Covered Bonds Outlook 2024

Stability Amid Turbulence

Dec. 11, 2023

S&P Global Ratings

This report does not constitute a rating action

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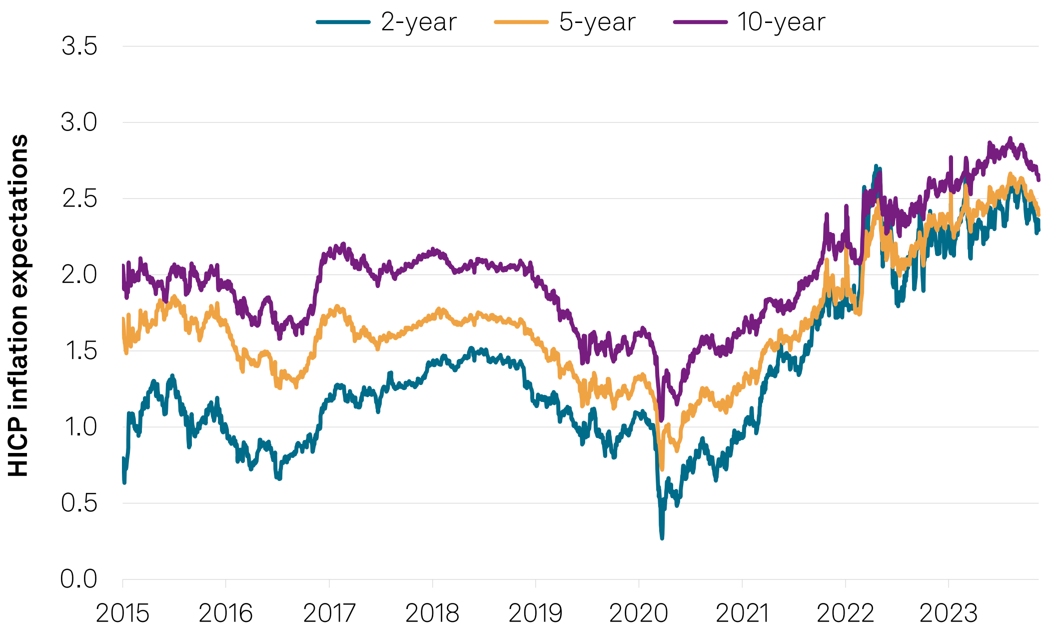
Key Takeaways

- Our ratings outlook on covered bonds remains stable, despite geopolitical tensions, market turbulence, the economic slowdown, and deteriorating asset performance. Overcollateralization should absorb any increase in losses, and unused notches of uplift in the ratings reduce the risk of covered bond downgrades even if there are downgrades among issuers.
- The return to positive real interest rates will take a toll on economic growth, but we expect a soft landing for the European economy. Inflation is past its peak, and we expect the European Central Bank (ECB) to gradually cut rates in the second part of 2024.
- Benchmark European covered bond issuance hit a ten-year high in 2023, with issuers focusing on secured funding as they repaid earlier borrowings from central bank liquidity schemes. The trends supporting covered bond issuance may be slightly weaker in 2024, but issuance will likely remain close to recent highs, at about €160 billion.
- 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.
- Higher-for-longer interest rates are also squeezing commercial real estate valuations, pushing capitalization rates up, and weighing on debt service coverage ratios and refinancing prospects. While we believe that more loans may default in 2024, we do not expect this to significantly impair the credit quality of the covered bonds that we rate.

Economic Conditions | Financing Conditions Will Remain Restrictive

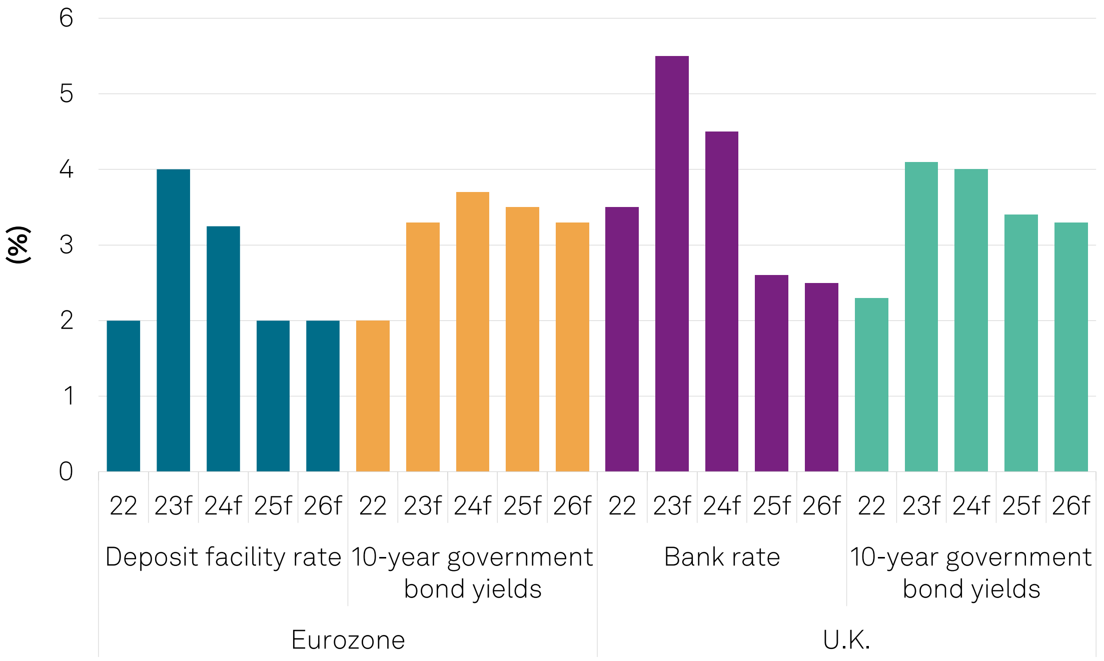
- Eurozone inflation is past its peak and should continue to recede to an average of 2.9% in 2024 and 2.0% in 2025. However, inflation expectations are lagging actual inflation with the risk that the ECB could cut policy rates later than we expect.
- Other monetary policy decisions could still come, such as a more rapid exit from the asset purchase programs or higher mandatory reserve requirements for banks.

Market-based inflation expectations remain above the target



Euro forward inflation-linked swaps. 2-year refers to 2-year, 2-year forward expectations etc. HICP--Harmonized index of consumer prices. Sources: Refinitiv, S&P Global Ratings.

Rates will likely start declining in 2024

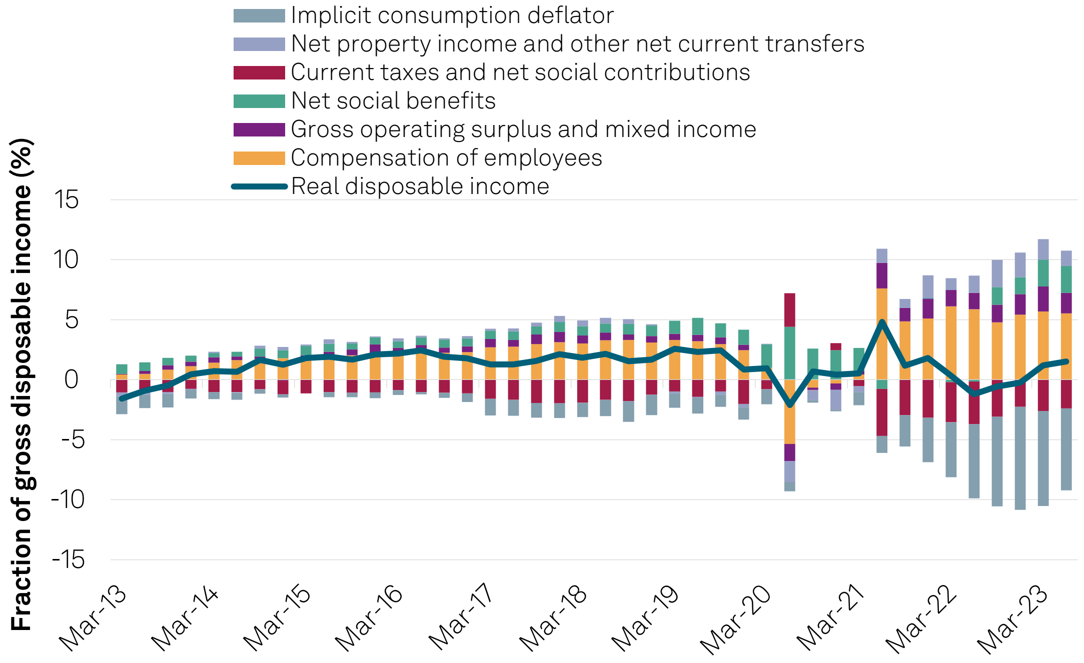


f--Forecast. Source: S&P Global Ratings.

Economic Conditions | The European Economy Is Heading For A Soft Landing

- The return to positive real interest rates will take a toll on growth, but we expect a soft landing for the European economy.
- Real incomes should increase because of disinflation and strong wage growth, supporting consumer spending. Job vacancies remain high, which reduces the likelihood of a spike in unemployment rates over the next 12 months.

Real income growth has resumed because of disinflation, high labor income, and social benefits



Real household disposable income, breakdown by contributions (YOY, % of GDI). GDI--Gross disposable income. YOY--Year on year. Sources: Eurostat, S&P Global Ratings.

S&P Global Ratings' European economic forecasts

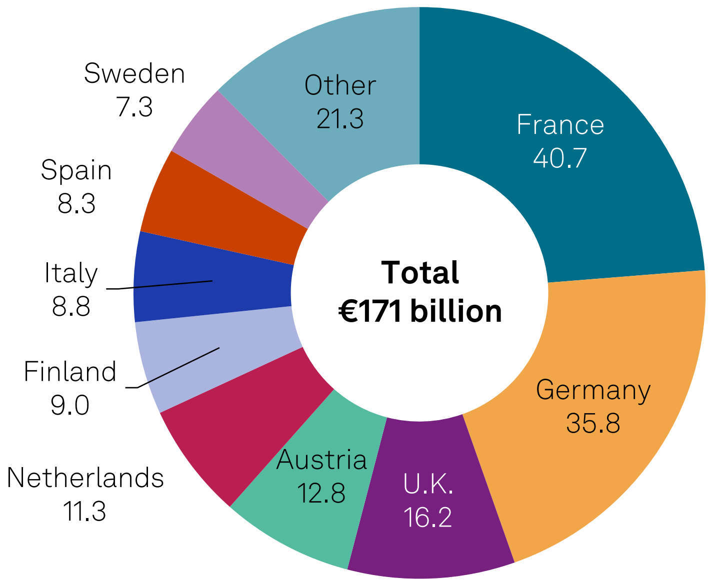
	Eurozone	Germany	France	Italy	Spain	Nether-lands	U.K.
GDP (%)							
2022	3.5	1.9	2.5	3.9	5.8	4.4	4.3
2023	0.6	(0.2)	0.9	0.7	2.4	0.4	0.5
2024	0.8	0.5	0.9	0.6	1.8	0.9	0.4
2025	1.5	1.5	1.5	1.2	2.0	1.4	1.5
2026	1.4	1.4	1.3	1.3	2.1	1.4	1.6
Unemployment rate (%)							
2022	6.7	3	7.3	8.1	12.9	3.5	3.7
2023	6.5	3.1	7.3	7.6	12.2	3.6	4.2
2024	6.6	3.1	7.5	7.8	12.1	3.8	4.6
2025	6.5	3	7.5	7.9	12.0	3.8	4.3
2026	6.3	3	7.3	7.8	11.8	3.7	4.2

Source: S&P Global Ratings. Economic Outlook Eurozone Q1 2024: Headed For A Soft Landing, Nov. 27, 2023.

