Global Covered Bond Insights Q4 2023: Weathering The Housing Market Correction

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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

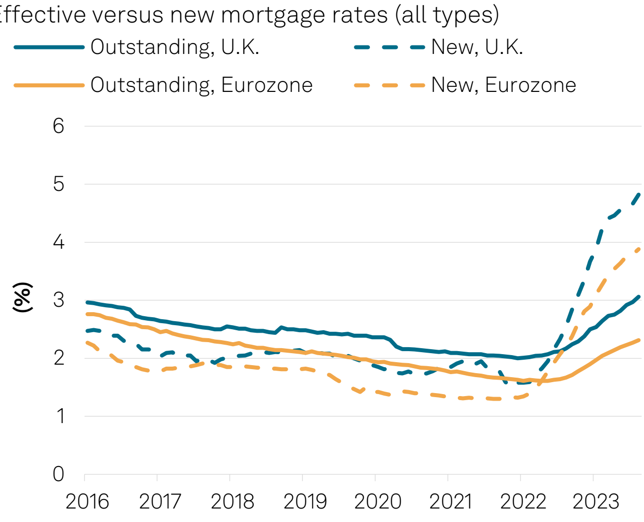
- Most European countries will see a sustained correction in nominal house prices as eurozone growth softens considerably into next year.
- Our analysis of historical housing market corrections suggests that mortgage arrears are generally linked to unemployment, house prices, and--for the U.K.--interest rates.
- We have conducted a scenario analysis of mortgage performance. Under a baseline scenario, which reflects our economic and house price forecasts, we see only a modest increase in mortgage arrears, mainly driven by weakening house prices.
- In a downside scenario, we see more material increases in mortgage arrears, especially in Italy and Ireland. However, the credit enhancement available in the covered bond programs that we rate should be sufficient to absorb the related losses.

Rising interest rates have set off a sustained correction in European housing markets. Although demand is weakening and prices are declining, asset quality is still strong--supported by stable employment and high savings rates during the pandemic period. But European GDP growth is softening, and labor markets are weakening. Moreover, the impact of the tighter monetary policy on European household budgets unfolds with a considerable lag, particularly considering the pivot toward fixed-rate mortgages in the past 15 years. We expect house prices to remain under pressure until 2025. This report investigates how the housing market correction will affect asset performance in the covered bond market.

Chart 1

Mortgage rates have increased substantially...

Effective versus new mortgage rates (all types)

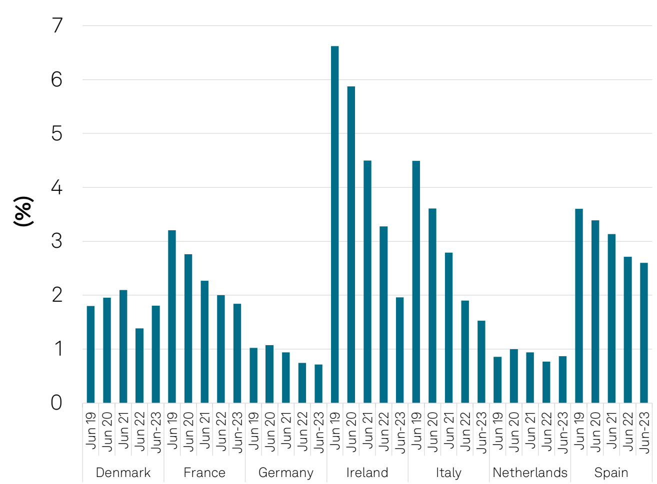


Sources: European Central bank, Bank of England, S&P Global Ratings.

Chart 2

... But mortgage performance has remained stable so far

Nonperforming loan ratio of residential household mortgages



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

Low Growth And High Interest Rates Are Here To Stay

We expect eurozone growth to soften considerably to 0.6% this year from 3.4% in 2022. GDP growth will remain tepid in 2024 at 0.9%, before a potential uptick to 1.5% in 2025-2026 (see "Economic Outlook Eurozone Q4 2023: Slower Growth, Faster Tightening," published on Sept. 25, 2023).

The eurozone economy has barely expanded over the past three quarters. GDP increased by a modest 0.1% quarter-on-quarter by the end of June 2023, after recording a decrease and then increase of 0.1% in the previous two quarters. The slowdown is here to stay: post-pandemic tailwinds are fading and higher inflation and interest rates are significantly curbing demand. The eurozone's risk of sliding into a shallow recession in 2023-2024 remains elevated.

