PFANDBRIEFE UND COVERED BONDS

COVERED BONDS AT A CROSSROADS: CHALLENGES AND OPPORTUNITIES AFTER COVID-19

„You can't have your cake and eat it." One feels reminded a little of this popular figure of speech when it comes to the current trade-offs in the covered market. On the one hand, there is a powerful und much appreciated help on part of fiscal and monetary institutions, which supports the asset class and its underlying collaterals. On the other hand, this support comes with some unpleasant side-effects, especially regarding the dampening of investor-placed issuances. Also, no one can yet fully assess the long-term risks of increasing indebtedness on credit quality. The authors take a close look at the state of the covered bond market and its perspectives in a hopefully soon-to-be post-Covid environment. Red.

The Covid-19 pandemic triggered an unprecedented policy response, which supported covered bond credit performance but depressed issuance. Some of these policies will be unwound once the economic recovery gathers pace, others will remain for longer, and most will have long-term consequences on the covered bond market.

Limited credit concerns

S&P Global Ratings estimates global debt-to-GDP leaped 14 to 267 percent by the end of 2020; higher leverage means elevated default risk. Covered bonds have grown into a 2.7 trillion euro asset class also thanks to their unblemished credit performance, with no defaults throughout their 250-year history.

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Even though the pandemic triggered the most severe peacetime economic contraction, it has caused limited credit concerns for covered bonds to arise due to two factors. First, the dual recourse of covered bonds – both to the issuing bank and the collateral pool – means that a bank downgrade or a limited deterioration in asset performance will not automatically lead to a lowering of covered bonds ratings.

Not a single downgrade

We have not downgraded any of the programs that we rate since the beginning of the crisis, and we revised outlooks to negative on less than 15 percent, mainly due to rating actions on the issuing bank or the related sovereign. By comparison, we have downgraded 7 percent of Western European banks and negatively revised our outlooks on 50 percent of them.

The second factor limiting the Covid-19 impact on covered bonds was a forceful and swift policy response that stabilized financial markets and prevented far worse economic outcomes. The IMF estimates that last year's severe collapse could have been at least three times larger had it not been for such policy support.

This response also helped asset performance. In Spain, for example, the stock of nonperforming assets declined in 2020. But what will happen once support measures are scaled back? Our sector outlook remains stable, even though almost 30 percent of covered bond issuing banks carry a negative outlook and we expect arrears to peak in Europe only in 2022.

Rating actions on the issuing bank have been the single biggest explanation for rating actions on covered bonds. Currently, rated programs benefit on average from 2.4 unused notches – the number of notches the issuer rating can be lowered by, without resulting in a downgrade of the covered bonds. The presence of these unused notches of ratings uplift reduces the risk of covered bond downgrades even if there are limited downgrades of issuing banks.

Substantial growth in Europe's house prices

During the financial crisis of 2007 and 2008, the residential housing market was a significant source of instability, both in the U.S. and in European countries, such as Ireland or Spain. Back then, house prices decreased in all the major European markets, with the notable exception of Germany.

Now we expect to see better performance. Europe's house prices grew substantially in 2020, due to the swift deployment of government support packages and central banks' record-low interest rates, which improved mortgage affordability.

House prices rose by 6.9 percent in Germany. Those in the U.K. increased by 6.7 percent, and in Sweden by a whopping 10.0 percent. Europe's house prices should still grow in 2021, albeit more slowly than in 2020, as pent-up demand from lockdowns last year is absorbed, affordability worsens, and economic activity remains subdued. We expect a limited correction only in the U.K., by 2.5 percent, and in Italy, by 0.5 percent (see figure 1).

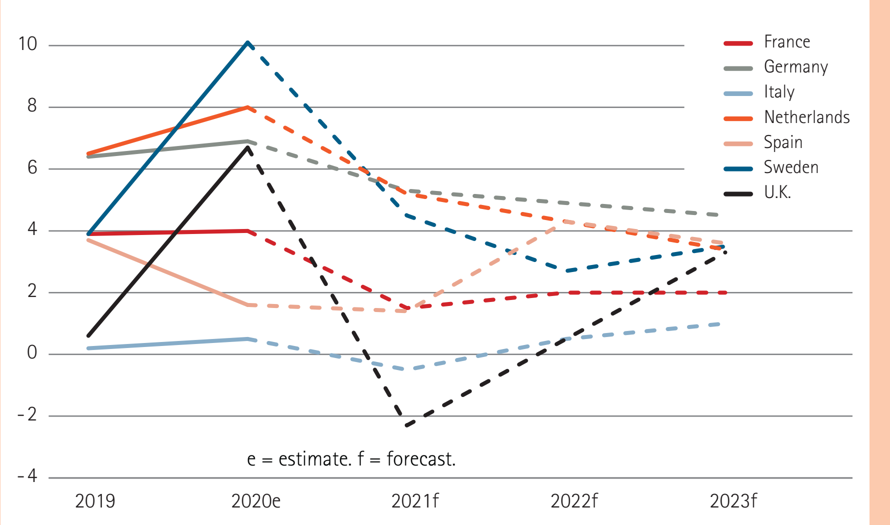
Waning support versus strong economic rebound

Short-time work schemes in the eurozone's largest economies have so far prevented an unemployment surge, and mortgage payment deferral schemes have prevented borrowers from falling into arrears. Collateral performance will be tested once this fiscal and regulatory support wanes, but we expect a limited credit impact on prime residential mortgage loans, because this will happen against a strong economic rebound.

