Covered Bond Outlook 2019: Stability for when the tide turns?

Positive economic momentum (if it lasts) and stable credit quality will once again position covered bonds as a growing asset class in 2019 and one of the most stable. Continued growth in house prices and upcoming covered bond maturities will support higher issuance volumes, although senior preferred debt might challenge covered bonds as an efficient funding instrument.

Supervisors have put macroprudential measures to work to avoid bubbles in the housing market, but they will take time to provide a lasting impact. And European covered bond harmonisation will finally become reality. While minimum credit quality will increase, national differences will persist and harmonisation will not mean high and stable credit quality for all. Scope expects ESG labelled covered bond issuance to gain further momentum. Issuers can use this emerging label to substitute lower ECB activity but increasing use will require more harmonisation.

Scope ratings expects real-money investors to return to covered bonds in 2019 reflecting higher spreads and less activity from the ECB. Issuers will need to issue as rising house prices will also translate into higher mortgage lending volumes. Finally, preparations for the post-TLTRO and CBPP3 period will also be supportive for further growth. After some years of stagnation, we expect the EUR 2.5trn. market to exhibit net growth in 2019.

Recourse to the cover pool will remain the least likely scenario investors will need to worry about, as stronger regulation and banks' bail-in-able debt levels will increase distance to regulatory intervention.

The European covered bond harmonisation, scheduled to pass the European Parliament in Q2 2019, will introduce common minimum standards and become an important pillar of the Capital Market Union. We expect the first covered bond transactions under the harmonised European legal framework template to appear at the end of 2019. Once the parliament has approved the consensus and principles-based EU covered bond directive, legislators can pull out the blueprints for requisite amendments. The parliamentary timelines of member countries will then determine which country will win the race to become the first fully-harmonised jurisdiction and which issuer will consequently issue the first 'premium' covered bond.

Knowledge around issuers' ability and willingness to maintain a well-groomed and low credit and market-risk cover pool continues to be of higher importance for achieving and maintaining high credit quality. Solely being a regulatory labelled premium covered bond will not guarantee highest credit quality. The less-pronounced focus on market and medium to long-term liquidity risks in the new directive will remain a decisive factor for achieving highest ratings – not asset credit risk which has been subject to heated debates.

High credit-quality covered bonds will provide investors with a pockets of stability – at a time when markets and credit quality might reach a turning point.

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Economic fundamentals remain supportive…

Scope expects continued growth among European economies in 2019 – even though moderation might occur over the year. Quantitative tightening is expected to take a while to appear in Europe.

In 2019, CBPP3, the covered bond component of the ECB's asset-purchase programmes, will continue to be a relevant factor for investors. By mid-November 2018 and close to its active phase, ECB covered bond holdings were already EUR 262bn, making the ECB the single largest investor in the asset class.

Investors to return in 2019 thanks to lower ECB purchases and higher spreads

From 2019 onwards, the ECB will no longer add to its stock and will just re-invest maturing covered bonds. But only re-investing will still result in more than EUR 20bn of ECB-driven demand. The previous ECB backstop will become less pronounced and issuers will need to provide more incentives, in particular higher premiums to investors to fully place their bonds. Helped by likely subtle interest-rate increases, covered bonds are likely to see positive spreads in 2019. As a result, real-money investors will slowly return to the asset class.

…stable and resilient banks support highest ratings for covereds

Covered bond ratings will remain firmly placed in the AAA category thanks to stable, even improving bank ratings (see Annex I for Scope's covered bond ratings). Scope expects downward rating adjustments mostly to reflect idiosyncratic events. Conduct risk (loose controls for money laundering, tax fraud) as well as ESG, in particular governance-related developments, might result in headline risk and, if sustained and structural, even prompt rating pressure for some banks.

With low interest rates, bank profitability will remain subdued, with banks only able to post high single-digit ROE in general. Operating expense will remain in focus but as with excess capacity will become increasingly difficult to address. Also, the ever-increasing regulation will continue to burden banks' cost bases.

Cover pool recourse remote due to regulation and stable bank ratings

Improved capitalisation and bail-in-able debt buffers coupled with a more pro-active regulation continue to stabilise issuer ratings and the sole recourse to the cover pool will remain the least likely scenario covered bond investors need to worry about.