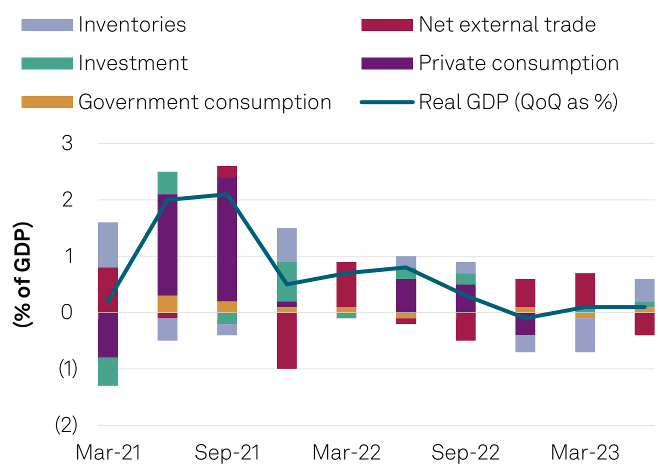
2024 growth prospects hinge on the labor market, which was slowing but remained strong in the second quarter. Ongoing labor tightness and resilience should prevent a more pronounced slowdown, since wage growth combined with slowing inflation will ease income pressure on households.

Inflation is falling, but price stability is still some way off. We only see inflation returning to the European Central Bank's (ECB) 2.0% target in late 2025, coming down from 5.6% in 2023 and 2.7% in 2024. The recent surge in oil prices and the removal of government subsidies on domestic energy prices in some countries will decelerate disinflation trends.

Chart 3

The eurozone economy has barely expanded over the last three quarters

Contributions to quarterly GDP growth

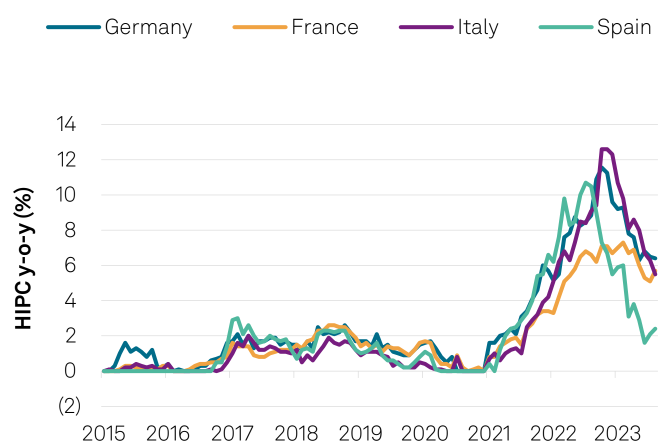


Source: S&P Global Ratings.

Chart 4

Spain is leading the disinflation process

HICP inflation y-o-y %



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

Against this backdrop, we believe that the ECB is not yet done normalizing its monetary policy. Interest rates may have peaked at 4% for the deposit rate, but it will take some time before the ECB starts cutting rates again. We also expect further quantitative tightening, affecting how the ECB supplies banks with liquidity (see "What An Acceleration of Quantitative Tightening Could Mean for Eurozone Banks," published on Sept. 13, 2023).

Table 1

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

(%)	Eurozone	Germany	France	Italy	Spain	Netherlands	U.K.
GDP							
2023	0.6	-0.2	0.8	0.9	2.1	0.5	0.3
2024	0.9	0.6	0.9	0.7	1.6	0.9	0.5
2025	1.5	1.4	1.5	1.3	2.2	1.5	1.5
2026	1.5	1.4	1.4	1.3	2.2	1.7	1.6
CPI inflation							
2023	5.6	6.3	5.6	6.3	3.5	4.9	7.5
2024	2.7	2.8	2.6	2.3	2.6	3.1	2.5
2025	2	2	1.9	2.1	1.9	2.2	2
2026	1.8	1.6	1.7	2	1.9	2	2
Unemployment rate							
2023	6.4	2.9	7.3	7.7	12.1	3.6	4.3
2024	6.5	3	7.5	7.9	12.1	3.7	4.7
2025	6.5	3	7.5	8	12	3.7	4.4
2026	6.3	3.1	7.3	7.9	11.8	3.6	4.2
		Eurozone (ECB)	**U.K.**				
Policy rates (end of year)	**Deposit rate**	**Refi rate**	**Bank rate**				
2023	4	4.5	5.5				
2024	3.25	3.75	4.5				
2025	2	2.5	2.6				
2026	2	2.5	2.5				

CPI--Consumer price index. Source: S&P Global Ratings.

