Covid-19: covered bonds holding steady

Strong covered bond ratings coupled with the ECB backstop are allowing banks to access funding if they need it. Bank credit fundamentals and the credit quality of cover pools could weaken over time, but available buffers will generally support strong ratings. Covid-19 impacts will vary between issuers. The duration and terms of lockdowns and moratoriums are key to ultimate impacts.

Since the onset of the Covid-19 crisis covered bonds have, once again in a crisis, become a preferred funding product for banks – even if only as retained bonds to tap into extended national central banks' repo facilities. The public market is open: European and Canadian issuers have been able to issue. Covered bond issuance reached almost EUR 40bn in the last two weeks. Scope does not expect the safe-haven status of covered bonds to change, even though their credit quality will deteriorate over time.

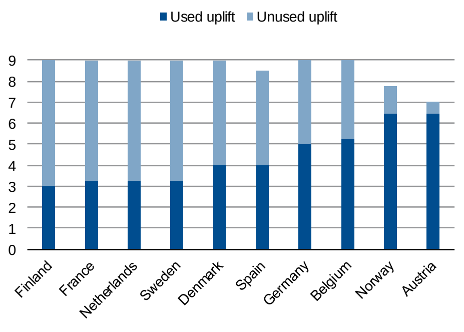
Market perception and CBPP backstop contains spread widening

For now, Covid-19 driven spread widening of 20bp for the iBoxx covered bond index is contained. However, new covered bond issues have become more challenging, as evidenced by spreads that are some 30bp to 40bp wider. For now, we view this as an indication of changed investor perceptions of liquidity and not concerns about credit quality. With 100bp widening seen for senior unsecured debt of the same issuer, covered bond spread volatility is much lower. As differences in the credit risk of issuers and their cover pools emerge over time, covered bonds will reposition as a credit product.

Covered bond credit quality to hold steady while headline risk for issuer ratings increases

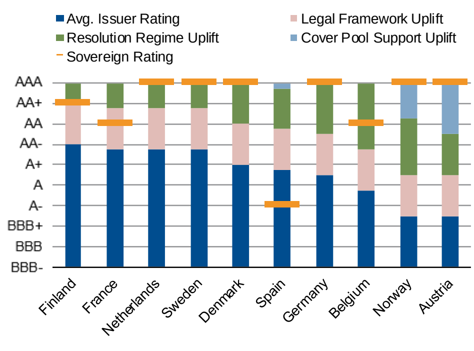
Covered bond ratings should hold steady for most issuers. Buffers against downgrades of issuer ratings are available for most rated covered bonds. Reflecting the higher issuer ratings, buffers are highest in Finland, France, Netherlands and Sweden, where on average the bank rating could deteriorate by up to six notches without endangering highest covered bond ratings.

Figure 1: covered bond rating buffer



Source: Scope Ratings

Figure 2: average ratings



Source: Scope Ratings

Banks are able to increase protection available to their covered bonds, which allows them to mitigate deteriorations in their own ratings and/or changes to the credit quality of cover pools. A correction of sovereign ratings will not uniformly impact the credit quality of covered bonds. Rather, changes to the credit quality of the first recourse for covered bonds – the bank rating – will drive the extent of potential rating changes.

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Emergence of payment holidays and moratoriums will not directly impact covered bonds

Moratoriums will require more active cover pool management

Government sponsored or voluntary bank moratoriums (see Appendix I) will be a double-edged sword for covered bonds and need to be analysed in detail.

They can prevent – but in some instances only delay – default by borrowers. Eligibility definitions for cover pools mean that increasing defaults will not directly impact cover-pool credit quality. Rather, banks will need more actively to add new or replenish delinquent borrowers. Encumbrance levels are still low, and most issuers have ample additional cover assets allowing them to replenish if and when needed. At the same time moratoriums might require more active liquidity management by issuing banks as scheduled payments for cover assets might be delayed.

Impact on cover-pool credit quality will only become visible in the medium term

Changes to unemployment key for development of credit risk

The uniform and bold measures initiated by euro area governments will likely mitigate first-round credit impacts on borrowers, likely avoiding defaults for now. Assuming spikes in unemployment rates do not become permanent, extension of loan terms as a result of moratoriums can be managed. Low interest rates still support loan affordability. However, once the markets return to normality the wheat will separate from the chaff.

Covid-19 moratorium impact difficult to trace unless additional transparency is provided

Share of cover assets impacted by moratoriums not directly visible

More aggressively-underwritten residential loans to weaker borrowers might see negative credit migration and will most likely prompt higher shares of moratoriums for individual cover pools. With accounting guidance allowing such loans not to be classified as “90 days past overdue”, investors will struggle to assess the impact on their cover pools. To alleviate concerns, issuers should proactively provide such additional information – which at best will only be needed temporarily.