Stable credit quality but more volatile spreads in 2019?

Despite the stable credit quality of covered bonds, debt capital markets will become more volatile and spreads could widen, in particular if geopolitical tensions further increase. Populist and nationally-focused strongman leaders – more than underlying economic developments – will move markets, and uncertainty will drive risk premia. Scope expects the stable credit profile of covered bonds will make them a preferred investment, in particular if the capital markets have to embrace negative headlines.

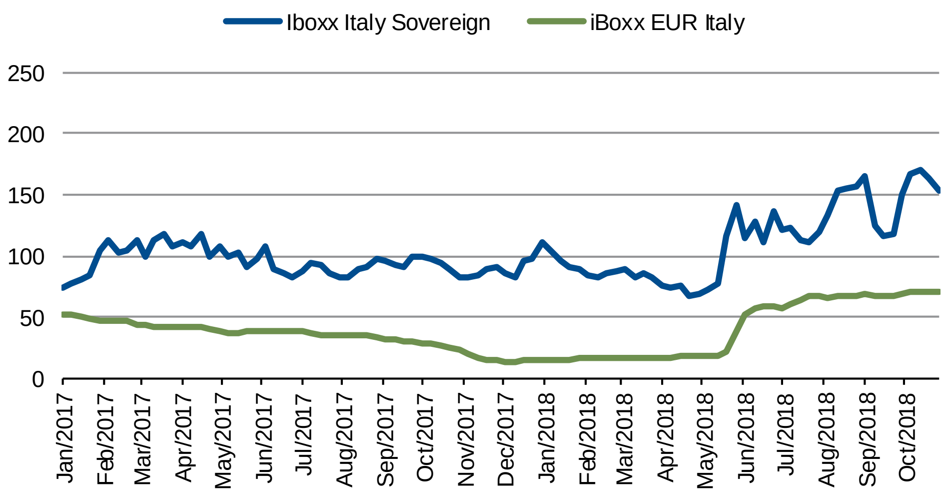
Covered bonds have repeatedly demonstrated their safe-haven status. Often, they are also the icebreaker for a market. 2018, for example, saw Greek covered bonds once again become ECB-eligible and new Greek covered issues were placed in public markets. At the same time, the Greek sovereign remained absent and will likely only test the public markets in 2019.

Covered bonds to provide funding when markets become more volatile

Covered bond funding remains less sensitive to the sovereign-bank nexus, where senior unsecured bank funding spreads are strongly influenced by sovereign spread developments. At times of rising economic uncertainty, covered bonds do not need to provide the same high premium as unsecured or sovereign debt. Figure 1 shows that such differences can be significantly exacerbated.

Italian covered bonds were not able to decouple from the sovereign widening seen in 2018. However, their volatility was less pronounced, and they have consistently traded below the sovereign. With banks' unsecured funding trading above the sovereign, covered bonds provide a clear funding advantage for banks – even if this only means more and cheaper repo funding.