Sustained House Price Correction Ahead

Even before central banks started to hike interest rates, house price dynamics appeared unsustainable. Affordability in most European countries deteriorated significantly over the pandemic years. As higher interest rate pressure mounts across the continent, we forecast a sustained correction of nominal house prices for most countries.

While we do not expect a crash, we see sizeable peak-to-trough declines of about 12% in Germany and the U.K., and an average drop above 8% across our sample (see "European Housing Markets: Sustained Correction Ahead," published on July 20, 2023). Structural factors, such as endemic housing shortages and shrinking household sizes, should help contain price declines. Also, lenders are still willing to lend and have the capacity to do so, albeit at now significantly higher costs.

We expect prices to bottom out by the end of 2024. But since borrowing costs will remain high in real terms even after central banks ease interest rates, we don't anticipate a strong rebound in house prices once the correction runs its course.

Table 2

S&P Global Ratings nominal house price forecasts

Year-on-year change in Q4 (%)

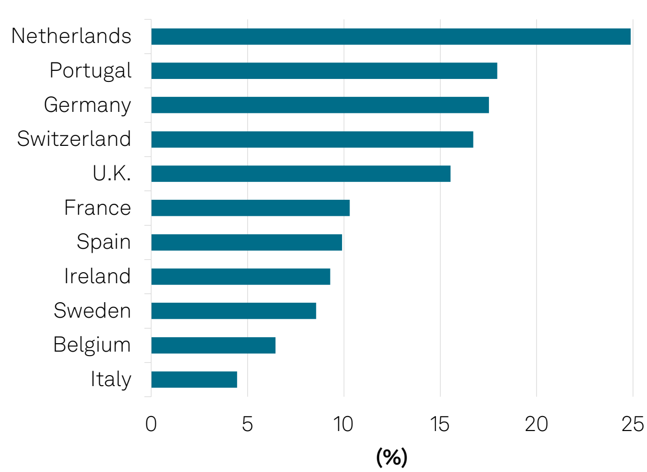
	2020	2021	2022	2023	2024	2025	2026
Germany	8.7	12.6	-3.6	-4.9	-1.5	1	2
France	6.3	7	4.6	-2.6	-4.0	1.5	2.5
Italy	1.6	4.1	2.8	0	-4.9	-2.0	1
Spain	1.7	6.3	5.5	-4.0	-2.0	1.5	2
Netherlands	8.8	19	5.3	-5.4	-1.5	1	2.3
Belgium	5.7	6.1	4.7	-2.4	-1.0	2	2.4
Portugal	7.9	11.5	11.3	-4.4	-3.0	2	4.1
Switzerland	5.4	8.3	5.5	0.3	0	1.5	2
U.K.	6	8.3	9.6	-6.6	-4.9	1.4	3
Ireland	0.7	13.8	8.6	-5.1	-4.3	1	3.5
Sweden	5.4	11	-3.7	-5.4	1.8	2.8	3.2

Q--Quarter. Sources: OECD, S&P Global Ratings.

Benchmark rate levels are still some distance from fully feeding through to household budgets, reflecting the Europe-wide pivot toward fixed-rate mortgages from variable rate deals. New fixed-rate contracts over 2015-2019 accounted for at least 50% of transactions on average (with the exception of Portugal and Sweden), and in many cases much more. In Spain, only 25% of newly originated mortgages were on variable rates in 2021, compared with over 80% in 2011.

Chart 5

Affordability of housing deteriorated markedly during the pandemic years

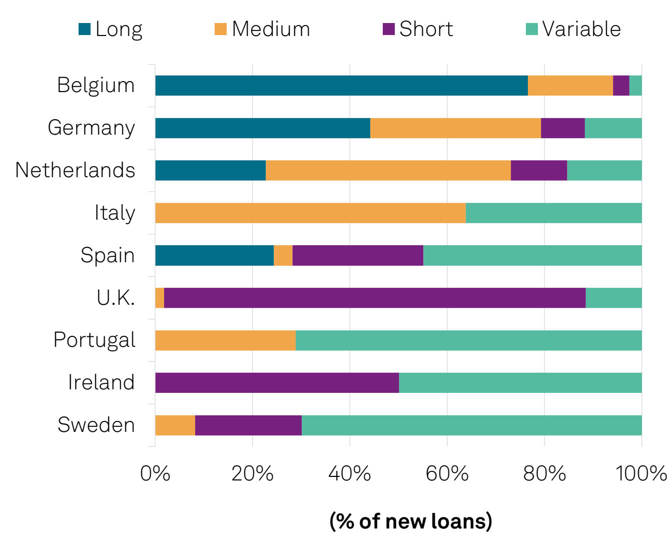


Price-to-income ratio, % change from the fourth quarter of 2019 to the peak. Sources: OECD, S&P Global Ratings.

