S&P Global
Ratings

Global Covered Bond Insights Q2 2023: The Implications Of Rising Interest Rates

April 12, 2023

This report does not constitute a rating action

Primary credit analyst

Antonio Farina
Milan
+39-0272-111-218
antonio.farina
@spglobal.com

Secondary credit analysts

Marta Escutia
Madrid
+ 34-91-788-7225
marta.escutia
@spglobal.com

Phuong Nguyen
Paris
+33-627-060-924
phuong.nguyen
@spglobal.com

Analytical manager

Barbara Florian
Milan
+39-0272-111-265
barbara.florian
@spglobal.com

Key Takeaways

- We believe that European banks' credit performance will prove resilient and the presence of unused notches will further isolate covered bond ratings from pressures in the banking sector.
- Despite a very strong start to the year, we expect 2023 covered bond issuance to be slightly lower than the 2022 peak given reduced funding needs and weak loan growth.
- Available credit enhancement should be sufficient to cover for higher requirements due to rising interest rates and deteriorating asset performance.

The rapid increase in interest rates since the beginning of 2022 has tightened financing conditions and increased broader credit risks, as demonstrated by such diverse episodes as recent U.S. bank failures, turmoil in cryptocurrency markets, and the U.K.'s pension fund debacle. Sticky inflation may force monetary authorities to raise rates further, leading to a tightening of bank lending standards, adjustment in property valuations, and deterioration in asset performance. This report examines the consequences for the covered bond market.

Ratings Outlook Stable On Bank Resiliency And Unused Notches

We believe that European banks' credit performance will prove resilient as the economic reset kicks in. European banks that we rate do not exhibit a combination of large unrealized losses on securities portfolios and highly confidence-sensitive funding models, as the recently-failed U.S. banks did. A strong deposit base and ample liquidity should mitigate contagion risk for the sector. We see the business and risk management deficiencies that led to UBS AG's takeover of Credit Suisse AG as quite unique in nature and scope relative to the rest of the European banking sector. We also maintain our view that, overall, European banks benefit in the rising interest rate environment (see "European Banks Can Weather The Market Turmoil," published on March 21, 2023).

Covered bond ratings are further isolated from banking sector pressures by the presence of unused notches--the number of notches the issuer credit rating (ICR) can be lowered without resulting in a downgrade of the covered bonds. More than 90% of the programs that we rate would be unaffected by a one-notch ICR downgrade, around three quarters by a two-notch ICR downgrade, and almost half by a four-notch ICR downgrade, all else being equal.

Chart 1

Unused notches partially mitigate bank downgrade risk

Percentage of program ratings affected by an issuer credit rating downgrade

No. of notches	1	2	3	4
Austria	40%	40%	60%	100%
Belgium	0%	0%	0%	25%
Germany	0%	17%	50%	50%
Denmark	0%	5%	14%	33%
Spain	50%	100%	100%	100%
Finland	11%	44%	56%	78%
France	9%	9%	9%	18%
Greece	0%	0%	0%	0%
Ireland	0%	0%	0%	100%
Italy	0%	100%	100%	100%
Netherlands	0%	10%	20%	40%
Norway	33%	33%	33%	33%
Sweden	0%	40%	60%	100%
U.K.	0%	50%	100%	100%
Total	**9%**	**25%**	**36%**	**53%**

ICR--Issuer credit rating. Source: S&P Global Ratings.

Policy instruments other than interest rates should address potential fragilities in the banking system and concerns over financial stability. European and U.S. authorities have adequate supervisory tools to protect financial stability and to prevent contagion through the regulated banking system. Consequently, we expect monetary authorities will continue down the path of policy tightening to bring inflation back toward target. In our opinion, the European Central Bank (ECB) will raise rates until the deposit facility rate reaches 3.5% by the summer--barring further financial market turmoil that could jeopardize prospects for growth and inflation. A restrictive monetary policy will weigh on demand, and we expect economic stagnation for the EU in 2023, with an elevated risk of mild recession. Fading momentum in industrial production and a slowdown in construction caused by higher interest rates over this year and next lead us to expect a slight increase in the unemployment rate in the region, which we forecast will rise to 7.2% in 2024 from 6.7% in 2022 (see “Economic Outlook Eurozone Q2 2023: Rate Rises Weigh On Return To Growth,” published on March 27, 2023).