Figure 1: Italian sovereign vs. covered bond spreads



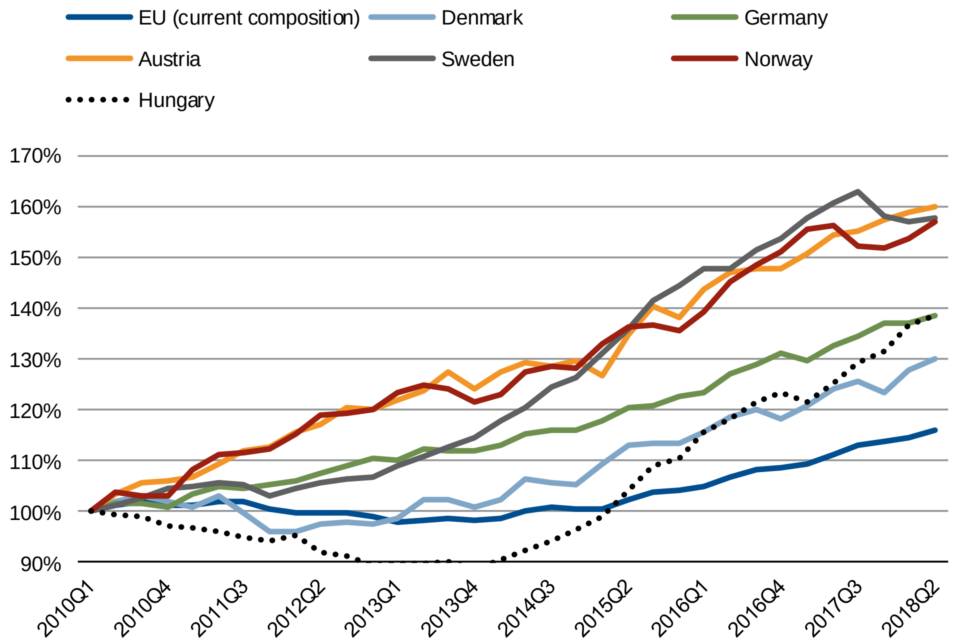
Source: Scope Ratings, Markit

Low rates and high affordability continue to push house prices to all-time highs

Since Mario Draghi's "whatever it takes" comment, interest rates have remained at ultra-low, even negative levels. While depressing bank profitability, low interest rates mean higher affordability for borrowers. Coupled with increasing consumer sentiment on the back of improving macroeconomic fundamentals, investment in housing has been one of the main beneficiaries. Not surprisingly, price indices (HPIs) across Europe continue to exhibit an upward trajectory (see figure 2).

Nominal HPIs in some European countries are already at elevated levels and there is growing scepticism around the sustainability of the trend. Scope does not expect volatility in house prices to become a major rating driver for covered bonds in themselves. In most instances, market and liquidity risks rather than cover pool-related credit risk are the major drivers for the rating, supporting over-collateralisation.

Figure 2: Selected HPI Developments in Europe (100=2010)



Source: Scope Ratings, Eurostat

..and also result in lower cover pool LTVs

As a side-effect of increasing HPIs, LTVs in European cover pools are trending down.. However, developments are not visible across the board. Reductions in the average cover pool LTV are mostly visible in countries where a regular indexation of the underlying mortgage collateral is stipulated in the legal framework1.

HPI developments with low potential to negatively impact ratings

Scope notes that low LTV thresholds from cover-asset eligibility criteria significantly limit the credit-risk contribution for the supporting over-collateralisation. Market-risk contributions are generally more relevant. Corrections and lower house prices are thus not expected to become are major factor in a covered bond's expected-loss calculation.

Stable banks credit and high affordability reduce relevance of credit – for the time being

Further, issuers are obliged to shield investors against negative house price developments. Regular collateral revaluation requirements mean that issuers need to increase or exchange collateral in case a mortgage loan or parts of the loan are no longer eligible for the cover pool. Last, covered bond credit risk only becomes relevant for covered bond investors upon the combination of the insolvency of the issuer and a borrower in default. The former becomes increasingly remote due to improved regulation and oversight, while the latter is addressed in sound underwriting criteria and additional, externally-imposed requirements.

Over-valuations create the potential for headline risk…

Scope expects the supportive environment to continue to fuel demand for financing. Coupled with higher house prices that need to be financed (= larger loan sizes) this environment results in higher refinancing needs which ultimately prompts banks to seek additional covered bond funding

[1] Banks need to revalue the collateral on a regular basis to maintain preferential risk weights for their mortgage loans; However, covered bond legislations often do not stipulate that market value updates are also used for the determination of the cover pool LTV. Some might contain 'at origination' market value LTV's or are based on prudent through-the cycle valuations. Average across-the-country LTV comparisons are therefore by definition skewed. Countries in which indexation is also used for the cover pool are the Scandinavian countries (Norway, Sweden, Denmark):

Headline risk from contained HPI corrections?

At the same time, headline risk, particularly in countries with already elevated house prices, cannot be ruled out. In major cities, there is some degree of over-exuberance and house price corrections can occur. However, it is often rather the norm than the exception that prices are more than 25-30% above sustainable levels (see Europe's residential real estate markets, 9. October 2018). In the absence of major macroeconomic changes, we expect HPI corrections to remain locally contained. Real supply-demand imbalances are more often drivers of HPI increases, whereas larger pockets of speculative investments are not yet present.

