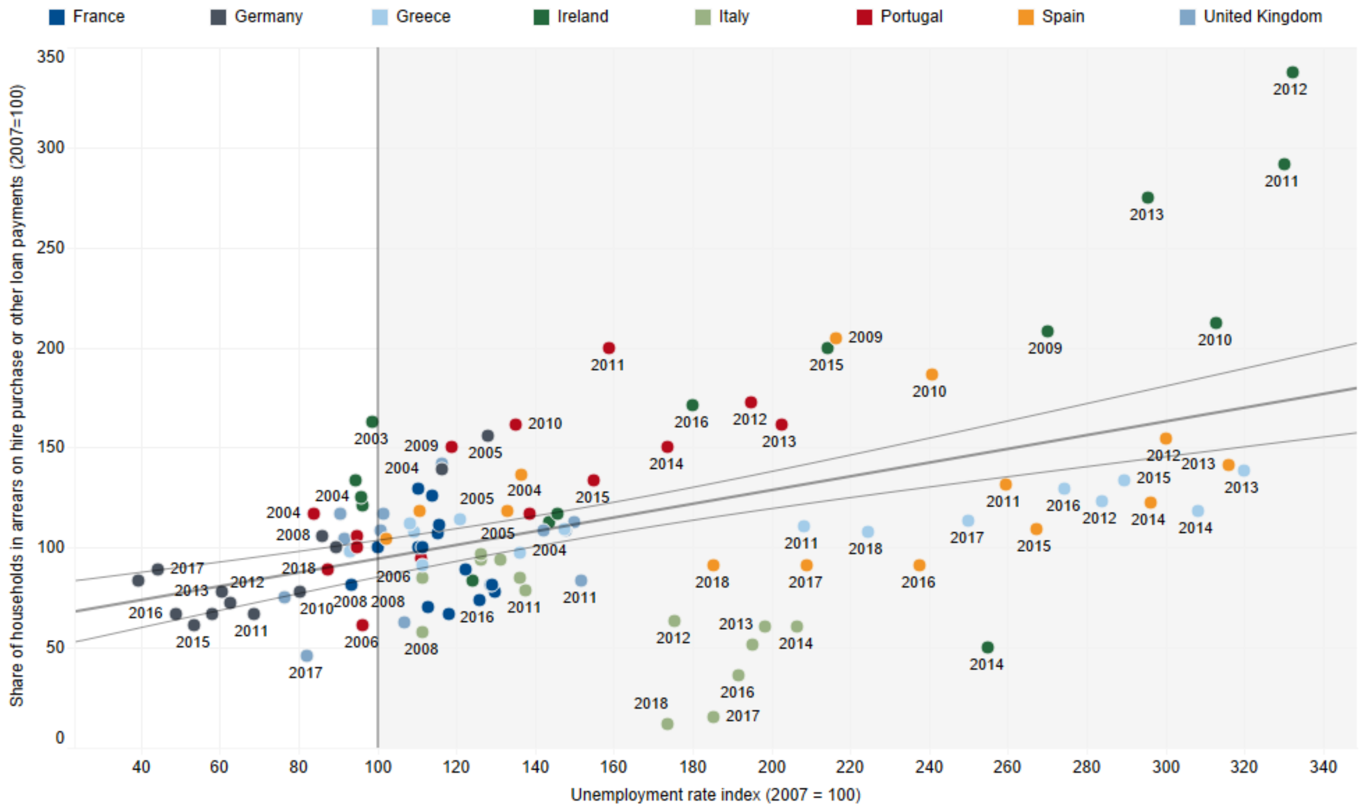
Banks have voluntarily offered forbearance to households in distress as a result of the crisis. In Ireland, the country's five main retail banks released a joint plan to offer a payment holiday of six months to all homeowners and deferring all legal proceedings over a three-month period. Likewise, the Greek banking association announced a three-month payment holiday for all borrowers who were previously not in arrears. Banking associations and individual retail banking institutions in other countries like Italy and Germany have taken similar measures.

Scope's outlook for consumer and mortgage credit securitisations

A range of scenarios remain possible

The Covid-19 pandemic will lead to a significant drop in incomes and elevated unemployment rates across Europe. However, the efficacy of steps taken by federal and supranational agencies to support households through this period remains to be seen. As consumers and the corporate sector are highly inter-dependent, besides the measures described above, initiatives to support European businesses are also relevant.

