Covered Bonds Outlook Midyear 2021:
Credit Stable Despite Waning Support

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S&P Global
Ratings

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Key Takeaways

We expect **investor-placed issuance** to stay depressed until 2023 as the unprecedented monetary policy support aimed at combating the COVID-19 pandemic unwinds.

Economic conditions are supportive and long-term scarring to the economy should be limited by Europe's coordinated fiscal and monetary policy response, enabling the region to close the output gap by 2024.

Eurozone **inflation has spiked** since the start of the year due to one-off factors. However, we expect the momentum to abate through to the end of 2021. The **ECB** will likely continue **net asset purchases** through 2023 and refrain from hiking rates before late 2024.

We expect only a **limited credit impact on prime residential mortgage loans** once this fiscal and regulatory support wanes, because payment moratoria have already expired in several European countries, and there is still no evidence of any cliff effects in the labor market from the phasing out of short-time work schemes.

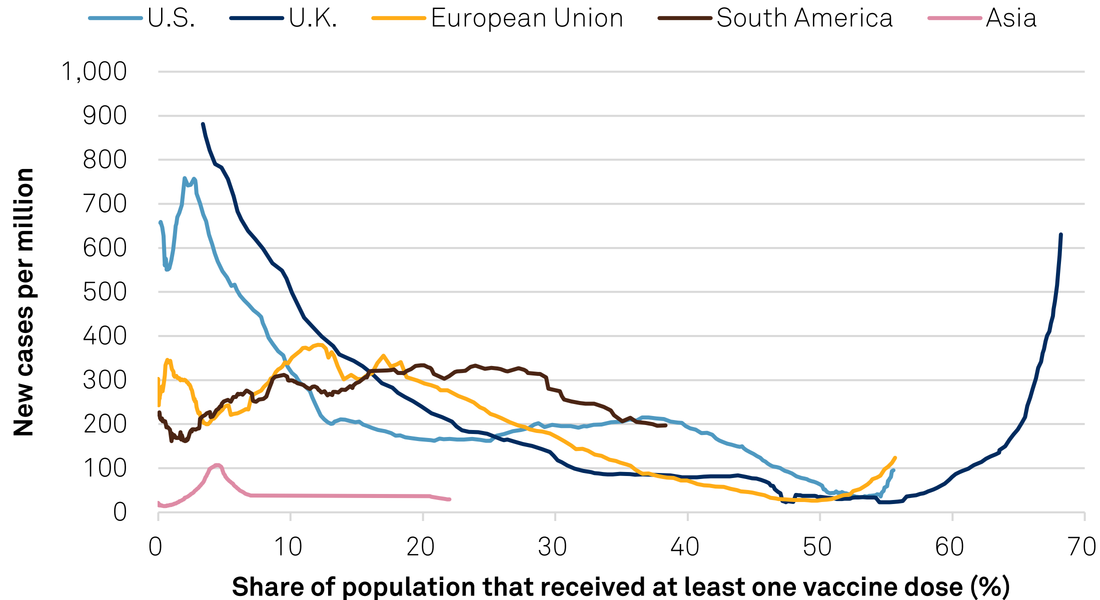
We expect a **more severe impact** on the performance of **commercial real estate assets**, especially for the retail and lodging sectors, but cover pools' exposures are limited.

Our **outlook remains stable**, because the credit enhancement available to most of the programs that we rate significantly exceeds the level required to maintain the current ratings. The presence of unused notches reduces the risk of covered bond downgrades even if there are limited downgrades of issuing banks.

Economic Conditions | The Recovery Is Now Moving To Services

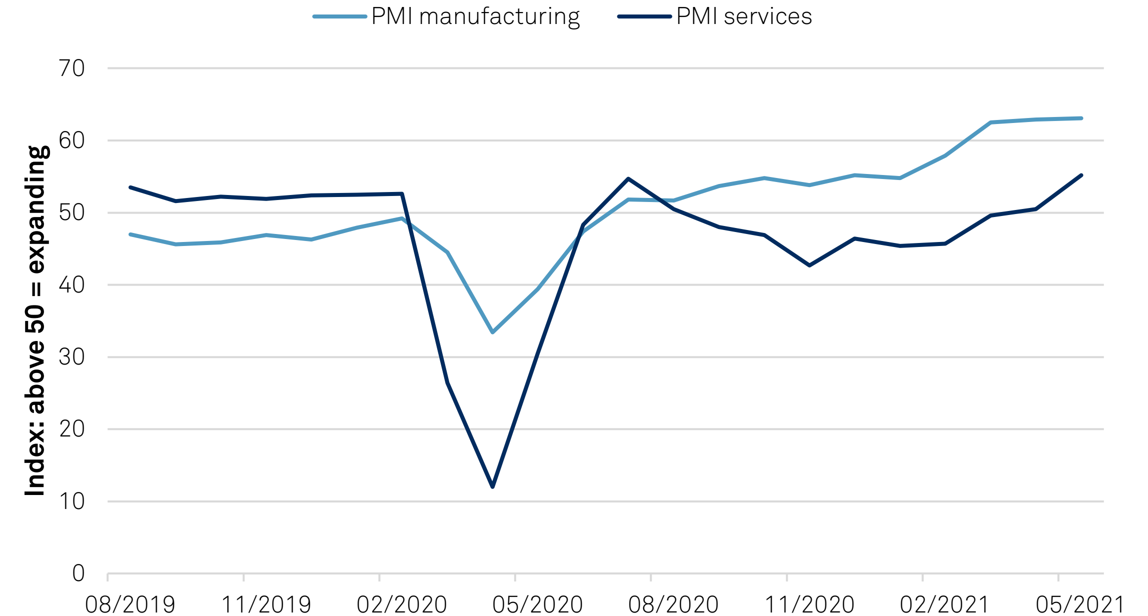
- Increasing vaccination rates are allowing European governments to gradually lift social-distancing restrictions.
- Services sectors are catching up with construction and manufacturing, where momentum has slowed due to semi-conductor shortages.
- The main risks stem from the impact of COVID-19 variants and financing conditions when central banks reduce their bond purchases.

Infections Are Low But Rising Again In Parts Of Europe



Latest data as of July 17, 2021. Source: Our World In Data, S&P Global Ratings.

Eurozone PMI Highlights Sectoral Rotation From Industry To Services-Led Growth Has Started

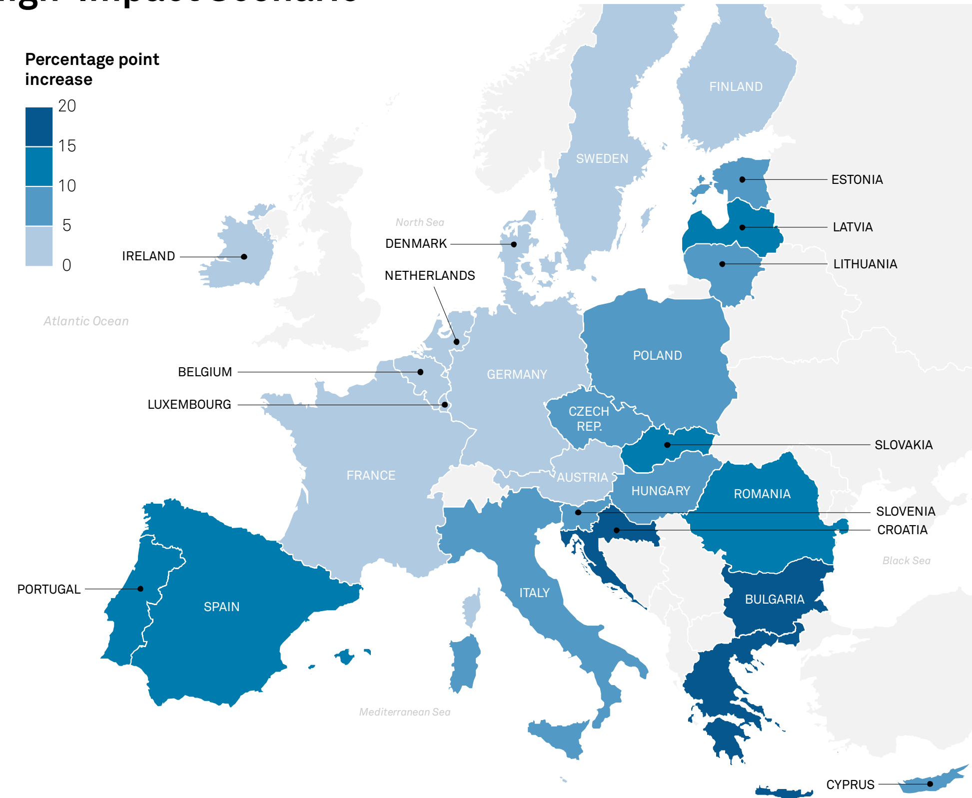


PMI--Purchasing managers' index. Source: IHS Markit, S&P Global Ratings. Economic Outlook Europe Q3 2021: The Grand Reopening, June 24, 2021.