… while regulators have started to sharpen their toolkits

The bursting of the US sub-prime market a decade ago triggered the global financial crisis. With the memory still fresh in the mind, regulators, supervisors are now more closely monitoring mortgage markets as well as banks' underwriting standards. With financial stability in mind, they can use micro and macroprudential toolkits to suppress excesses up-front. We see it as a positive that most European supervisors have already implemented, are discussing or can at least introduce such measures to moderate growth in lending and ultimately mortgage markets.

Scandinavian regulators most actively using macroprudential measures

Countries that have seen the highest increase in house prices (among others Norway and Sweden) are also those that have used the toolkit most intensively[2]. Currently the most common measures are caps to the initial LTV when the loan is granted. However, this measure only partially addresses the risk of high leverage.

Scope views positively that there is increasingly a shift towards affordability measures that address a borrower's current and stressed ability to service debt. In the end, recoveries only become relevant if borrowers are no longer able to regularly service their debt.

Figure 3: Most common, covered bond related macroprudential measures

Type of Measure	No of countries	most common measure
loan-to-value restriction	19	Max. LTV between 80 - 90%; 85% most common
Debt-to income	13	no common threshold
Loan maturity	6	typically max 30 years
Loan amortisation	4	either LTV or DTI driven

Scope Ratings, ESRB

However, it is also noted, that a substantial share of mortgage loans in Sweden, Norway or Denmark are interest only loans or feature a redraw-able loan balance. Even though this was addressed by regulators limiting such loans based on the respective outstanding LTV, it exposed the loans to severe drops in property values triggering repayments and stressing affordability. Further, the variable nature of mortgage loans in the Nordics stresses affordability in a rising interest rate scenario.

Borrower default risk currently very contained

Scope currently views borrowers' likelihood to default in European cover pools at very low levels. European economies are either stable or improving and unemployment levels are trending down; some are even at all-time lows. Sound credit performance also reflects the persistent low interest rates that support high loan affordability across Europe.

[2] European systemic risk boards overview: https://www.esrb.europa.eu/national_policy/shared/pdf/overview_macroprudential_measures.xlsx

Macroprudential measures will take time to become effective

Lasting impact of macroprudential measures takes time

Macroprudential measures generally only apply to newly-underwritten loans. It might five years before such measures can have a material impact on the credit metrics in a mortgage book and in particular for cover pools..

As such regulators, should not be complacent. In particular, in countries where regulators only observe and have not yet implemented measures we would expect them to act now to avoid downward spirals observed during the last crisis repeating themselves.

Covered bonds not always the most efficient bank funding – but needed?

Covered bond funding might soon see competition emerging. Bank treasuries increasingly look to senior preferred funding when trying to optimise funding costs. Given the shorter maturities, senior preferred might be the instrument of choice when banks are looking to lengthen their funding profile or exchange TLTRO funding,

Italian banks – with about EUR240bn – have been the most avid TLTRO users followed by Spanish banks that took about EUR170bn. There is a high likelihood that the ECB will introduce another TLTRO. However, it will likely not provide banks with the same favourable funding costs. Also, we believe regulators will start encouraging banks to revert to market-based funding to wane them off the unsustainable cheap and easily available funding.

Better economics from senior preferred than covered bonds?

Covered bonds remain banks' most cost-efficient funding instrument and would be the natural choice to preserve favourable funding costs. However, senior preferred bonds might increasingly come into focus. Since the split of unsecured bank funding into bail-in-able senior non-preferred and senior-preferred, the latter has emerged as an additional and cost-efficient funding instrument. While spread volatility has not been tested during a crisis, senior preferred ranks between covered bonds and senior non-preferred. With higher spreads and ranking almost as high as covered bonds upon regulatory intervention, we see a strong competitor emerging. Without encumbering additional assets and no dedicated management needed, the all-in maintenance costs for both instruments could even flip in favour of senior preferred.