Issuance | European Volumes Charged To A Ten-Year High In 2023

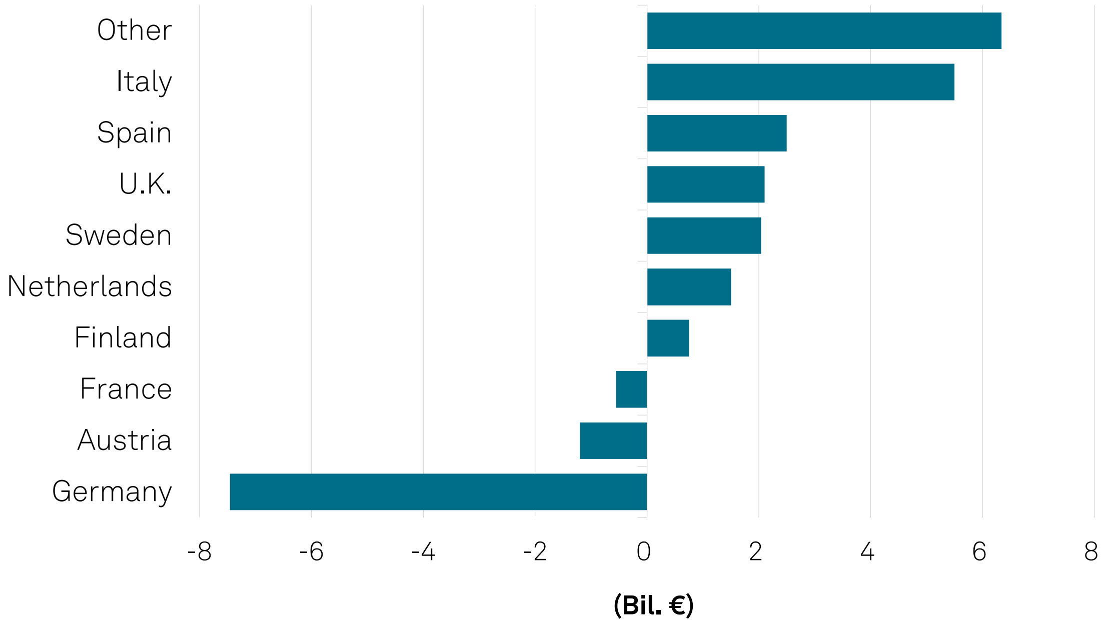
- In 2023, increased activity in several smaller covered bond markets more than compensated for relative weakness in the core countries of France and Germany, resulting in overall year-on-year issuance growth of more than 5%.
- Benchmark covered bond issuance in Europe has not reached this level for at least ten years and is set to remain elevated.

2023 YTD European benchmark issuance, by country



YTD—Year to date. Based on 2023 issuance as of Nov. 26, 2023. Source: S&P Global Ratings.

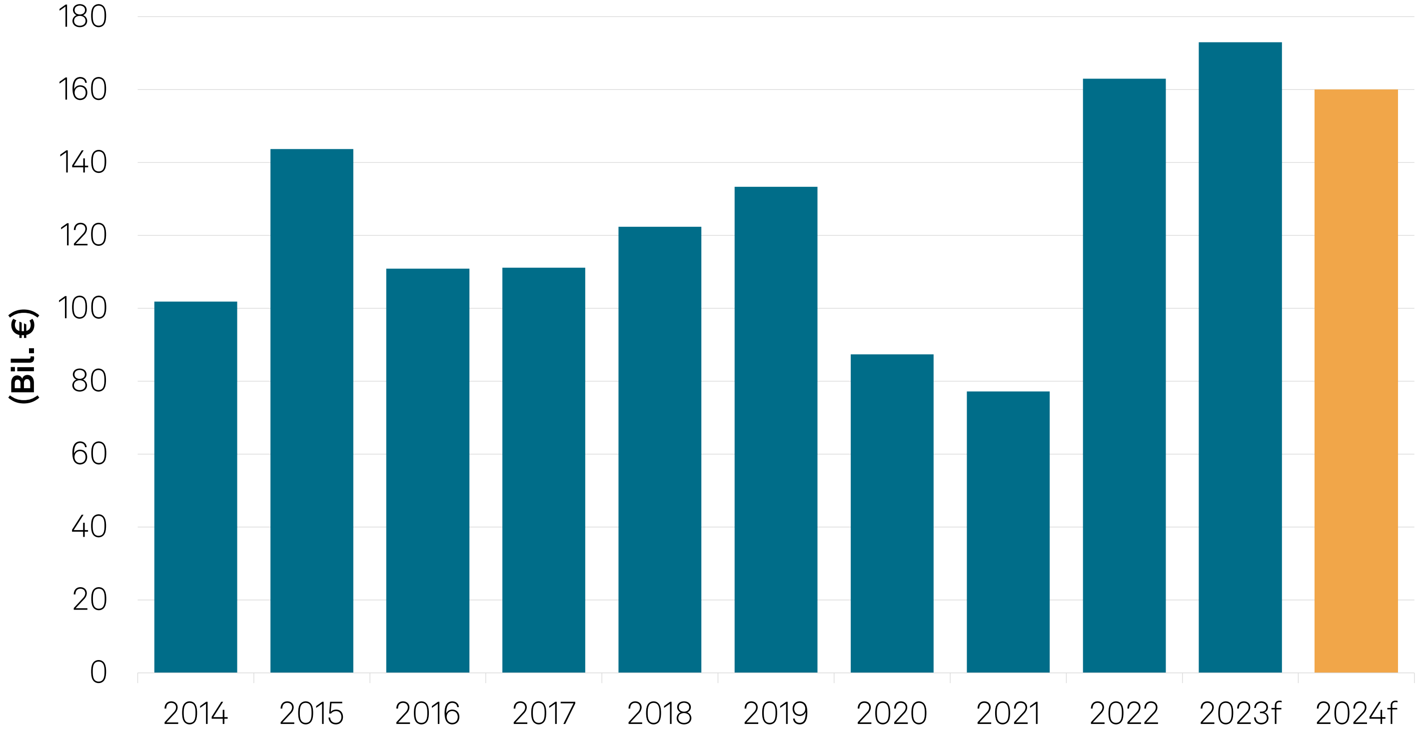
Change in YTD issuance, 2023 versus 2022, by country



YTD--Year to date. Based on issuance as of Nov. 26 each year. Source: S&P Global Ratings.

Issuance | Strong Covered Bond Volumes Will Likely Continue In 2024

European investor-placed benchmark covered bond issuance



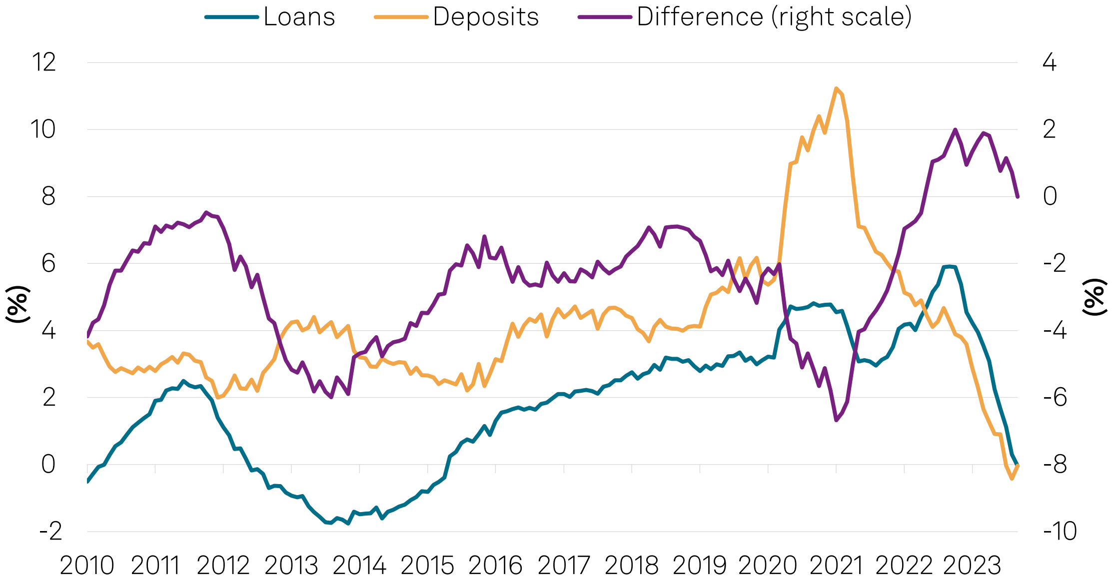
f--Forecast. Source: S&P Global Ratings.

- High consumer price inflation has led to slower growth in banks' deposit bases.
- At the same time, earlier borrowings from central bank liquidity schemes have been maturing, potentially adding to some issuers' funding needs.
- This has raised banks' incentives to tap covered bond markets, boosting supply.
- These trends may be weaker in 2024 and scheduled covered bond redemptions are also set to fall by about 5%, reducing one source of refinancing pressure.
- That said, European benchmark covered bond issuance still looks set to remain elevated at about €160 billion, in our view, close to recent highs.

Issuance | Loan And Deposit Growth Trends Still Support Supply

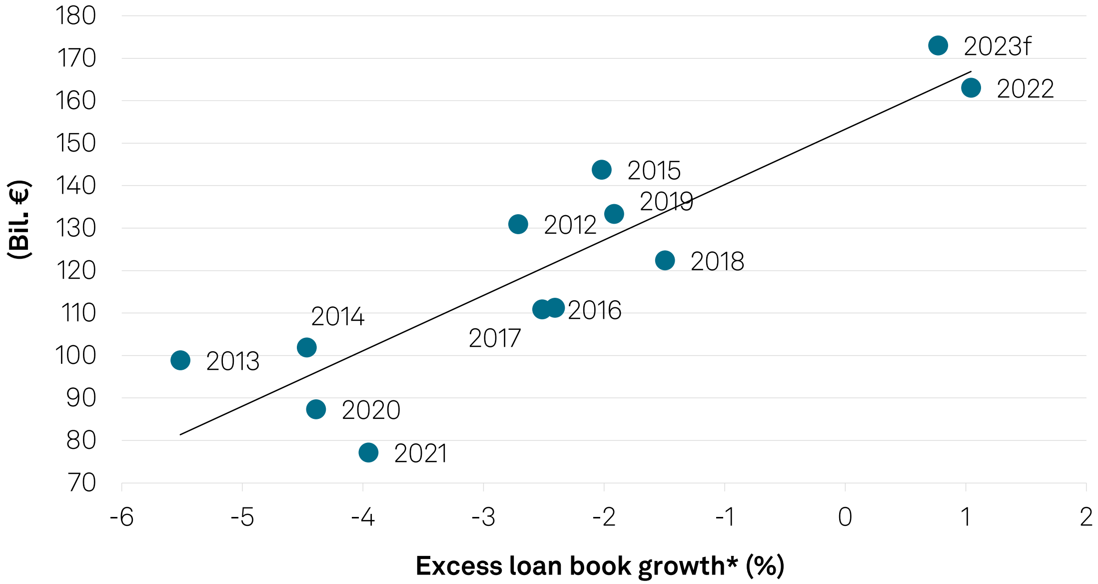
- Growth in eurozone banks' loan books has flattened but deposit growth has also declined sharply from its pandemic-related peak. The difference between these two rates--excess loan book growth--while trending lower, remains elevated.
- Covered bond issuance is historically correlated with this measure, supporting supply if the effect continues in 2024.

Lending/deposit growth, Eurozone households and NFCs



NFCs--Nonfinancial corporates. Difference is loan growth minus deposit growth. Source: European Central Bank.

European covered bond issuance versus excess loan growth*



*Defined as 12-month loan growth minus deposit growth at mid-year. f--Forecast. Source: European Central Bank, S&P Global Ratings.