Table 1

S&P Global Ratings European economic forecasts (March 2023)

Real GDP (% change)	Eurozone	Germany	France	Italy	Spain	Netherlands	Belgium	U.K.
2022	3.5	1.8	2.6	3.9	5.5	4.5	3.1	4
2023	0.3	0	0.4	0.4	1.1	0.9	0.5	-0.5
2024	1	0.9	1.2	1	1.6	1.3	1.4	1.5
2025	1.7	1.8	1.6	1.4	2.3	1.8	1.8	1.8
Unemployment rate (%)								
2022	6.7	3	7.3	8.1	12.9	3.5	5.5	3.7
2023	6.9	3.2	7.6	8.2	13	3.9	5.9	4.3
2024	7.2	3.2	7.9	8.2	13.2	4	6	4.5
2025	7	3.1	7.9	8	12.9	3.8	5.9	4.2

Source: S&P Global Ratings Research.

Although we view prolonged banking system contagion as unlikely, confidence will remain fragile for some time. Banks may feel forced to increase remuneration of deposits earlier than they anticipated, and most likely will no longer anticipate the repayment of targeted longer-term refinancing operations (TLTRO) facilities. Banks' underwriting standards may tighten and asset quality may weaken, primarily among small and midsize enterprises (SMEs) and unsecured consumer lending portfolios. Let's consider the impact on covered bond issuance and collateral performance.

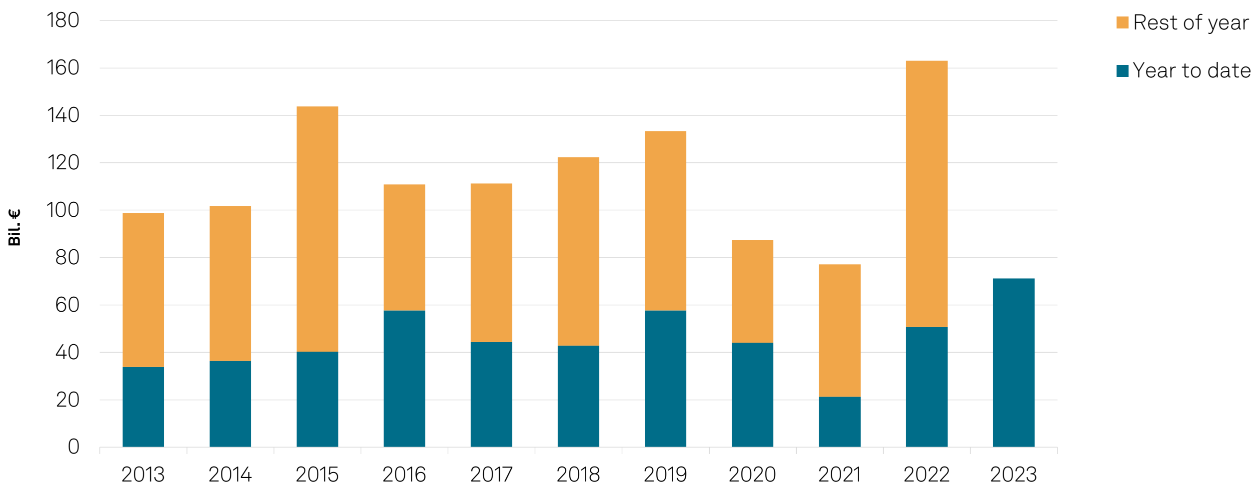
Weaker Lending Growth Will Weigh On Issuance

European investor-placed covered bond issuance exceeded €73 billion in Q1 2023--the highest level since 2012, despite global bank wobbles causing a marked slowdown in mid-March. Two factors supported this surge. First, hefty TLTRO redemptions, which banks partially replaced with covered bond issuance. Second, the expectation that quantitative tightening will further reduce covered bond demand as the ECB stops its asset purchases, which led banks to front-load their issuance plans.

Chart 2

Record Q1 issuance despite March hiatus

European investor-placed benchmark covered bond issuance



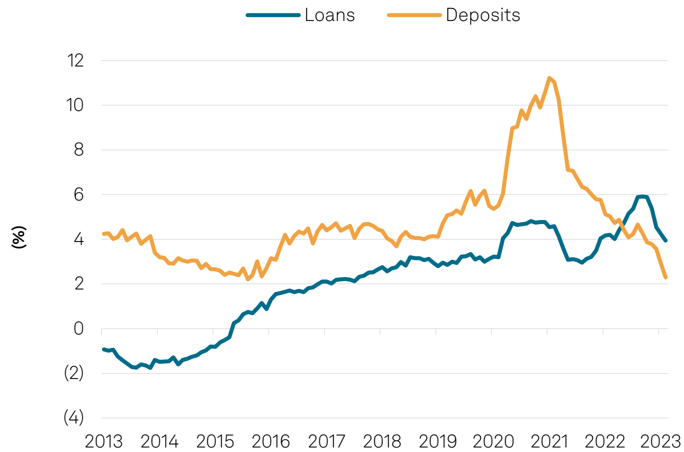
Year to date figures as end-March each year. Source: S&P Global Ratings.

