Covered Bonds Outlook Midyear 2023: Rising Interest Rates Will Test Asset Performance

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This report does not constitute a rating action.

S&P Global Ratings

Contents

Key Takeaways

As the COVID-19 recovery fades and higher rates start to dampen demand, eurozone economic activity may contract around the turn of the year, but we don't expect unemployment to rise sharply. The medium-term outlook is brighter due to fiscal stimulus and a more supportive monetary policy.

Although disinflation has started, the European Central Bank (ECB) continues to have core inflation worries and is likely to raise rates once more in July. We don't expect the central bank to achieve its price stability target before 2025. Monetary policy should move away from restraining demand within the next two years.

European banks will continue to issue significant amounts of wholesale debt in 2023 and 2024, with a further increase in covered bonds issuance as they seek to optimize funding costs. New markets and sustainable issuance will support further growth.

The household sector has proved resilient to higher inflation and interest rates and lower property valuations, thanks to accumulated savings and resilient employment. Tightening financial conditions and a weakening economy could still exert pressure on asset performance, especially for low-income individuals.

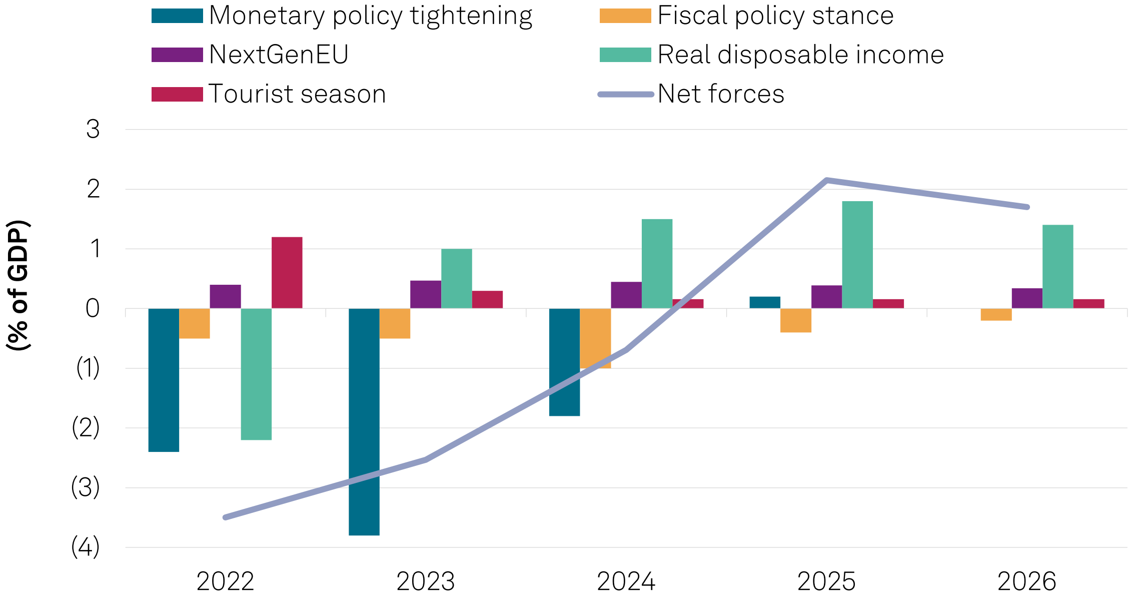
Commercial real estate nonperforming loans (NPLs) have been broadly stable despite rising interest rates and economic uncertainty leading to declining values and falling investor demand. However, a deterioration is likely, exposing banks to higher credit losses.

Our covered bond rating outlook remains stable, underpinned by the ample credit enhancement available to most of the programs that we rate, and the presence of unused notches, which reduces the risk of covered bond downgrades.

Economic Conditions | Eurozone Economic Activity May Contract

- We expect the eurozone will emerge from stagflation in the second to third quarters, thanks to disinflation and the first normal tourist season since COVID-19. However, other post-pandemic tailwinds are fading, and higher interest rates are dampening demand.
- The medium-term outlook is brighter because monetary policy should have moved away from restraining demand within two years, the labor market might prove more resilient than in previous slowdowns, and fiscal policy will provide support through the Next Gen EU plan.

The eurozone is subject to opposing forces whose balance is negative in the short term and turns positive in the medium term



Note: Impact of monetary policy tightening and of Next Gen EU according to ECB estimates; fiscal policy stance according to the last IMF fiscal monitor; real disposable income and impact of tourism are based on our assumptions. Source: S&P Global Ratings.

S&P Global Ratings' European economic forecasts

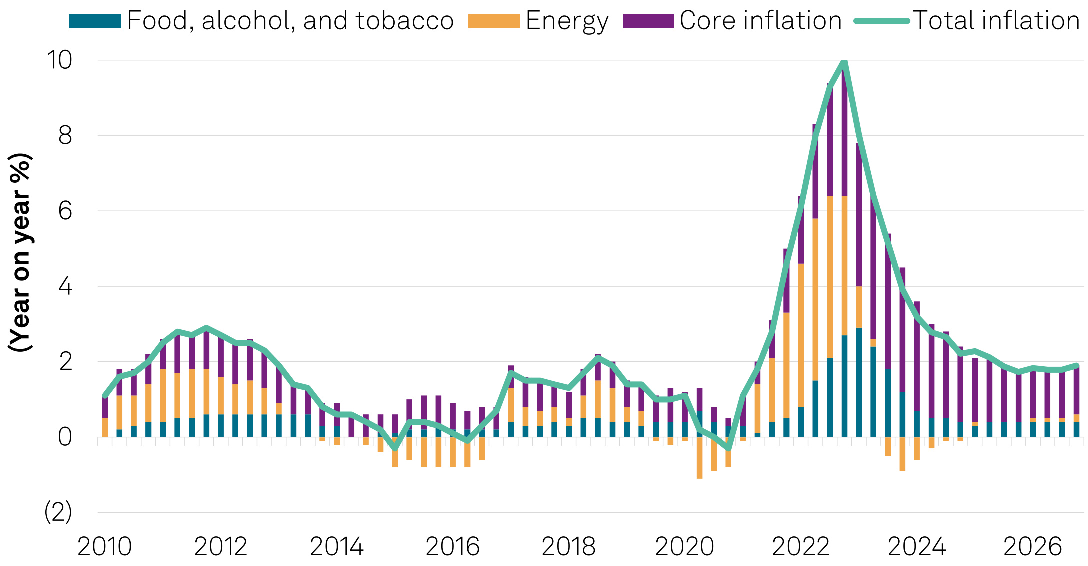
	Eurozone	Germany	France	Italy	Spain	Netherlands	U.K.
GDP (%)							
2022	3.6	1.9	2.5	3.8	5.5	4.5	4.1
2023	0.6	(0.1)	0.7	1	1.6	0.7	0
2024	0.9	0.8	0.9	0.6	1.3	1.1	0.8
2025	1.6	1.6	1.5	1.3	2.3	1.7	1.6
2026	1.6	1.7	1.4	1.3	2.2	1.7	1.7
Unemployment rate (%)							
2022	6.7	3.1	7.3	8.1	12.9	3.5	3.7
2023	6.7	3.1	7.2	7.8	12.6	3.5	4.2
2024	6.9	3.2	7.5	8	12.8	3.7	4.6
2025	6.7	3.2	7.5	8	12.7	3.6	4.3
2026	6.6	3	7.2	7.9	12.7	3.6	4.2

Source: S&P Global Ratings. Economic Outlook Eurozone Q3 2023: Short-Term Pain, Medium-Term Gain, June 26, 2023.

Economic Conditions | Real Interest Rates Will Start To Fall In 2024

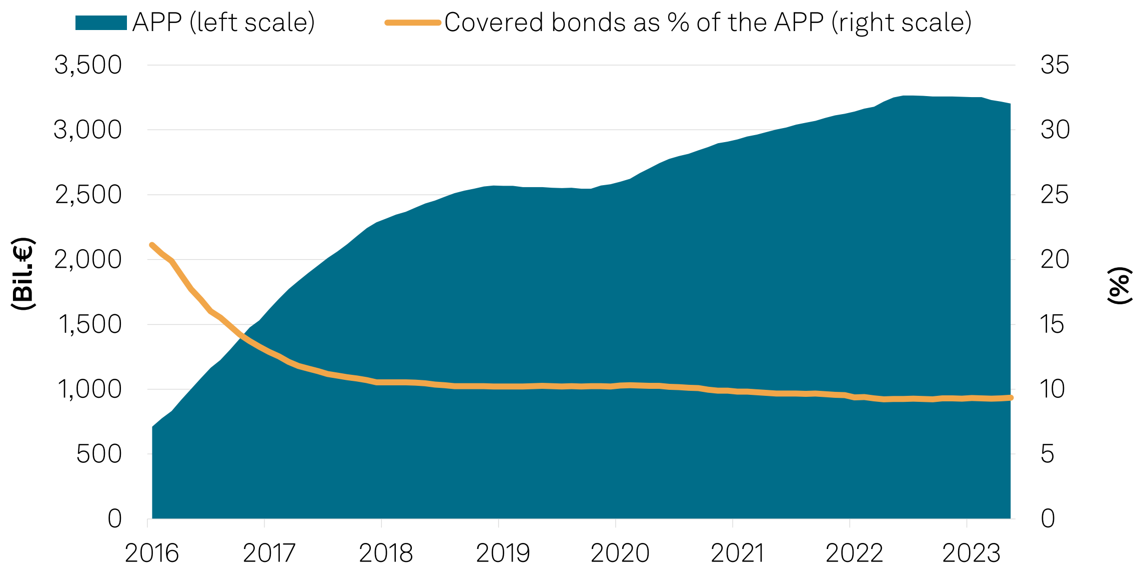
- Although disinflation has started, the ECB has core inflation concerns and is likely to raise rates once more in July, before pausing. We don't expect the central bank to achieve its price stability target before 2025.
- The ECB stopped reinvestments under its asset purchase program (APP) in July 2023. We expect the discussion about the speed of the balance reduction to continue, potentially covering whether the ECB should start considering selling assets held under the APP.

Core inflation is set to make the biggest contribution to inflation
Breakdown of HICP inflation by main contributors



HICP--Harmonized index of consumer prices. Source: S&P Global Ratings.

Covered bonds constitute almost 10% of cumulative net purchases under the APP



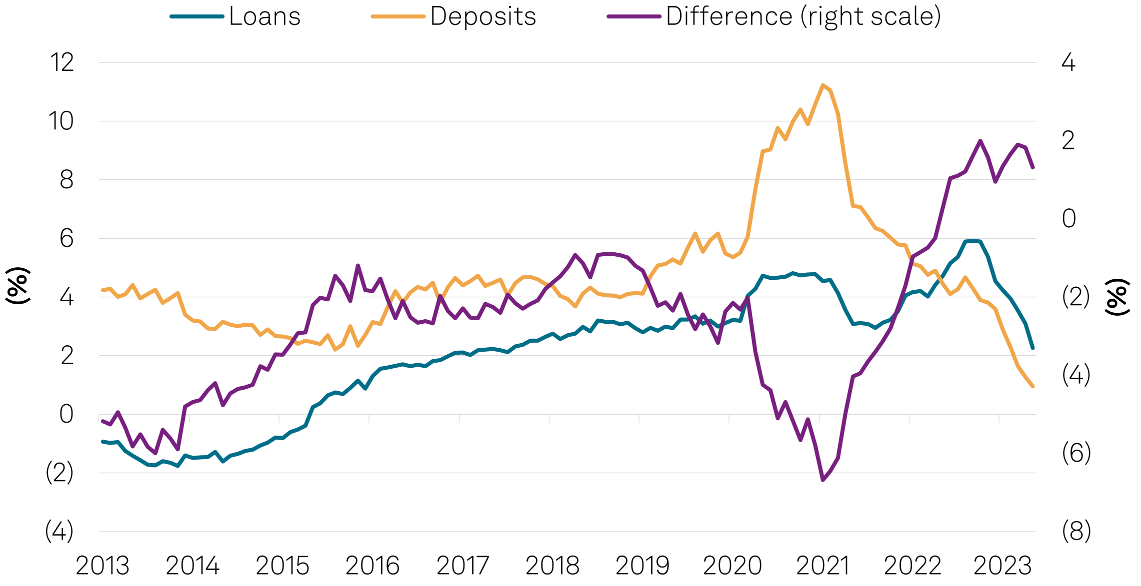
Data as of May 2023. Sources: European Central Bank, S&P Global Ratings.