Figure 7: Relationship between unemployment and share of households in arrears on hire purchase or other loans



Source: EUROSTAT, Haver Analytics, Scope Ratings

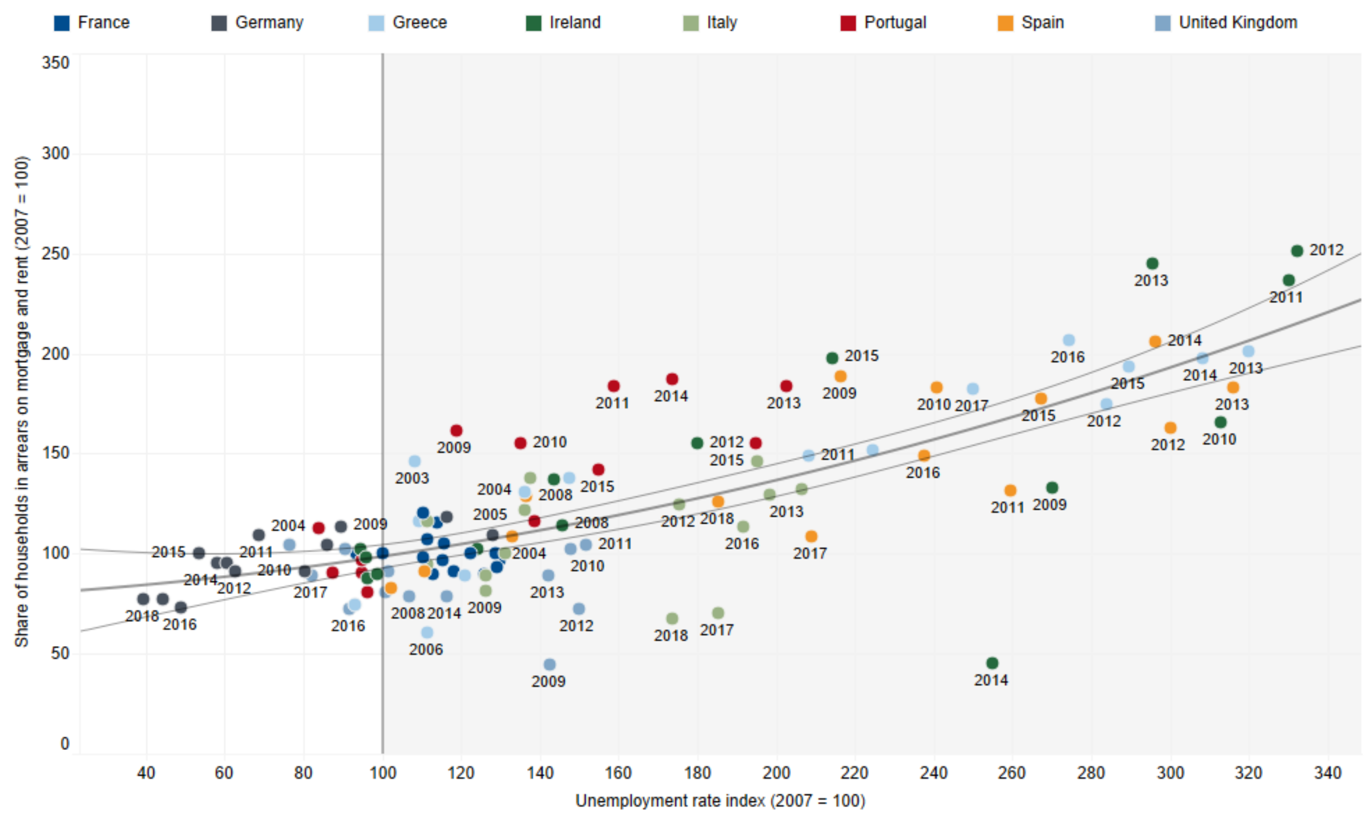
Effect of government measures still uncertain

With regard to consumer and mortgage credit securitisations, there are some traditionally important themes to follow, such as elevated default and contraction risks (and a potential for limited extension risks from moratoriums). However, for reasons described above, the extent of a potential rise in delinquencies and defaults is still very uncertain. Therefore, we believe it is most appropriate to address the current situation by factoring in a range of scenarios into our assumptions.

Rise in unemployment to lead to higher delinquency rates

Our analysis of data from the European Commission's Survey of Income and Living Conditions going back to 2003 shows that across eight European jurisdictions, unemployment was strongly correlated with the share of households in arrears on their mortgage or rent payments (see **Figure 8**).

Figure 8: Relationship between unemployment and share of households in arrears on mortgage or rent[4]



Source: EUROSTAT, Haver Analytics, Scope Ratings

Peak employment through a crisis a key driver of delinquencies

We find that household delinquencies often continue to materialise years after the initial shock, as we continue to see decelerating growth in unemployment. This implies that the cumulative rise in unemployment through a crisis is more relevant than the periodic rate of change. In fact, a quadratic relationship appears most suitable for mortgage arrears i.e. there is a steeper rise in mortgage delinquencies when peak cumulative unemployment through the crisis is higher. A potential rationale for this relationship follows in the next section.