Despite a very strong start, we still expect 2023 issuance to be slightly lower than in 2022 (see "Covered Bonds Outlook 2023: Sailing Through Choppy Waters," published on Dec. 6, 2022.) Persistent market volatility could prove a supporting factor if it makes other sources of funding uneconomical, and the recent drop in bank deposits could compel banks to increase their wholesale market funding. On the other hand, the front-loading of issuance in the first quarter of the year will reduce funding needs for the rest of the year, and tighter bank underwriting standards, coupled with weaker loan demand, should result in a deceleration in bank loan growth this year, from 4%-5% last year (see "Credit Conditions Europe Q2 2023: Costs Rising To Cure Inflation," published on March 28, 2023).

Chart 3

Lending and deposit growth is weakening

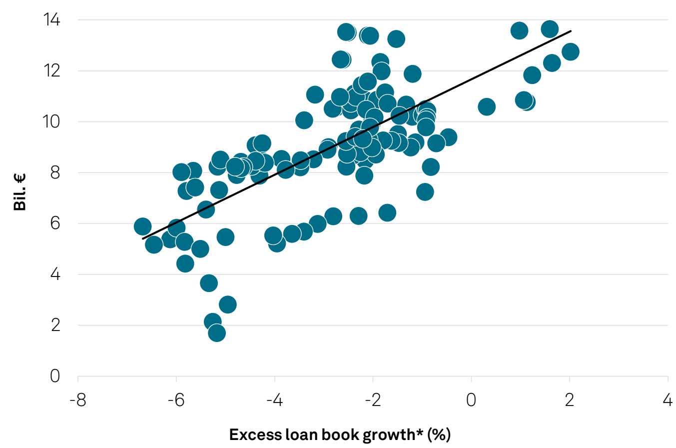
Year on year growth, eurozone households, and NFCs.



NFCs--Nonfinancial corporates. Source: European Central Bank.

Chart 4

European covered bond issuance is strongly correlated with excess loan book growth



*Defined as 12-month loan growth minus deposit growth. Sources: European Central Bank, S&P Global Ratings.

Available Credit Enhancement Is Sufficient To Mitigate Increasing Risks

Higher interest rates can negatively affect our collateral analysis. They can increase the credit enhancement (CE) required to maintain the ratings on programs exposed to unhedged interest rate mismatches. They can also reduce bank lending and the CE available for the cover pool. Finally, they can increase the probability of borrowers defaulting on their mortgage loans, especially if they are paying a floating interest rate.

We have compared the CE required to maintain our covered bond ratings in Q1 2023 against the same requirements in Q1 2022. While several factors besides interest rates affect this required CE, we note a limited average increase, around 0.5 percentage points, despite the sharp increase in interest rates. Also, around three quarters of the rated programs experienced an increase below two percentage points.

In order to isolate the impact of higher interest rates on the required CE, we have conducted a scenario analysis where we tested the impact of a further two percentage point increase in interest rates for a selected subset of programs (see chart 5). The impact is limited: the average change is less than one percentage point, and the maximum increase is 2.5 percentage points. These results show that most of our rated programs have some form of effective interest rate hedging--either through swap agreements or a balance between the interest paid on the assets and on the liabilities--that mitigates the impact of rising interest rates. The smallest impact is on Danish programs, where the match-funding principle structurally mitigates interest rate risk. German programs that we have included in the analysis also show little variation in the results, due to the fact that most liabilities pay a fixed interest rate and the mismatch between asset and liabilities is limited. Similarly, most of the French programs feature a limited payment mismatch and limited changes in the results, but there are three exceptions where the mismatch is more material and which constitute the outliers in our analysis. Most of the Spanish programs benefit from a higher share of floating rate assets than floating rate liabilities, and this--together with the implementation of the covered bond directive (see box below)--explains the better results. Finally, Dutch programs benefit from the fact that they pay fixed rate bonds while the assets reset over time, hence the improved results. (This analysis does not take into consideration the impact of higher refinancing costs that banks will face once they need to repay maturing notes, but this will be partially mitigated by the fact that the assets added to the pool will probably pay a higher interest rate.)

Chart 6 shows that the CE available to most of the rated programs is, on average, more than nine times the level required to maintain the current ratings. This appears sufficient to compensate for the increase in required CE due to rising interest rates. Even the expected slowdown in lending should not materially reduce this buffer.