Economic Conditions | Long-Term Scarring Likely To Be Limited

- We expect eurozone economic growth of 4.4% this year and 4.5% in 2022, after a 6.7% contraction in 2020.
- External demand remains dynamic as the eurozone's main trading partners, like the U.S. and China, recover from the pandemic and vaccination rollouts continue to pave the way for a sustainable reopening of the economy.
- Long-term scarring to the economy should be limited by Europe's coordinated fiscal and monetary policy response, enabling the region to close the output gap by 2024.
- The Recovery and Resilience facility could add 1.3%-3.9% to eurozone GDP over the next five years, marking a shift in the type of fiscal support.
- While at the start of the crisis governments concentrated on maintaining household incomes and companies' access to finance, they are now looking to restart growth through large investment programs.

Next Generation EU: Cumulative GDP Impact By 2026 Under Our High-Impact Scenario

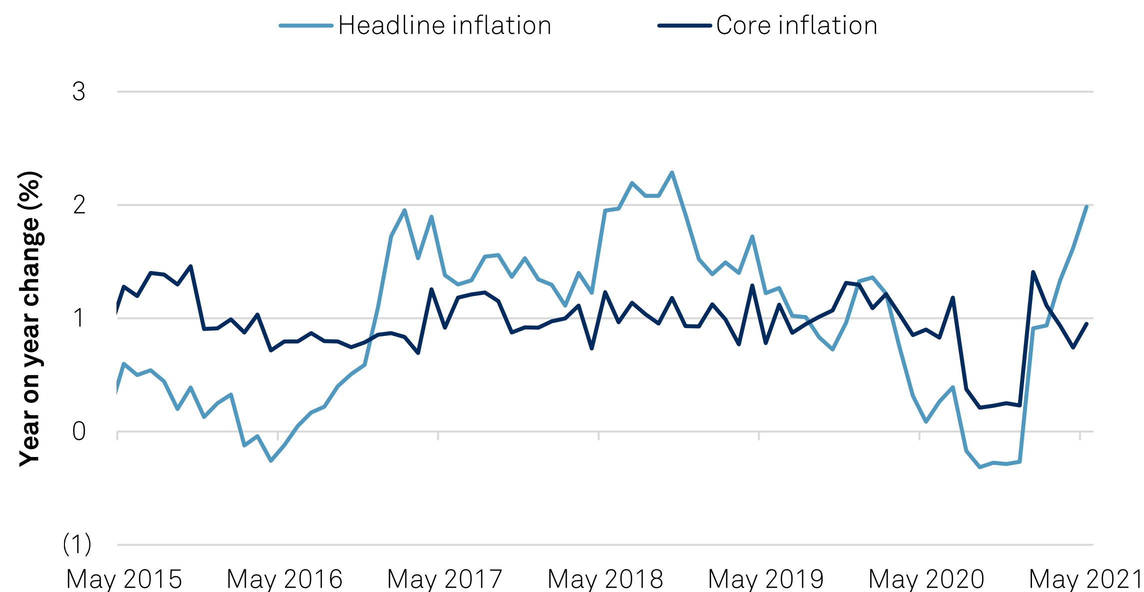


S&P Global Ratings' estimate of Recovery and Resilience Facility component of the plan. Source: S&P Global Ratings. Economic Outlook Europe Q3 2021: The Grand Reopening, June 24, 2021.

Economic Conditions | The ECB's New Inflation Strategy Signals Smooth Tapering

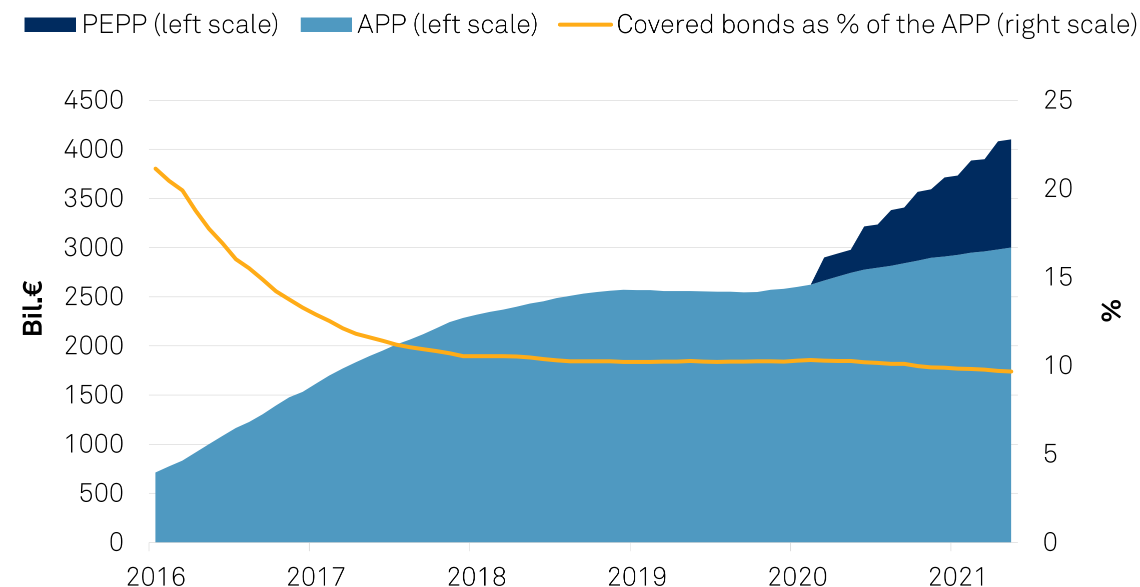
- Consumer prices have been rising on the back of higher energy prices, but these effects will likely slow in the second half of this year.
- The ECB's new strategy addresses shortcomings in how it targets inflation and will likely make it more comfortable about tapering.
- We still expect the ECB to continue net asset purchases through to 2023 and refrain from hiking rates before late 2024.

Headline Inflation Increased Mainly Due To Energy Prices, While Underlying Inflation Remains Subdued



Sources: Eurostat, S&P Global Ratings. European Economic Snapshots, July 9, 2021, and The ECB's New Strategy Signals Smooth Tapering And Cautious Greening Ahead, July 9, 2021.

Covered Bonds Constitute Almost 10% Of Cumulative Net Purchases Under The Asset Purchase Program



Sources: European Central Bank, S&P Global Ratings.

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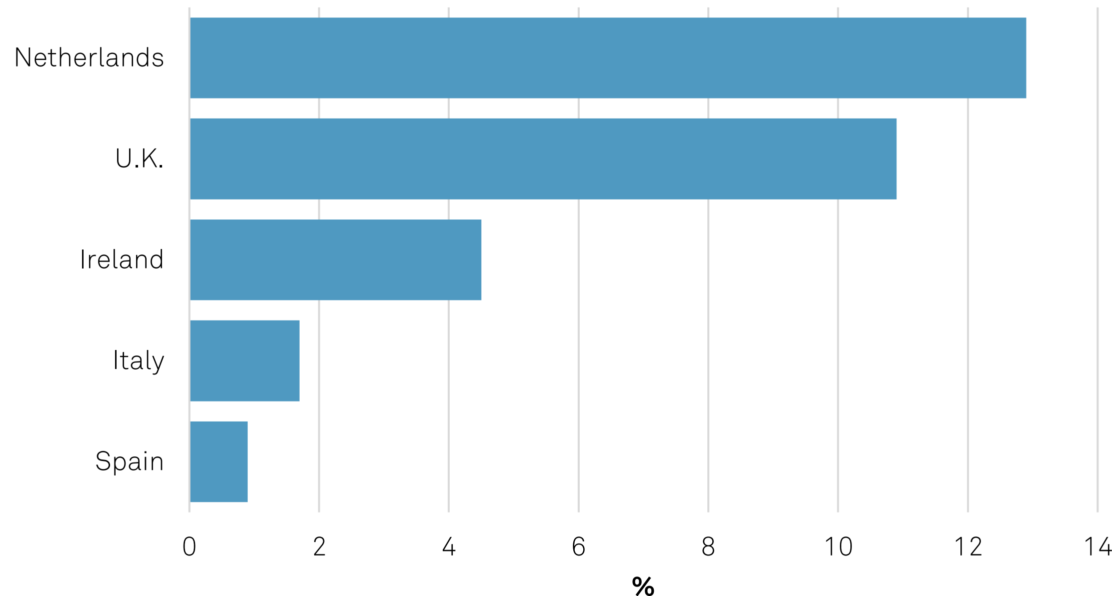
Economic Conditions | Economic Rebound Supports Housing Market