2019 the year of the European covered bond harmonisation

For the Chinese, 2019 is the Year of the Pig and marks the end of their 12-year zodiac. For covered bond aficionados, 2019 will be the year of the European Covered Bond Directive and a process almost as long will come to an end.

On 20 November 2018, the proposal passed the European Parliament's ECON committee[3] and the path is now cleared for the remaining trialogue and the final vote in the European parliament (expected mid-April 2019). As soon as published in the official gazette, the race will start to see which country and which issuer will be the first to issue under the new template and whether it will be a "European Premium covered bond"[4].

As the process has been lengthy, we expect the well-established core markets will be in pole position for 2019 issuance. Amendments to existing frameworks are often pure formalities and will only hinge on finding a slot in the legislative agenda. In other countries, more material discussion between impacted parties will need to take place. As

[3] We still expect clarity on final wording of the asset definitions in Article 6 and the 'homogeneity' requirements in article 10. Further, whether or not European Secured Notes receive legislative backing and regulatory support will be revisited within the next two years. None of the pending changes are expected to have direct rating implications

[4] The current draft of the Directive envisions a distinction between fully-compliant covered bonds, currently labelled European premium covered bonds or EPCBs or European Standard covered bonds. In line with the current CRR and only UCITS-compliant covered bonds (the latter mainly ship, and aircraft covered bonds) the distinction will prompt a different regulatory treatment

such, some countries might translate the directive just before the transition window closes.

Spain might need the longest transition period

For Spanish issuers, uncertainty on a new framework[5] and how to get there will likely persist longest. Wording around grandfathering and the transition to the new status quo will be important. If not adequately addressed, issuers might end up in an oxygen tent if they have to manage the new covered bonds under two regimes.

In Spain investor recourse to the full mortgage book might cease in favour of a more clearly defined cover pool – which only will have recourse to the assets registered therein and will need to become more actively managed than before.

Without adequately-phrased grandfathering language, investors might also become challenged. They might need to identify on a bond-by-bond basis whether it is a new or a legacy covered bond. If the transition wording does not clearly address the different ringfencing (and despite ranking pari-passu), ratings might in a worst case become floored at the lower of the two.

Guidance on interpretation will counter fragmentation

To avoid a loosening of the Directive's principles during the national translation, Scope believes that the upcoming Trialogue[6] should task the Commission, and respectively the EBA, to provide more affirmative guidance on the interpretation of key terms, the implications of failing to meet certain conditions and clear timelines and guidelines on the transition between old and grandfathered and new covered bonds issued under the Directive. Limited details could undermine some of the potential harmonisation benefits.

National translation as test bed for the cohesiveness of stakeholders?

Domestic stakeholders should find a common understanding on the best translation

The translation of the directive might shed more light on the cohesiveness of domestic stakeholders – an important element in the agencies' assessment of fundamental support factors and a covered bonds credit quality. In several countries the frameworks have not been touched since their inception and co-operation between stakeholders has been rather loose since.

National 'finish' will allow for structural improvements

The European Covered Bond Council (ECBC) has been instrumental in aligning the different views within the industry at a European level. As the directive is principles-based, it will now rest with national stakeholders to reveal whether they will simply translate the directive or introduce a specific national finish. As the directive establishes minimum standards, such differences will only enhance the quality of covered bonds.

Scope will closely monitor the interaction between issuers, authorities and investors to identify whether the primarily issuer-driven co-operation within the ECBC also finds consensus with domestic authorities (the respective ministries, regulators and supervisors) and of course investors.

Based on our understanding of the directive, we do not expect changes to our current framework classifications. Minimum legal requirements will only become more clearly defined and we strongly welcome the more explicit supervision requirements imposed by the directive. However, the national translation could eventually prompt a positive re-assessment of the country-specific elements in Scope Ratings' resolution regime and systemic importance assessment.

[5] Spanish stakeholders are tasked with coming up with a better-defined cover pool. They need to introduce ongoing monitoring of asset-eligibility compliance including the update of LTVs, establish cover pool-specific liquidity and risk monitoring. Changes have to visibly improve the credit quality to counter investors' concerns over lower protection. Investors will be deprived from recourse to the whole mortgage book and will experience a significant lowering of minimum over-collateralisation. From 25% for Cedulas Hipotecarias/ 43% for Cedulas Territoriales to the 2%-5% nominal OC stipulated in the directive.