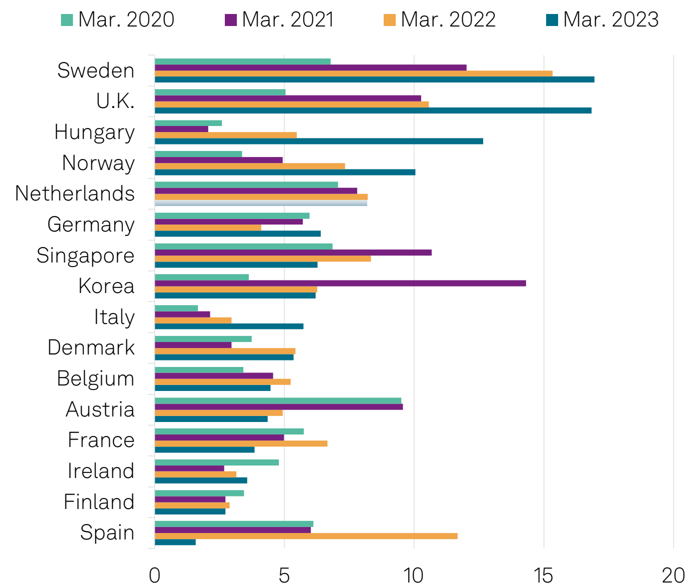
Chart 5

Higher interest rates have limited impact on required CE

Chart shows the impact of a 200 basis point interest rate increase scenario on the required CE of selected program. The orange dots indicate weighted average values, the blue dots indicate program values. CE--Credit enhancement. Source: S&P Global Ratings.

Chart 6

Available CE is on average more than nine times what's required for the ratings



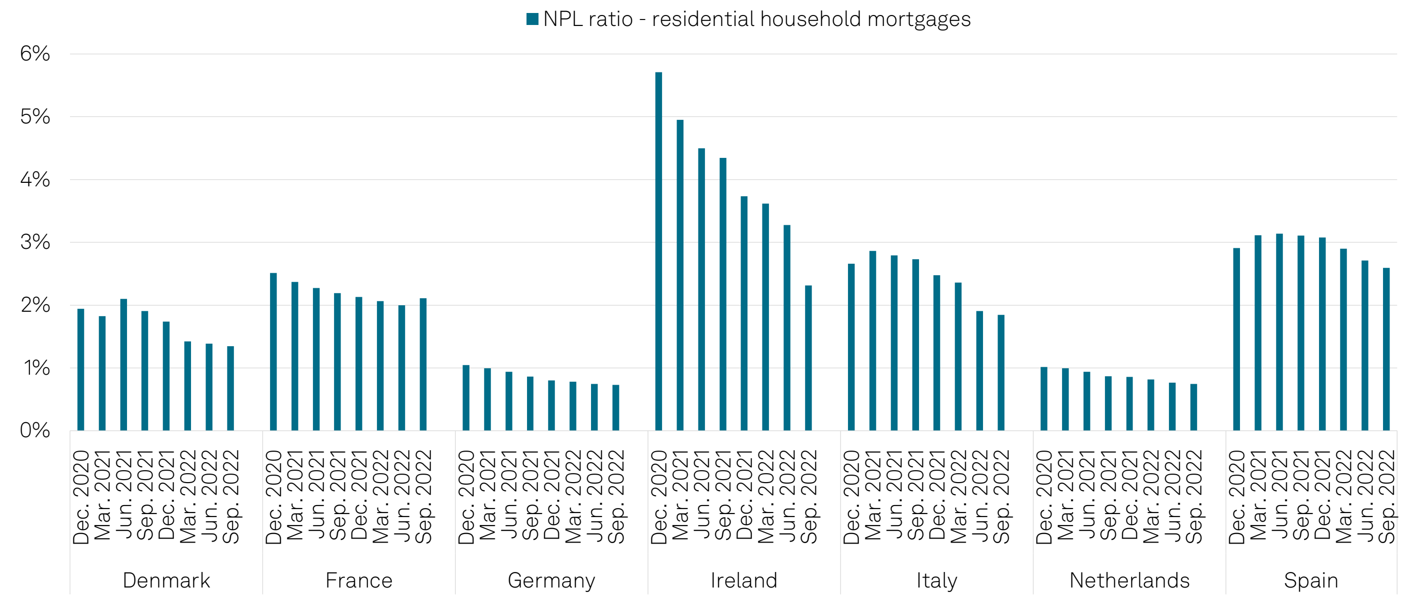
CE--Credit enhancement. Source: S&P Global Ratings.

The available CE should also cushion the expected deterioration in collateral performance due to inflation and rising interest rates, which may also affect property prices going forward.