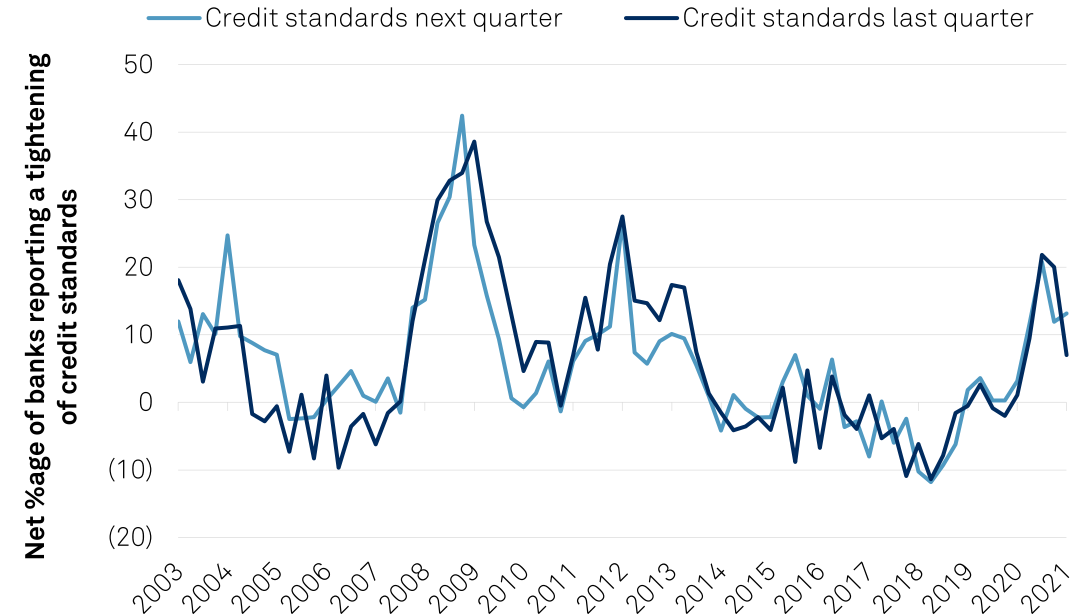
- Short-time work and furlough schemes, increased savings, and loose monetary policy kept housing demand afloat in 2020 and 2021.
- The expected sustained recovery in the economy and employment will support the housing market beyond 2021.
- Structural changes in a post-pandemic housing world are possible, but we still expect cities to remain attractive to homeowners.

House Prices Are Still Growing Fast In Europe...



To May 2021. Sources: National statistical offices, Nationwide (U.K.).

...Despite Banks Tightening Credit Standards To Limit Credit Risk



Sources: ECB, S&P Global Ratings.

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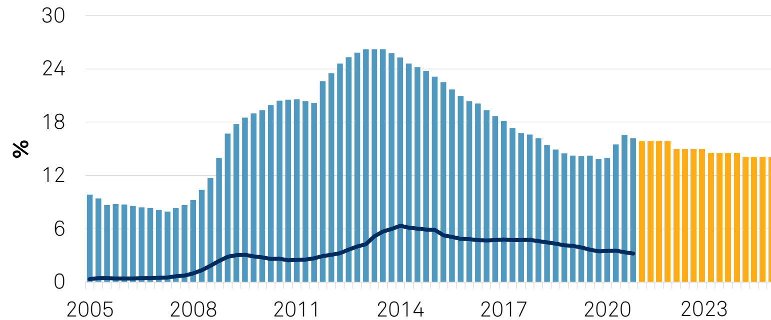
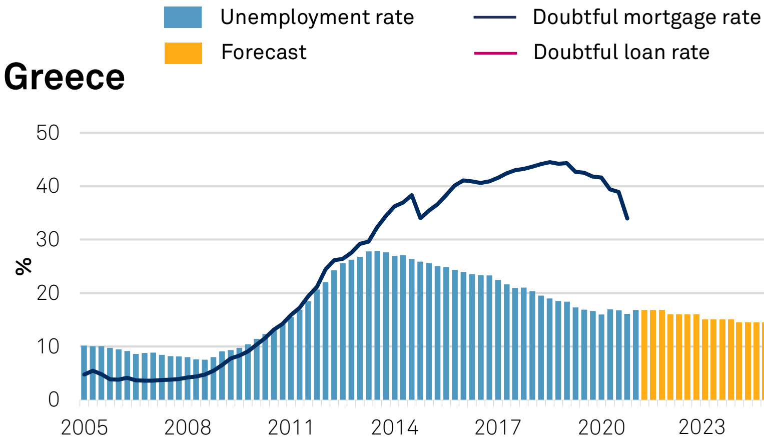
Credit Performance | Expect A Limited Increase In NPLs

Mortgage Arrears Should Remain Well Below The Levels Experienced A Decade Ago

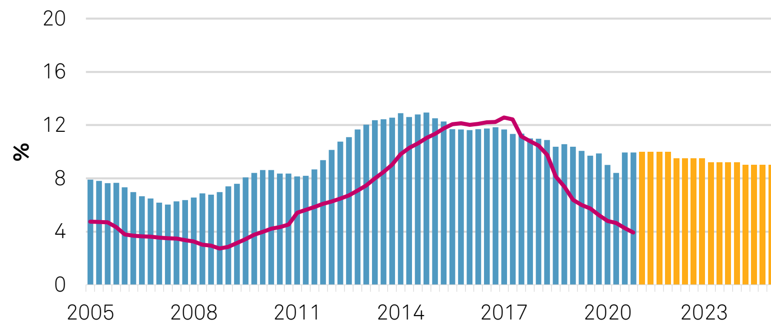
Spain



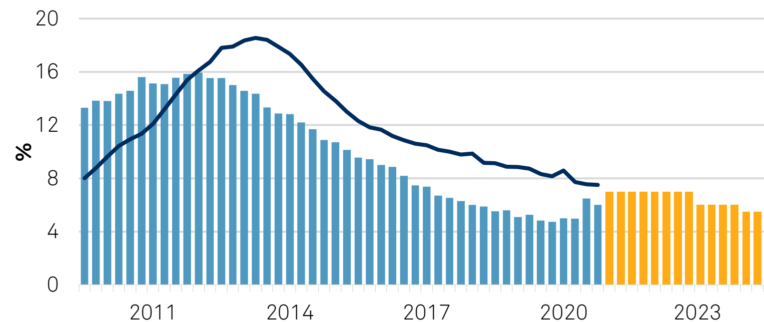
Greece



Italy



Ireland



Sources: OECD, National Central Banks, S&P Global Ratings. Covered Bonds Must Adjust To A New Reality After COVID-19, June 30, 2021.