Chart 6

Mortgage maturities differ widely across Europe

Maturity buckets as percent of new loans, 2015-2019 average



Note: Countries are shown in descending order of estimated average maturity of outstanding loans. Long = longer than 10 years; medium = 6-10 years; short = 2-5 years; variable = variable + fixed for up to 1 year. Due to a lack of disaggregation in the data, for Sweden, medium and long maturities are reported under "medium." For the same reason, all fixed rate shares are reported under "medium" for Italy and Portugal. Sources: European Mortgage Federation, S&P Global Ratings.

A Strong Labor Market Will Help Limit Asset Quality Deterioration

The European housing market landscape today looks very different to the usual pre-crash scenario. Typically, the precursor to a housing market crash is widespread job losses, causing a significant degree of distressed selling at a time when there is little to no demand, a scenario last seen in the wake of the global financial crisis (GFC).

Labor markets have weakened recently, but from a position of extraordinary strength. And while we expect unemployment to rise further, it will remain low by historical standards. A strong labor market will support asset quality, in our view, and we expect the housing market correction to lead to a normalization of loan losses from their current lows, rather than a spike.

To gain further insights into the outlook for the current market, we explored historical links between various macroeconomic factors and the banking sector's mortgage arrears in four countries which experienced significant housing market corrections since the GFC. We believe that our results are also valid for other better-performing covered bond markets, given the homogeneity of asset eligibility criteria. We used the banking sector's mortgage arrears rather than those of covered bond programs, because loans in arrears are typically removed from cover pools, and cover pool assets tend to be underwritten to a very high standard. Moreover, our models are calibrated using data that include the period before the GFC, when underwriting regimes were generally looser than today. They may therefore not fully capture the behavior of more recent loan originations in certain countries, such as Ireland, where underwriting standards have changed significantly.

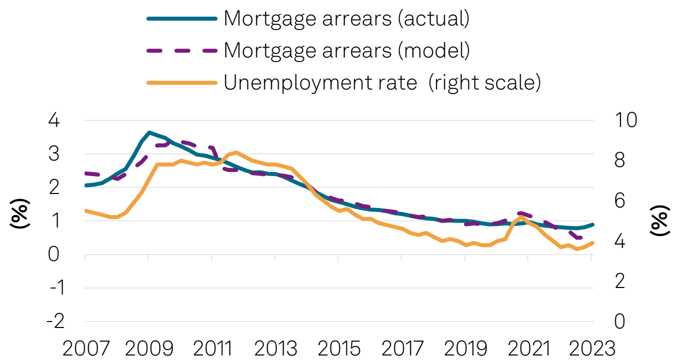
We found that arrears have generally been linked to unemployment, house prices, and--for the U.K. only--interest rates. Mortgage arrears are closely connected to real house prices in Spain, Italy, and Ireland, while in the U.K. correlation is stronger with both nominal house prices and interest rates. These results are consistent with our global methodology for assessing pools of residential loans, where unemployment expectations affect our base case scenario and considerations on property valuations and interest rate risk affect our loan-level analysis (see "Global Methodology And Assumptions: Assessing Pools Of Residential Loans," published on Jan. 25, 2019.)

All three variables are statistically important driving factors for mortgage arrears. Changes in unemployment typically have a delayed effect on arrears, reflecting the impact of unemployment benefits.

Unemployment levels and interest rates directly affect borrowers' ability to make scheduled mortgage payments, and therefore determine whether they fall into arrears and ultimately default. House prices affect borrowers' equity positions. Low mortgage equity is a credit risk because it can limit borrowers' ability to refinance, making them vulnerable to foreclosure if interest rates rise or their income is reduced--for example, through unemployment. A low equity position can also reduce a borrower's incentive to make mortgage payments if finances tighten.