Pressured by rising interest rates, a price correction is underway in most European property markets, which we think will lead to falls of 5% to 15% from the highs of June 2022 (see "European Housing Prices: A Sticky, Gradual Decline," published on Jan. 11, 2023). For residential properties, we generally anticipate more pressure in countries with a high share of variable rate mortgages and where the interest rate rise is largest, such as Sweden. At the same time, asset performance has been remarkably stable, and we expect that low unemployment and elevated household savings will limit the deterioration of mortgage performance. In commercial real estate (CRE), offices (particularly non-prime), logistics, and lower-yielding assets appear more exposed as yields adjust. But here asset performance has also been broadly stable so far, and pressure appears to be more on valuations and refinancing. Moreover, the availability of CE to absorb losses, and the limited exposure to sectors that we consider to be more at risk should protect covered bond ratings from the expected deterioration in CRE performance.

Chart 7

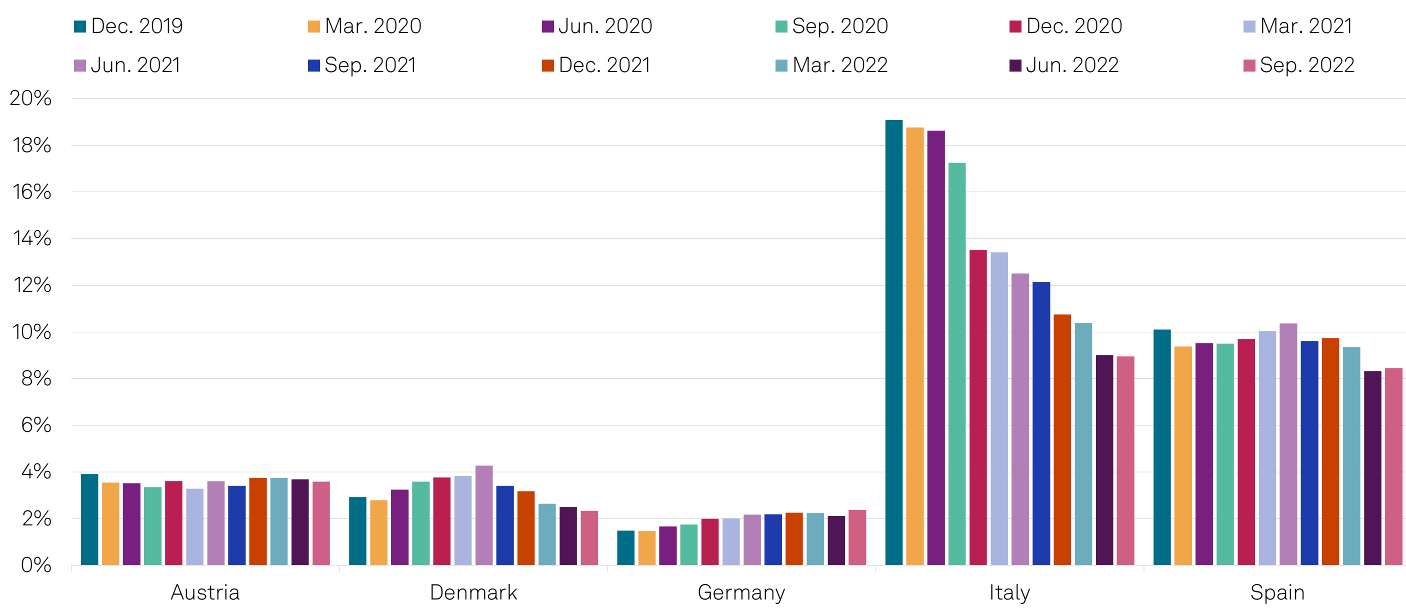
Performance of residential mortgages stable despite higher interest rates



NPL--Nonperforming loan. Sources: European Banking Authority, S&P Global Ratings.

Chart 8

CRE NPL ratios remain stable despite valuation pressure



CRE--Commercial real estate. NPL--Nonperforming loan. Sources: European Banking Authority, S&P Global Ratings.

Better Credit Quality But Lower CE Following The Transposition Of The Harmonization Directive In Spain

The Spanish Royal Decree Law from November 2021, partially amended in June 2022, aligns the Spanish covered bond framework with the EU harmonization directive. The Decree Law defines the cover pool as a specific pool of assets that guarantee payment obligations linked to a covered bond program, and that are registered and segregated from other assets on the issuer's balance sheet. This differs significantly from the previous framework, where covered bonds were backed by the issuer's entire nonsecuritized mortgage or public sector loan book, and which benefited from substantially higher levels of CE than the Decree Law requires (see “Spanish Covered Bonds: Harmonization Achieved Through Royal Decree Law,” published on July 13, 2022).

The Decree Laws also introduce (1) stricter eligibility criteria, including loan-to-value ratio limits, for the mortgage loans to be included in the cover pool register, (2) the appointment of a cover pool monitor, (3) 180-day liquidity provision, (4) the possibility to issue covered bonds with extendible maturities, and (5) derivatives to hedge risks associated with the program.