S&P Global
Ratings

Issuance | Funding Needs Could Rise

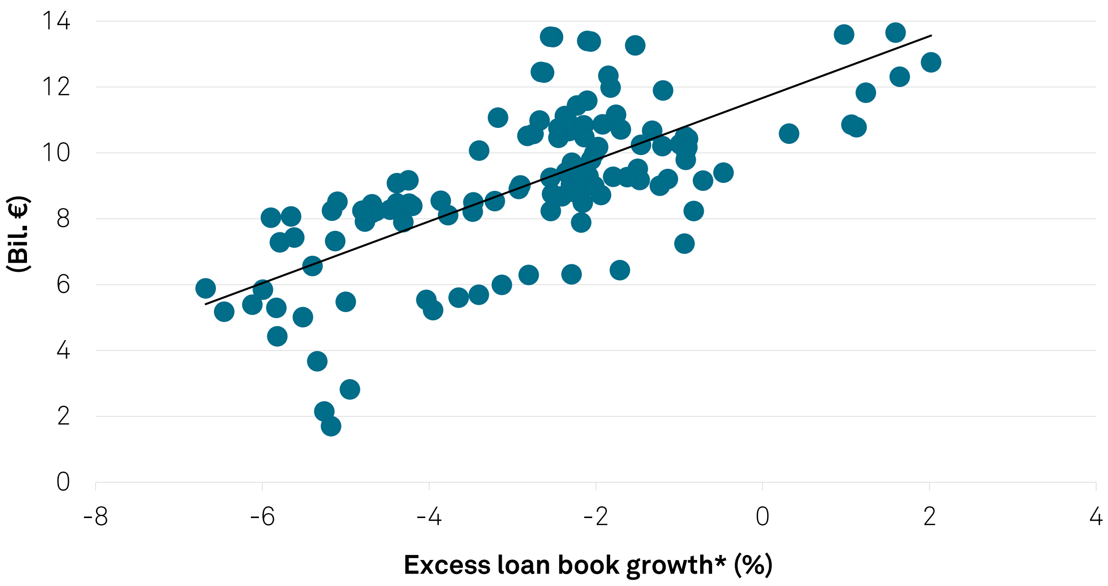
- Housing loan demand is sharply decelerating due to higher interest rates, weaker consumer confidence, and a darkening market outlook. But issuance strongly correlates with the difference between loan growth and deposit growth, which is also decelerating sharply.
- Eurozone banks still have plenty of retained covered bonds that could be redeemed to free up collateral for distributed issuance.

Lending and deposit growth is weakening
Year on year growth, eurozone households, and NFCs



NFCs--Nonfinancial corporates. Source: European Central Bank, S&P Global Ratings.

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

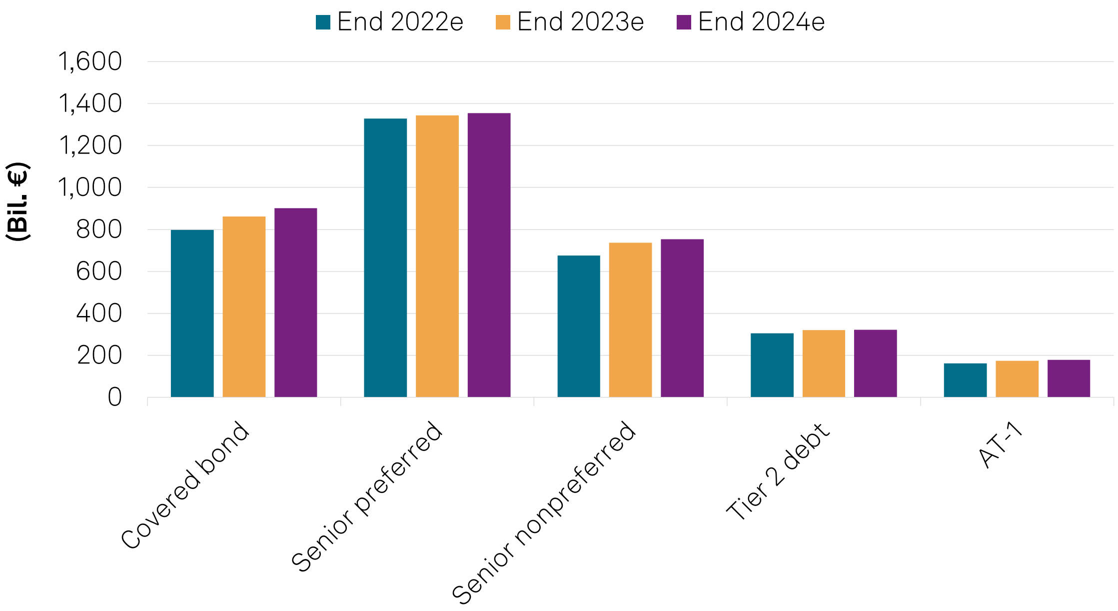


**Defined as 12-month loan growth minus deposit growth. Sources: European Central Bank, S&P Global Ratings.*

Issuance | European Banks' Significant Wholesale Debt Issuance To Continue

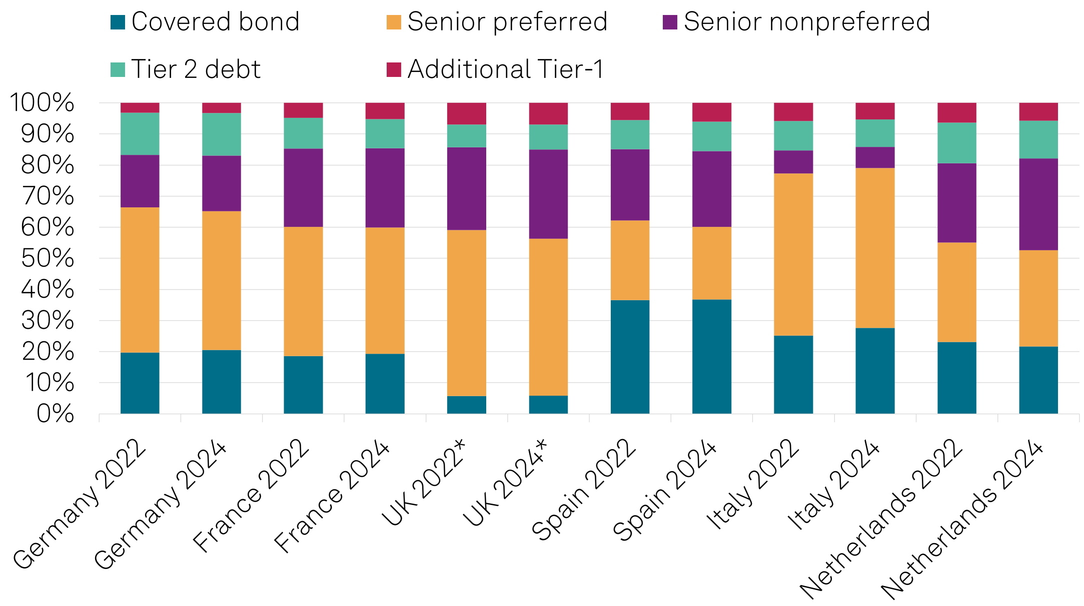
- European banks' funding costs are likely to further rise in 2023 and 2024—as deposit availability will likely decrease and central banks accelerate the pace of their balance sheet reduction—and profitability will peak later this year.
- We expect European banks will continue to issue significant amounts of wholesale debt in 2023 and 2024, with a further increase in covered bonds as banks seek to optimize funding costs.

Material debt issuance planned until 2024



*Wholesale funding composition estimates for the top 50 rated European banks. *For U.K. banks, senior nonpreferred refers to senior holdco debt. e--Estimate. Source: S&P Global Ratings. European Banks: Protecting Liquidity Will Come At An Increasing Cost, June 29, 2023.*

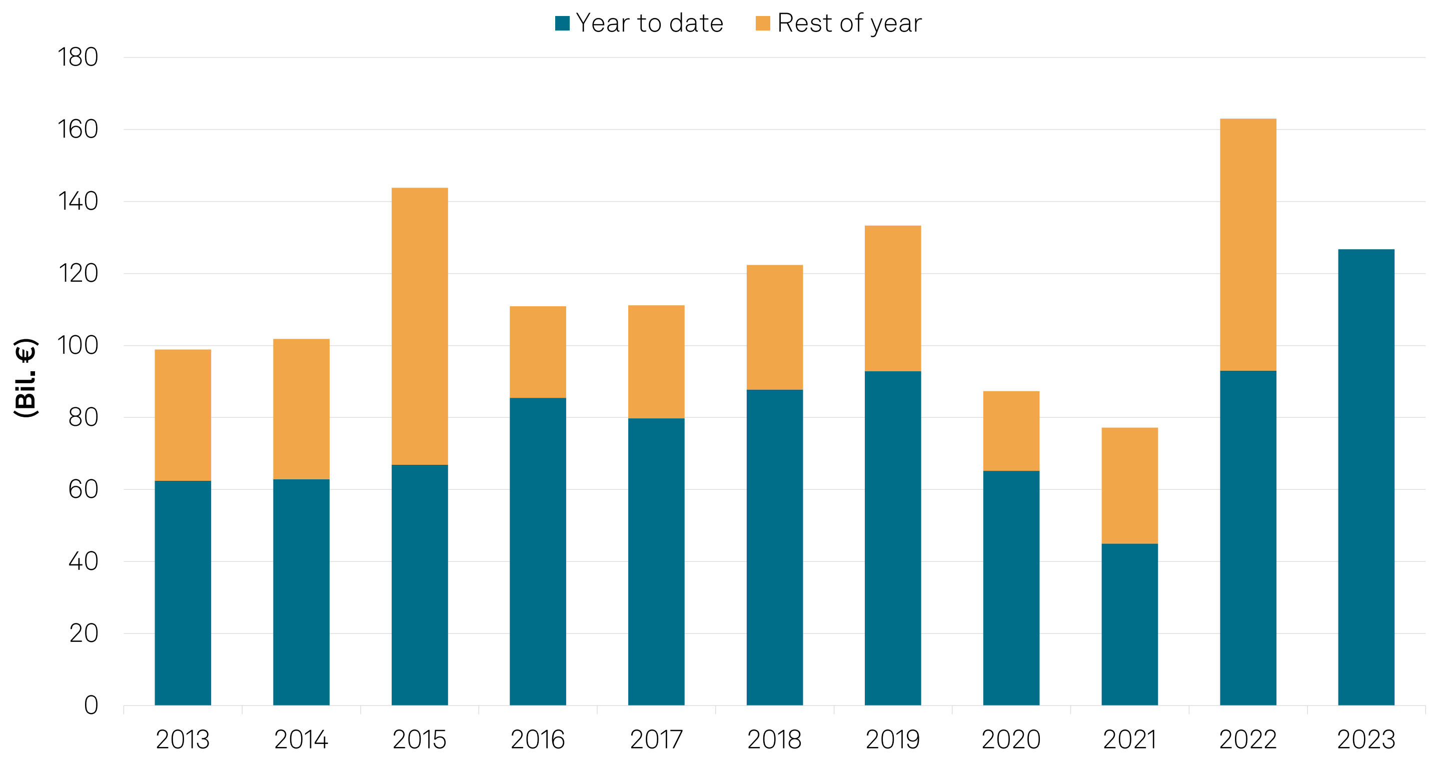
Wholesale funding composition to remain broadly unchanged