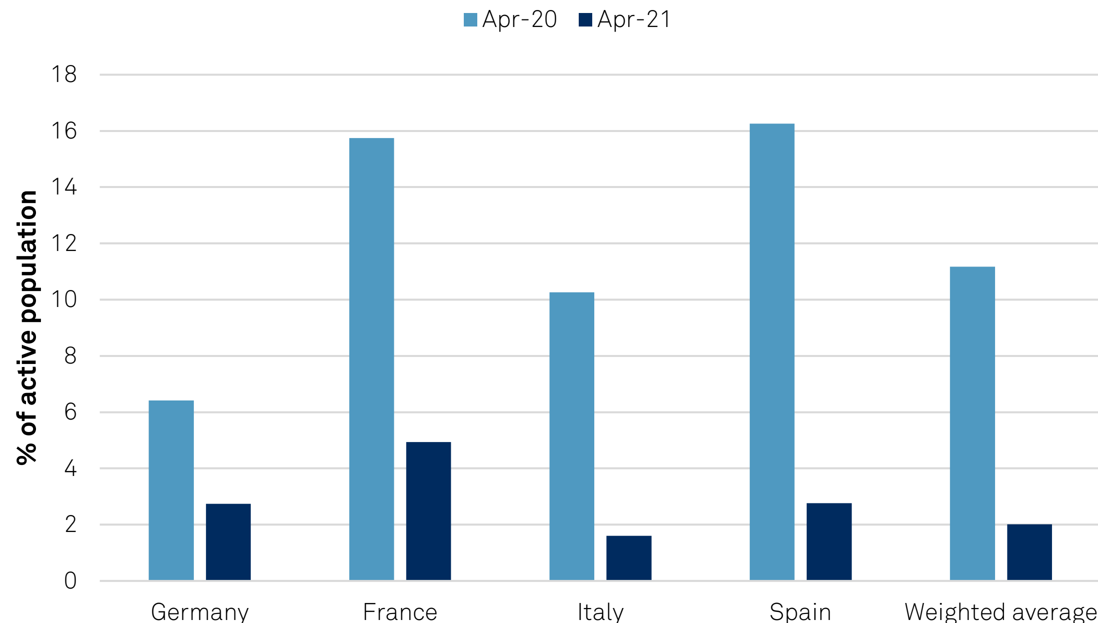
- Collateral performance has been remarkably stable since the onset of the pandemic, with residential mortgage arrears generally steady or decreasing.
- Short-time work schemes in the eurozone's largest economies have so far prevented an unemployment surge, and mortgage payment deferral schemes have prevented borrowers from falling into arrears.
- We expect only a limited credit impact on prime residential mortgage loans once this fiscal and regulatory support wanes, because it will happen against a background of a strong economic rebound.

Credit Performance | Strong Job Market Supports Residential Assets

- There is still no evidence of any cliff effects in the labor market from the phasing out of short-time work schemes, and only about 2% of the eurozone's active population was using these schemes during the third wave of lockdowns.
- Payment moratoria have already expired in several European countries, without a meaningful hike in delinquencies.

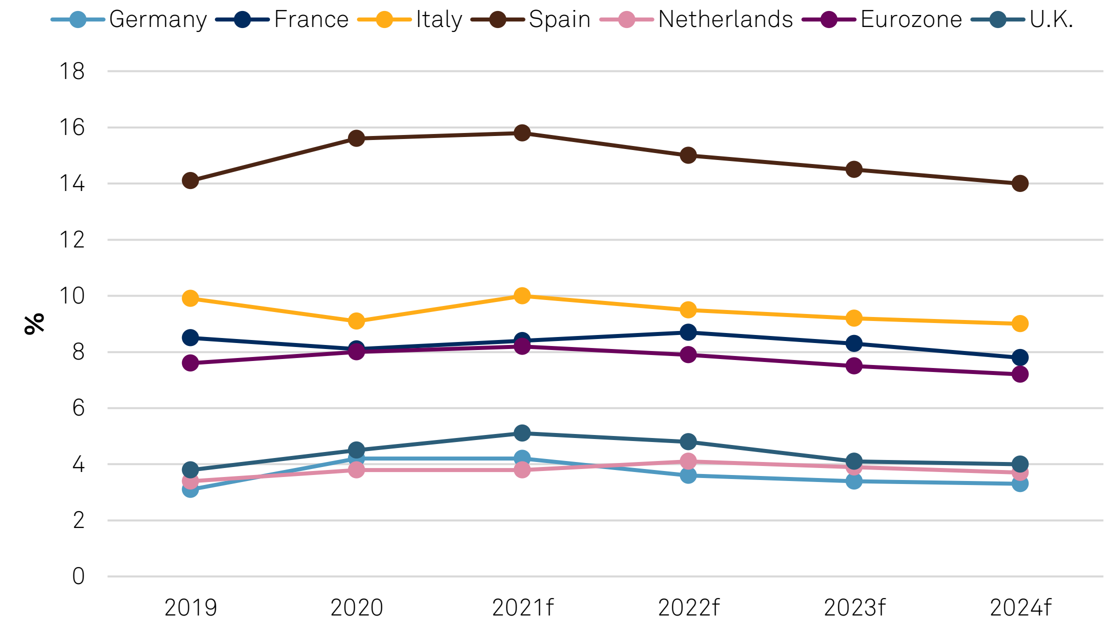
Only A Small Part Of The Active Population Is Still On Furlough

Employment-equivalent measure



Source: National Labor Ministries, Eurostat, S&P Global Ratings calculations.

Eurozone Unemployment To Recover To Its Pre-COVID-19 Levels By The Second Half Of 2022



f--Forecast. Source: S&P Global Ratings.

Credit Performance | Commercial Mortgages Under Pressure But Cover Pool Exposure Is Limited

- Secular trends--such as the rise of working from home and the growth of e-commerce--and commercial real estate prices outpacing residential prices before the pandemic, have clouded the outlook for segments of the commercial real estate sector. Retail and lodging are more at risk, while it is still early to assess the long-term impact on offices.
- That said, the supply-demand mismatch in retail real estate is much more significant in the U.K. than it is in continental Europe. And even before COVID-19, many key European office markets were undersupplied, manifested in low vacancy rates and increasing rents, and ever-declining yields.
- While we believe that commercial real estate asset performance may deteriorate, we do not anticipate this significantly impairing the credit quality of the covered bonds that we rate, due to the availability of credit enhancement to absorb losses and the limited exposure to sectors that we consider to be more at risk.

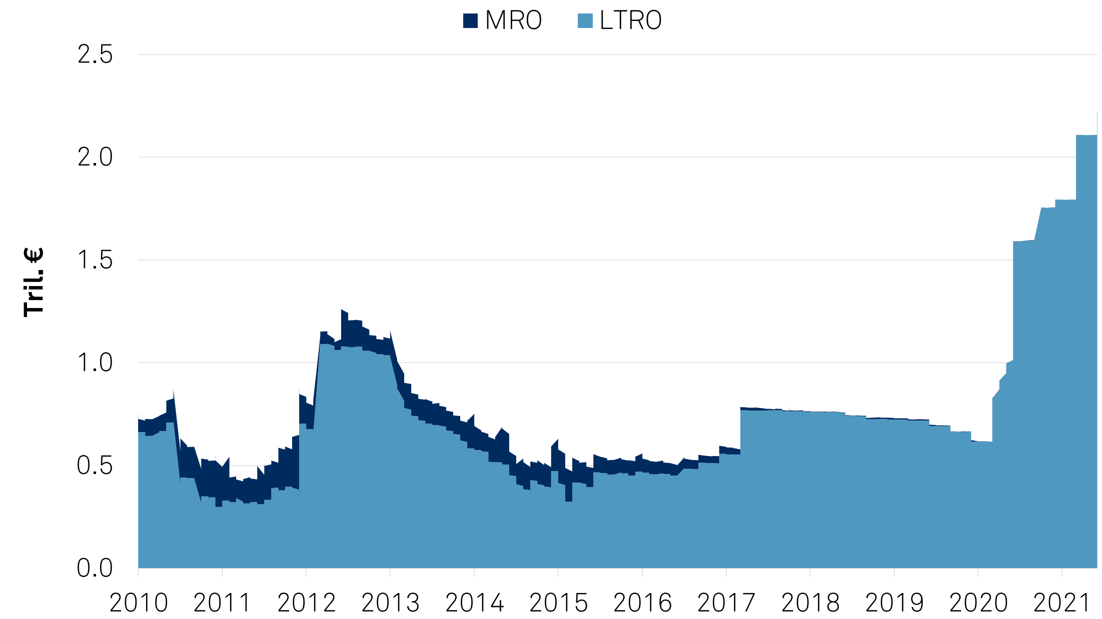
Eurozone Commercial Real Estate Prices Grew Faster Than Residential Real Estate Prices Before The Crisis

Source: ECB, S&P Global Ratings.

Issuance | Central Bank Funding And Deposit Growth Depress Issuance

- Non-standard monetary policy measures, such as the ECB's TLTROs, have partly substituted investor-placed covered bonds as a bank funding tool during periods of market turmoil.
- European households accumulated excess savings of about 12 percentage points of disposable income, limiting wholesale funding needs.