Table 2

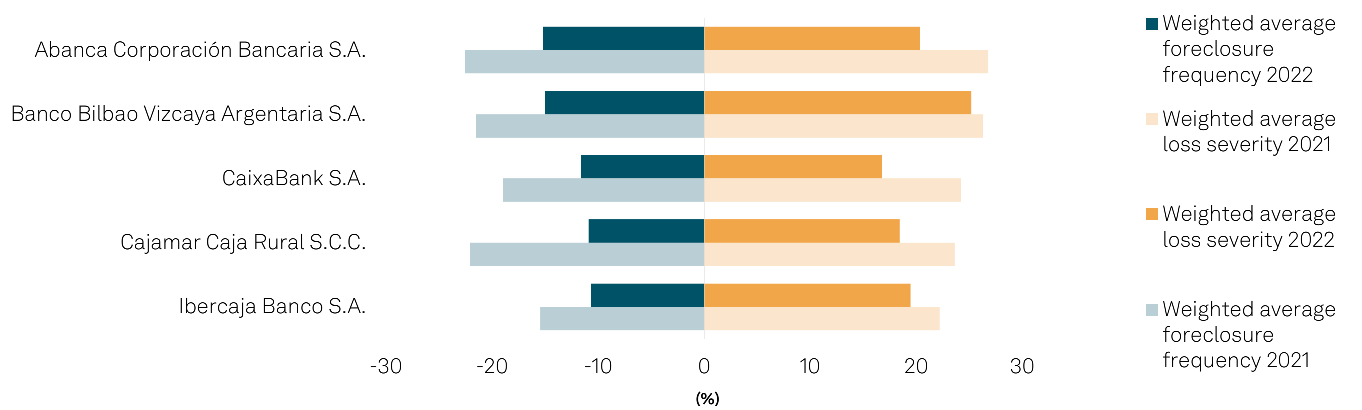
Key features of Spanish covered bond programs

	Abanca		Bankinter		BBVA		Caixabank		Cajamar		Ibercaja	
	Dec. 31, 2022	**Dec. 31, 2021**	**Dec. 31, 2022**	**Dec. 31, 2021**	**Dec. 31, 2022**	**Dec. 31, 2021**	**Dec. 31, 2022**	**Dec. 31, 2021**	**Dec. 31, 2022**	**Dec. 31, 2021**	**Dec. 31, 2022**	**Dec. 31, 2021**
Total outstanding assets (mil. €)	4,635.17	16,096.18	21,135.41	33,047.55	43,871.23	59,007.14	107,778.33	139,971.93	6,931.00	13,157.00	4,774.47	18,320.11
Cover pool breakdown												
Residential (%)	87.94	80.65	87.43	84.66	82.22	85.35	88.36	82.34	91.61	76.08	91.79	86.42
Commercial (%)	9.11	19.35	12.57	15.34	12.71	14.65	10.91	17.66	4.35	23.92	6.79	13.58
Other (%)	2.96	0.00	0.00	0.00	5.06	0.00	0.73	0.00	4.04	0.00	1.43	0.00
Residential assets												
Asset balance (mil. €)	4,075.96	12,981.48	18,479.71	27,978.97	36,071.17	50,360.18	95,231.70	115,254.22	6,349.70	10,010.00	4,382.43	15,833.09
Number of loans	59,361	187,920	170,216	268,448	591,538	806,612	1,484,655	1,768,519	101,611	150,650	78,665	233,203
Weighted average seasoning (months)	108.94	111.10	77.00	84.00	120.60	115.87	113.30	120.20	114.69	98.95	113.10	107.12
Weighted average loan-to-value (LTV %)	51.89	54.07	51.59	50.72	47.65	63.02	44.58	55.65	46.35	53.93	45.91	50.34
LTVs above 70%	16.73	21.43	15.38	15.94	15.25	27.07	10.62	22.24	8.88	19.75	6.08	16.01
Total arrears (%) > 30 days	0.40	1.79	0.32	1.48	0.00	1.01	0.22	3.26	0.37	5.03	0.00	0.02
Commercial assets												
Asset balance (mil. €)	422.21	3,114.69	2,655.70	5,068.58	5,578.07	8,646.96	11,756.37	24,717.70	301.30	3,147.00	323.96	2,487.03
Number of loans	2,584.00	11,051.00	8,968.00	15,390.00	37,341.00	49,925.00	90,550.00	127,209.00	5,033.00	24,802.00	4,572.00	21,458.00
Weighted average seasoning (months)	63.44	50.98	57.00	57.00	90.45	75.40	95.33	82.58	103.81	92.12	92.21	76.21
Weighted average loan-to-value (LTV %)	38.23	52.36	38.18	49.77	41.07	74.24	35.57	67.40	32.76	55.79	36.39	57.59
LTVs above 70%	0.00	16.43	0.00	7.76	0.00	19.27	0.84	21.70	0.04	18.85	0.12	27.82
Total arrears (%) > 30 days	0.42	3.79	1.07	2.38	0.00	2.34	0.26	5.36	0.68	14.52	0.01	0.06
Overcollateralization and asset liability profile												
Reported available OC (%)	62.05	438.35	28.44	110.56	88.48	84.98	80.92	106.87	38.62	128.82	43.33	346.78