We forecast that the eurozone economy will grow by 4.2 percent in 2021 and 4.4 percent in 2022. A strong economy should limit labor market deterioration and an increase in nonperforming assets. Unemployment is expected to peak at 8.5 percent in 2021, a level well below the 13.0 percent reached in 2013, after the sovereign debt crisis.

Similarly, we expect nonperforming assets to increase throughout 2022 but remain well below the levels experienced a decade ago.

Figure 1: Pent-up Demand, resilient Creditworthiness and low Financing Costs will prop up Housing Prices (in percent, year-to-year)



Sources: OECD, S&P Global Ratings

Commercial real estate is more vulnerable

We predict a greater negative impact on commercial real estate assets than residential real estate assets. First, commercial real estate prices outpaced residential prices before the pandemic. Second, secular trends such as the rise of working from home and growth of e-commerce may negatively affect asset performance long after the crisis is over.

Retail and lodging are most at risk, while it is more challenging to assess the long-term impact on offices. The existing pressure from online sellers on bricks-and-mortar retailers will continue and shopping center values could fall further.

That said, the supply-demand mismatch in retail real estate is much more significant in the U.K. than it is in continental Europe. The Association of German Pfandbrief Banks (VDP) estimates that prices of retail properties in the country were down by just 2 percent at the end of 2020 year-on-year, and rents under new contracts declined by 1.4 percent over the same period.

Conversely, U.K. shopping center values fell by approximately 25 percent over the same period, predominantly due to declining rents. Even before Covid-19, many key European office markets were undersupplied, manifested in low vacancy rates and increasing rents, and ever declining yields.

No significant impairing of credit quality expected

GDP declines and increasing unemployment are typically associated with higher vacancy rates, declining rents, and falling property values. However, because of long leases, these developments do not normally happen overnight, but take months if not years to show.

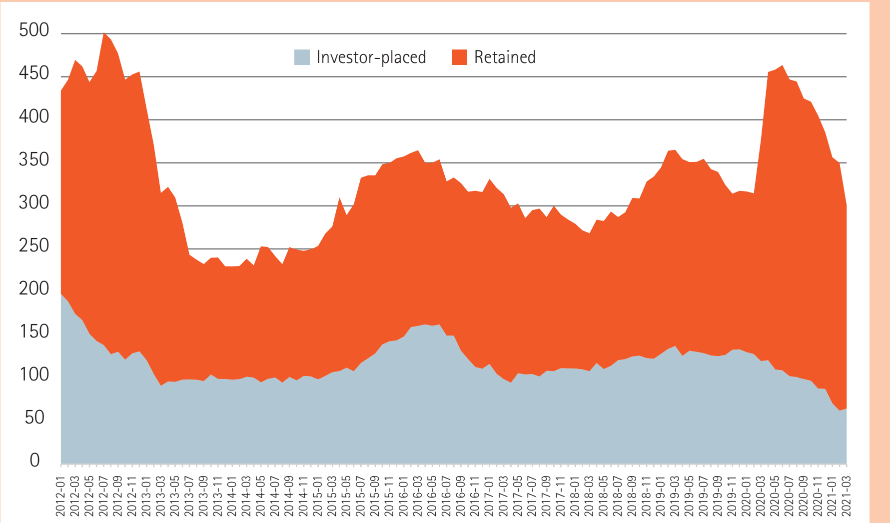
The VDP estimates that prices for office properties in Germany actually increased by 1.7 percent in 2020. The Covid-19 blow may make some office tenants reduce their footprint to save costs but it may also encourage employers to use more space, to give their employees more room per person.

While we believe that commercial real estate asset performance may deteriorate, we do not anticipate this significantly impairing the credit quality of the covered bonds that we rate, due to the availability of credit enhancement to absorb losses and the limited exposure to sectors that we consider to be more at risk.