…no impact on covered bond cash flows for now

Share of cover assets subject to moratoria as traffic light

The impact of missing repayments due to moratoriums is less relevant for covered bonds than securitisations. The sponsor, the bank issuing the covered bonds, must provide the first recourse and thus make-whole payment delays. Unless a bank is close to regulatory intervention or a BRRD-like bail-in scenario, the share of loans subject to a moratorium or payment holiday only serves as a traffic light for potential replenishment needs and potentially higher levels of over-collateralisation.

Covered bond harmonisation does not address system-wide moratoriums

Moratoriums highlight the importance of issuer support

The introduction of a dedicated 180-day liquidity cushion for covered bonds is one of the most important improvements in the upcoming covered bond harmonisation. Supportive central banks have prevented the current crisis from migrating into a liquidity one. The widespread emergence of moratoriums highlights a weak point in the liquidity protection of covered bonds.

The required 180-day liquidity cushion will be established as a net amount and as the cumulative highest outflow. The calculation takes into account scheduled amortisations from cover assets and subtracts scheduled interest and principal due on the covered bonds. To avoid double coverage, scheduled redemptions in the first 30 days will not need additional coverage as they are part of the LCR requirements banks need to comply with.

Allowing the carve-out of the first 30 days of liquidity protection establishes the banks as the first lines of defence. The Covid-19-driven moratoriums offer a different angle and provide food for thought.

Widespread moratoriums reduce the inflow of scheduled asset repayments requiring additional issuer support. As such, additional stresses might be needed to ensure strong short-term liquidity protection.

Liquidity buffers within the cover pools are not yet common

Importance of liquidity management reinforces credit status

The 180-day liquidity requirement is reality in only a few European countries. In most countries, issuers have opted for soft-bullet covered bonds to mitigate liquidity risk (see Appendix II). The 180-day liquidity requirement will only become a requirement for all in 2021, once the harmonisation is transposed into all covered bond frameworks. It might not be as powerful in all countries, as the belt-and-braces approach (having soft bullets plus a 180-day liquidity cushion) will not become the gold-plated standard for all.

The relevance of the credit quality of the bank and its ability to generate sufficient liquidity to buffer against moratoriums or similar disruptive and system-wide events will remain an important credit factor. With deteriorating bank ratings likely, these changes will re-establish covered bonds more firmly as a credit product.

Granular residential mortgage pools less likely to be impacted by moratoriums

Granular residential mortgage pools impacted least

Residential mortgage portfolios are generally the least impacted in crisis. The impact of the 2020 pandemic on the credit quality of cover pools might even be lower than during the global financial and the European sovereign crises. Most households have not entered the current overly leveraged, and for most European countries, house prices are elevated but not too overvalued.

Road back to normality decisive for ultimate impact

However, the length of the pandemic as well as the shape of the road back to normality is not yet known and will be decisive on the ultimate impact of residential homeowners. We currently assume a U-shaped recovery with steep GDP declines in Q2 followed by a gradual recovery beginning in Q3 (see “Q2 2020 Sovereign Update”). For now, the immediate impact of the largest default risk for residential housing loans – rising unemployment – will be mitigated by moratoriums which allow principle and interest payments to be delayed by between three and 18 months. Additional forbearance measures can further reduce pressure due to the low interest-rate scenario.

Banks will have to weather higher provisioning. The significance of asset quality deterioration in their core activities – corporate and retail lending – will ultimately determine the impact on their ratings and ultimately on covered bond ratings.

Mild one or two-notch bank downgrades will support covered bond ratings at current levels (see figure 1) but significant asset-quality erosion could impact covered bond ratings if the ratings already rely on cover-pool support.

Commercial real estate portfolios require more attention

Commercial real estate loans potentially more volatile

Banks and cover pools with high shares of commercial real estate exposure might exhibit higher credit volatility and deserve more attention. The impact of the lockdown on corporate default rates will be more significant than for residential-backed covered bond programmes. In particular, exposures in the wider leisure and hospitality industry, retail as well as some parts of the office sector might have to go through deep troughs and need closer monitoring.

Payment moratoriums and additional guarantees to bridge the crisis will help those corporates with functioning business models. Corporates with less solid models, in particular sole bricks-and-mortar-based models that were already challenged by multi-channel players, will more likely be crowded out and potentially tipped over the edge.

And commercial real estate focused business models might be put to the test

Focused CRE lenders put to the test

Covered bond issuers with larger shares of commercial real estate in their cover pools are often specialised mortgage lenders. Before the crisis, they strongly benefited from the low rate environment and the strong financing demand for commercial real estate. They entered the pandemic with less seasoned portfolios, larger shares of non-prime financing, low margins as well as lower capitalisation levels than diversified universal banks. In addition, they are often more dependent on wholesale funding.