Following the implementation of the Decree Laws, the credit quality of Spanish cover pools has materially improved, as measured by our weighted-average foreclosure frequency (WAFF; our measure of aggregate default rate) and weighted-average loss severity (WALS; our measure of aggregate loss-given default). At the same time, Spanish issuers have materially decreased the level of available overcollateralization (OC), but generally maintained the level commensurate with the currently assigned ratings. OC commensurate with the ratings has remained relatively stable despite the improvement in the pool credit quality because other components in our analysis, such as asset-liability maturity mismatch, available excess spread, or interest rate mismatch have also affected the results.

Chart 9

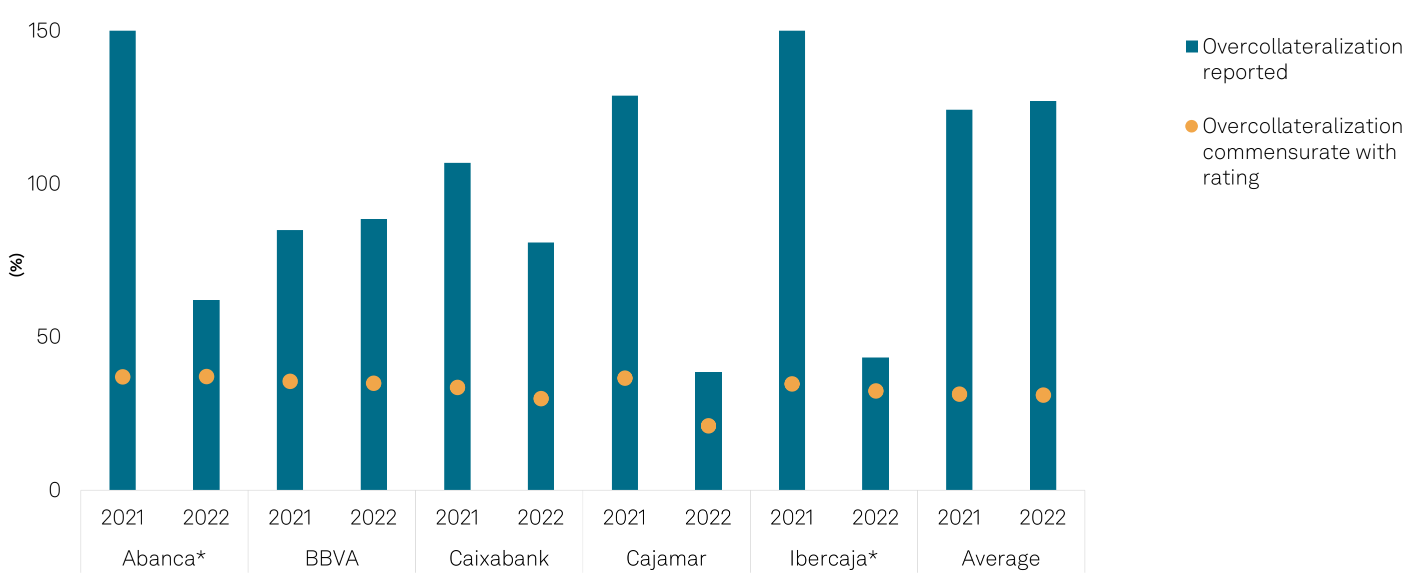
Credit quality has improved following the implementation of the covered bond directive



Source: S&P Global Ratings.