Drastic plunge in issuances

Stable credit performance could not avert a plunge in covered bond issuance since the onset of the pandemic. Investor-placed issuance in the first three months of 2021 was half the amount in the first quarter of 2020, and one-third of that at the same point in 2019 (see figure 2). The policy response to the pandemic again played a pivotal role. The drop in issuance reflects banks' limited need for new wholesale funding due to a surge in customer depos-

Figure 2: Retained Issuance surged since March 2020
(12-month rolling benchmark issuance, in billion euro)



Sources: Bloomberg, S&P Global Ratings

its, as well as ultra-cheap central bank loans offered during the pandemic. Generous fiscal support measures, along with lockdowns which limited households' opportunities to spend, contributed to the increase in savings.

Eurozone household saving rates as a percentage of disposable income almost doubled to an unprecedented 24.6 percent in summer 2020 from a long-term average of 12.8 percent. Moreover, eurozone banks took almost 1.5 trillion euro of additional ECB funding since the terms of its long-term refinancing operations were eased in 2020.

Massive demand for ECB's TLTRO

And countries where issuance decreased the most, namely France, Germany, and Spain, are also among those with the stronger take-up under this facility. While dampening investor-placed issuance, central bank intervention is encouraging retained issuance, given the need to create high quality collateral for repo operations: covered bonds constitute almost 25 percent of the collateral posted with the ECB.

Covered bonds enjoy favorable regulatory treatment because of their systemic importance and low risk profile. According to the European Mortgage Federation, more than 30 percent of the residential mortgage loans in the eurozone are funded by covered bonds.

Banks need to maintain a footprint

Can a prolonged period of weak issuance threaten such favorable regulatory treatment of covered bonds, by reducing their systemic importance? We don't expect issuance to return to pre-crisis levels before 2023 at the earliest. Volumes should tentatively pick up from the current low levels once social distancing measures are relaxed and the economy rebounds in the second half of the year.

Households will spend at least part of the excess savings they accumulated during lockdowns, and an improving economic outlook will support asset formation. When mortgage lending outpaces customer deposits, lenders typically access wholesale funding markets and can use mortgage loans as collateral for issuing covered bonds.

Moreover, banks also need to maintain a footprint in the covered bond market and won't want to be absent for too long, which could compromise their relationship with investors. Still, continued access to cheap central bank funding will slow the rebound in issuance volumes.

Inflation appears to be the key. Low inflation could allow the ECB to maintain a looser monetary policy for longer; higher-than-expected inflation could force monetary authorities to curb quantitative easing and encourage banks to issue and lock in the current low interest rates.

High inflation is unlikely

Inflation spiked at the start of the year to an annual 0.9 percent from minus 0.3 percent on one-off factors, and energy prices will drive inflation close to the ECB's target of 2 percent by the summer.

However, we expect the momentum to abate through the end of 2021, before a slide back to 1.2 percent in 2022, as pressure on wages will remain low and oil prices likely stabilize.

Low inflation will allow the ECB to keep stimulating demand for at least the next couple of years, preventing a return to normal covered bond issuance volumes before 2023.

What will be the shape of the asset class once the economic recovery is well established and central banks withdraw monetary support? Growth will probably remain subdued in traditional markets, due to modest demand for mortgage assets and limited funding needs.

Source of future growth: new markets ...

Volumes already declined by 9 percent in the Eurozone in the decade before the Covid-19 crisis, while increasing globally by 13 percent. This points to the first source of growth: new markets. Outstanding covered bonds issuance increased by almost five times over that period outside established markets, such as in Central and Eastern Europe and Asia-Pacific.

The transposition of the EU harmonization directive should support further covered bond issuance in Central and Eastern Europe, by either aligning existing local frameworks to international best practices or by introducing new dedicated legislation.

Outside the EU, we can expect additional issuance from new markets, such as Japan and Brazil. Housing demand should also grow substantially in the coming decades in emerging Asia and Latin America, and covered bonds could become an important instrument for mobilizing private capital toward mortgage financing in these regions.

... and sustainability

The second source of growth should be sustainable issuance, namely green and social covered bonds. Sustainable covered bonds constituted around 5 percent of overall issuance in 2019, growing to nearly 20 percent in the first quarter of this year.

Sustainable issuance poses considerable challenges for issuers, including the dearth of eligible assets, considerable upfront costs, and limited pricing differentials versus vanilla issuance. However, it benefits from a supportive regulatory environment and ravenous investor demand.

The EU has approved or amended several regulations, including the benchmark regulation, the regulation on sustainability-related disclosures in the financial services sector, and the taxonomy regulation for climate change. These initiatives provide clarity to market participants and allow issuers to plan the necessary investments required to set up a green or social covered bond issuance program.

Throughout their 250-year history, covered bonds have weathered the ebb and flow of the financial markets by adapting and innovating. While the post-Covid recovery poses unique challenges for this asset class, it's likely covered bonds will remain resilient as they have the potential to adapt and remain an essential funding tool for financial institutions, in Europe and beyond.

For further information on S&P's covered bond research, please visit **www.spglobal.com/ratings/en/sector/structured-finance/covered-bonds**.