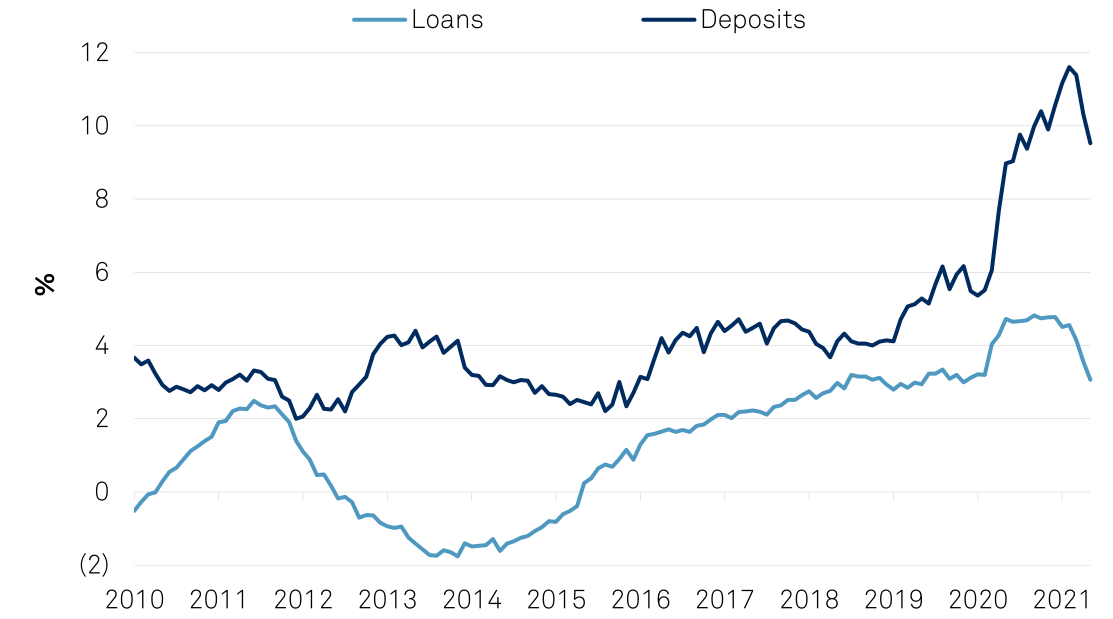
Eurozone Financial Institutions' Use Of Term Funding From Central Banks Has Ticked Higher Once Again



LTRO--Long-term refinancing operations. MRO--Main refinancing operations. Source: European Central Bank.

Deposit And Loan Book Growth Are Beginning To Normalize

12-month lending and deposit growth, Eurozone real economy

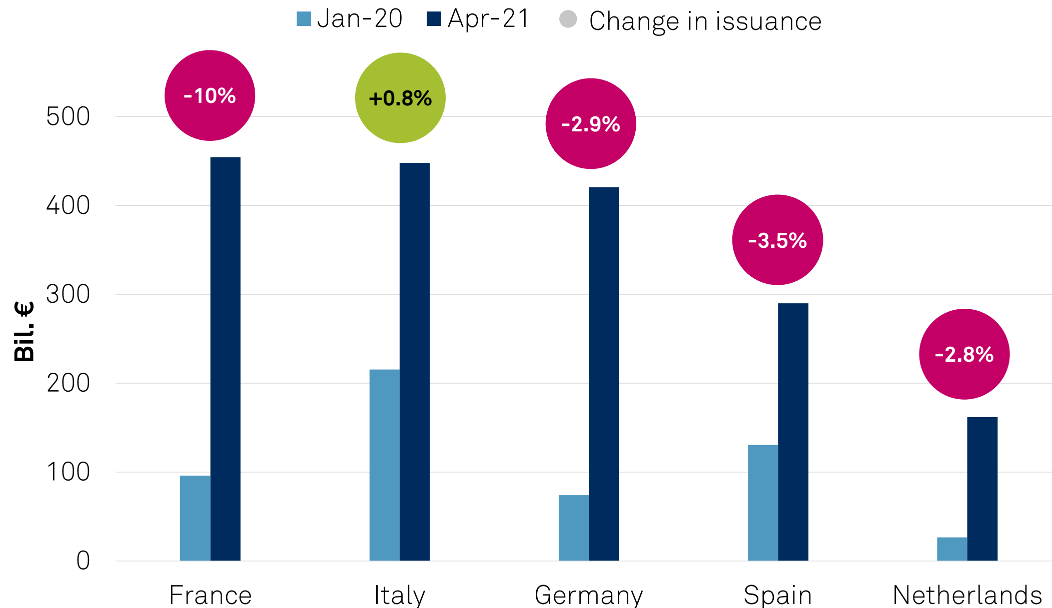


Real economy includes households and nonfinancial corporates. Source: European Central Bank.

Issuance | Retained Issuance Likely To Play A Larger Role For Longer

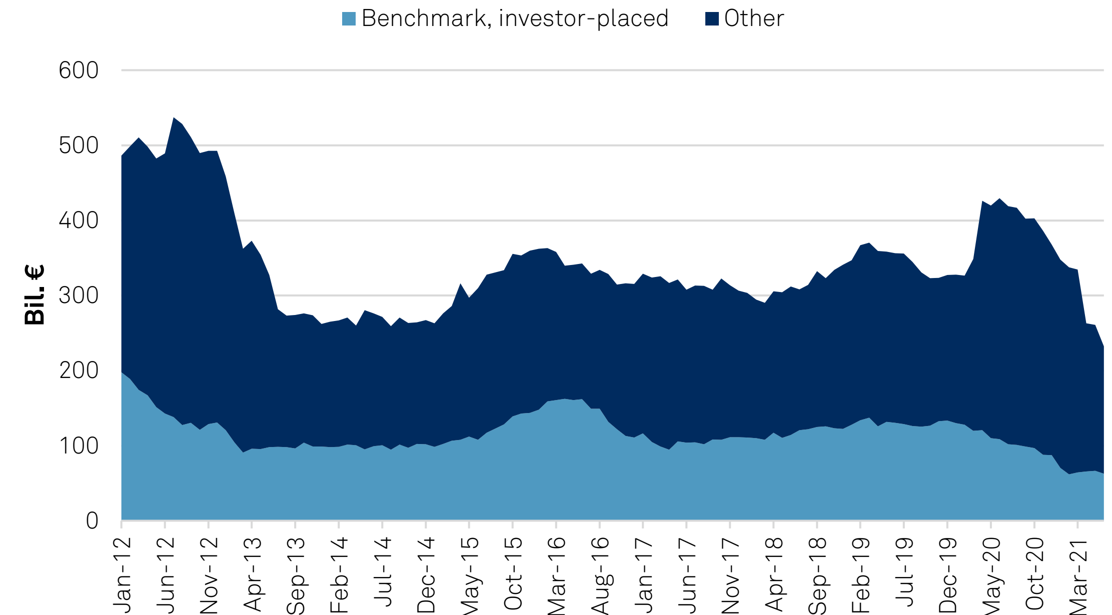
- The ECB may need to stimulate demand at least until 2023, so we expect retained covered bond issuance to play a significant role for the next few years.
- It is unclear what investor appetite for covered bonds will be once monetary policy intervention wanes.

Strong Take-Up Of ECB Funding Drives Down Issuance



Sources: ECB, S&P Global Ratings.

Retained Issuance Surged In March 2020 At The Expense Of Investor-Placed Issuance