Covid-19 is not a single-country problem and the perceived benefits of an internationally-diversified portfolio cannot provide their usual benefits. The most attractive metropolitan areas are currently most impacted by the lockdown and exposures in those areas will be more prone to fall-out. Exposures in these regions are typically more sizable, resulting in much swifter credit migration even upon a low number of failed financings and eventually earlier and higher provisioning needs compared to granular residential mortgage-backed portfolios.

Cover pools will benefit from eligibility criteria that dictate that defaulted loans need to be purged from the cover pool or not be accounted for (see Appendix I). Refinancing higher shares of ineligible loans on an unsecured basis will become more expensive and increasing provisioning needs will drive credit spreads upwards. Ultimately the pandemic crisis could put monoline business models to the test.

Stressed recovery proceeds not expected to change – for now

Defaulted CRE exposures to benefit from high recoveries

Even in the worst-case scenario, the credit loss from defaulting borrowers providing commercial real estate collateral should not materially increase compared to the pre-pandemic scenario, owing to the maximum 60% loan-to value restrictions.

We monitor the deterioration of commercial real estate values and the impact of longer vacancy periods and recovery processes. Stressed recovery assumptions should hold steady, though, as assumptions used to support highest credit stresses are only supposed to fluctuate once structural changes are observed. While this is currently not our base assumption, more highly-leveraged exposures without additional covenants focused on leisure and hospitality as well as retail could require higher protection levels.

Covid-19 to reverse direction of house prices

House prices will drop but impact low to moderate for most

The number of real estate transactions will significantly slow down reflecting i) the combination of the lockdown and the inability to do on-site inspections and ii) the fact that land registers in most European countries are not digitalised. Coupled with poorer sentiment for both corporates and homeowners and their likely strategy to wait, larger financings will significantly reduce demand and reverse the trajectory of house prices at least for Q2 and Q3.

For most markets, negative growth of 10% in residential house prices– similar to what was observed after the global financial crisis – is likely. The impact on European cover pools will vary.

For countries that stipulate regular typical index-based revaluations, average cover pool LTVs will likely increase. Further, and depending on the finer details of current covered bond frameworks, this could mean that mortgages will become ineligible and will need to be fully replenished with new loans. But in most cases, banks will need to top up the ineligible portions of cover pool assets.

Neither a replacement nor additional collateral pose an insurmountable challenge. Banks generally do not manage over-collateralisation just at the levels needed to comply with legal requirements or those needed to support their current ratings. Further, the availability of alternative central bank funding options, such as the various TLTROs, means that encumbrance levels are low.

GDP contraction and higher debt pressures sovereign but not uniformly covered bond ratings

Covered bond ratings will not move in tandem with the sovereign

The economic environment and banks' specific credit performance are cornerstones of any assessment of current and stressed borrower and collateral performance relevant for the cover pool analysis. Changes to the economic environment, GDP and debt levels will be reflected in the development of sovereign ratings. However, changes to the sovereign rating do not mean that bank nor covered bonds will automatically move in tandem. In particular for mortgage-backed covered bonds and securitisations in euro area countries, Scope does not believe that an artificial cap is warranted. The individual analysis of the first recourse (the bank) and where needed the cover pool are the main drivers.

Credit differentiation back on the radar even though credit quality will remain high

Fundamental support for covered bonds to remain strong

The Covid-19 impact on covered bond ratings will be driven predominantly by the length of the pandemic and the resulting economic impacts to countries and most importantly, issuing banks. Covered bonds ratings entered the crisis from a position of strength and the key rating driver (fundamental support) remains very strong. Stakeholders continue to proactively support the product as evidenced by the first-time inclusion of local covered bonds into the collateral framework of the Canadian central bank, widened acceptance of covered bonds by the Swedish central bank and the ongoing inclusion in the significantly topped up purchase programmes of the ECB.

European covered bond harmonisation will remain supportive and raise the bar for all European covered bonds. It increases investor protection in a worst-case scenario of a bank default. It does not ensure highest ratings, however. Until a very unlikely bank default results in a stand-alone cover pool; the management, composition and ultimately the credit quality of covered bonds will predominantly be driven by the issuing bank.

The pandemic highlights that covered bonds are a credit product. Covered bond credit quality and ratings only look uniform at first glance. As the pandemic evolves, the credit quality of covered bonds will be impacted differently. For some covered bonds, the pandemic will only prompt small changes in required credit protection while for others, in particular those issuers with commercial real estate focused cover pools, efforts to maintain the rating will require more effort.

