2021 European Covered Bond Outlook

Covid-19 as a stress test? What stress test?

Covered Bond, Scope Ratings GmbH, 13 January 2021

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| Bloomberg: RESP SCOP

Executive summary

The credit quality of covered bonds in 2021 will remain as benign as it was in 2020, as the ECB's low interest rates and generous support measures will continue to provide an effective vaccine for the credit quality of issuers. Creeping insolvencies and rising unemployment could weaken the second line of defence of cover pools – the credit quality of borrowers in underlying cover pools – though this will have little impact.

Most covered bond issuers entered the crisis adequately capitalised so can absorb modelled or real impairments, enabling them to purge defaulted loans from cover pools. Except for some pockets of commercial real estate, foreclosures will only result in a timing delay. Potentially higher foreclosures will still allow for full recovery thanks to ongoing bullish residential real estate markets. As such, market risk rather than credit risk will remain the main driver of the protection issuers need to put in to support and maintain highest credit quality.

Real-money investors in covered bonds are getting used to being sidelined. Extended central bank liquidity remains a cheaper funding option for most issuers; and covered bond supply will to a large extent end up with the ECB. The ECB, both directly (via purchase programmes) and indirectly (via repo and TLTRO collateral), is sitting on EUR 900bn of covered bonds. As such, it is the ECB rather than covered bond issuers that needs to be watched for signs of market disruptions.

Covered bonds in 2021 will remain attractive only for those that must invest (i.e. bank treasuries) or which lack alternatives. Covereds will remain attractive for these buyers as they can offer slightly less negative yields than other high liquid and high credit quality investments. Other investors will be weaned off covered bonds and be attracted only by the potential for spread tightening across all jurisidictions. The current situation calls into question the long-term attractiveness of covered bonds for investors.

As they fall off the radar for traditional investors, one key theme is how to keep covered bonds attractive in the medium term. ESG is one answer. The number of issuers participating or ramping up their ESG capabilities is set to further increase.

Scope remains constructive on ESG covered bonds as mortgage collateral is well suited to provide the backbone for green or social investments. However, industry and bank specific efforts to provide more data on the ESG impact on credit quality is not yet sufficiently robust – mostly because of the benign environment and the lack of consistent reporting.

Hopes that the EU taxonomy will provide consistency and nurture the tender shoots might prove to be wide of the mark, however. Current European proposals with a focus on EPC A graded collateral could undermine the potential for increasing green covered bonds.

The benefits of EU covered bond harmonisation are not expected to become a relevant factor – yet. Covid will likely push implementation beyond the July 2021 deadline. Only at the end of the grandfathering period in 2022 will the Capital Markets Union become a reality for covered bonds.

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Key trends for 2021

Covered bond credit quality will remain well shielded throughout 2021. Rating actions will reflect idiosyncratic issuer events such as the impact of mergers rather than widespread Covid contagion.

Credit quality themes for covered bonds in 2021 will focus on how swiftly individual countries and covered bond issuers are able to emerge from the Covid crisis. With diverging recovery speeds in 2021, shakeouts for some pockets of risk in commercial real estate or rising unemployment rates will have to be carefully monitored.

As well regulatory and supervisory developments, including the impact of covered bond harmonisation for cross-border investments, the impact of the EU taxonomy on green covered bonds and expectations by the ECB on what constitutes an “eligible” covered bond.

Covid-19: a sovereign issue?

2020 saw the sharpest global economic contraction since the end of World War II, with global contraction estimated at about 4.0% and 9.0% for the Euro Area. We expect the tide to turn in 2021, when the recovery will become firmer. Uncertainties will persist in the first half; in the second half of 2021 the vaccine effect will render the recovery more sustainable. Scope does not expect full economic normalisation before 2022. For further information see our sovereign Outlook 2021.

Both global and European GDP growth are projected to pick up to reach around 5.5% for 2021. The 2020 recession will likely leave its mark, however. The shake-out in some corporate segments will lead to rising unemployment, triggering an expected increase of 1% for 2020/21 for most of the Euro Area.

While unemployment might only rise in Germany from 3% in 2019 to about 5% in 2021 the impact will differ because other countries are starting from a higher base. In Spain for example, we expect unemployment to increase to 18% in 2021 from about 14% in 2019.