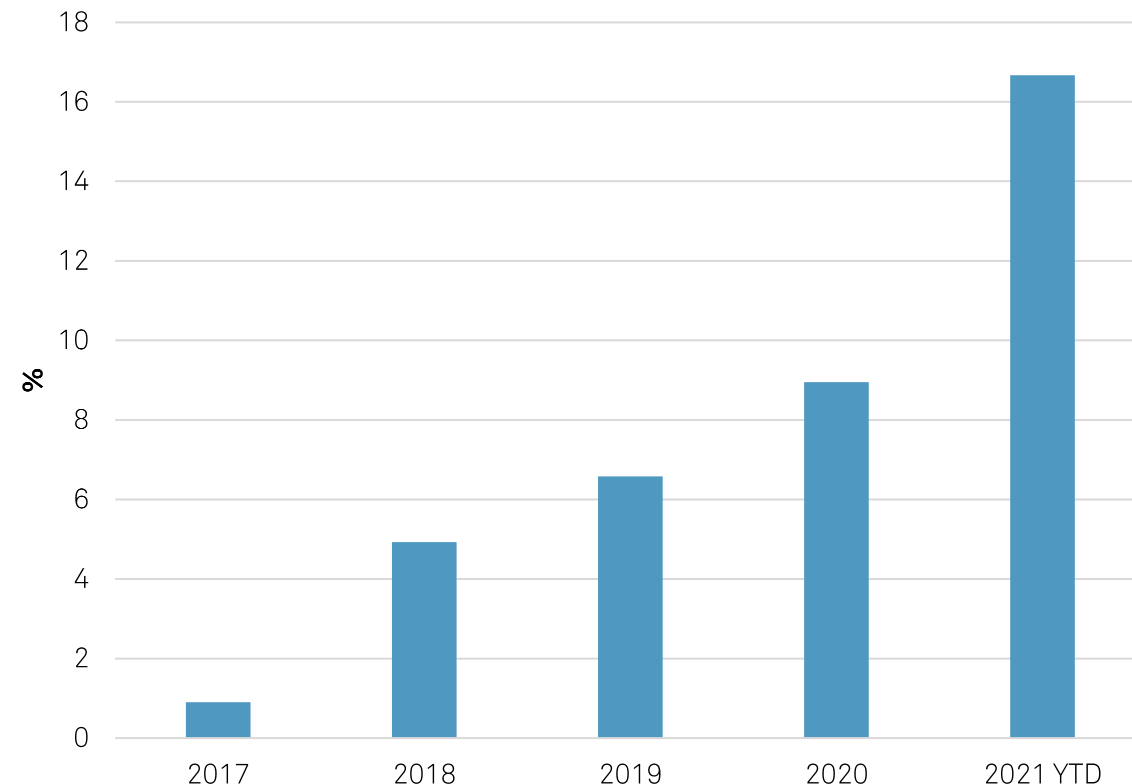


12-month rolling benchmark issuance. Sources: Bloomberg, S&P Global Ratings.

Issuance | Regulatory Developments Could Spur Sustainable Covered Bond Growth

- Sustainable covered bonds grew to almost 17% of overall issuance so far in 2021, from less than 5% in 2018.
- Despite limited pricing differentials compared with vanilla issuance, sustainable covered bonds benefit from strong investor demand and a supportive regulatory environment.
- The EU has recently approved or amended several regulations, including the benchmark regulation, the regulation on sustainability-related disclosures in the financial services sector, and the taxonomy regulation for climate change, which establishes the list of activities considered environmentally sustainable.
- These initiatives provide greater clarity for market participants, allowing issuers to plan the necessary investments required to set up a green or social covered bond issuance program.

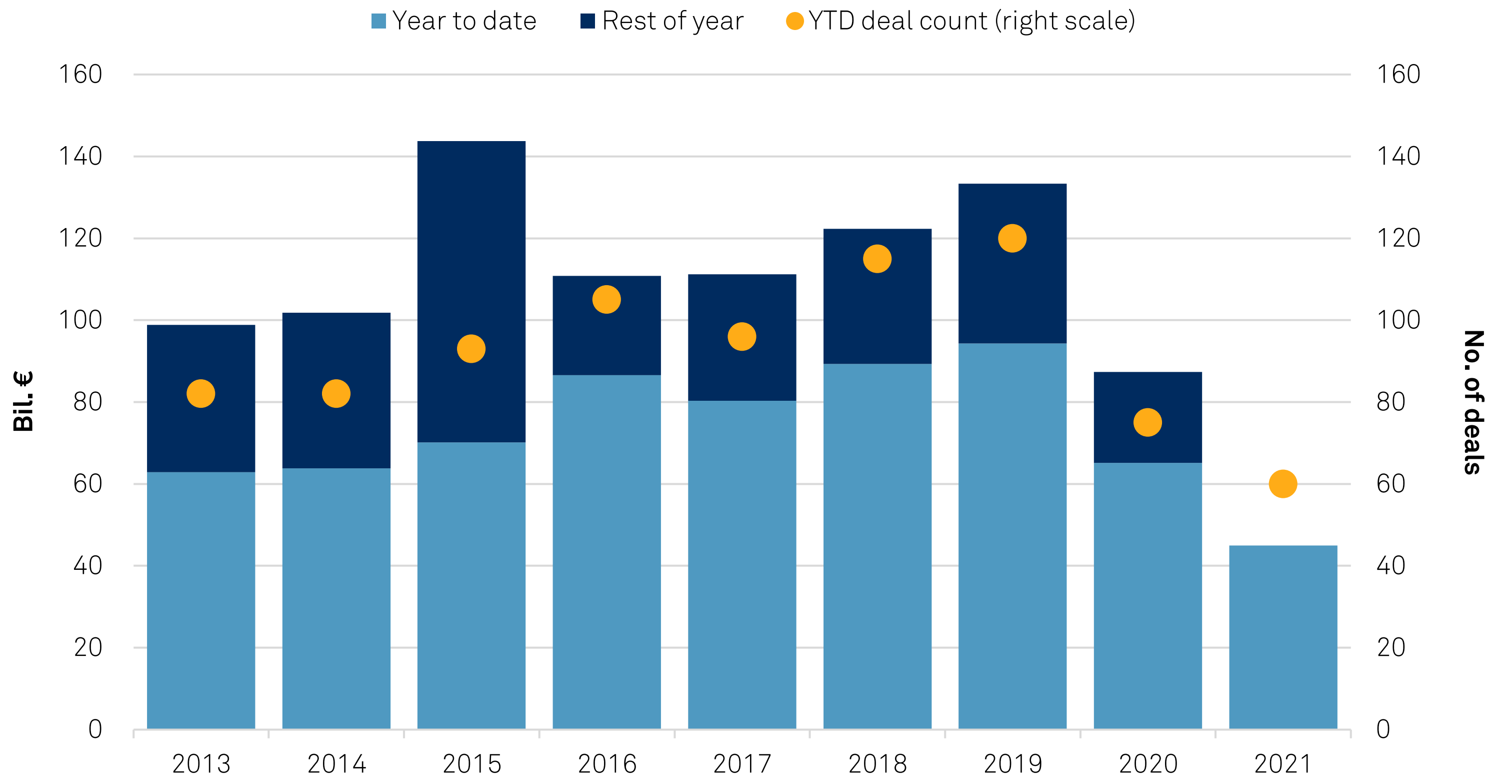
Sustainable Covered Bonds Represent A Growing Share Of New Issuance



Based on benchmark investor-placed issuance only. 2021 YTD figures as of July 16, 2021. Source: S&P Global Ratings.

Issuance | European Investor-Placed Issuance Volumes Set To Remain Subdued For The Rest Of 2021

European Investor-Placed Benchmark Covered Bond Issuance

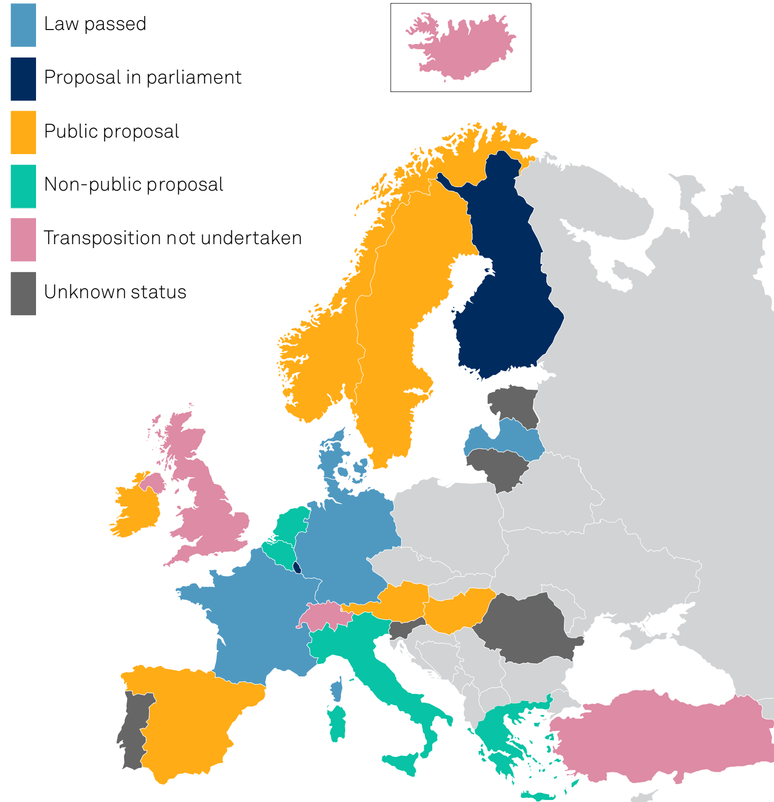


Year to date figures as of July 16 each year. Source: S&P Global Ratings.

- Issuers' continued access to cheap central bank funding and strong deposit growth will continue to substitute for some European covered bond issuance in the short term.
- However, issuers will likely still come to market occasionally in order to maintain investor relationships for the longer term.
- Covered bonds may remain an attractive method to fund at longer maturities than those offered by central bank schemes.
- There will also likely be increasing interest in covered bonds as a platform for sustainable (i.e., green or social) issuance.