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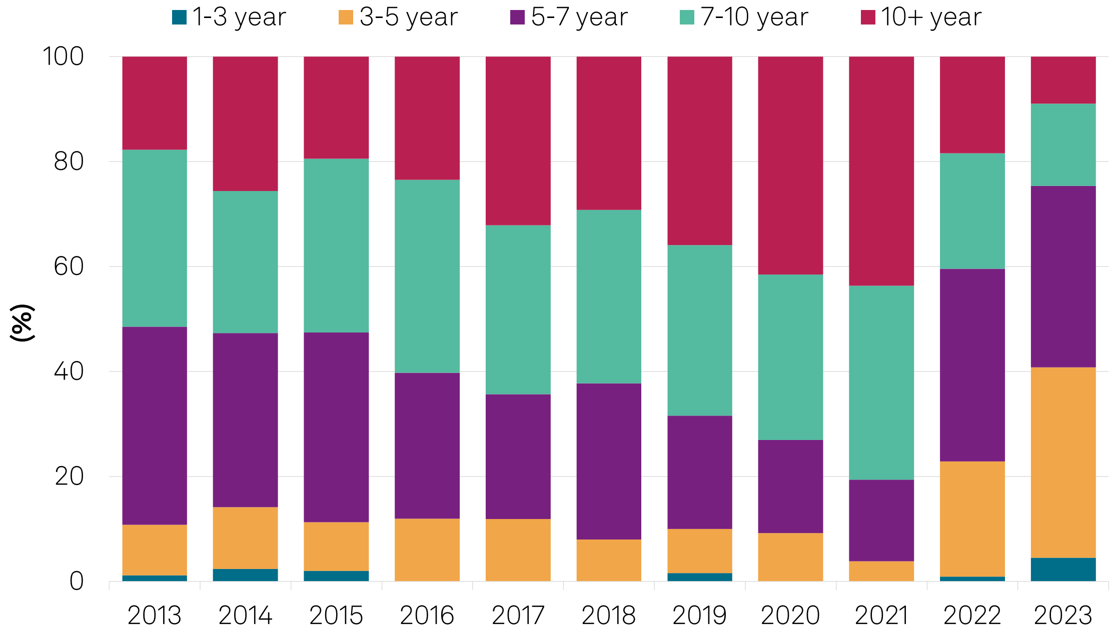
Issuance | Timing Of A Return To Higher-Duration Issuance Remains In Doubt

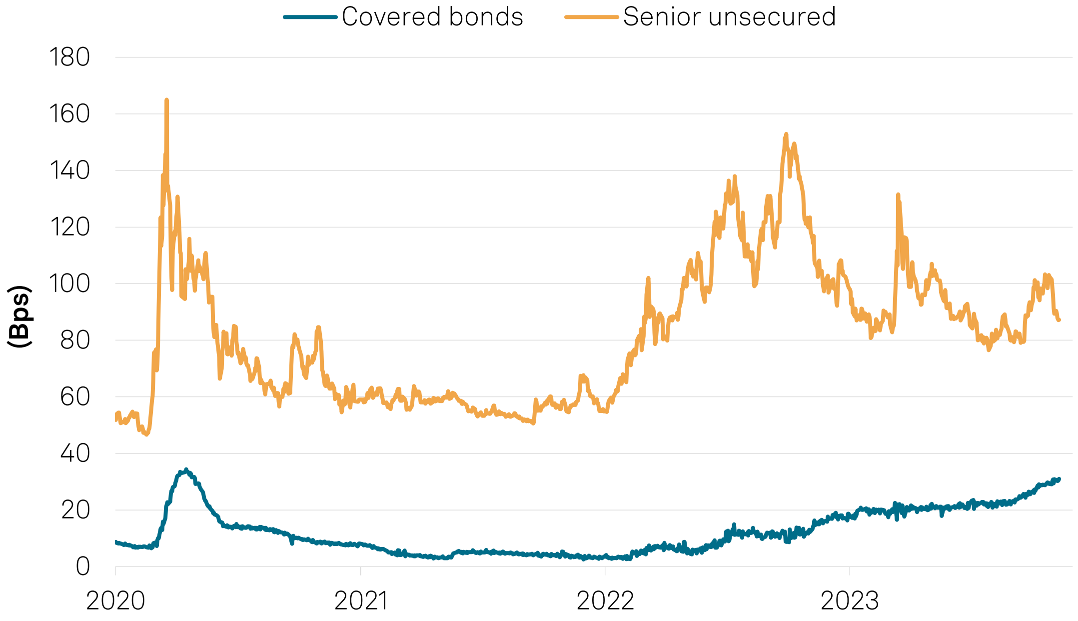
- Due to inverted yield curves, investor demand for covered bonds has been concentrated on shorter maturities, constraining most of the recent high volume of supply to products with tenors of no more than seven years.
- Covered bond spreads have widened as a result, while remaining relatively stable compared with unsecured funding.

Benchmark European covered bond issuance, by maturity



2023 figures based on issuance as of Nov. 26. Source: S&P Global Ratings.

Indicative funding spreads for financials



Bps--Basis points. Senior unsecured based on five-year iTraxx Senior Financials. Source: Bloomberg, S&P Global Ratings.

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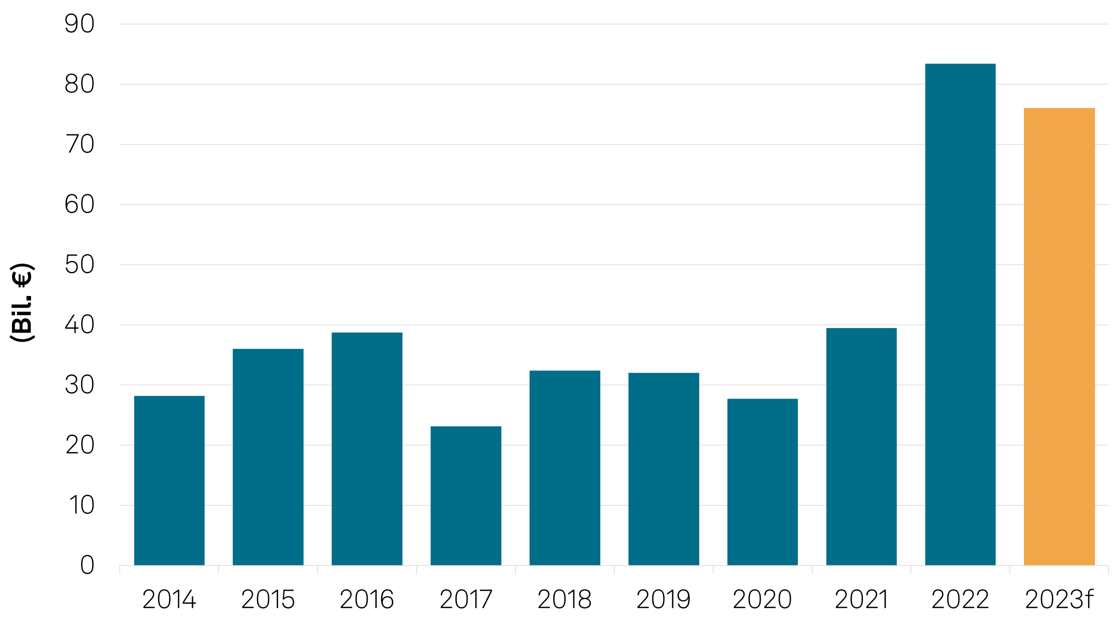
Issuance | Outside Europe, 2023 Was The Second Year Of Outsized Volumes

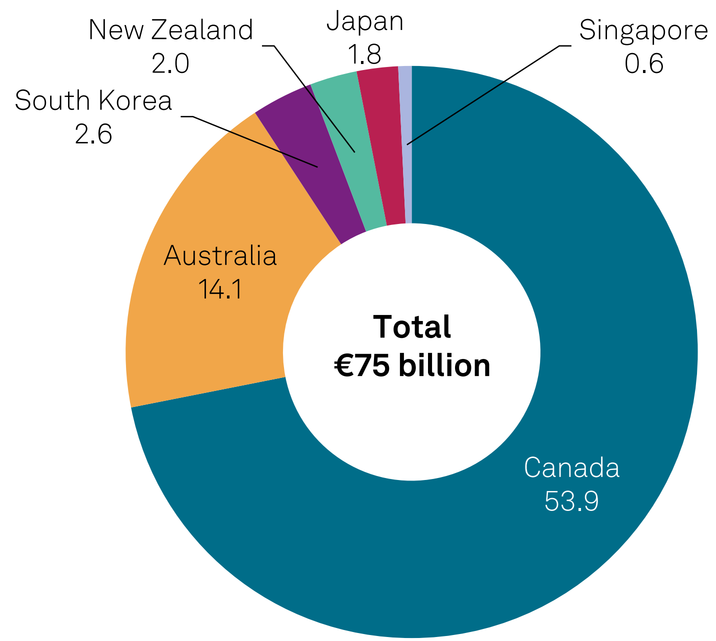
- Benchmark covered bond issuance from non-European banks remained significantly elevated in 2023.
- A large portion of this activity was likely due to a high volume of redemptions among outstanding Canadian covered bonds, although this trend may in subside in 2024, when scheduled redemptions are set to fall considerably.

Non-European benchmark covered bond issuance



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

2023 YTD non-European benchmark issuance, by country

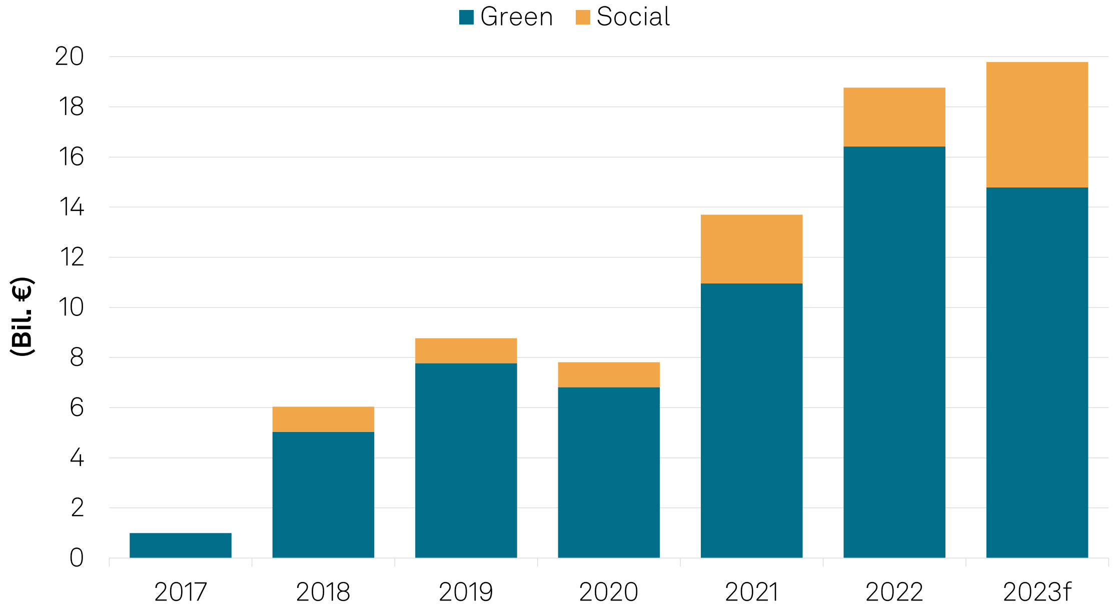


YTD--Year to date. Based on 2023 issuance as of Nov. 26. Source: S&P Global Ratings.