[6] Trialogue refers to the meetings between the European Commission, the European Parliament, and the Council of the EU.

No impact on framework assessment but stronger cohesiveness might increase downgrade buffer.

At the same time, we do not expect rating changes. All covered bonds rated by Scope (see Appendix for our current coverage) are rated AAA. A positive re-assessment will only provide an additional rating buffer against a potential downgrade of the issuer.

Growing ESG issuance will prompt more harmonisation ?

Scope anticipates further ESG issuance in 2019. Existing countries will see more widespread usage while new countries are lining up (i.e. France, Finland). In addition, Luxembourg might see the first issuance under a dedicated ESG covered bond framework (*Lettre de Gage Verte*), introduced in 2018.

ESG covered bonds will grow further in 2019

With the ECB backstop waning, we expect ESG-type covered bonds to become a useful instrument for issuers to attract additional and often less price-sensitive investors. Scope notes that due to the lack of more widespread offerings, some ESG investors simply siphon off available bonds to fulfil their investment quotas.

The covered bond asset class has been among the first to embrace environmental, social and governance (ESG) labelled covered bonds with the first-ever ESG-labelled covered bond dating back to 2015 (Germany's Münchner Hyp).

Since then, ESG has gained strong traction among issuer and investors (AUM dedicated to impact investing will have grown to more than USD 1.7 trillion by year-end 2018). Also politicians and regulators are strongly interested in further institutionalising sustainable and green financing.

2018 as turning point for ESG covered bonds?

In previous years, annual ESG-type covered bond issuance has been a trickle with one or two issues a year but 2018 marked a turning point. A total of 10 ESG-type covered bonds were offered to investors andwere well received. Momentum is picking up.

With Norway (DNB and Sparebank 1 Boligkreditt), Sweden (Landshypotek) as well as Korea (Korea Housing Finance Corporation), three new countries were placed on the ESG covered-bond map. At the same time, German issuers have become the most active, with issuers returning (Berlin Hyp, Münchner Hyp and Deutsche Hyp) or new ones starting with inaugural green or social covered bonds (e.g. LBBW and DKB).

Scope notes a strong divergence on what constitutes ESG. There is no possibility to assess different levels of greenness, sustainability or social benefits and increasingly investors want to have 'greenwashing' to become addressed. Scope views positively that co-operation and standardisation now gains traction.

Low relevance of ESG factors for credit – will this change?

To-date, the ESG impact on credit risk has not been a driving rating factor. Generally, more diverse funding is beneficial for banks, but the incremental improvement is not likely to become a rating driver. Similarly, a credit-positive impact of ESG is difficult to establish for covered bonds. ESG is one of many factors that impacts the likelihood of default or drives recovery proceeds.

We view positively the fact that the mortgage and covered bond industry has embarked early on to establish evidence on a potential lower credit risk for ESG type financings. Under the umbrella of the Energy Efficient Mortgages Initiative[7], the EeMAP and EeDaPP initiatives aim to provide evidence that energy-efficient investments can effectively lower a borrower's likelihood of default and a more energy-efficient building can provide higher recoveries.

Information is scarce and taxonomies diverge among issuers and countries. As such, it might take a while to establish tangible and robust evidence for lower credit risk. Some studies even suggest that while the above relationship holds true during benign times,

[7] http://eemap.energyefficientmortgages.eu/ ; EeMAP - Energy Efficient Mortgages Action Plan; EeDaPP - Energy efficiency Data Portal & Protocol

during a downturn the willingness and ability to pay up for a more efficient building reduces more significantly and market value declines during a downturn are more pronounced for energy-efficient buildings.

Focused ESG programmes the way forward

Scope ratings highlights that to-date, there are no dedicated ESG covered bond programmes. Only individual issues have emerged, with use-of-proceeds pledges attached. With such ESG bonds ranking pari passu with remaining covered bonds, any potential credit benefit becomes co-mingled.

To establish a clear and visible distinction and allow a better relative ESG ranking, setting up dedicated and stand-alone ESG covered bonds programmes would be beneficial. From a credit perspective, a dedicated programme would allow issuers to better demonstrate the potentially different credit performance.