Chart 10

CE is lower but still sufficient to support ratings

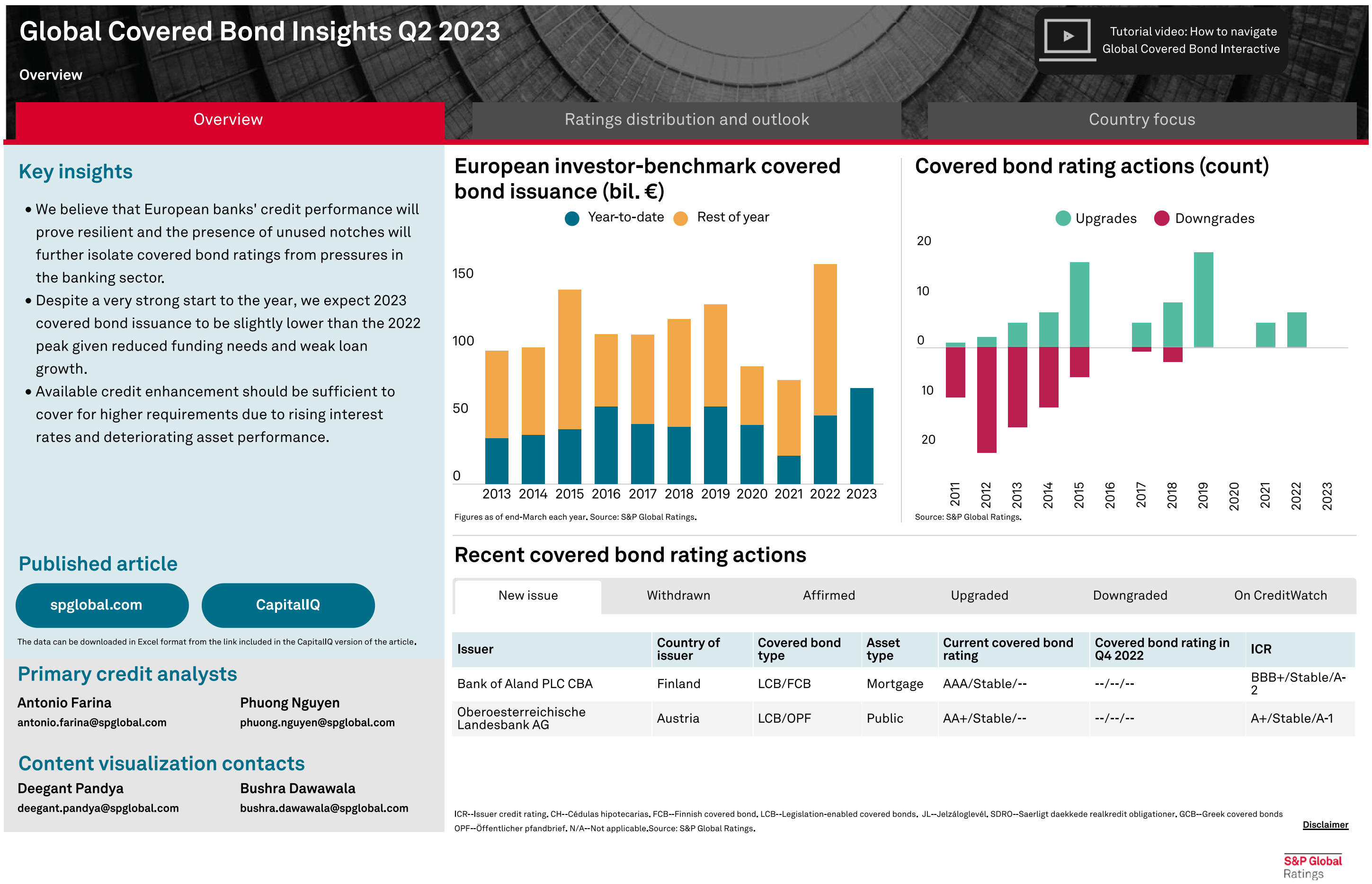


*We cap the axis at 150%. Abanca overcollateralization is 438% in 2021; Ibercaja overcollateralization is 347% in 2021. CE--Credit enhancement. Source: S&P Global Ratings.

On March 31, 2023, the Spanish government further amended the Royal Decree Law 24/2021, to allow issuers to actively manage the available OC and to clarify that the administrator's right to accelerate the covered bonds upon issuer insolvency applies only if the value of cover pool assets is less than the value of the covered bonds.

Core Characteristics And Risk Indicators

The main core characteristics and risk indicators are accessible here.



Related Research

- The French Covered Bond Legal Framework: A Closer Look, April 3, 2023
- Credit Conditions Europe Q2 2023: Costs Rising To Cure Inflation, March 28, 2023
- Economic Outlook Eurozone Q2 2023: Rate Rises Weigh On Return To Growth, March 27, 2023
- Economic Outlook U.K. Q2 2023: Growth Eludes This Year Even As Inflation Eases, March 27, 2023
- European Banks Can Weather The Market Turmoil, March 21, 2023
- Dutch Covered Bond Market Insights 2023, Jan. 26, 2023
- European Housing Prices: A Sticky, Gradual Decline, Jan. 11, 2023
- Covered Bonds Outlook 2023: Sailing Through Choppy Waters, Dec. 6, 2022
- Spanish Covered Bonds: Harmonization Achieved Through Royal Decree Law, July 13, 2022