*Estimated wholesale funding composition for top 50 rated European banks. *For U.K. banks, senior nonpreferred in this chart refers to senior holdco debt. Source: S&P Global Ratings.*

Issuance | Strong Covered Bond Issuance Is Here To Stay

Issuance reaches new record in H1



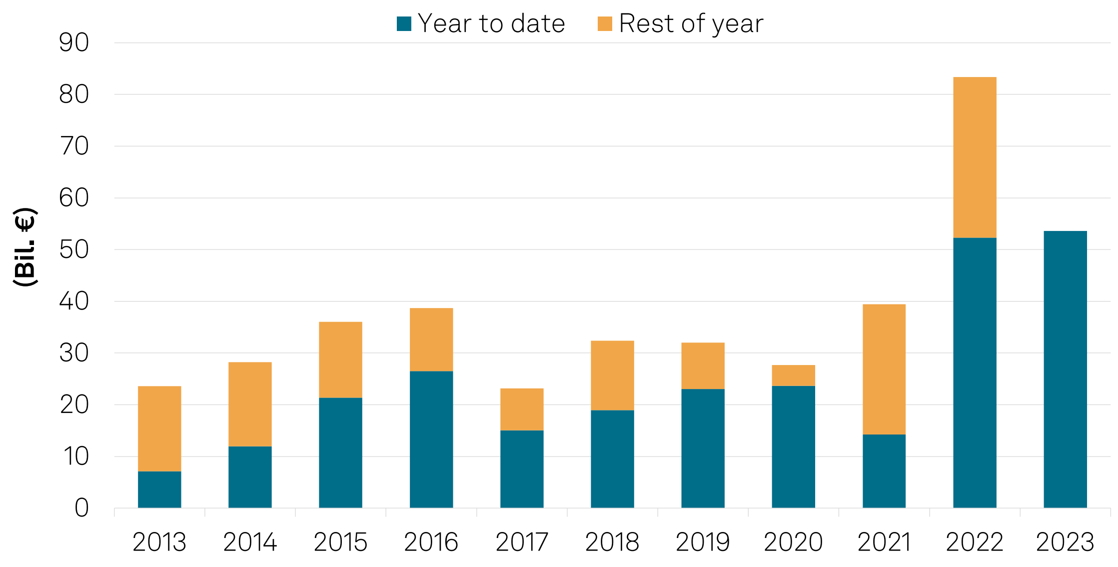
European investor-placed benchmark covered bond issuance. Year-to-date figures as of July 10 each year. Source: S&P Global Ratings. *Global Covered Bond Insights Q3 2023: Strong Issuance Is Here To Stay, June 29, 2023.*

- Investor-placed benchmark issuance in the first half of 2023 was up by a third on volumes recorded for the same period in 2022, supported by hefty targeted longer-term refinancing operation (TLTRO) maturities and in anticipation of reduced European Central Bank intervention.
- We believe 2023 full-year investor-placed issuance will near the decade-high set in 2022, with 2024 set to be another strong year.
- In a "higher for longer" interest rate environment, issuers may continue to favor covered bonds over other, more expensive, sources of wholesale funding.
- New markets and sustainable issuance will support further growth.

Issuance | Volumes Outside Europe Setting New Highs

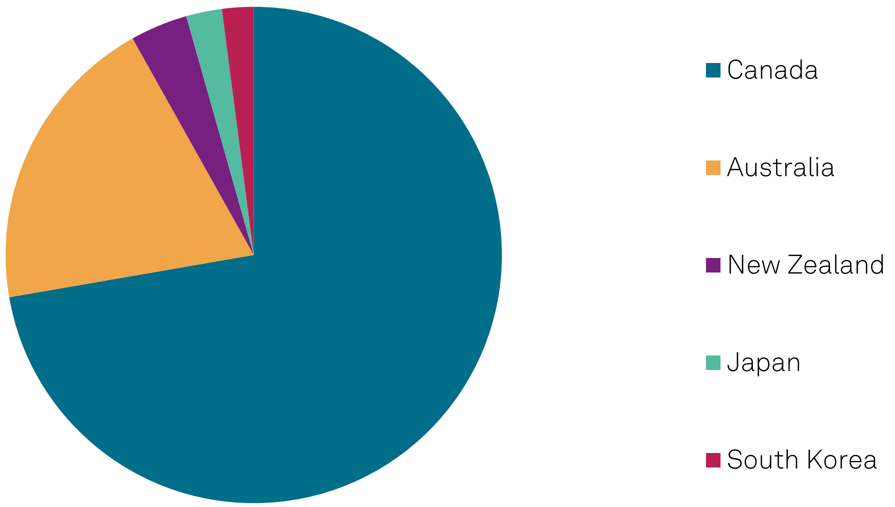
- Covered bond issuance has surged outside Europe too, especially in countries where issuers partially replaced central bank funding with covered bonds, such as Canada.
- We expect issuance in new markets to increase further, supported by new issuers in countries with an established legislative framework, such as South Korea and Singapore.

"Rest of world" investor-placed benchmark covered bond issuance



Year-to-date figures as of July 10 each year. Source: S&P Global Ratings. Covered Bonds In New Markets: A Shifting Paradigm, May 24, 2023.

Led by Canada and Australia



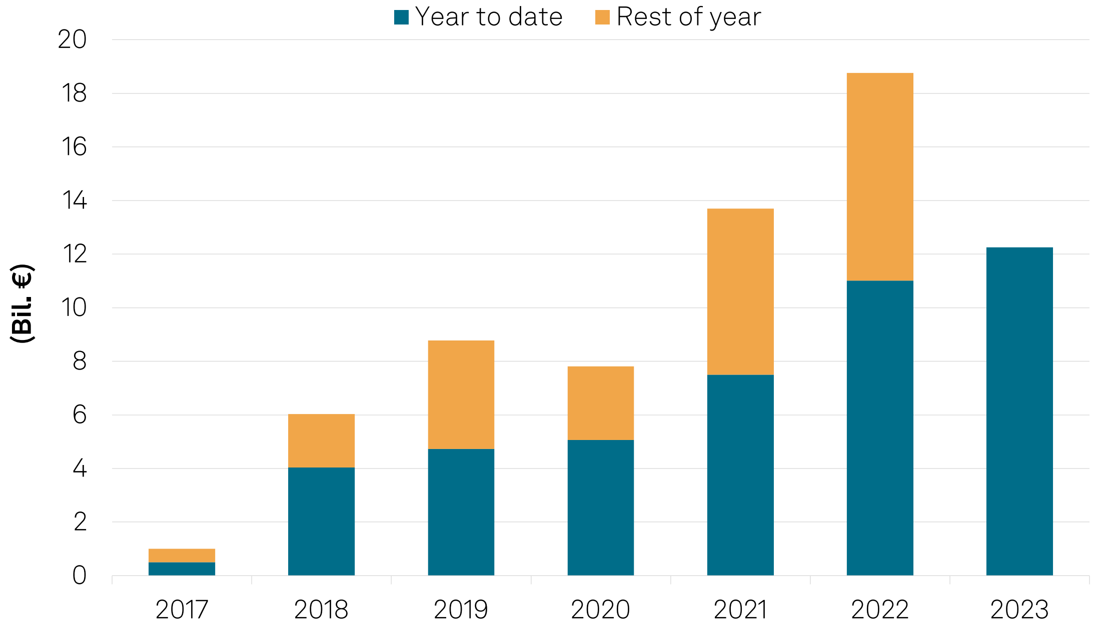
2023 year-to-date investor-placed benchmark covered bond issuance outside Europe, by country, as of July 10, 2023. Source: S&P Global Ratings.

Sustainable Covered Bonds | Volumes Reach Record Levels In H1

– Sustainable issuance of more than €12 billion as of first half 2023 exceeds 2022 record volumes, but accounts for the smallest share of overall issuance since 2019. Lack of eligible assets, a limited greenium, and the challenges of implementing the EU Taxonomy have limited supply volumes.

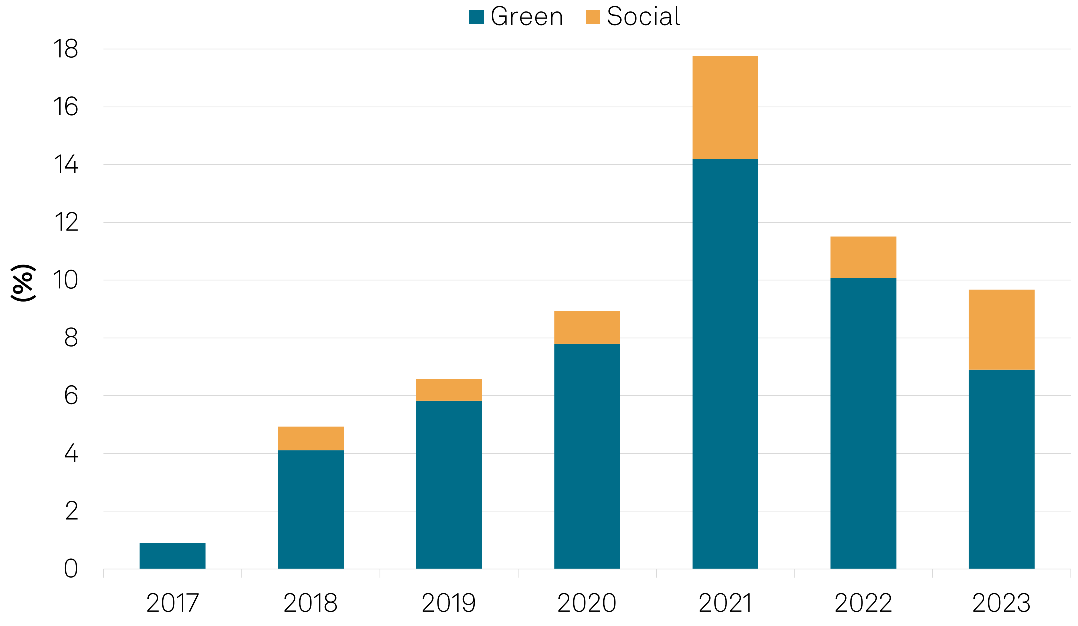
– We expect additional clarity regarding applicable regulations and strong investor demand to support further growth.

Sustainable covered bonds hit a new YTD record in 2023...



Sustainable benchmark covered bond issuance. Year-to-date figures as of July 10 each year. Source: S&P Global Ratings.

...But represent a declining share of overall issuance



Sustainable covered bonds' share of issuance. 2023 YTD figures as of July 10, 2023. Source: S&P Global Ratings.