Sustainable Covered Bonds | Labeled Issuance Reached A New High In 2023

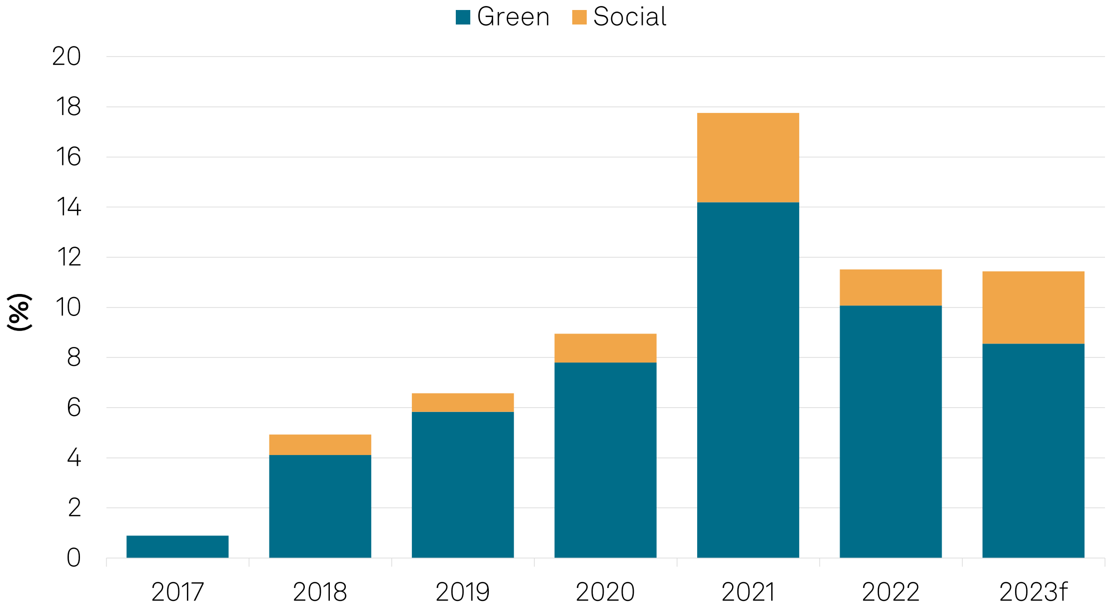
- Close to €20 billion of new covered bonds were labeled either "green" or "social" by issuers in 2023--a new record.
- This corresponded to a 12% share of overall issuance, somewhat down from the peak of 18% in 2021.

Sustainable benchmark covered bond issuance



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

Sustainable share of benchmark issuance



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

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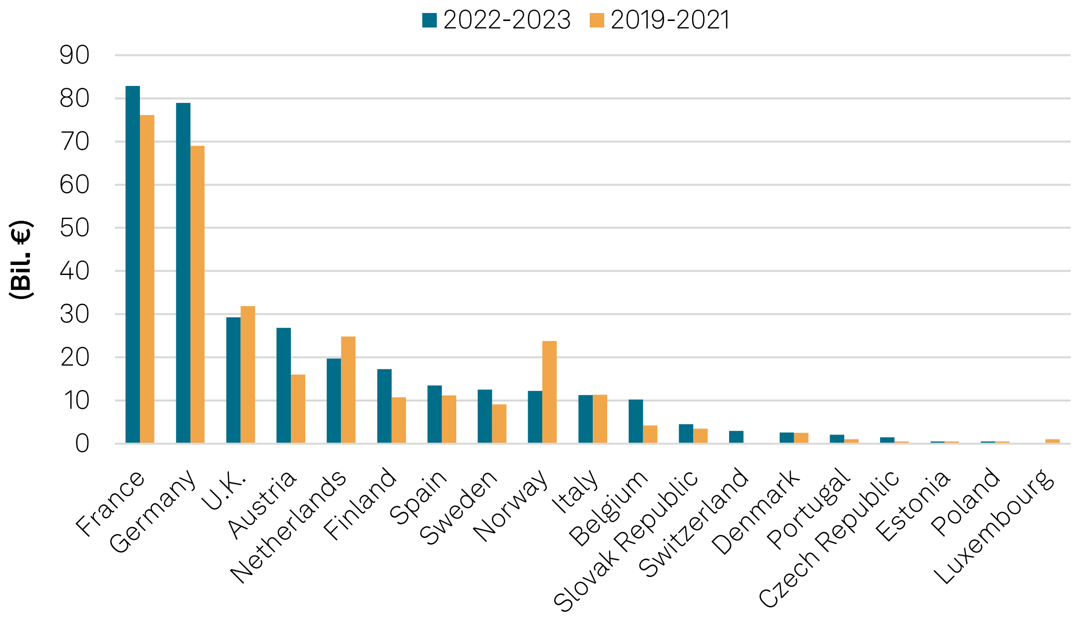
Harmonization | Evidence Of Widening Market Access Is Minimal So Far

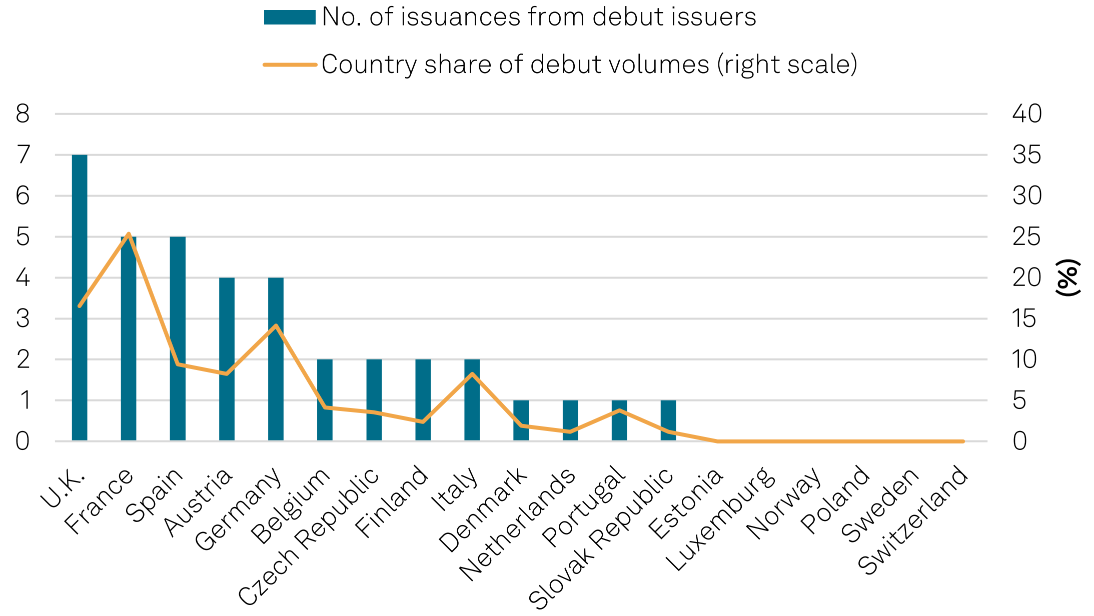
- The EU harmonization initiative sought to broaden and improve access to covered bond markets for issuers across the member states, but so far there are few signs of a significant shift in issuance dynamics as a result.
- Volumes in some smaller markets have increased but remain limited, and many member states have yet to see any covered bond issuance. Issuers making a debut in 2022-2023 (or returning since pre-2019) have mostly been from established markets.

Bulk of new issuance from the two largest markets, with smaller markets emerging only slowly



Bars show benchmark investor-placed issuance in the corresponding time periods. Source: S&P Global Ratings.

Debut (and returning) benchmark issuers in 2022 and 2023 were still mostly from established covered bond markets

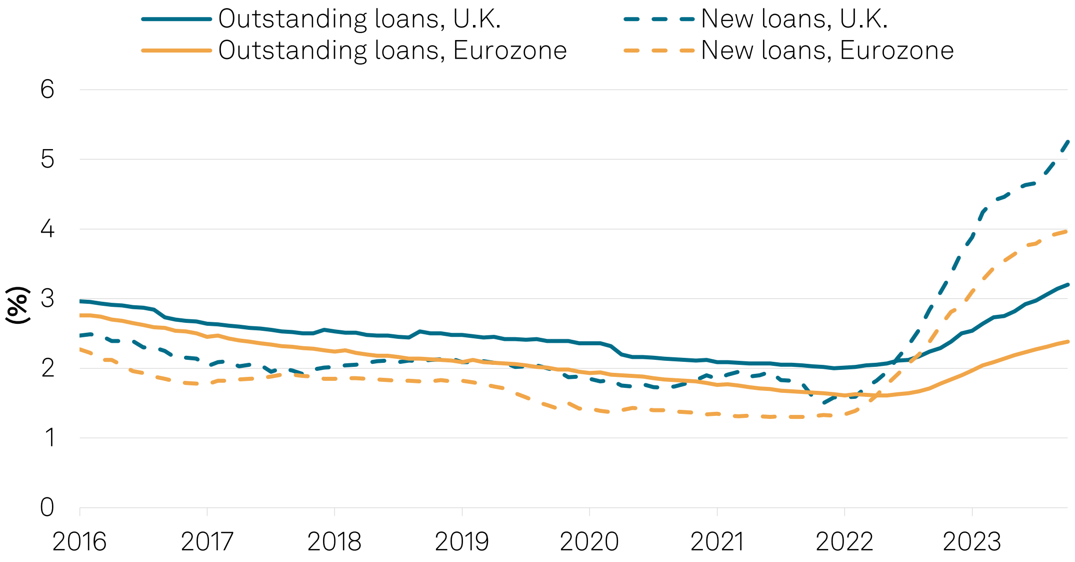


Based on 2022-2023 period. Debut issuers include those returning to benchmark issuance in 2022-2023, having been absent since at least 2018. Source: S&P Global Ratings.

Credit Performance | The Mortgage Rate Shock Will Take Time To Play Out

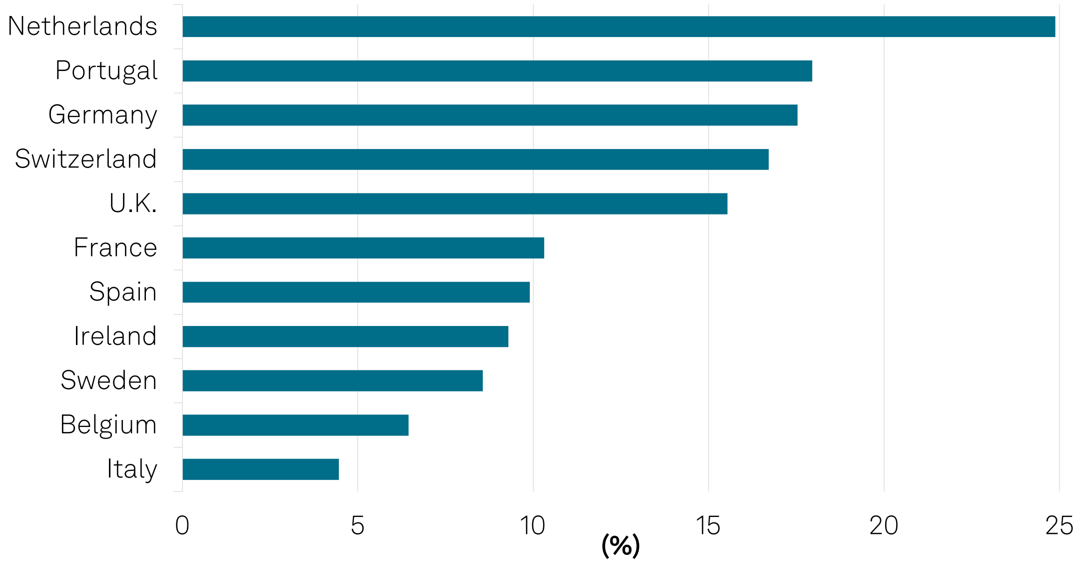
- Higher benchmark interest rates will still take some time to fully feed through to household finances, reflecting a Europe-wide pivot toward fixed-rate mortgages from variable-rate products over recent years.
- Even before central banks started to hike interest rates, house price dynamics appeared unsustainable, as affordability in most European countries deteriorated significantly during the years of the COVID-19 pandemic.