Finally, we also find that unemployment explains much less of the variation in the share of households in arrears on hire purchase and other loan payments, including credit cards (see **Figure 7**), even as the share of households in arrears on such credit grows more steeply compared to delinquencies on mortgages in absolute terms.

The pecking order of household defaults

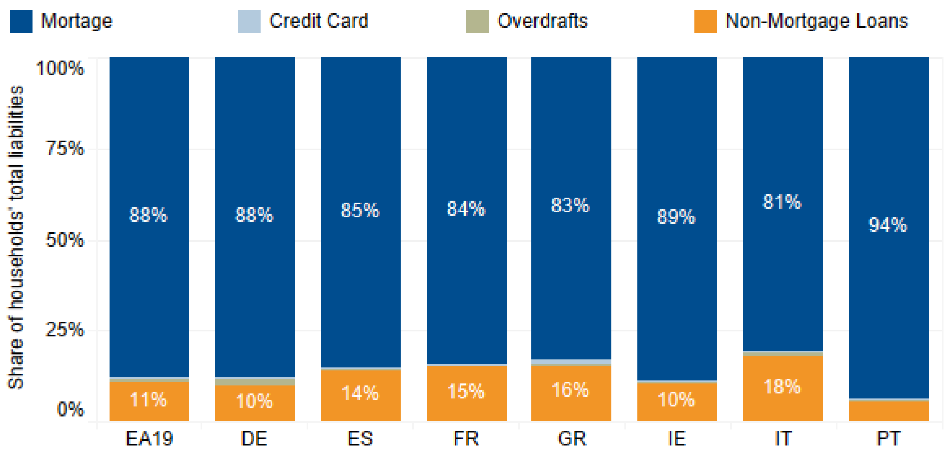
Mortgage credit more resilient in order of defaults

Relative resilience of mortgages as opposed to other forms of consumer credit extended to households implies that mortgages are likely situated at the bottom of the pecking order of household defaults. This may be rooted in a variety of reasons, including the stigma associated with individual defaults and the fundamental utility of housing to households, which could lead to a lower likelihood of mortgage delinquencies during periods with relatively muted rise in the unemployment rate. Consider, for example, one member of a two-person household being laid-off, and yet mortgage payments continuing

[4] While past studies that used aggregate unemployment rates to predict defaults on loan level data found no significant relationship between mortgage default and unemployment in the United States, a more recent study found both household unemployment and local unemployment rate to be important predictors of mortgage default.

to be paid from the other member's income. For such a household, delinquency on mortgage payments is much more likely when both members of the household lose their jobs, thus supporting the quadratic relationship between unemployment and delinquencies observed in **Figure 8**. In fact, analysis from the Bank of Italy shows that the most vulnerable households were more than twice as likely to have been in arrears on consumer debt as on their mortgages between 2010-2016[5].

Figure 9: Types of debt owed by households



Source: EUROSTAT, Scope Ratings

Research shows that the nature of unemployment also affects homeowners' likelihood of default on mortgages[6]. Shorter bouts of cyclical unemployment allow rationalisation of the liquidation of other assets to prevent foreclosure, as opposed to long-term structural unemployment, where the homeowner would rather use said assets to fund their move to a more robust labour market, for example.

Ultimately, all other things being equal, the pecking order hypothesis would imply a lower likelihood of default on mortgage credit in jurisdictions where consumer credit forms a larger share of household liabilities (see **Figure 9**). However, given the depth of this particular crisis, this may have a negligible impact, as described in our considerations for a highly stressed scenario.

Baseline scenario

Scope expects unemployment to rise by 25%-30% in Europe

In our baseline scenario, we assume a slowing of the pandemic by the end of Q2 2020 in Europe and US, followed by a gradual withdrawal of containment measures. In this scenario, the approach in Europe would echo 'the hammer and the dance' tactic adopted by Chinese authorities, accompanied by a phased pivot from antigen (diagnostic) to antibody (immunity) tests for SARS-CoV-2 as proposed in France and Germany – which will allow segments of the population to go back to work.