Sustainable Covered Bonds | Transparency Requirements Will Help Identify Eligible Assets

The EU sustainable finance framework calls for greater disclosure

EU Taxonomy

- Taxonomy Regulation in force since July 2020.
- Delegated act on sustainable activities for climate change adaptation and mitigation objectives appliable since January 2022.
- Delegated act for economic activities substantially contributing to the rest of the environmental objectives adopted in June 2023.

Disclosure

- SFDR applies since March 2021. Delegated regulation containing its technical standards appliable since January and February 2023.
- CSRD in force since January 2023. Opening of feedback process on first draft of sustainability reporting standards in June 2023.

Tools

- EU Climate Benchmark Regulation applies since April 2020. Minimum technical requirements applicable via delegated acts since December 2020.
- Standard for European green bonds proposed by the EU Commission in July 2021 and political agreement reached in February 2023.

Sources: European Commission, S&P Global Ratings.

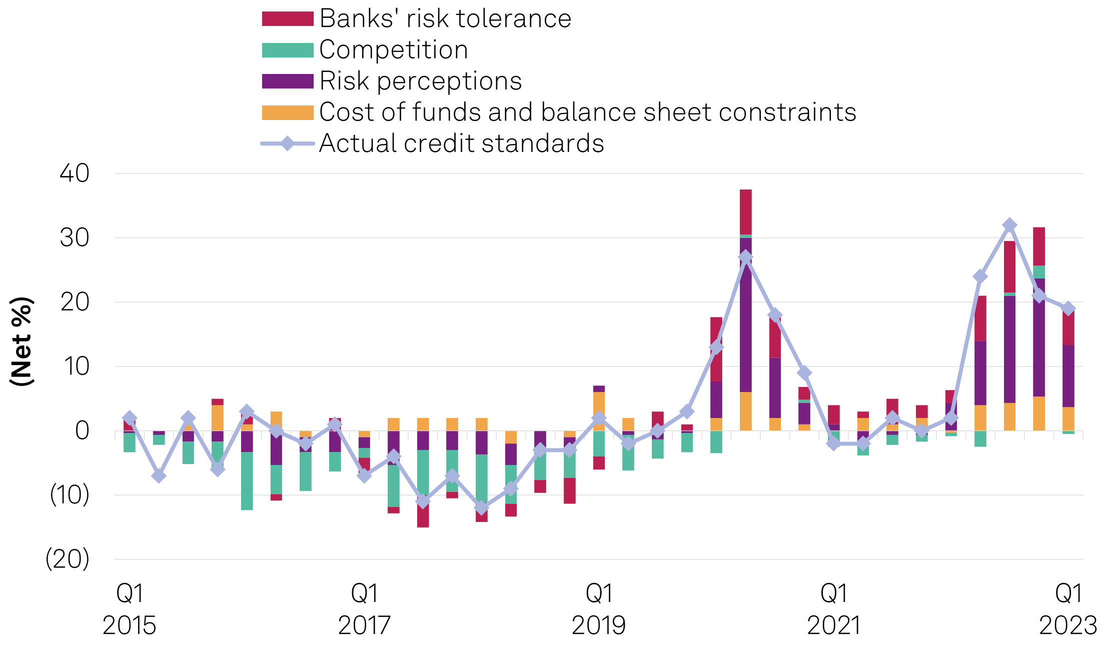
- New disclosure requirements will incentivize and—in some cases—facilitate issuers to identify eligible assets, in our view.
- The key EU sustainable finance framework initiatives promoting transparency are the corporate sustainability reporting directive (CSRD) and the sustainable finance disclosure regulation (SFDR).
- Under the CSRD entities will have to disclose their share of taxonomy-aligned economic activities, which will serve as an input for companies investing in their financial products given that, in turn, they must also prove to what extent their investments are sustainable under the SFDR.
- Furthermore, the EPBD sets specific targets on real estate data, requiring all energy performance certificates (EPCs) to be based on a harmonized scale by 2025 and setting progressively higher minimum EPCs for the worst-performing buildings.

Credit Performance | Lending Growth Set To Slow

– The combination of lower credit demand and tighter underwriting standards--the sharpest tightening in banks' credit standards since the euro sovereign debt crisis in 2011 according to the ECB's Q1 2023 Bank Lending Survey--points to a further decline in lending growth.

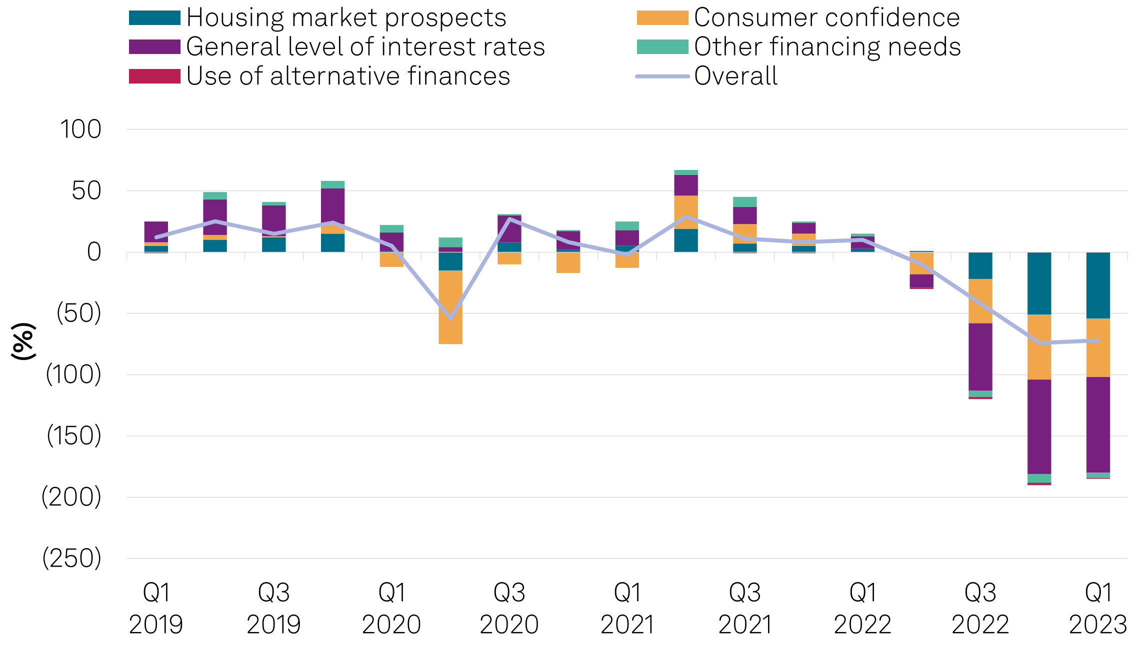
– In Italy and Spain the private sector is actually deleveraging, with households using excess savings to prepay mortgages.

Banks are tightening credit standards for home purchase...



Net percentages of banks reporting credit standards tightening, and contributing factors. Source: ECB lending survey Q1 2023.

...And housing loan demand is contracting sharply in the Eurozone

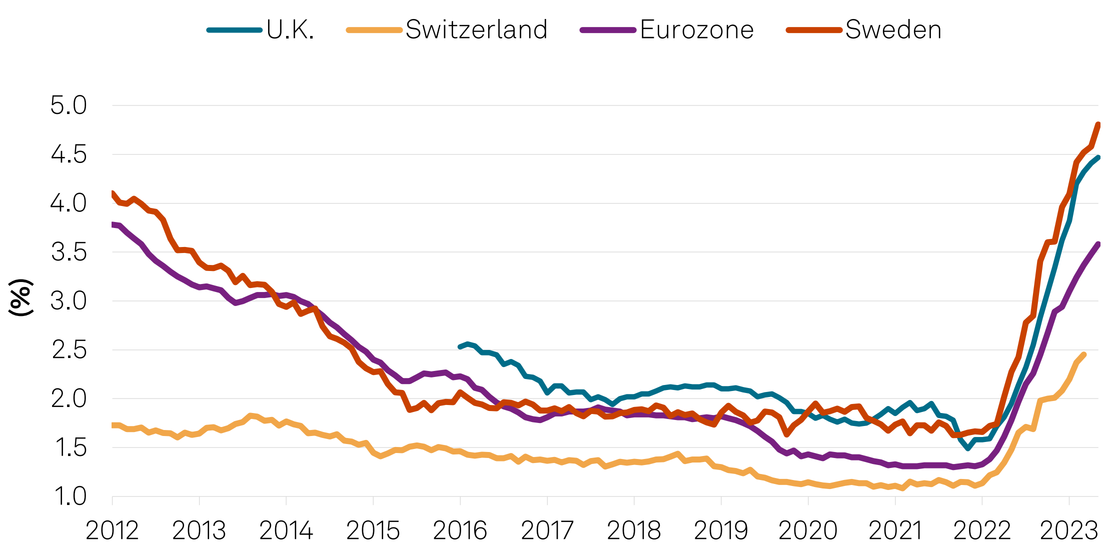


Net percentages of banks reporting an increase in demand. Source: ECB lending survey Q1 2023.

Credit Performance | Higher Interest Rates Hit The Housing Market

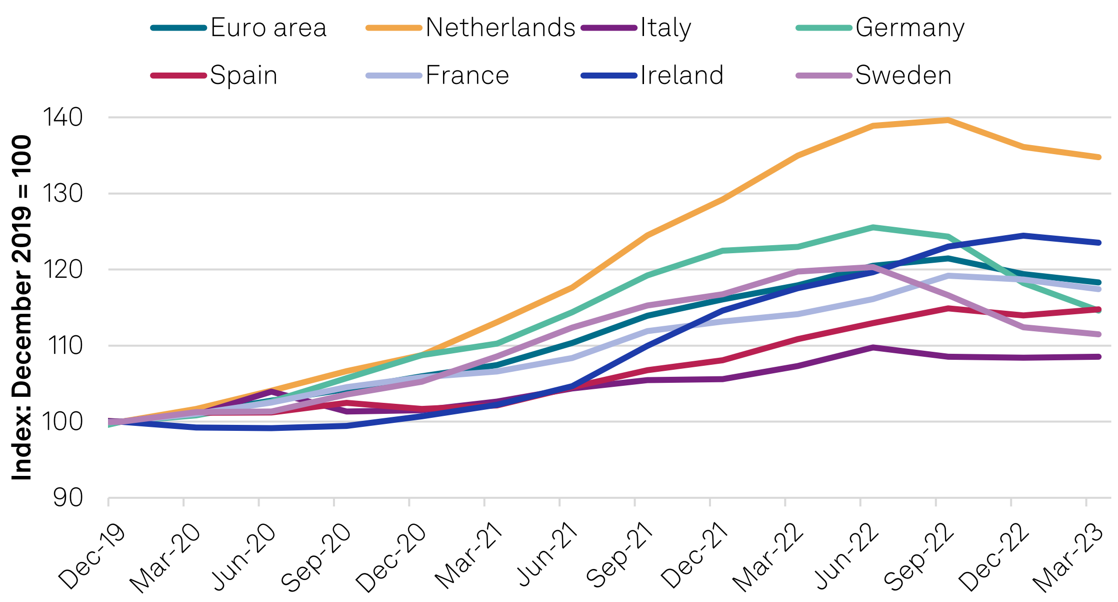
- In nominal terms, mortgage rates have accelerated to their highest level in a decade or so. However, in real terms, adjusted for inflation in consumer prices or in construction costs, they are still negative and likely to remain negative until mid-2024.
- Rapidly rising mortgage rates have hit the housing market hard. House prices are likely to fall in most European countries over 2023 and 2024, with few if any prospects of a strong rebound through 2025.