Higher borrowing costs have yet to hit the majority of mortgage holders



Effective interest rates across all types of mortgage loans. Sources: European Central Bank, Bank of England, S&P Global Ratings. See also "European Housing Markets: Sustained Correction Ahead," July 20, 2023.

Affordability of housing deteriorated markedly during the pandemic years

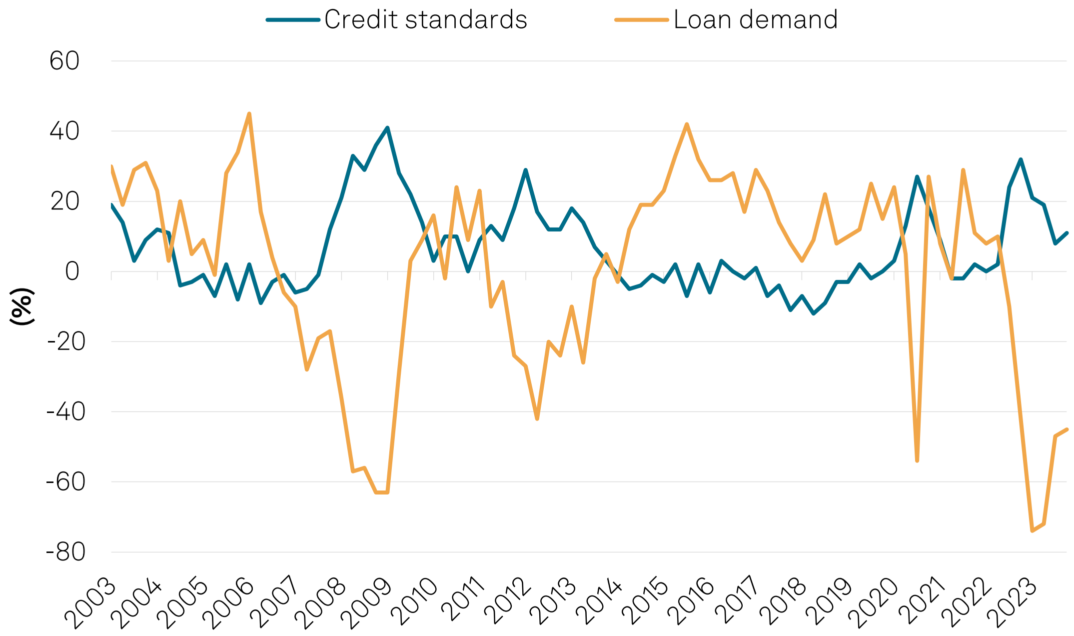


Price-to-income ratio, % change from the fourth quarter of 2019 to the peak. Sources: OECD, S&P Global Ratings.

Credit Performance | A Sustained House Price Correction Lies Ahead

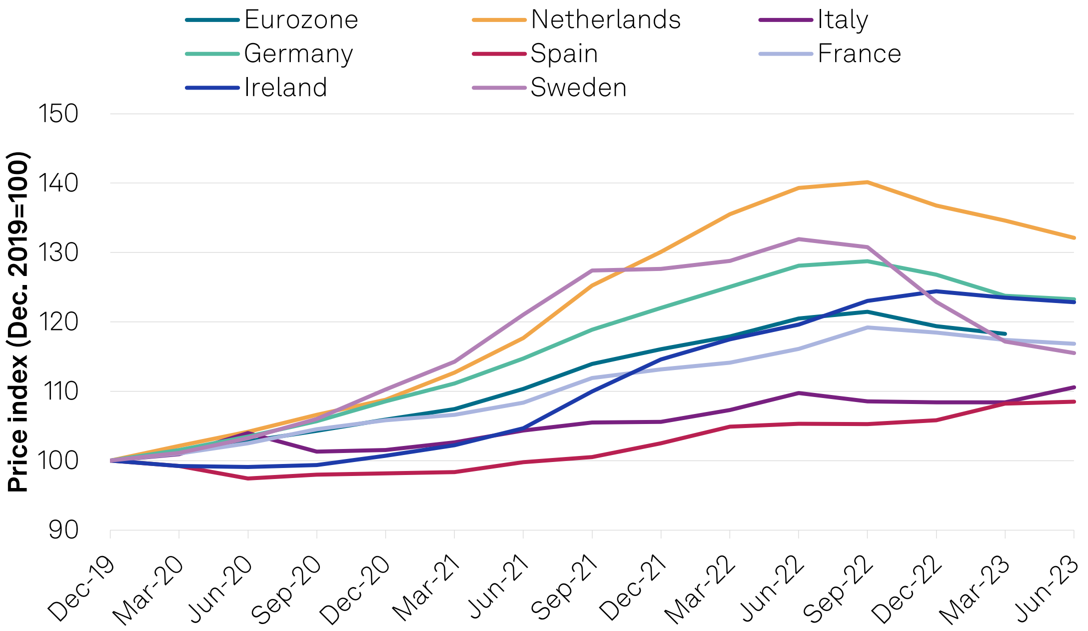
- Higher mortgage rates and tighter lending standards are the main drivers of weakening demand and declining prices.
- Most European countries will see a sustained correction in nominal house prices as eurozone growth will soften considerably moving into next year.

Banks are tightening credit standards for home purchases while housing loan demand is contracting sharply...



Net proportion of banks reporting credit standards for household mortgages tightening, and of banks reporting an increase in housing loan demand. Source: ECB lending survey Q3 2023.

...And house prices are weakening across Europe

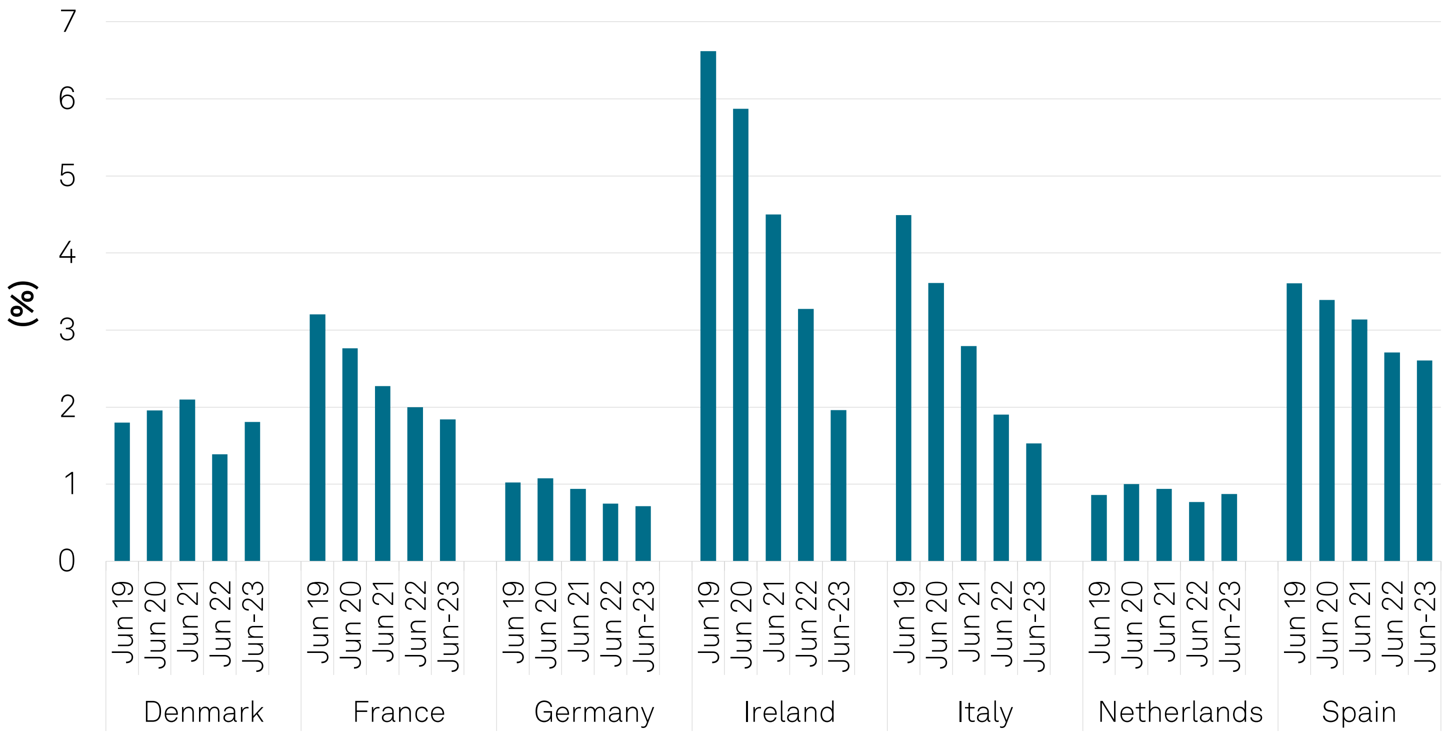


Sources: Eurostat, European Central Bank, S&P Global Ratings.

Credit Performance | A Strong Labor Market Will Help Limit Asset Quality Deterioration

Mortgage performance is stable despite a house price correction

Nonperforming loan ratio of residential household mortgage loans



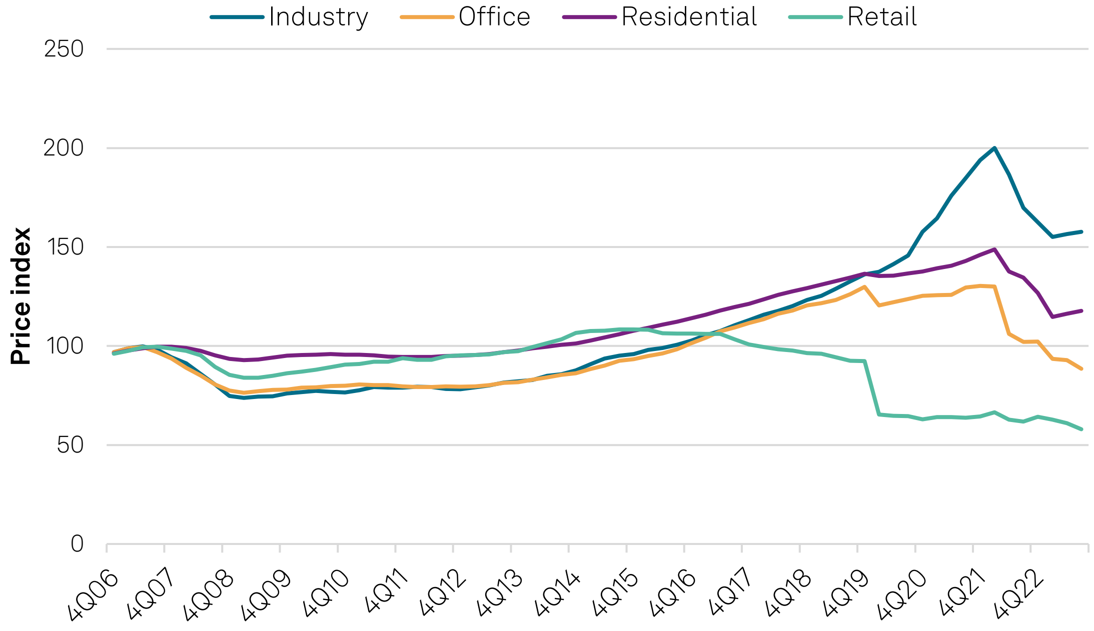
Sources: European Banking Authority, S&P Global Ratings.