Covered bonds as a high credit-quality funding instrument are able to provide sustainable and energy-efficient financings needed to achieve the European Commission's sustainability and energy-efficiency goals. As such, ESG issuance is poised to further grow. To avoid fragmentation, Scope believes that more standardisation is needed. Hopefully stakeholders can fast-forward developments so that European ESG harmonisation will not take the same two decades the covered bonds needed to become a Europe-wide high credit quality and comparable instrument, well received by investors.

Appendix I: Public covered bond ratings

Country	Covered bond issuer (or parent)	Issuer rating (Long term/ Outlook)	Covered bond programme/ Covered bond type	Primary collateral type	CB Rating (Long term/ Outlook)
Austria	Bausparkasse Wüstenrot AG	N/D	Hypothekenpfandbriefe	Mortgages	AAA/ Stable
	Hypo-Bank Burgenland AG	N/D	Hypothekenpfandbriefe	Mortgages	AAA/ Stable
Denmark	Danske Bank A/S	A+/ Negative	Pool C – SDO	Mortgages	AAA/ Stable
			Pool D – SDO		AAA/ Stable
			Pool I – SDO		AAA/ Stable
	Realkredit Danmark A/S	A+/ Negative	Capital Centre S - SDRO	Mortgages	AAA/ Stable
			Capital Centre T - SDRO		AAA/ Stable
France	BNP Paribas SA	AA-/ Stable	BNP Paribas Home Loan SFH (Obligation d'habitat)	Mortgages	AAA/ Stable
			BNP Paribas Public Sector SCF (Obligation foncières)	Public Sector	AAA/ Stable
	BPCE SA	AA-/ Stable	BPCE SFH (Obligation d'habitat)	Mortgages	AAA/ Stable
	Crédit Foncier de France	AA-/ Stable	Compagnie de Financement Foncier SA (Obligation foncières)	Mixed	AAA/ Stable
	Credit Agricole SA	AA-/ Stable	Credit Agricole Home Loan SFH (Obligation d'habitat)	Mortgages	AAA/ Stable
			Credit Agricole Public Sector SCF (Obligation foncières)	Public Sector	AAA/ Stable
	Societe Generale SA	A+/ Stable	Société Générale SFH (Obligation d'habitat)	Mortgages	AAA/ Stable
			Société Générale SCF (Obligation foncières)	Public Sector	AAA/ Stable
Germany	Commerzbank AG	A/ Stable	Öffentliche Pfandbriefe	Public Sector	AAA/ Stable
			Hypothekenpfandbriefe	Mortgages	AAA/ Stable
Norway	Landkreditt Bank AS	A-/ Stable	Landkreditt Boligkreditt AS Obligasjoner med fortrinnsrett	Mortgages	AAA/ Stable
	Totens Sparebanken AS	A-/ Stable	Totens Sparebanken Boligkreditt AS Obligasjoner med fortrinnsrett	Mortgages	AAA/ Stable
Spain	Banco Santander SA	AA-/ Stable	Cédulas Hipotecarias	Mortgages	AAA/ Stable
			Cédulas Territoriales	Public Sector	AAA/ Stable
	Bankia SA	BBB+/ Stable	Cédulas Hipotecarias	Mortgages	AAA/ Stable
	BBVA SA	A+/ Stable	Cédulas Hipotecarias	Mortgages	AAA/ Stable
			Cédulas Territoriales	Public Sector	AAA/ Stable
Sweden	Nordea Bank AB	AA-/ Stable	Nordea Hypotek AB/ Säkerställda obligationer	Swedish Mortgages	AAA/ Stable
	Svenska Handelsbanken AB	A+/ Stable	Stadshypotek AB/ Säkerställda obligationer	Swedish Mortgages	AAA/ Stable
			Stadshypotek AB/ Säkerställda obligationer	Norwegian Mortgages	AAA/ Stable
	Swedbank AB	A/ Stable	Swedbank Mortgage AB/ Säkerställda obligationer	Swedish Mortgages	AAA/ Stable

All ratings as of 27 Nov. 2018

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