Mortgage rates are rapidly rising in Europe
Rates on new mortgage loans



Sources: ECB, SNB, BoE, Refinitiv, S&P Global Ratings.

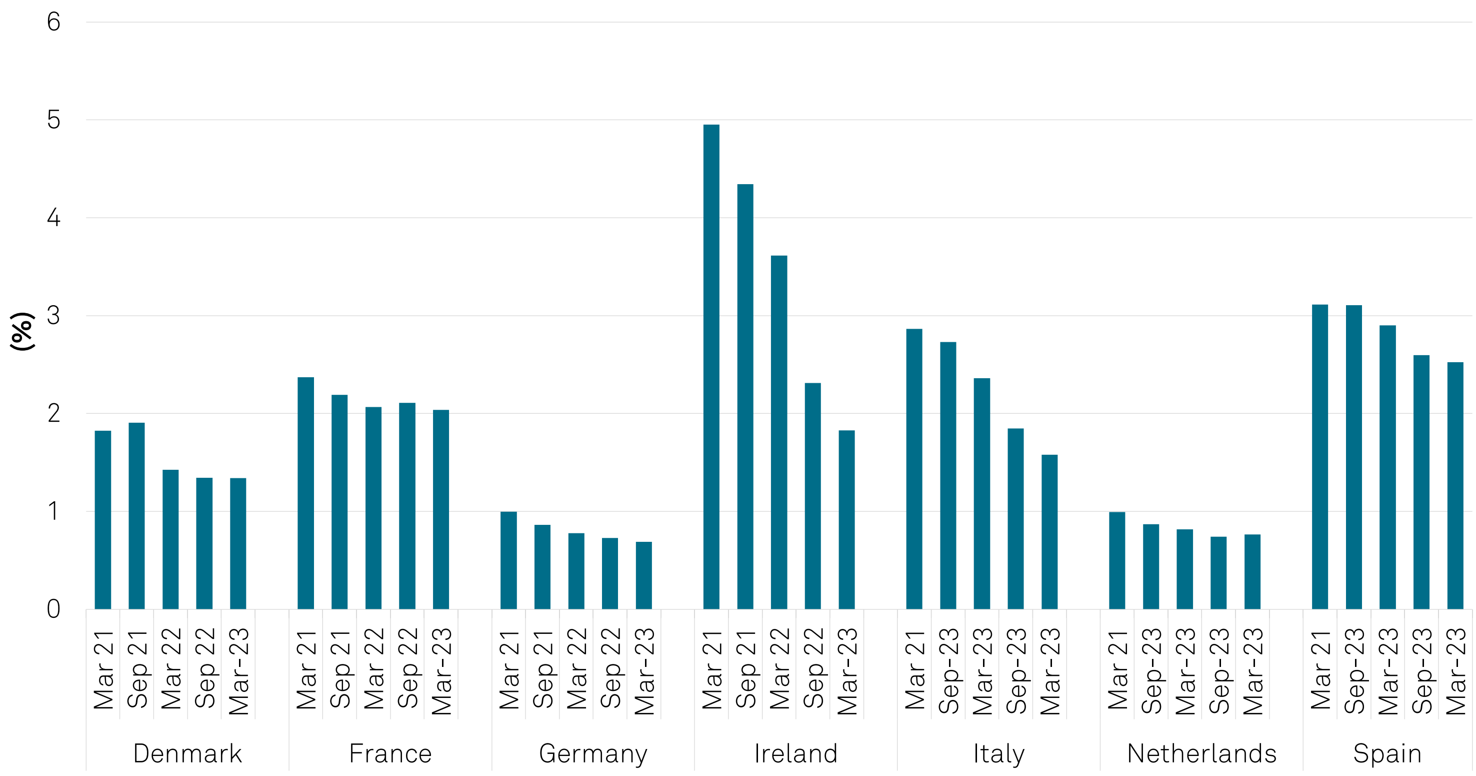
House prices are weakening in Europe



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

Credit Performance | Residential Mortgage Performance Resilient To Sharpest Tightening In Financial Conditions

Residential mortgage performance stable despite rising rates
Nonperforming loan ratio of residential household mortgages



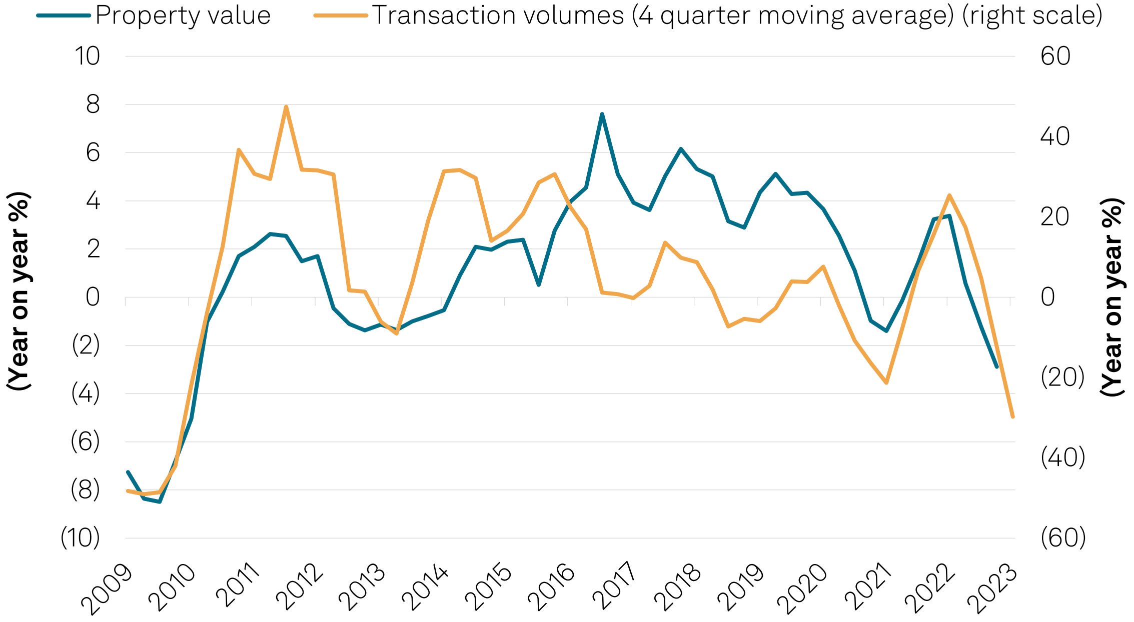
Sources: European Banking Authority, S&P Global Ratings.

- Government fiscal support, household saving buffers, prudent underwriting standards, and a tight labor market supported residential mortgage performance.
- This resilience also reflects that much of the real impact of rising interest rates has yet to materialize.
- We generally anticipate more pressure in countries with a high share of variable rate mortgages and where the interest rate rise is highest, such as Sweden.
- Low-income individuals are more exposed to inflation and higher financing costs, but they typically hold only a low share of overall household debt.

Credit Performance | Commercial Real Estate Price Correction Increases Funding Challenges

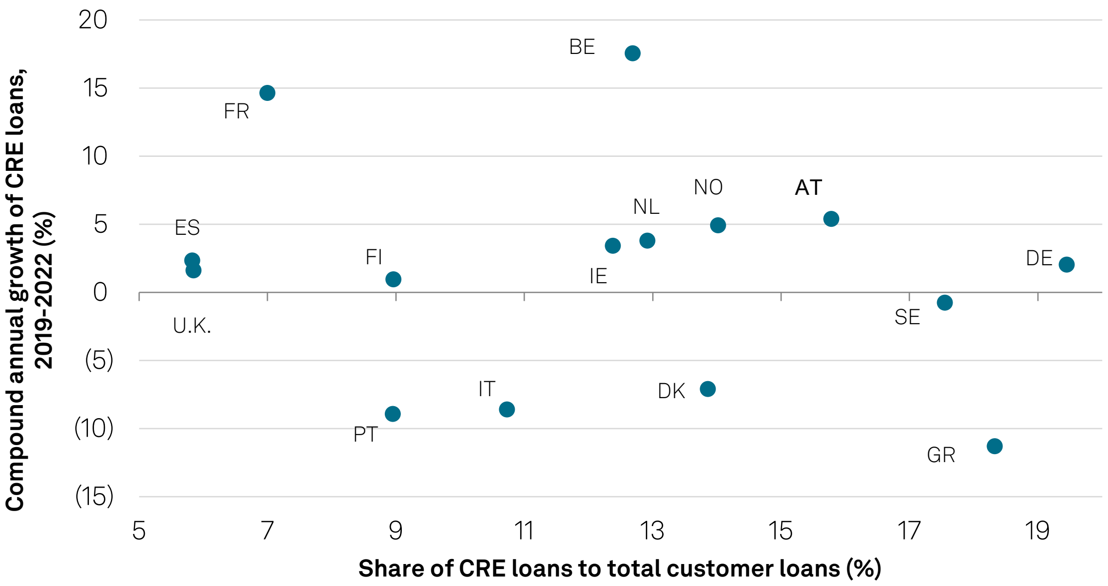
- Pressured by rising interest rates, a price correction is underway in most European commercial real estate markets, which we think will continue until the end of the year. Offices (particularly non-prime) and lower yielding assets appear more exposed.
- European banks' loan books continue to have moderate exposure to real estate. While we understand banks are likely to continue supporting the property sector, they could become more selective particularly with existing clients.

Property prices and transaction volumes are falling across CRE assets



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

CRE loans represent about 10% of large EU banks' total lending portfolios, but exceed the average in Germany and Sweden

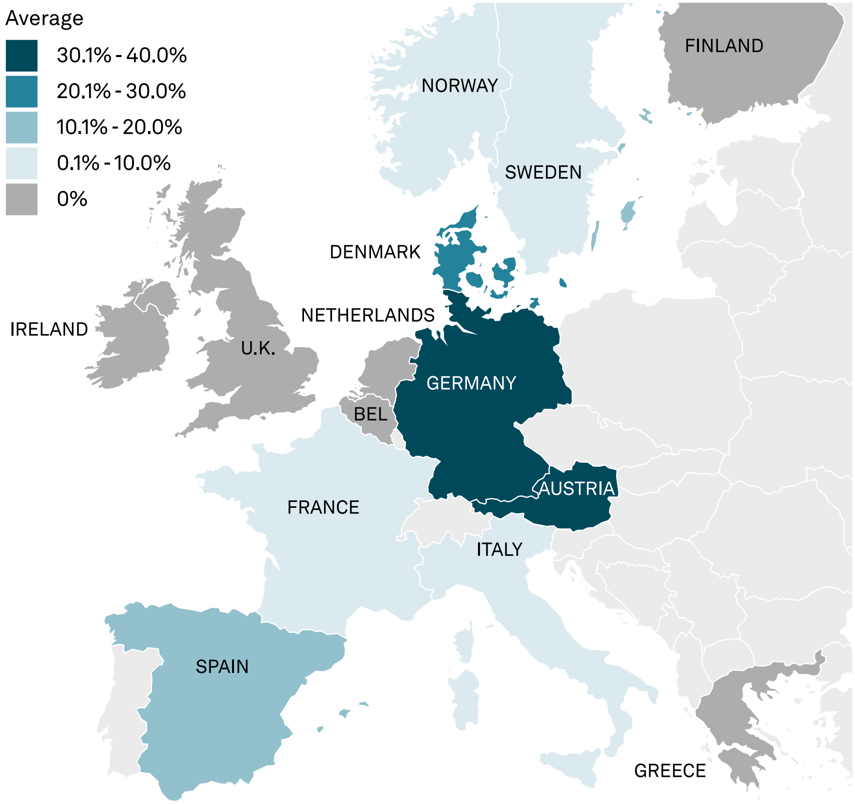


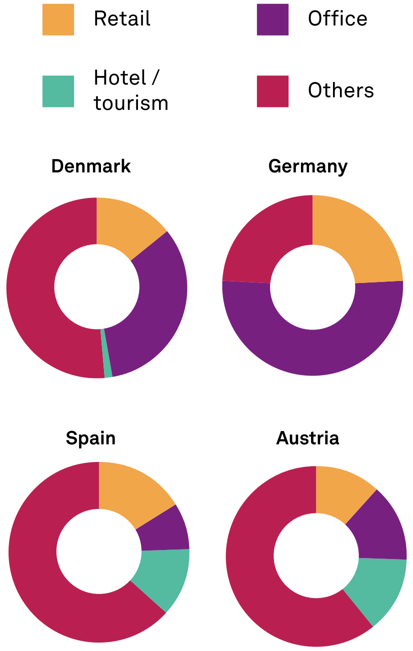
Sources: EBA, Bank of England, S&P Global Ratings. Credit FAQ: Spotlight On Refinancing Risks In European Commercial Real Estate, April 24, 2023.