- Household saving buffers, prudent underwriting standards, and a still tight labor market are supporting residential mortgage performance.
- This resilience also reflects the fact that part 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.
- 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 Property Is In Search Of A New Equilibrium

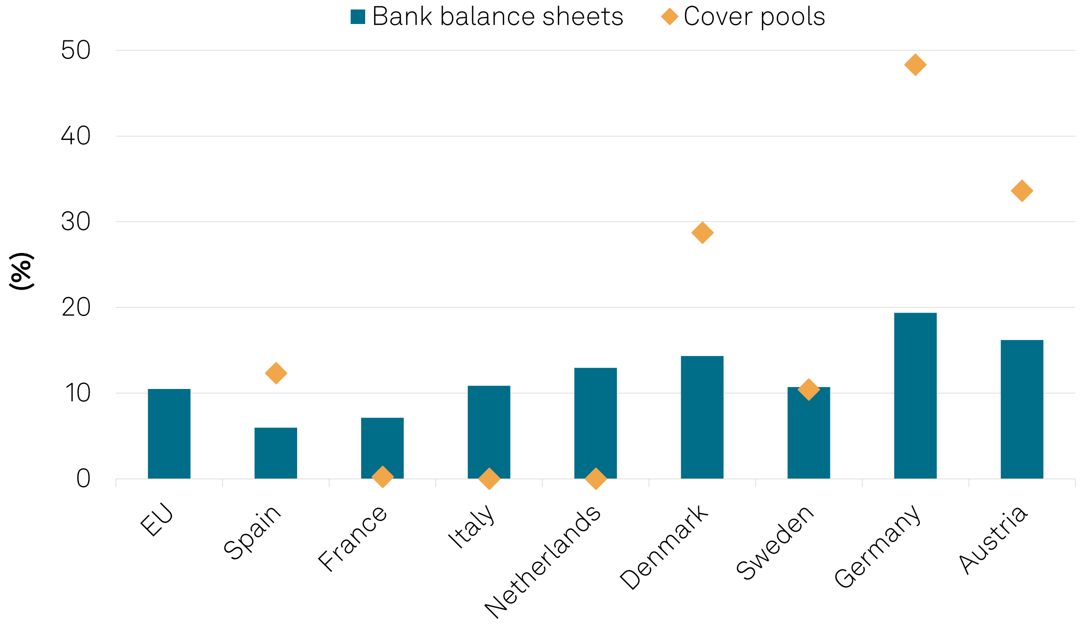
- Higher-for-longer interest rates are squeezing commercial real estate valuations, pushing capitalization rates up and weighing on debt service coverage ratios. Access to funding has narrowed, which could affect liquidity and borrowers' refinancing plans.
- Banks' well-diversified loan portfolios and conservative underwriting should mitigate losses, although office exposures could suffer from longer-term changes in work arrangements. Vacancy rates in retail continue to rise as online sales penetration keeps increasing.

Commercial real estate values remain under pressure, particularly in the office and retail sectors



Green Street pan-European commercial property price indices. Sources: Green Street UK, S&P Global Ratings.

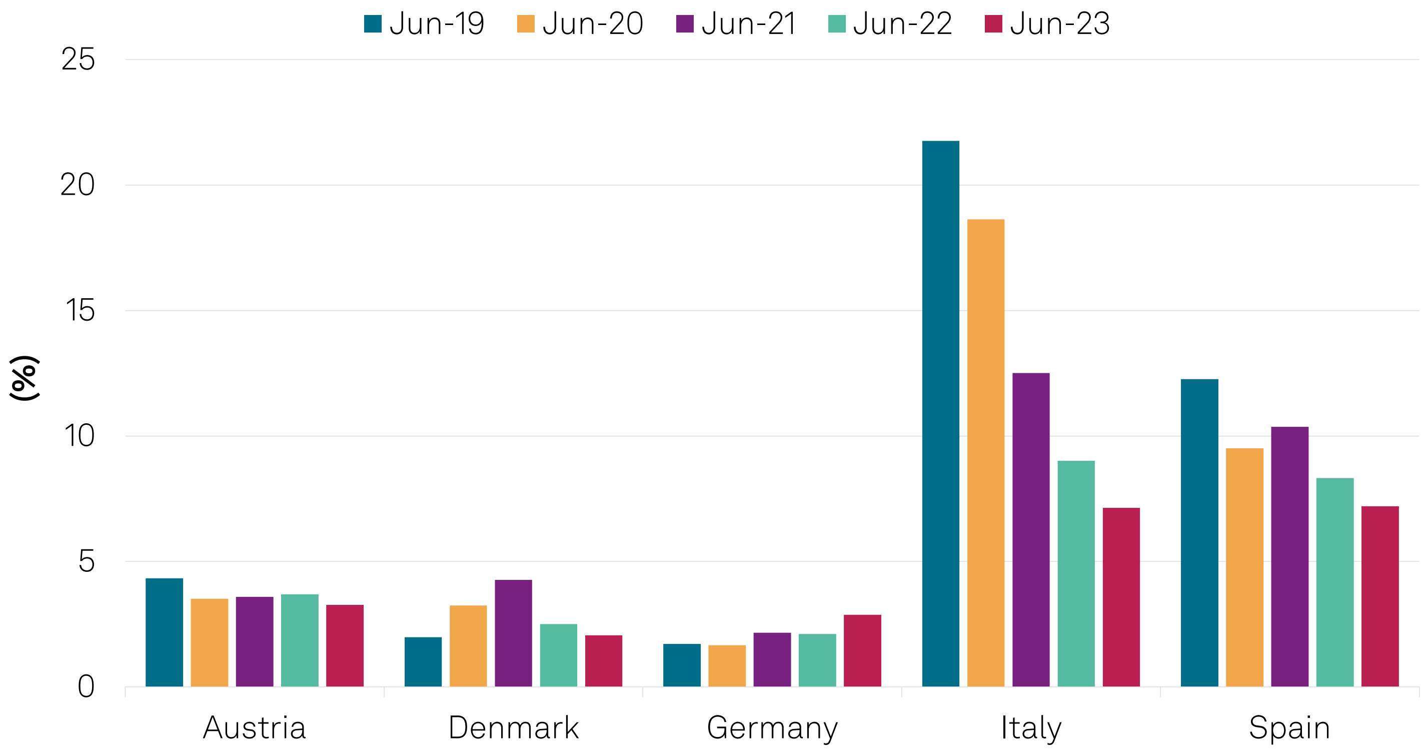
CRE loans represent only around 11% of total lending for large EU banks, but more in some covered bond pools



Average commercial real estate (CRE) loan exposures for system-wide bank balance sheets and covered bond cover pools. Data as of June 2023. Source: European Banking Authority, S&P Global Ratings.

Credit Performance | CRE Asset Performance May Deteriorate In Some Sectors

CRE NPL ratios remain stable despite valuation pressure on more segments



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

- Asset performance has been broadly stable despite increasing office vacancy rates, inflation, and a longer-than-expected return to normal for hotels. The office and retail subsectors remain more at risk, especially for properties in secondary locations.
- A new equilibrium has yet to emerge for office real estate following the adoption of the hybrid work model. Landlords face higher vacancy rates and lower values over the next few years in most markets. Rental levels, however, remain stable or have even increased across the markets that we monitor. As a result, the declining property values are mostly a result of the higher interest rate environment. The growing threat of recession adds to the downside risk.
- While we believe that more commercial real estate loans may default in 2024 due to deteriorating asset performance, we do not anticipate that this will significantly impair the credit quality of the covered bonds that we rate. Rising loan-to-value ratios may lead to substitutions and changing composition for some cover pools, but the impact should be limited.

Banks Outlook | European Overview

What we expect for the next 12 months

- **European banks will be resilient** but divergent as the economic reset--higher interest rates, slower growth--kicks in.
- The rise in (real) interest rates clouds the outlook for banks' business volumes and asset quality. **Credit costs will normalize**, with banks most exposed to commercial real estate, small and midsize enterprises, and unsecured retail loans seeing the biggest impact.
- As central banks drain off excess liquidity, **funding costs will continue to rise,** constraining further net interest margin upside. But earnings will remain comfortable and allow banks to easily absorb higher credit costs.
- **Solid capitalization and liquidity** will also provide resilience to potential shocks.

Downside risks...

- A protracted, **painful recession**, leading to higher corporate insolvencies and unemployment.
- **Market volatility and financial instability** due to overly restrictive financial conditions.
- Banks' **failure to deliver commercially and operationally resilient business** models.

...and what they mean for the sector

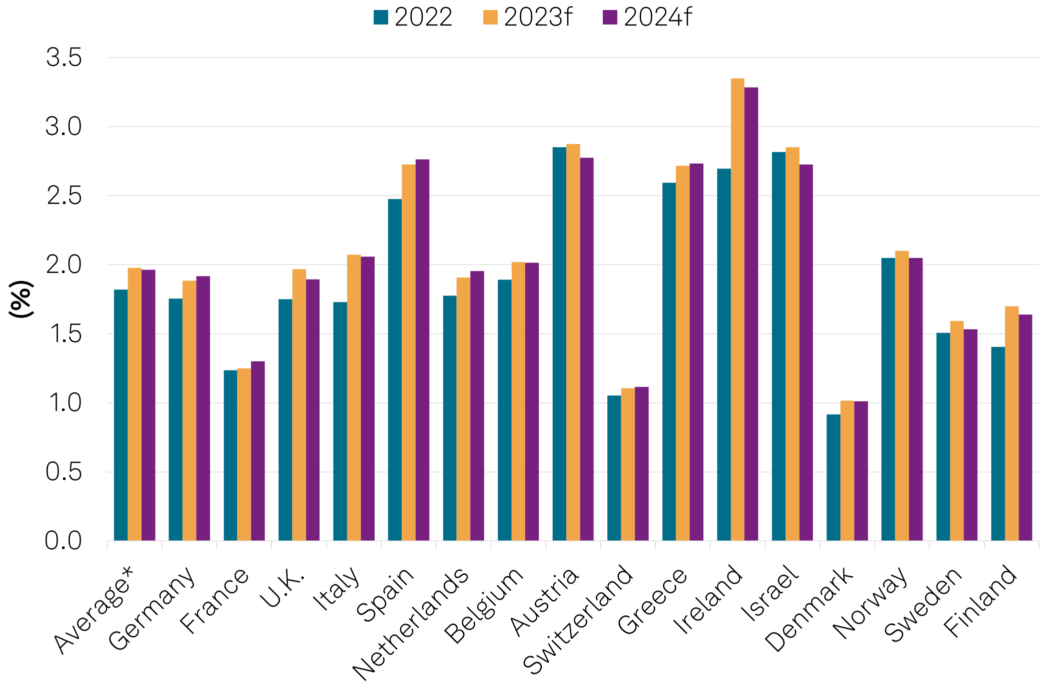
- A recession could undermine the financial health of corporates and households, **weakening banks' asset quality** and business prospects.
- Tighter financing conditions would **pressurize financial institutions with weaker funding structures**, especially nonbank financial institutions with high refinancing needs, and expose banks to higher counterparty risks.
- Failure to tackle inefficiencies, properly digitalize the business, and sustain resilience to cyber attacks could **challenge the long-term viability of some institutions.**

Global Banks Outlook 2024: Forewarned Is Forearmed, Nov. 16, 2023.

Banks Outlook | Profitability Should Remain Comfortable

Net interest margins will not grow, but be largely preserved in 2024...