Chart 7

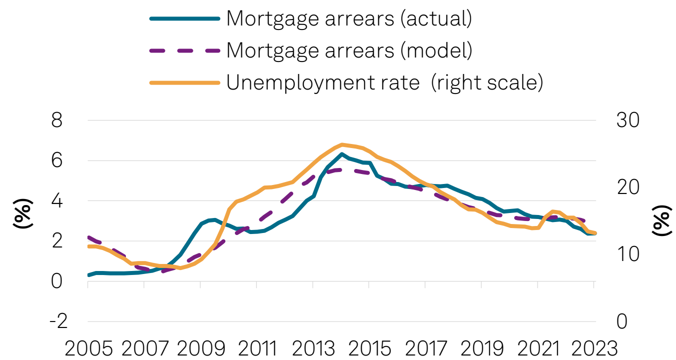
Doubtful mortgage rate and unemployment U.K.



Source: Bank of England, OECD, S&P Global Ratings.

Chart 8

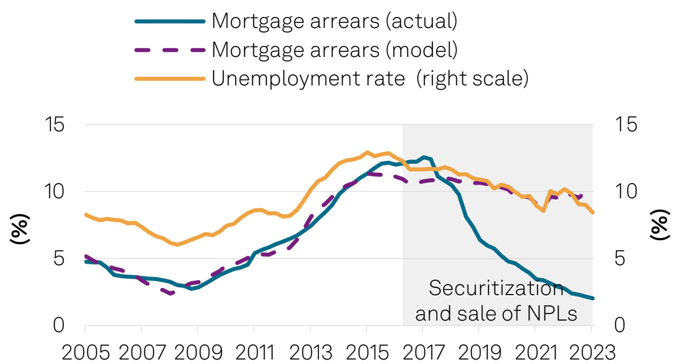
Doubtful mortgage rate and unemployment Spain



Source: Bank of Spain, OECD, S&P Global Ratings.

Chart 9

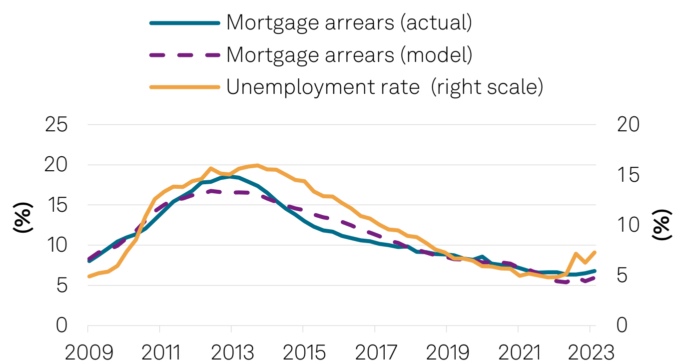
Doubtful loan rate and unemployment Italy



NPLs--Nonperforming loans. Source: Bank of Italy, OECD, S&P Global Ratings.

Chart 10

Doubtful mortgage rate and unemployment Ireland



Source: Bank of Ireland, OECD, S&P Global Ratings.

Unemployment, house prices, and interest rates (for the U.K. only) explain more than 90% of the level in mortgage arrears in the U.K. and Ireland, and more than 80% in Spain. Italy followed a similar trend until 2016, when banks started using securitization to remove nonperforming loans from their balance sheets. Based on these findings, we believe that adjusting these input variables according to our forecasts may provide insight into mortgage arrears in the coming quarters.

Covered Bond Programs' Credit Enhancement Sufficient To Absorb Losses From Higher Arrears