S&P Global Ratings

Credit Performance | Office Market Under Pressure But Limited Exposure In Most Countries

Commercial real estate exposure
% of total assets



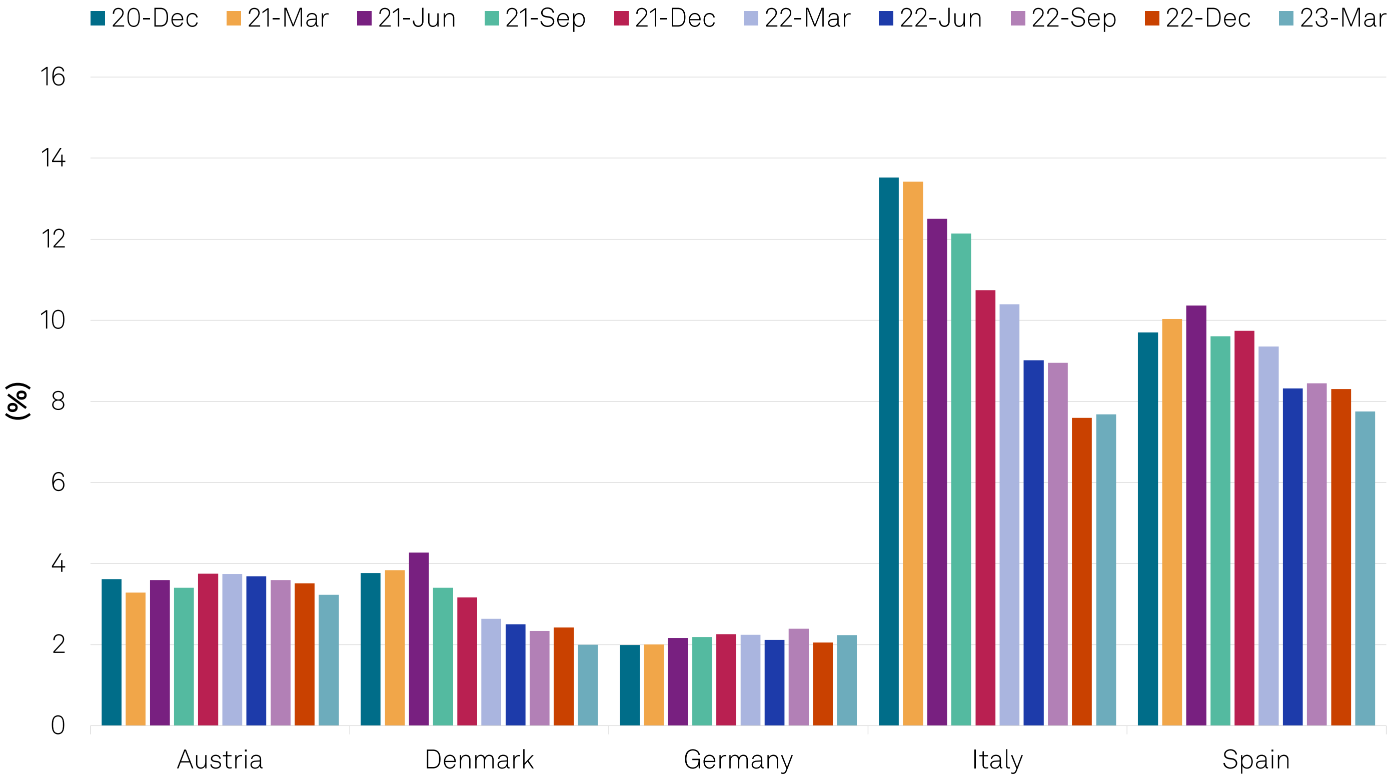


- Increased remote working and sluggish economic growth could weaken tenant demand in Europe this year and exert further pressure on vacancies and rents. Combined with low yields, this will also result in further revaluation losses.
- We expect a widening gap between grade-A assets, located in central districts, and grade-B assets, located in peripheral locations.
- Sustainability standards regulations are also likely to tighten in Europe, with the U.K. now requiring a minimum energy performance rating for commercial properties.
- Conservative underwriting (which include strict loan-to-value limits), limited office sector exposure (except in Germany), and available credit enhancement, should limit any deterioration of the credit quality of the covered bonds that we rate.

Based on issuer Harmonized Transparency Template reports and S&P Global Ratings estimates. Covered Bonds Could Ease The Pain In European Commercial Real Estate, May 16, 2023

Credit Performance | CRE Asset Performance Likely To Deteriorate

CRE NPL ratios remain stable despite valuation pressure



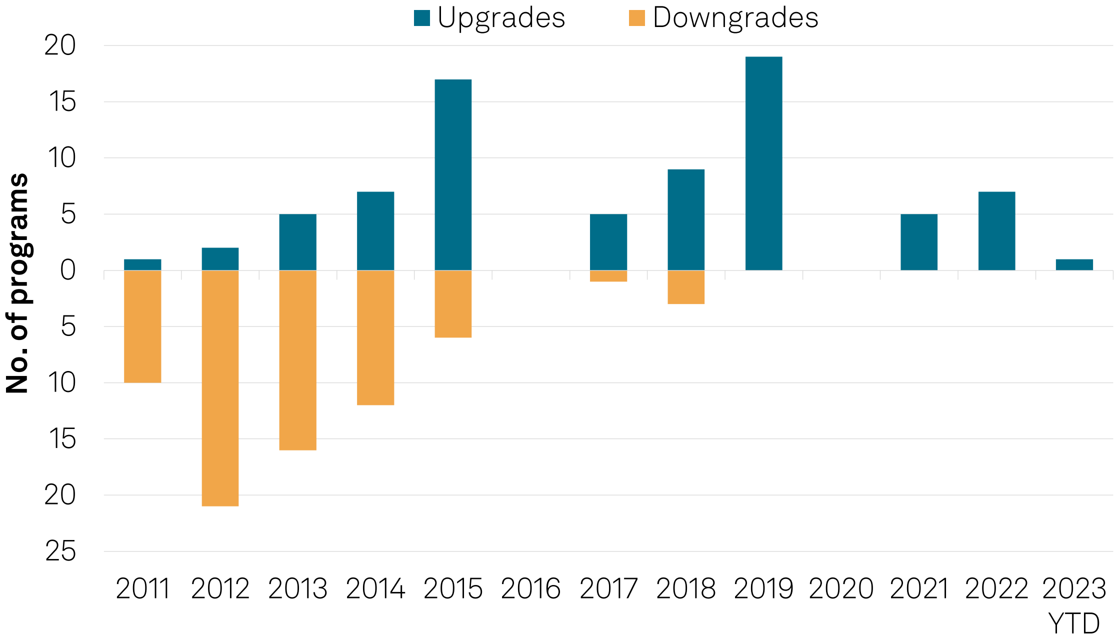
CRE--Commercial real estate. NPL--Nonperforming loan. Sources: European Banking Authority, S&P Global Ratings.

- NPL ratios have been broadly stable so far despite rising interest rates and economic uncertainty leading to declining prices and falling investor demand.
- Unlike during the pandemic, contracting investor demand applies to all CRE asset types, as investors in every segment are facing rising financing costs and macro-financial uncertainty.
- While some deterioration in CRE asset quality is likely, most EU CRE bank lending is from larger banks, which tend to have more capacity to absorb potential losses.
- Even so, any distressed sales surge could undermine market sentiment, exposing banks to higher credit losses.

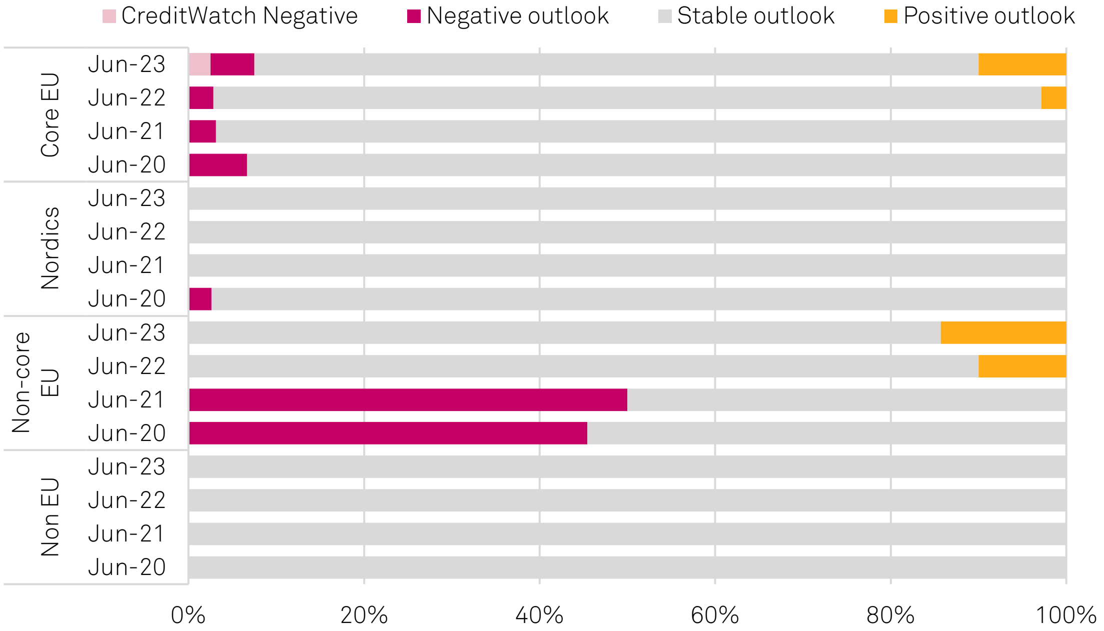
Ratings Outlook | Covered Bond Ratings Withstand Rising Interest Rates And Banking Wobbles

- Since 2019, we have not downgraded any of the covered bond programs that we rate. We revised our outlooks positively on about 6% of the programs we rated in 2022 and upgraded eight due to rating actions on the issuing banks or related sovereigns.
- Of the covered bond programs that we rate, 97% have stable or positive outlooks.