Harmonization | Pandemic Has Delayed The Transposition Into National Legislations

Current State Of Covered Bond Harmonization Transpositions



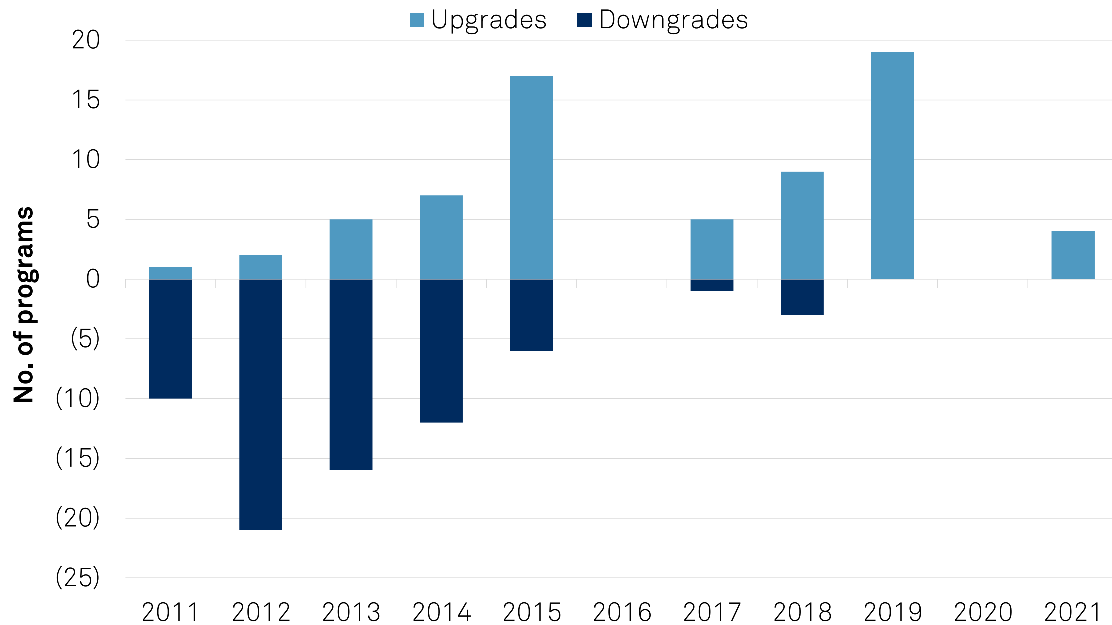
S&P Global Ratings. Covered Bond Harmonization In The EU Remains A Work in Progress, July 13, 2021

- The legislative package for the harmonization of EU covered bond frameworks entered into force in January 2020. Member states had until July 2021 to transpose it into national laws, and the new measures will apply by July 2022.
- The COVID-19 crisis delayed the process in most countries. At the same time, the transposition into law of certain elements, such as provisions on extendible maturities and the calculation of liquidity buffers, has proven difficult. That's because the directive is principles-based, leaving greater room for interpretation at the national level.
- To date, only Germany, France, Denmark, and Latvia have enacted the law, but we still think that most member states will be able to meet the July 2022 target date.

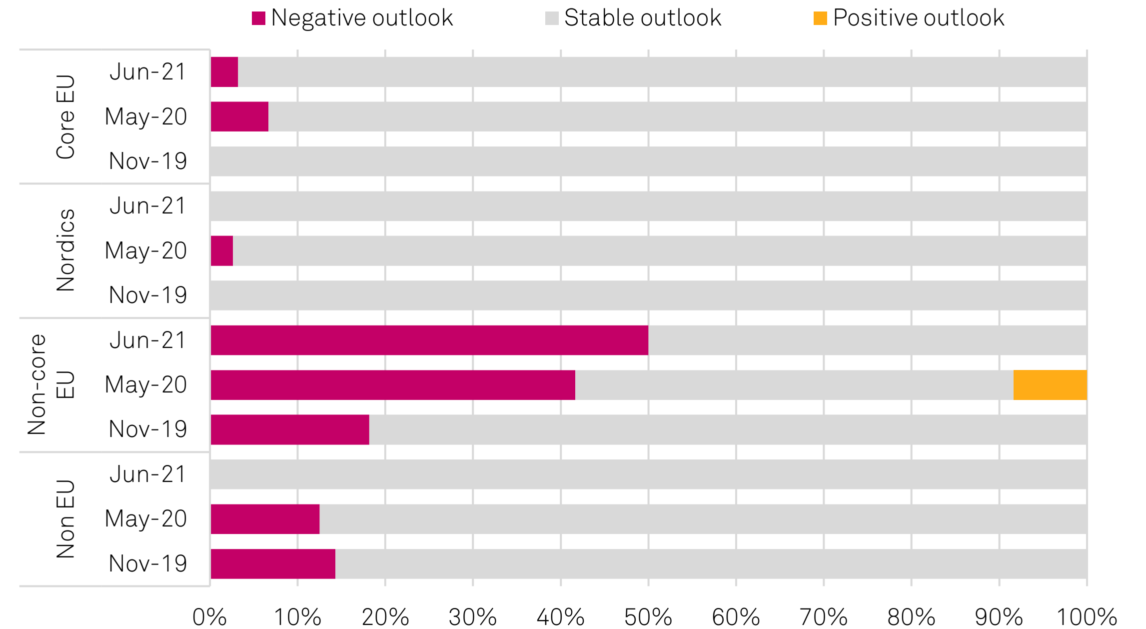
Ratings Outlook | Ratings Stable Despite Lockdowns And Drop In Economic Activity

- Since the beginning of the COVID-19 crisis we have not downgraded any of the covered bond programs that we rate. We revised outlooks to negative on less than 15% of them, and upgraded four of them, due to rating actions on the issuing banks or the related sovereigns.
- Most programs that we rate still have stable outlooks, except those in Spain.

No Downgrades So Far Due To The Pandemic



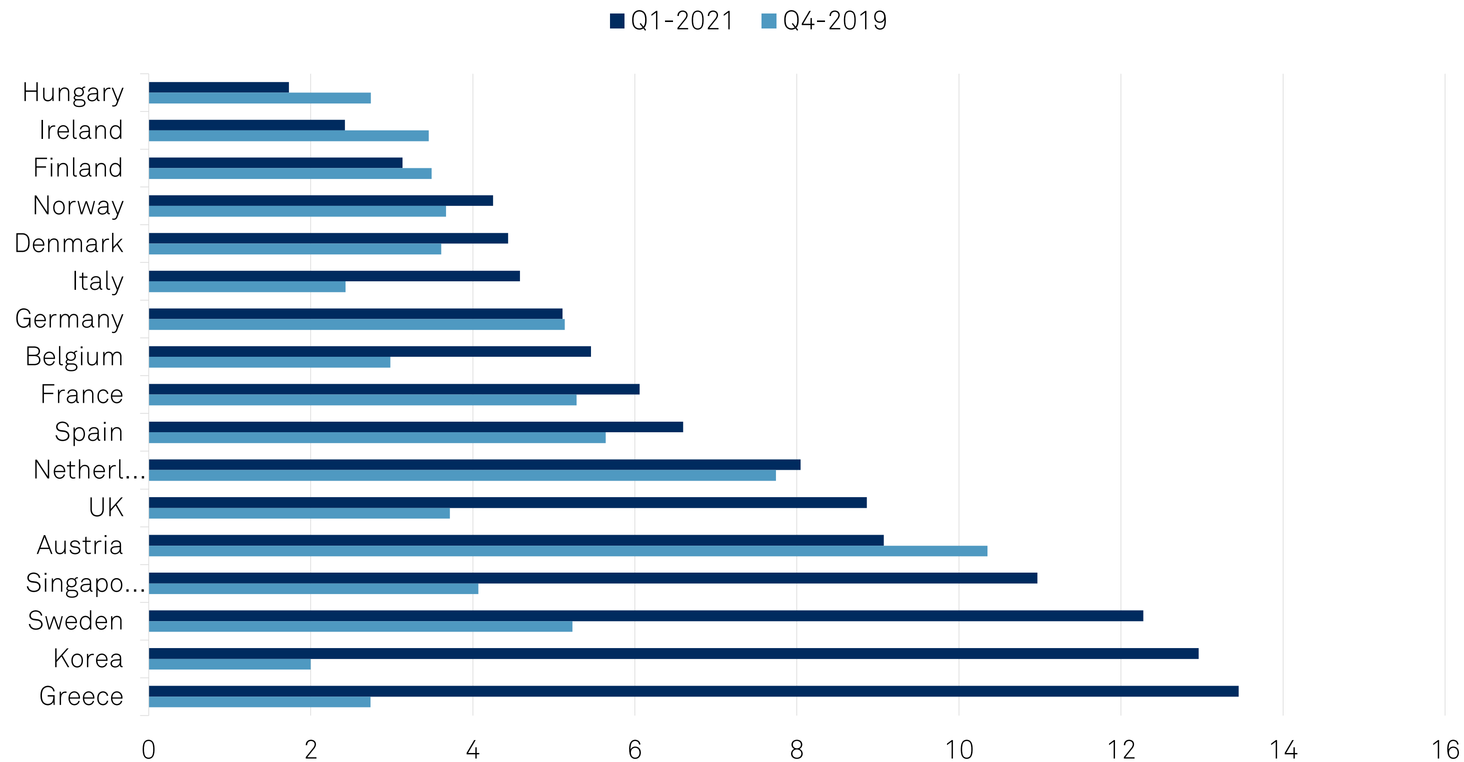
Negative Rating Bias Highest In Non-Core Eurozone, Due To Spanish Sovereign Outlook