Both sides of the dual recourse can impact ratings

Some banks may not be able to sustain the highest ratings. However, rating change drivers will not be a result of broad-brush changes to assumptions or sovereign ratings but will reflect changes in the individual credit performance of the two key pillars: the bank and the cover pool.

Appendix I: selected payment holidays or moratoriums across Europe

Covid-19 support for borrowers by their governments as well as the financial industry is strong and as the pandemic is still increasing. As of 3 April 2020, the following support measures across selected European countries were available.

Country	Law/ Voluntary	Covid-19 support available to borrowers	90 days past due (dpd) impact on eligibility
Austria	Special law	No special moratorium on mortgages; emergency aid, subsidies and guarantees for SMEs; no moratorium. Bank voluntarily offer payment holidays.	No need for removal but no inclusion in test
Belgium	Special law/ decree & voluntary measures by banks	Moratorium until Sept 30, 2020 for principle and interest for mortgage loans (households, companies and self-employed), no accrual of interest for homeowners if rate below EUR 1,700, additional EUR 50bn fund for banks to support lending (losses are split between the banks and the government based on a dedicated loss waterfall)	No need for removal but no inclusion in coverage test (30dpd already discounted)
Denmark	Voluntary by banks	Ability to use payment holidays or remortgage for longer maturities with interest-only periods, Government guarantee for liquidity of corporates including extension of VAT payment, compensation of fixed expenses if ordered to close down, else if turnover dropped by more than 40% compensation of fixed expenses between 25-80%; property valuation requirements no longer require an inside inspection (until end April)	No need for removal
France	Voluntary by banks	No general six-month moratorium yet; grace period for evictions (Têve hivernal) extended until 31 May 2020; banks specific payment deferrals possible	No need for removal, can count for minim OC; SFH ACTs exclude or discount NPLs
Germany	Special law/ decree	Three-month moratorium on interest and principal for homeowners and SMEs upon request; no termination of rent contracts if rent is not paid until June 30, 2020 and Covid-19 related-termination only possible after June 30. 2022; insolvency does not need to be filed until Sept. 30, 2020	May remain in the cover pool if full recovery expected
Ireland	Voluntary by banks	Three-month moratorium on principal and interest for mortgages, personal and business loans, additionally no evictions or repossessions	May remain in the cover pool and are accounted for in OC calculations and other tests
Italy	Special law/ decree	Moratorium on residential, micro-enterprises and SME's for mortgage repayments until Sept. 30, 2020. Additional moratoriums for special regions and support from the solidarity fund	Can remain in the cover pool; ACTs either give no or discounted value to NPLs
Netherlands	Voluntary by banks	Voluntary three-month moratorium on principal and interest for residential mortgage loans provided by the banks upon request	May remain in the cover pool, no value for OC, are excluded or discounted in the ACT
Norway	Special law/ decree	No dedicated mortgage moratorium but increased unemployment benefits; reduced countercyclical buffer for banks to ease additional lending; several guarantee schemes for SMEs	NPLs can remain in the cover pool but do not count for OC calculations
Portugal	Voluntary by banks	Interest-only period for up to 12 months for mortgages and six months for consumer credit (credit lines 90% guaranteed by the State)	NPLs must be removed from the cover pool
Spain	Special law/ decree	Moratorium on principal and interest for homeowner mortgages and no repossession for those: i) who become unemployed or corporations that lose at least 40% of revenues and ii) caps for those financially better off; has to be claimed within two weeks after the publishing of the decree	Overdues are excluded from the OC calculation (are ineligible)
Sweden	Special law/ decree	Guidance by the Swedish FSA that borrowers should be able to suspend principle repayments for Covid-19 reasons, exemptions may apply for three to 12 months; countercyclical buffer reduced	Can remain in the cover pool but loans 60dpd have to be excluded from cover test
UK	Special law/ decree	Guidance by the FCA to grant payment holidays of up to three months; additional measures by the industry for residential, BTL and help-to-buy loans longer periods possible; three-month no evictions for tenants, Government decree	Can remain in the cover pool; ACTs either give no or discounted value to NPLs

Source: Scope Ratings, ECBC, national covered bond frameworks

Appendix II: Short term liquidity coverage in cover pools

Country	Hard Bullet without mandatory liq. buffer	Hard Bullet with liq. buffer	Soft Bullet	CPT
Austria	x		x	
Belgium			x	
Denmark	x		x	
Finland	x		x	
France		x	x	
Germany		x		
Greece			x	x
Ireland			x	
Italy			x	x
Netherlands		x	x	x
Norway			x	
Poland			x	x
Portugal			x	x
Slovakia			x	
Spain	x			
Sweden	x		x	
Switzerland			x	
UK			x	

Source: Scope Ratings, national covered bond frameworks, market practice

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