No covered bond downgrades since 2019



Convergence toward stable outlooks for ratings in all markets

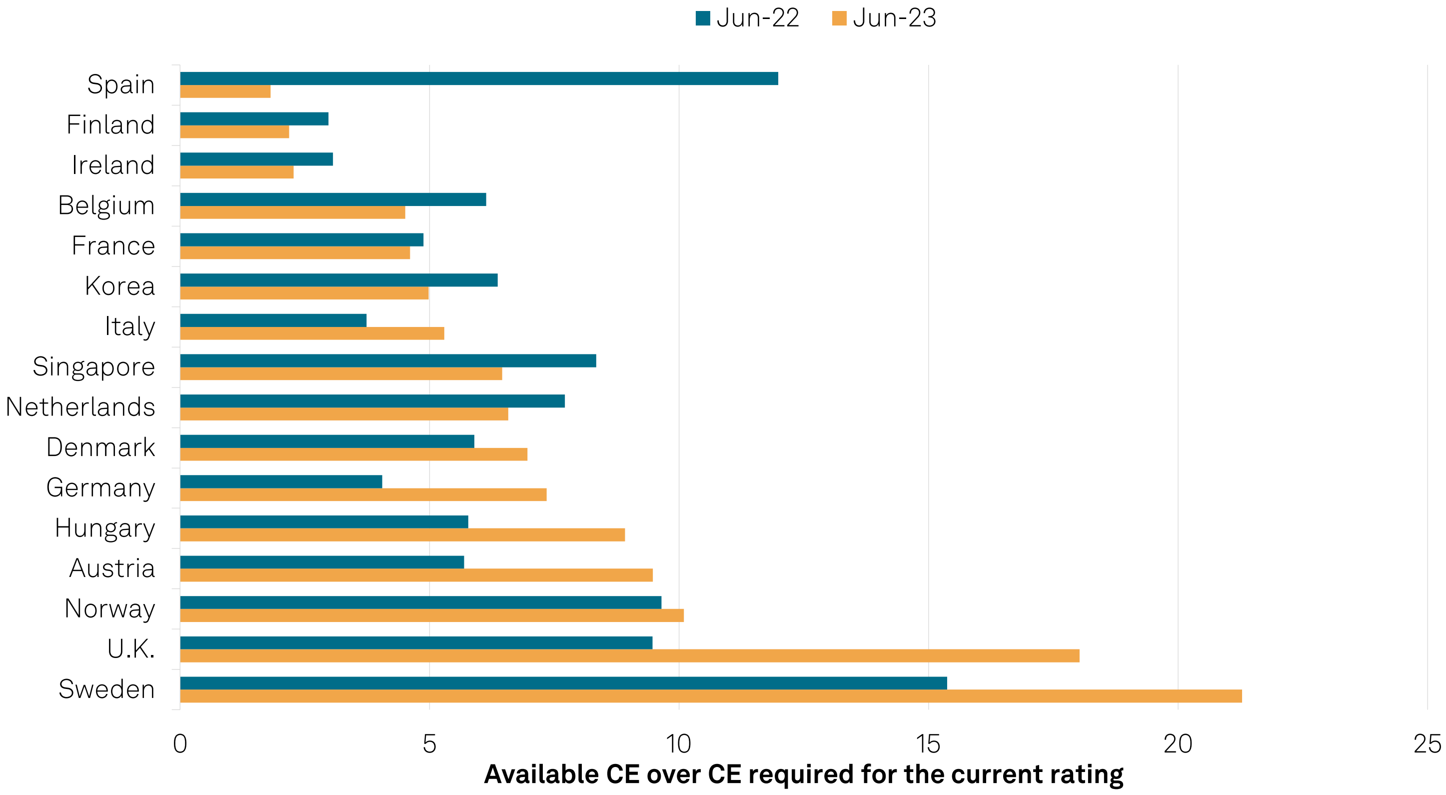


YTD--Year to date. Note: Core EU: Austria, Belgium, France, Germany, The Netherlands. Nordics: Denmark, Finland, Norway, Sweden. Non-core EU: Greece, Hungary, Ireland, Italy, Spain. Non EU: Singapore, South Korea, U.K. Source: S&P Global Ratings.

S&P Global Ratings

Ratings Outlook | Overcollateralization Should Cushion Collateral Performance Deterioration

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

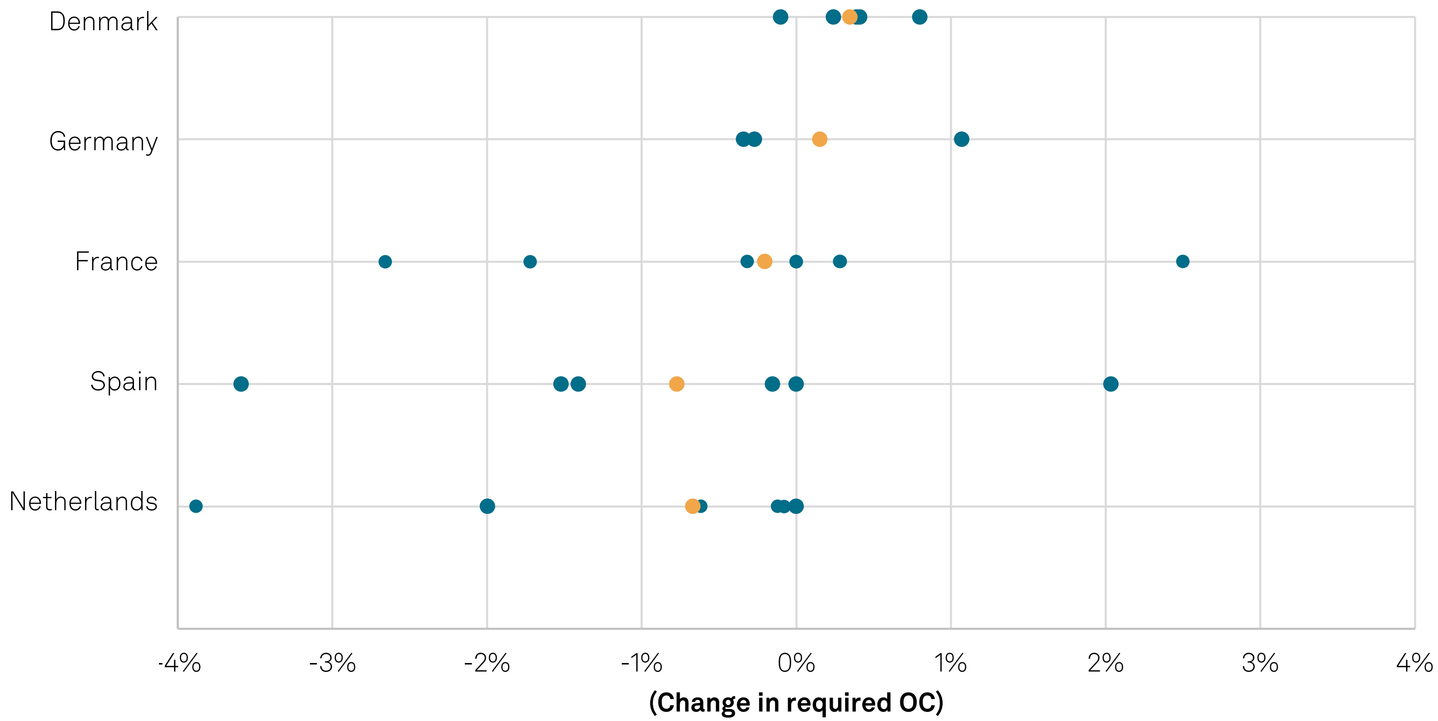


CE--Credit enhancement. Source: S&P Global Ratings.

- Available credit enhancement to rated programs represents, on average, more than nine times the level required to maintain their current ratings.
- Despite record covered bond issuance since 2022, available credit enhancement has not decreased significantly, except for programs in Spain.
- Following the transposition of the European covered bond directive, Spanish issuers have reduced their available credit enhancement, but to levels sufficient to support our covered bond ratings.
- We believe the available credit enhancement should cushion any deterioration in collateral performance arising from inflationary pressures.

Ratings Outlook | Available Credit Enhancement Can Mitigate Higher Interest Rates

Impact of higher interest rates on credit enhancement

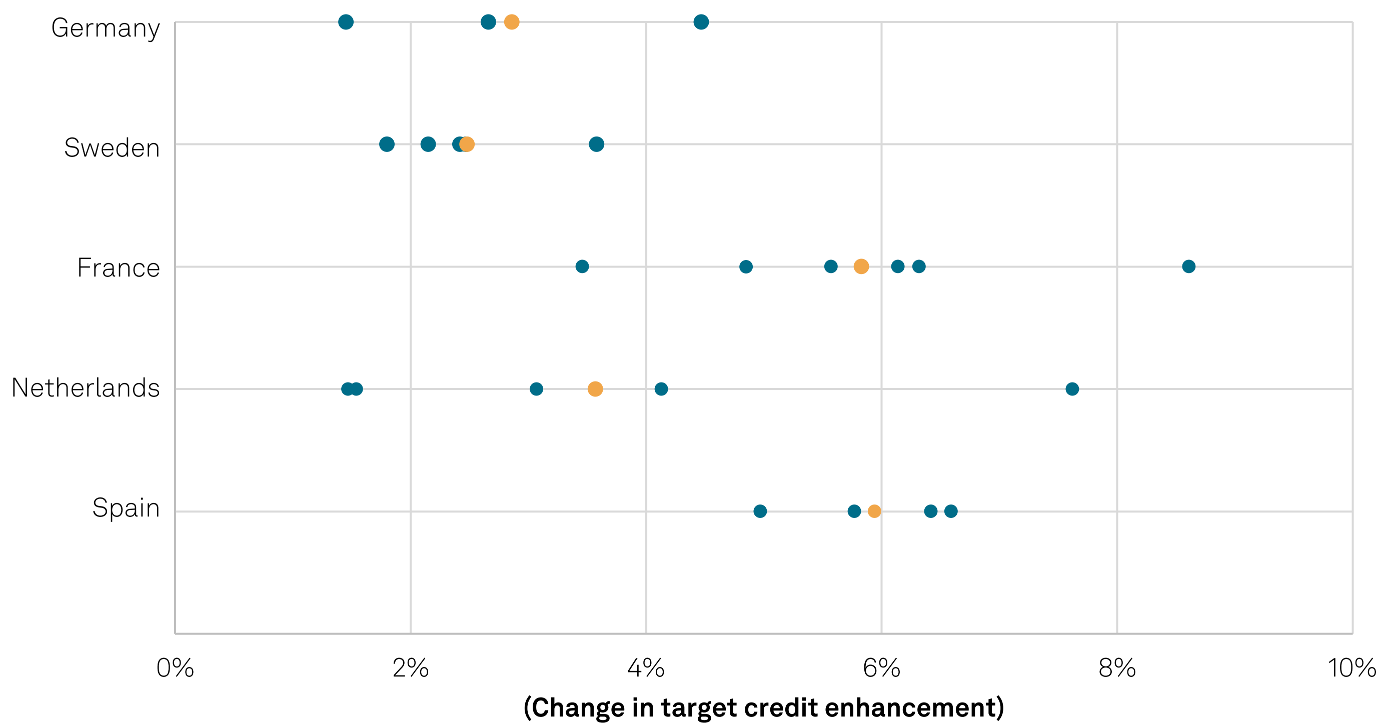


OC--Overcollateralization. The orange dots indicate weighted average values, the blue dots indicate program values. Source: S&P Global Ratings. Global Covered Bond Insights Q2 2023: The Implications Of Rising Interest Rates, April 12, 2023

- Higher interest rates can negatively affect our collateral analysis results for programs exposed to unhedged interest rate risks.
- We conducted a scenario analysis where we tested the impact of a further two percentage point increase in interest rates on the required credit enhancement for a selected subset of programs.
- The average change is less than one percentage point, and the maximum increase is 2.5 percentage points. This shows that most of our rated programs have some form of effective interest rate hedging that mitigates the impact of rising interest rates.