Even with such measures in place, Scope expects unemployment rates across Europe to grow by between 25-35% from pre-Covid levels in 2020[7]. As shown in **Figure 7** and **Figure 8**, in countries like Portugal, Spain, and Ireland, a similar rise in unemployment rates in the first year of the GFC led to as much as a tripling of delinquencies on

[5] Attina et. al, *Modelling households' financial vulnerability with consumer credit and mortgage renegotiations* (2019), Bank of Italy Occasional Papers.
[6] Quercia et. al, "*Differential Impacts of Structural and Cyclical Unemployment on Mortgage Default and Prepayment*" (2014). Journal of Real Estate Finance and Economics.
[7] *Q2 2020 Sovereign Update*, Scope Ratings.

consumer credit and up to a doubling in the share of households in arrears on mortgages. In more diversified economies like the UK, Germany and France, mortgage delinquencies rose by less than 20%, while the share of households delinquent on consumer loans grew by more than 50%. As discussed in previous sections, given that households in peripheral economies like Portugal and Spain remain more leveraged than most European countries, we expect such divergence to re-emerge between better diversified, larger economies and peripheral countries with concentrated exposures to tourism.

France and Italy countries to watch for vulnerabilities

We also expect France and Italy to beat this general trend to the downside. In the case of France, we expect households to be more vulnerable than the prior crisis, as they are not only more leveraged, but their indebtedness has also grown faster than their income, leading to higher susceptibility to volatility or loss of income. In Italy, the public health crisis is perhaps the most severe of anywhere in the world, triggering the longest and most stringent lockdowns anywhere in Europe, which is expected to lead to much larger losses in income in relative terms, especially given the economy's exposure to tourism.

Special asset classes like Italian CQS expected to perform better

Not all securitised products are likely to suffer, however. We expect Italian payroll-deductible (CQS) loans will suffer less compared to standard unsecured loans. Defaults triggered by death and job-loss events are the main source of risk for CQS loans, but their multiple layers of protection will mitigate any deterioration in performance.

CQS loans are collateralised by the borrower's salary or pension and their employer or pension provider repays the loans by deducting the instalments directly from the salary or pension. In addition, mandatory product-specific insurance policies cover CQS loans against death and job-loss risks, which do not exclude pandemics as a cause of death. We also expect a lower impact from incidence of mortalities, as most borrowers are located in south and central Italy (75% in CQS transactions rated by Scope), which are relatively less impacted by the outbreak. Scope is monitoring counterparty risks, such as potential insurer insolvencies.

Highly stressed scenario

The scenario described above is subject to several downside risks, which include:

1. Extension of containment measures, leading to more permanent business closures;
2. A more pronounced recession in the United States;
3. Inadequate or inefficient implementation of government relief packages; or
4. Re-emergence of an epidemic in China.

If one or several of these events were to occur, we expect especially severe depressions in the euro area periphery. The only reference point for such an extreme scenario would be the Great Depression, even though it was primarily a credit crisis and the systemic backstops were vastly inferior at the time.

Delinquencies to grow 3-4 fold if unemployment shoots to Great Depression highs

At the peak of the great depression in 1934, as unemployment was just past its peak but still seven times pre-crisis levels at 22%, roughly 44% of US American homes were reported to have been in arrears on mortgages[8]. While forming a precise view on a rise in delinquencies in such an extreme scenario is difficult, based on this information and pre-Covid unemployment rates and share of delinquent households in all eight jurisdictions in our sample, we expect between a three to four-fold increase in delinquencies across Europe, with Greece, Portugal, Spain, Italy and France among those most vulnerable.

[8] Wheelock, D., *The federal response to home mortgage distress: Lessons from the great depression (2008)*. REVIEW - FEDERAL RESERVE BANK OF SAINT LOUIS, 90 (3), p.133.

In such a scenario, however, differences between delinquency rates for mortgages and consumer credit would likely be relatively small. Indeed, as previously described, the pecking order hypothesis would imply a lower likelihood of default on mortgage credit versus consumer credit. However the loss of employment and incomes that we envision in this scenario will leave a large share of consumers unable to differentiate between loans and to continue servicing their mortgage debt (similar to the US following the GFC[9]).

[9] Andersson et. al, 2013. *The changing pecking order of consumer defaults*. Journal of Money, Credit and Banking.

I. Key household financial situation ratios across Europe

COUNTRY	Debt service to income ratio	Net liquid assets as % of gross annual income
CY	25.8	1.7
FR	17.2	16.9
HR	16.7	0.1
LU	15.5	23.8
ES	15.2	14.8
BE	14.2	26.7
PT	13.8	14.2
NL	13.5	33.9
MT	13.1	64.6
EU	**13.0**	**17.1**
GR	12.3	3.3
IE	12.3	6.1
SI	12.3	3.8
IT	12.0	20.5
SK	11.4	8.3
PL	11.1	11.7
FI	10.6	10.1
HU	10.4	2.5
LV	9.8	0.5
DE	9.7	16.8
LT	8.8	6.1
EE	8.5	7.9
AT	7.6	30.9

Source: European Central Bank

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