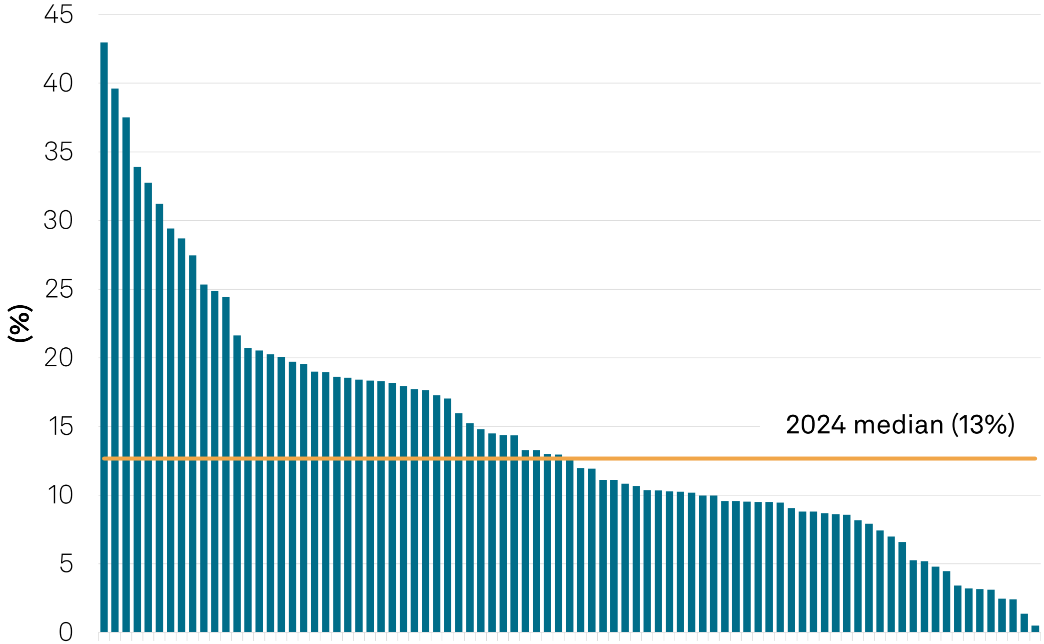
Evolution of net interest margins, top 50 European rated banks



*Average for top 50 EMEA banks. f--Forecast. Source: S&P Global Ratings.

...Allowing banks to easily absorb more normalized credit costs

2024 credit losses as a proportion of pre-provision earnings, top 100 European rated banks



Source: S&P Global Ratings.

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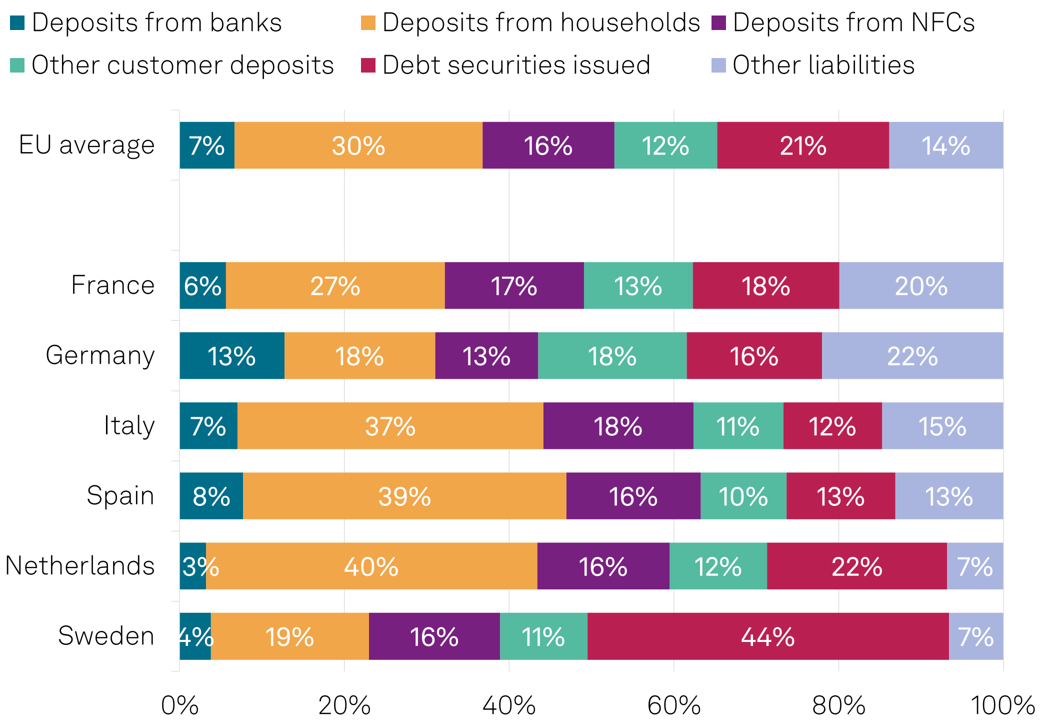
Banks Outlook | Banks Are Well Positioned To Weather Tightening Liquidity

European banks are largely deposit-funded, with households contributing the highest share...

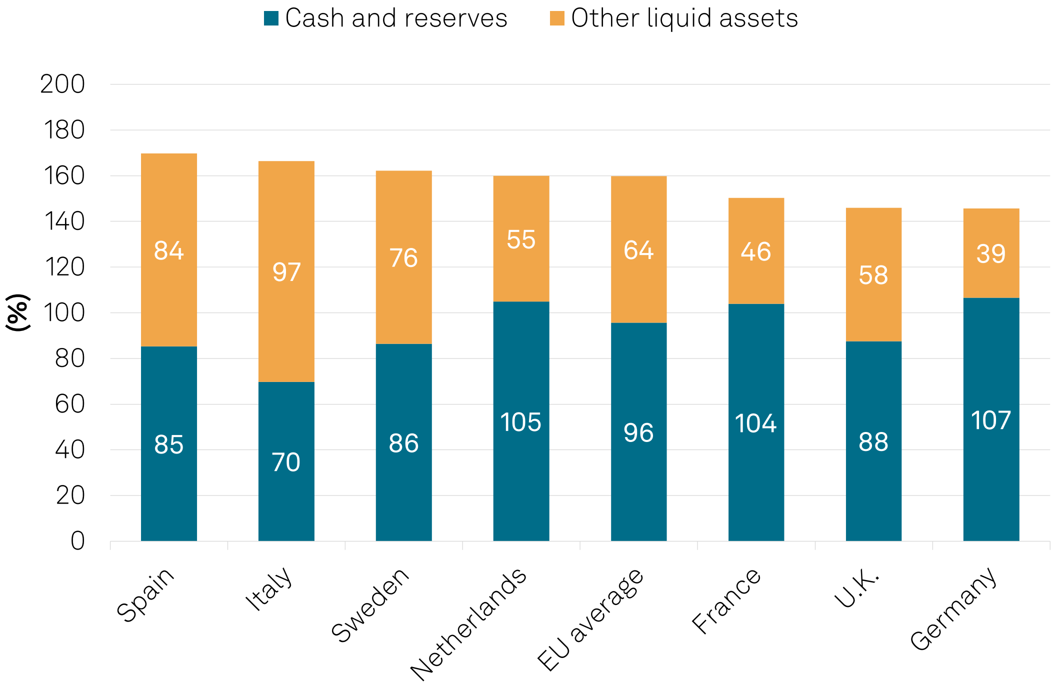
Liability composition of large EU banks



As of June 30, 2023. Sources: European Banking Authority, S&P Global Ratings.

...And hold high liquidity buffers

Large European banks' LCR ratios and mix



As of June 30, 2023. LCR--Liquidity coverage ratio. Sources: European Banking Authority, S&P Global Ratings.

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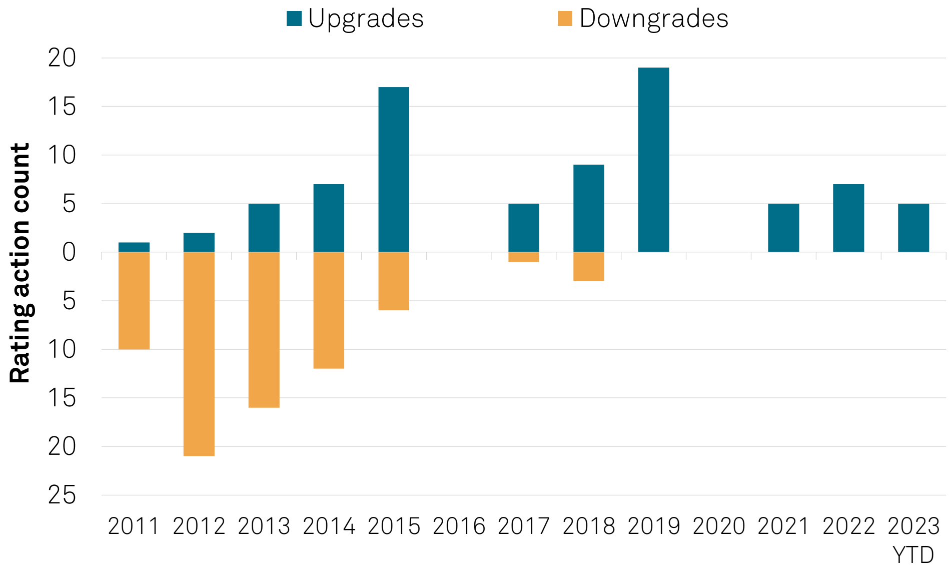
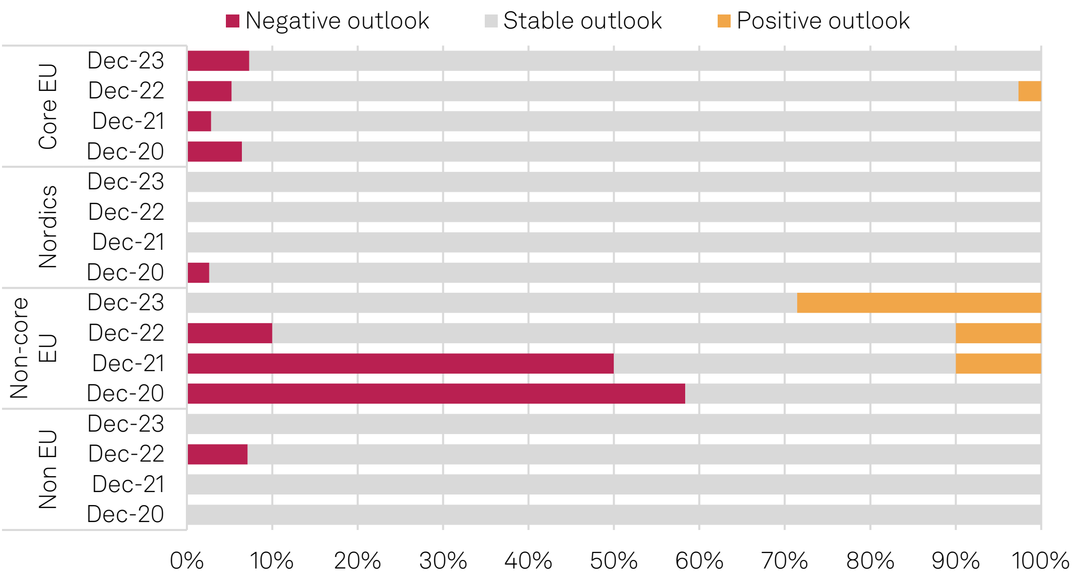
Ratings Outlook | Covered Bond Upgrades Have Followed Sovereign Actions

- In 2023, we upgraded five covered bond programs due to upgrades of either the sovereigns (Iceland and Greece) or of the issuing banks, and revised our outlooks positively on about 2% of them.
- Of the covered bond programs that we rate, 97% have stable or positive outlooks. Only three of the programs have a negative outlook, in line with the outlook on the corresponding sovereign.