Ratings Outlook | Available Credit Enhancement Can Offset Maturity Risks

Impact of shorter maturities on credit enhancement levels



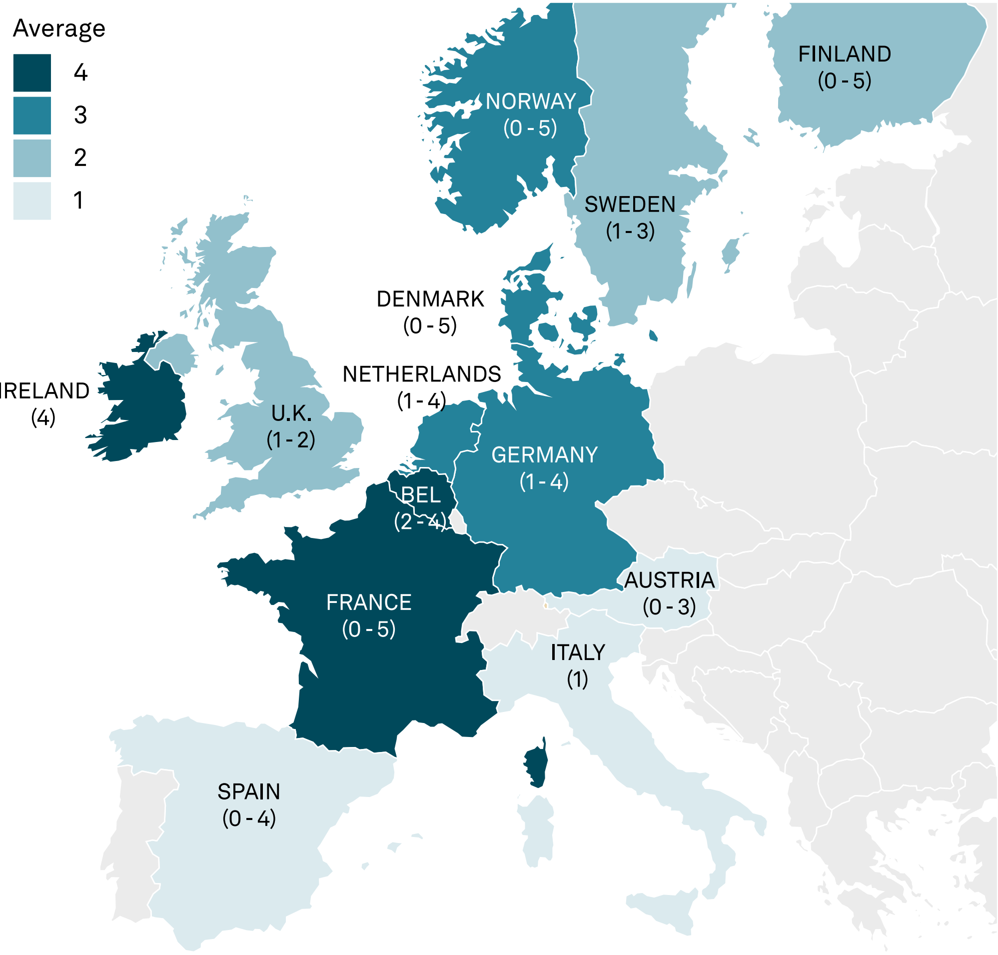
The orange dots indicate average values, and the blue dots indicate program values. Source: S&P Global Ratings. Global Covered Bond Insights Q3 2023: Strong Issuance Is Here To Stay, June 29, 2023.

- Shorter covered bonds' maturities can increase refinancing risk when they widen a program's asset-liability maturity mismatch.
- We conducted a scenario analysis where we tested the impact on target credit enhancement of a one-year decrease of the liability maturity profile.
- The average change is about four percentage points, and the maximum increase is 8.6 percentage points. While the impact is material for most of the programs we tested, the available credit enhancement continues to well exceed what's required for our current ratings.

Ratings Outlook | Unused Notches Partially Mitigate Bank Downgrade Risk

- Potential changes in sovereign or issuer credit ratings are the most likely triggers for changes to our covered bond ratings.
- Currently, rated programs benefit on average from two unused notches--the number of notches the issuer rating can be lowered without resulting in a downgrade of the covered bonds.
- French, Belgian, and Danish 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.

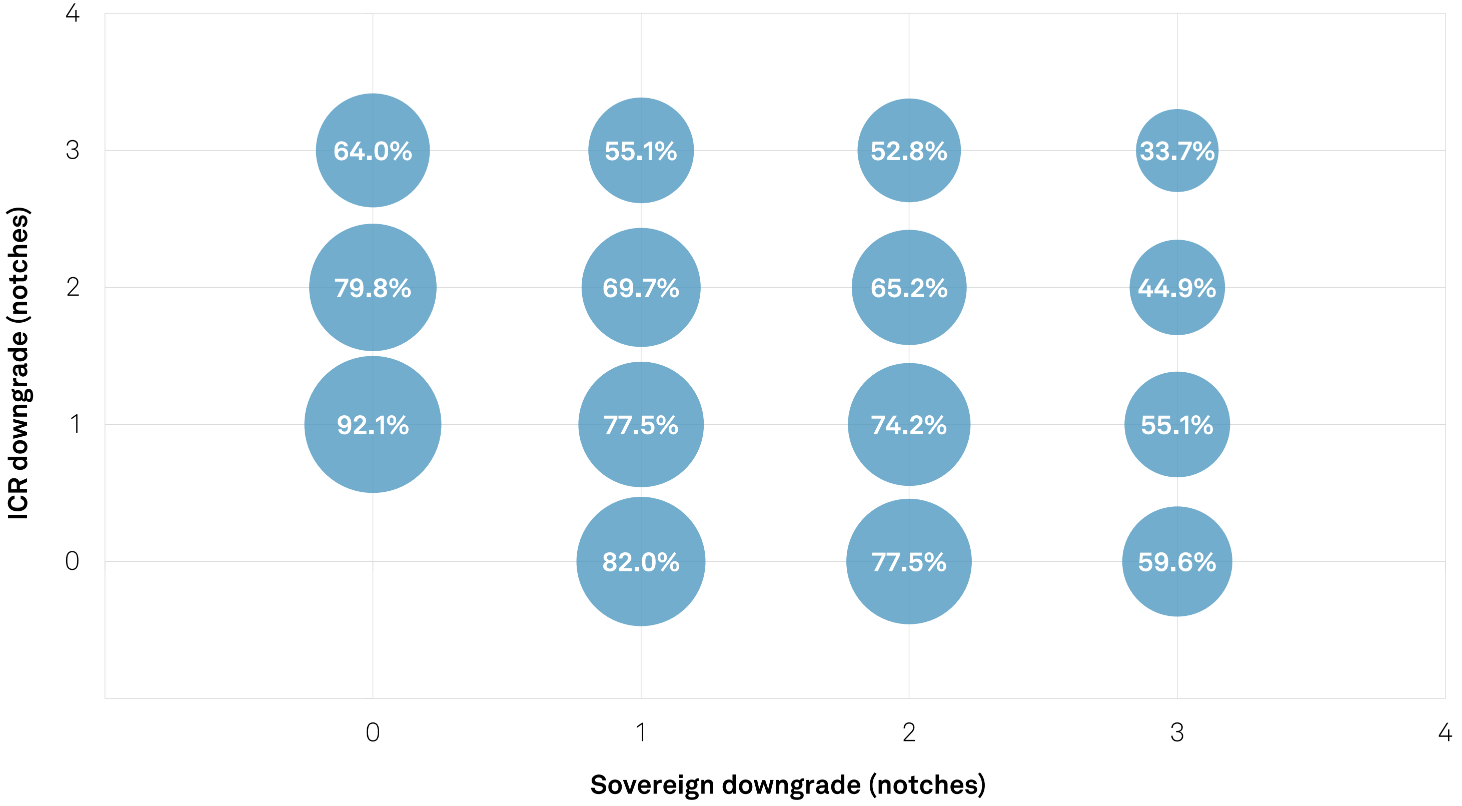
Average and range of unused notches by country



Source: S&P Global Ratings.

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

Most 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 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.
- The ratings on more than 75% of the programs we rate would be unaffected by a one-notch downgrade of both the sovereign and the issuer credit rating.

Note: Percentage of covered bond program ratings unaffected by an ICR or sovereign downgrade. ICR--Issuer credit rating. Source: S&P Global Ratings.

Core Characteristics And Risk Indicators

The main core characteristics and risk indicators for our rated covered bond programs are accessible here

Global Covered Bond Insights Q3 2023

Overview

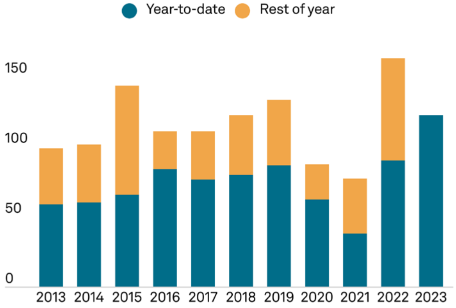
Tutorial video: How to navigate Global Covered Bond Interactive

Overview | Ratings distribution and outlook | Country focus

Key insights

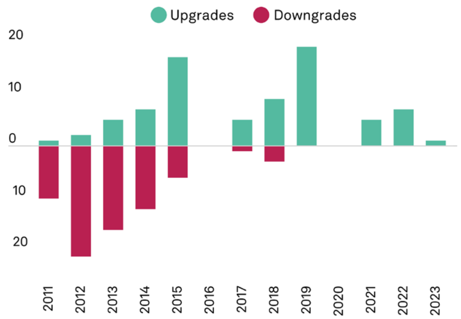
- Shorter bond maturities increase programs' asset-liability mismatch, but available credit enhancement can still cover this risk.
- Lending growth is decelerating, but eurozone banks still have plenty of retained covered bonds that could be redeemed to free up collateral for distributed issuance.
- Regulatory developments will help banks identify green assets and support sustainable issuance.

European investor-benchmark covered bond issuance (bil. €)



YTD figures as of June 21 each year. Source: S&P Global Ratings.

Covered bond rating actions (count)



Source: S&P Global Ratings.

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The data can be downloaded in excel format from the link included in the CapitalIQ version of the article.

Recent covered bond rating actions

New issue | Withdrawn | Affirmed | Upgraded | Downgraded | On CreditWatch

Issuer	Country of issuer	Covered bond type	Asset type	Current covered bond rating	Covered bond rating in Q1 2023	ICR
No new issues for Q2 2023						

ICR--Issuer credit rating. LCB--Legislation-enabled covered bonds. ICB--Icelandic Covered Bonds. SCB--Structured Covered Bonds. JL--Jelzáloglevél. OF--Obligations Foncières

Disclaimer

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- Economic Outlook Eurozone Q3 2023: Short-Term Pain, Medium-Term Gain, June 26, 2023
- EMEA Structured Finance Chart Book: June 2023, June 21, 2023
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This report does not constitute a rating action

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