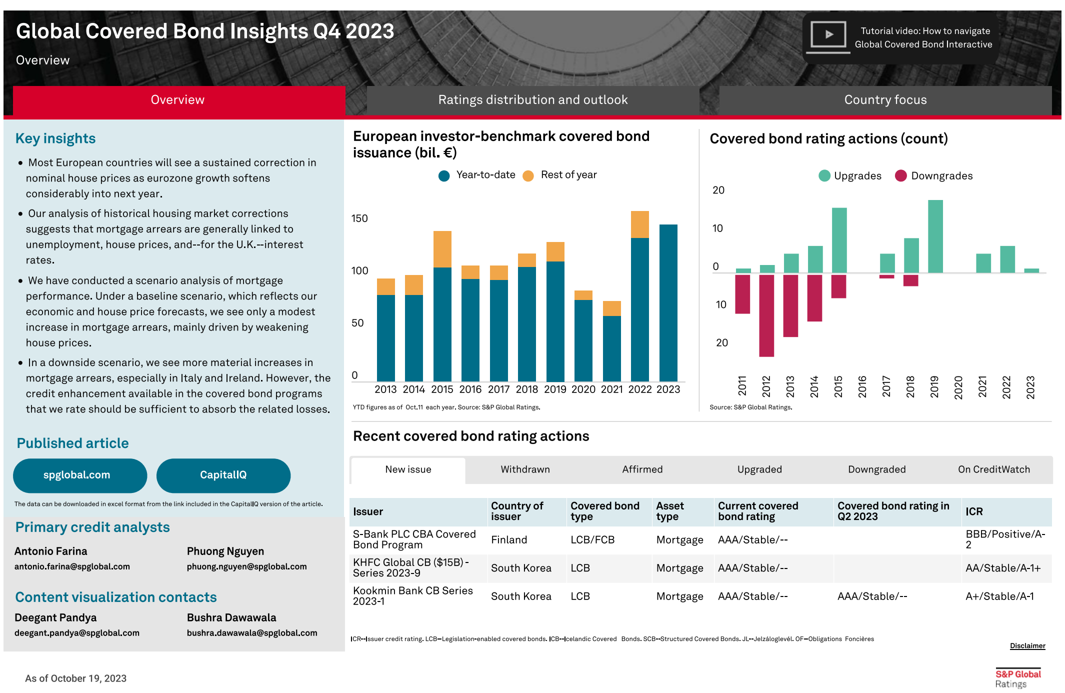
We conducted a scenario analysis of mortgage performance in Ireland, Italy, Spain, and the U.K. We believe that our results are also valid for other covered bond markets, given the homogeneity of asset eligibility criteria. Under a baseline scenario, we applied our economic and house price forecasts (see tables 1 and 2) to determine the increase in arrears through 2026. Under this scenario, we see modest increases in arrears in the U.K. and Spain of 0.9 percentage points and 0.5 percentage points, a more significant increase in Italy of 1.7 percentage points, and a marginal decrease in Ireland of -0.4 percentage points. These results reflect our expectations of Italy's house price corrections primarily starting next year, and unemployment rates in Spain and the U.K. being lower in 2026 than today.

Under our downside scenario, we applied a combined three percentage point increase in the unemployment rate, a 20% decline in real house prices, and, for the U.K. only, a further three percentage point increase to interest rates. These parameters reflect the historical volatility of the relevant variables.

Under this scenario, arrears increase more significantly, especially in Italy (+4.3 percentage points) and Ireland (+3.4 percentage points), due to the strong correlation between their historical arrears and unemployment. Arrears in Spain and the U.K. would increase by 1.5 percentage points and 1.7 percentage points. While the increases are more material in this scenario, the covered bond programs that we rate have generally sufficient credit enhancement to absorb the related losses, with no impact on their ratings (see "Covered Bonds Outlook Midyear 2023: Rising Interest Rates Will Test Asset Performance," published on July 19, 2023).

Core Characteristics And Risk Indicators

The main core characteristics and risk indicators are accessible here.



Related Research

- Economic Outlook Eurozone Q4 2023: Slower Growth, Faster Tightening, Sept. 25, 2023
- EMEA Structured Finance Chart Book: September 2023, Sept. 22, 2023
- German Covered Bond Market Insights 2023, Sept. 13, 2023
- Credit FAQ: What An Acceleration Of Quantitative Tightening Could Mean For Eurozone Banks, Sept. 13, 2023
- French Covered Bond Market Insights 2023, Sept. 7, 2023
- European Housing Markets: Sustained Correction Ahead, July 20, 2023
- Covered Bonds Outlook Midyear 2023: Rising Interest Rates Will Test Asset Performance, July 19, 2023
- EMEA Structured Finance Chart Book: July 2023, July 18, 2023
- Global Covered Bond Insights Q3 2023: Strong Issuance Is Here To Stay, June 29, 2023
- Covered Bonds In New Markets: A Shifting Paradigm, May 24, 2023
- Covered Bonds Could Ease The Pain In European Commercial Real Estate, May 16, 2023
- Global Covered Bond Insights Q2 2023: The Implications Of Rising Interest Rates, April 12, 2023
- Covered Bonds Outlook 2023: Sailing Through Choppy Waters, Dec. 6, 2022