No covered bond downgrades since 2019



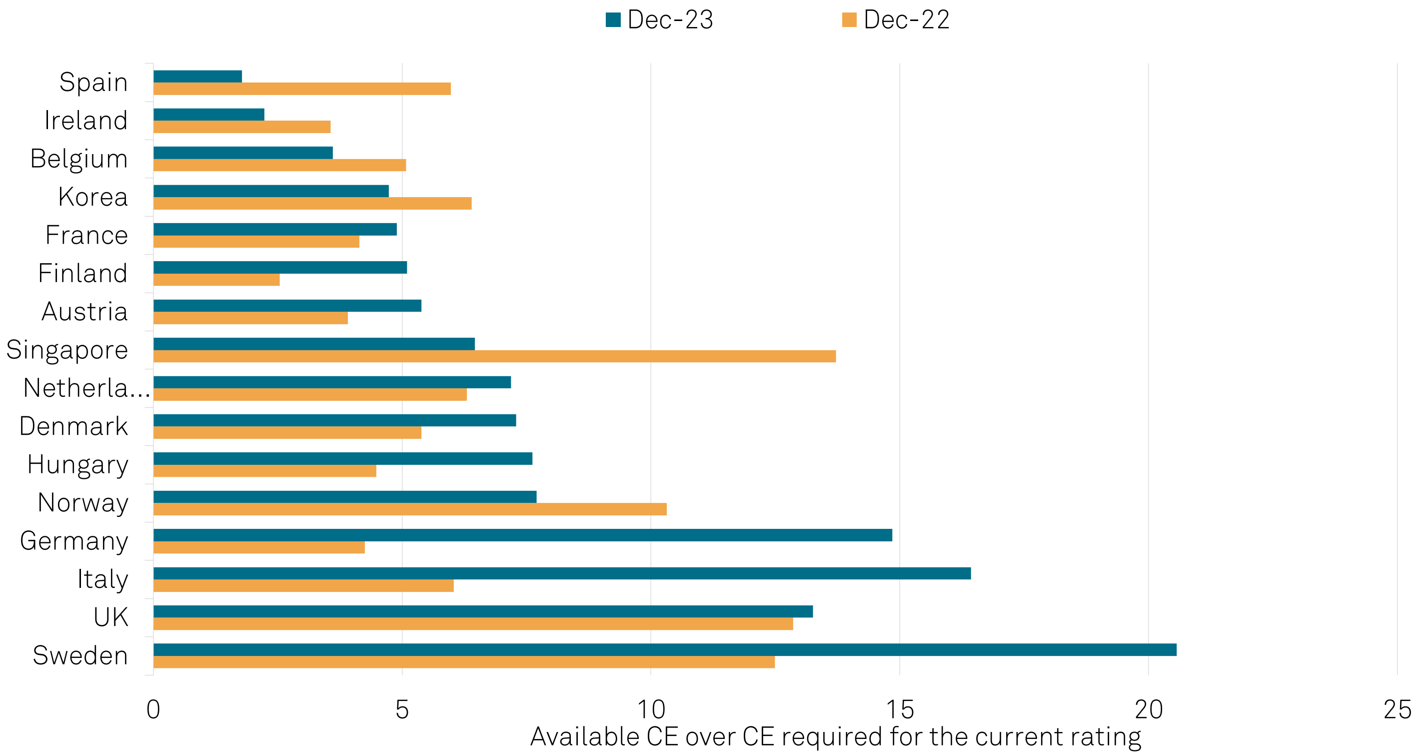
Convergence toward stable outlooks on ratings in all markets



YTD--Year to date, as of Dec. 5, 2023. 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 | Programs Can Absorb A Modest Increase In Credit Losses

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



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

- The credit enhancement (CE) available to most of the covered bond programs that we rate is, on average, more than eight times the level we require to maintain the current ratings.
- We have generally not observed any material deterioration in available CE, even when banks used their programs extensively for retained issuance and following the transposition of the EU Covered Bonds Directive. The CE we require for the ratings has also remained stable.
- The available CE should cushion the deterioration we expect in collateral performance due to inflation and rising interest rates.

Ratings Outlook | Unused Notches Partly Mitigate Bank Downgrade Risk For Rated Covered Bond Programs

- 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, Danish, and Dutch programs are more protected from the risk of bank downgrades.
- Icelandic, Spanish, Italian, and Austrian programs have less of a buffer to mitigate the effect of bank downgrades, as the lower number of unused notches reflects.

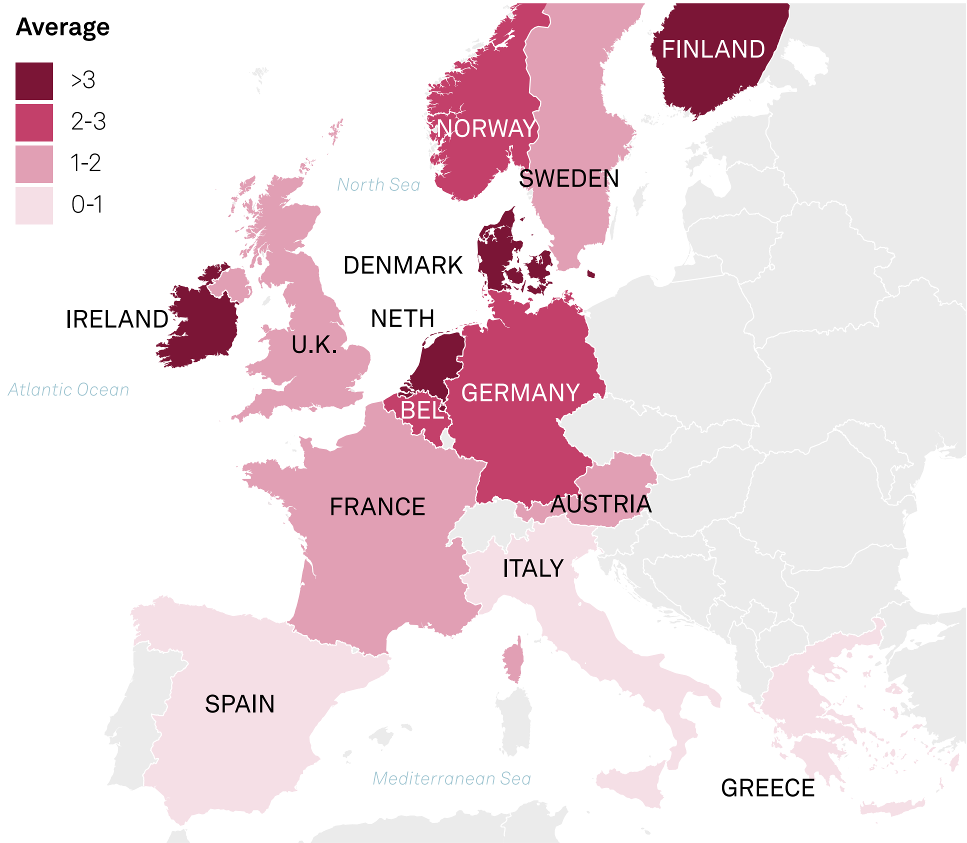
Unused notches by country

	Average	Range
Austria	0.9	0 - 3
Belgium	3.5	3 – 4
Germany	2.8	1 – 4
Denmark	3.4	0 – 5
Spain	0.5	0 – 1
Finland	1.5	0 – 5
France	3.5	0 – 5
Hungary	0.0	0 – 0
Ireland	4.0	4 – 4
Iceland	0.0	0 – 0
Italy	1.0	1 – 1
Netherlands	3.1	1 – 5
Norway	1.3	0 – 4
Sweden	2.2	2 – 3
U.K.	1.8	1 – 2

Note: Conditional pass-through programs are excluded because the ratings are delinked from the issuer credit rating and do not benefit from unused notches.
Source: S&P Global Ratings.

Ratings Outlook | Noncore European And Public Sector Programs Have More Exposure To Sovereign Risk

Sovereign downgrade sensitivity, by country

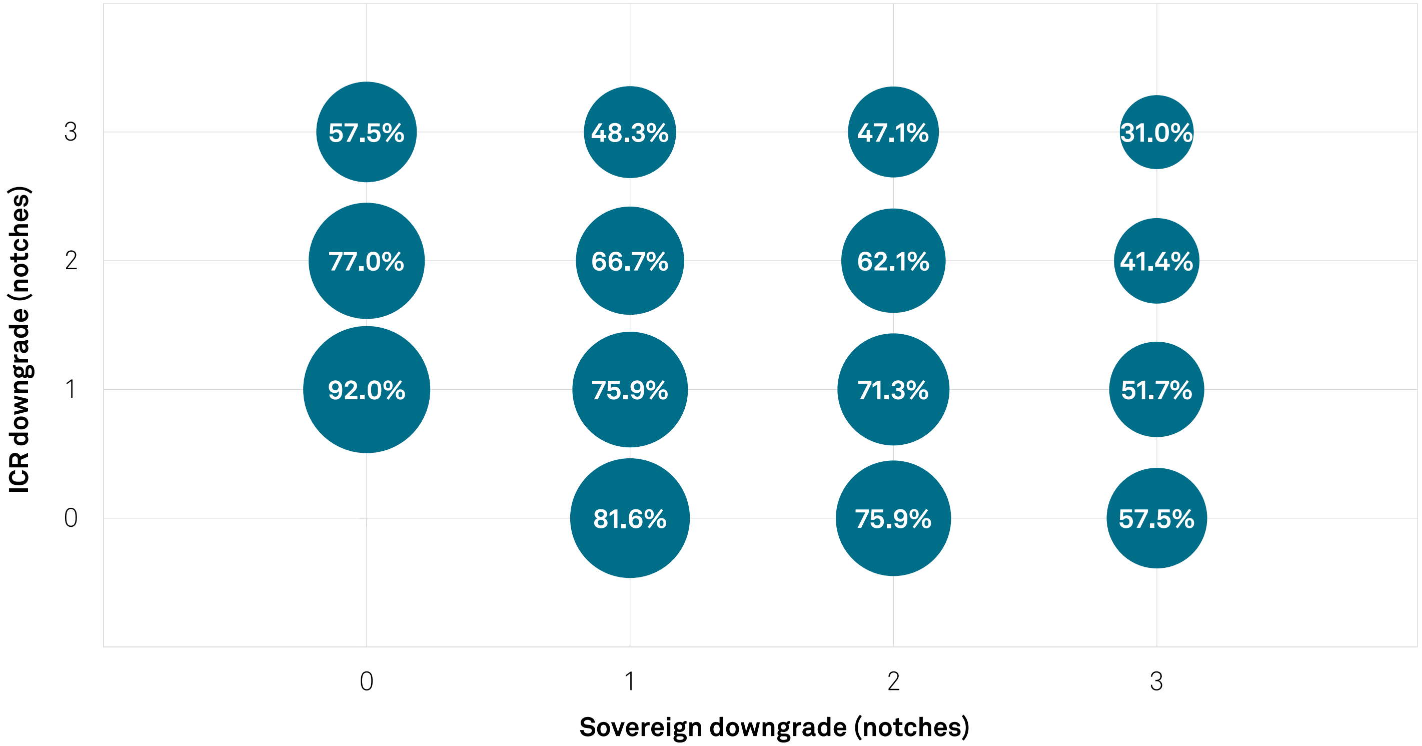


Map shows the average notches of sovereign downgrade that rated covered bond programs can withstand without affecting their own rating. Source: S&P Global Ratings.

- Rated covered bond programs would, on average, maintain the current ratings if their respective sovereigns were downgraded by up to 2.6 notches, all else being equal.
- Dutch, Danish, and Finnish programs are more protected from the risk of sovereign downgrades.
- Greek, Italian, and Spanish programs have less of a buffer to mitigate the effect of sovereign downgrades, and, in some instances, would be immediately affected by such an event.

Ratings Outlook | Limited Issuer Or Sovereign Downgrades Would Not Affect Most Program Ratings

Percentage of covered bond ratings unaffected by an ICR or sovereign downgrade



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

- 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 about 76% of the programs we rate would be unaffected by a one-notch downgrade of both the sovereign and the issuer. Furthermore, about 62% of the program ratings would still be unaffected by a combined two-notch downgrade, all else being equal.

Related Research

- Danish Covered Bond Market Insights 2023, Nov. 30, 2023
- Economic Outlook Eurozone Q1 2024: Headed For A Soft Landing, Nov. 27, 2023
- Global Banks Outlook 2024: Forewarned Is Forearmed, Nov. 16, 2023
- Global Covered Bond Insights Q4 2023: Weathering The Housing Market Correction, Oct. 20, 2023
- Swedish Covered Bond Market Insights 2023, Oct. 5, 2023
- German Covered Bond Market Insights 2023, 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
- 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
- Credit FAQ: Spotlight On Refinancing Risks In European Commercial Real Estate, April 24, 2023
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