Note: Core EU: Austria, Belgium, France, Germany, The Netherlands. Nordics: Denmark, Finland, Norway, Sweden. Non-core EU: Greece, Hungary, Ireland, Italy, Spain. Non EU: Singapore, South Korea, U.K. Source: S&P Global Ratings.

Ratings Outlook | Overcollateralization Should Cushion Collateral Performance Deterioration

Available CE Is On Average More Than Six Times What's Required For The Ratings



CE--Credit enhancement. Q--Quarter. Source: S&P Global Ratings.

- The credit enhancement available to most of the programs that we rate exceeds, on average, more than six times the level required to maintain the current ratings.
- We have not recorded any material deterioration in available credit enhancement, even when issuers used their programs extensively for retained issuance.
- Our rating outlook remains stable, even though we expect mortgage arrears to peak in Europe only in 2022.
- We expect a more severe effect on the performance of CRE assets, but they generally constitute a relatively small part of the cover pools backing programs that we rate.

Ratings Outlook | Unused Notches Partially Mitigate Bank Downgrade Risk

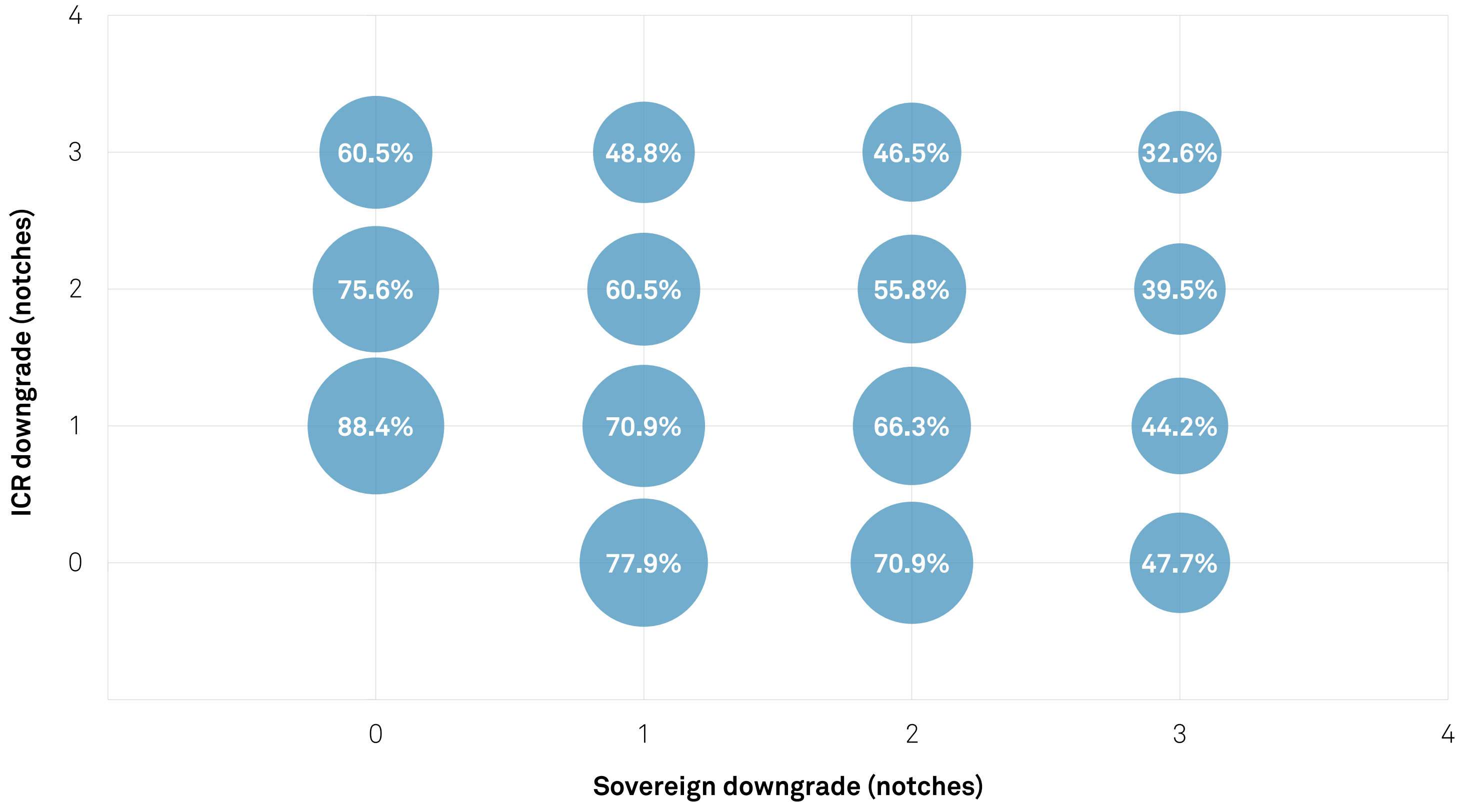
- We continue to expect any potential changes in sovereign or issuer credit ratings to be the most likely trigger for changes to our covered bond ratings.
- Currently, rated programs benefit on average from 2.4 unused notches--the number of notches the issuer rating can be lowered without resulting in a downgrade of the covered bonds.
- French, German, and Dutch programs are more protected from the risk of bank downgrades.
- Spanish and Italian programs have less of a buffer to mitigate the effect of bank downgrades and could be immediately affected by a sovereign downgrade.

Unused Notches By Country

Source: S&P Global Ratings. Global Covered Bond Insights Q2 2021, June 30, 2021.

Ratings Outlook | Non-Core European And Public Sector Programs More Exposed To Sovereign Risk

Most Program Ratings Will Be Unaffected By A Limited ICR Or Sovereign Downgrade



- Given our current sovereign ratings, covered bond ratings in most jurisdictions would not change due to a one-notch downgrade of the sovereign, with some exceptions.
- We would expect mortgage programs in Ireland, Greece, Italy, and Spain, as well as programs backed by public sector assets in Belgium, France, and the U.K., to be most sensitive to changes in the respective sovereign ratings.

Note: Percentage of covered bond program ratings unaffected by an ICR or sovereign downgrade. Unused notches are the number of notches the ICR can be lowered by, without resulting in a downgrade of the covered bonds, all else being equal. ICR--Issuer credit rating. Source: S&P Global Ratings.

Related Research

- Covered Bond Harmonization In The EU Remains A Work in Progress, July 13, 2021
- The ECB's New Strategy Signals Smooth Tapering And Cautious Greening Ahead, July 9, 2021
- European Economic Snapshots: The Economy Is Responding Quickly To The Grand Reopening, July 9, 2021
- Commercial Real Estate In Covered Bonds: Is It Worth The Risk?, July 8, 2021
- Covered Bonds Must Adjust To A New Reality After COVID-19, June 30, 2021
- Global Covered Bond Insights Q2 2021, June 30, 2021
- Economic Outlook Europe Q3 2021: The Grand Reopening, June 24, 2021
- Covered Bonds In New Markets: Expect Only A Gradual Recovery, March 8, 2021
- Sustainable Covered Bonds: Assessing The Impact Of COVID-19, Dec. 1, 2020
- ESG Industry Report Card: Covered Bonds, Nov. 9, 2020

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