Bold measures to fight Covid-19 remain key to avoiding a stronger depression. To-date, sovereigns have borne the brunt of financing lockdowns. As a result, debt-to-GDP ratios will skyrocket to 100% in 2020 from 84% for the Euro Area. While the lower-for-longer interest-rate environment will facilitate the financing of this debt burden, over the medium-term, consolidating public finances will be a significant challenge, particularly for sovereigns with low growth potential.

Rating stability for Euro Area sovereigns will hinge on budget consolidation on the back of economic growth over the next few years.

For now, higher debt levels are sustainable thanks to the low interest-rate environment and accommodative monetary policy. Most Euro Area sovereigns can refinance at lower rates than pre crisis; many at negative rates.

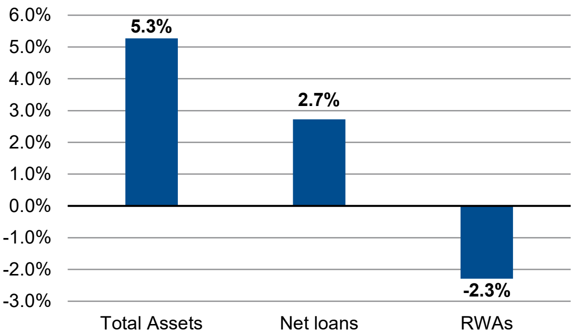
Scope’s through-the-cycle rating approach will anchor its rating actions in 2021. For the Euro Area, Scope entered 2021 with Negative Outlooks on Belgium (AA), Spain (A-), Italy (BBB+) and Slovakia (A+); Positive Outlooks on Ireland (A+), Lithuania (A-) and Greece (BB); and Stable Outlooks on all other sovereigns. Sovereign rating actions in 2021 will depend on the impact of the crisis and expected speed of recovery; the efficacy of monetary and fiscal policy responses; and sovereign credit profiles at a given rating level as the global economy enters a new recovery phase.

Covid-19: a banking issue?

The Covid crisis is the banking sector’s first real-life stress test since the GFC. Despite deep damage to the economy, we see no signs yet of a banking crisis. This is partly the result of a bold fiscal policy response, including public-sector support to households and companies, generous furloughs and tax breaks. A material relaxation of accounting and solvency requirements provided banks and their clients with additional breathing room.

Banks entered the crisis with strong financial fundamentals, which played a paramount role in avoiding a credit crunch that would otherwise exacerbate the initial output shock of the lockdowns. At the end of September 2020, European banks’ balance sheets were 5.3% larger than a year earlier, bloated by TLTRO liquidity and central bank asset purchases. Loan growth was there too, though RWAs were down at most lenders. This was in large part due to the lower risk-weight of lending under public guarantee schemes.

Figure 1: Banks have kept the taps open in 2020 (% growth 9M 2020 vs 9M 2019)



Source: SNL, Scope ratings

Note: Sample of top 50 European banks by total assets

Note: Italy and Spain’s total loans to NFC figures as of June 2020

Public support measures are expected to taper in 2021, leading to a belated increase in non-performing loans. How banks navigate the Covid recession and its aftermath will shed light on whether the new regulations were successful in ensuring that the sector has turned from a source of financial instability into a stabilising factor at a time of high macroeconomic volatility. For further information on our views of the banking sector for 2021 see our 2021 Banking Outlook.

Covid-19: a covered bond issue?

It is too early to draw conclusions on the longer-term impact of the pandemic on bank and cover-pool asset quality. To date, the pandemic is a non-event for credit, and we do not expect it to become one in the 2021.

With regard to the security packages in cover pools (primarily residential mortgages), we see more bright than dark spots across Europe. Despite rising house prices, the low-rate environment remains one of the strongest support factors for the affordability of mortgage loans – even more so for the attractiveness of housing investments.

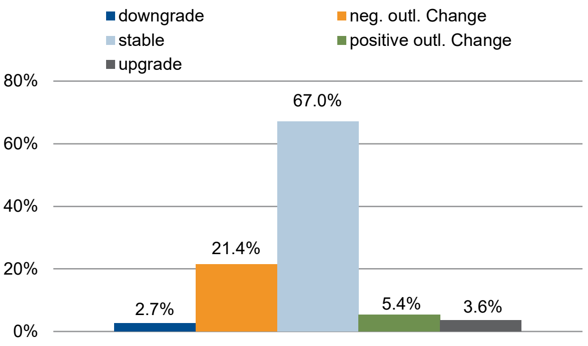
A wide majority of European mortgage markets remains tied to floating rates. In these countries, borrowers have already strongly benefited from the downward adjustment of rates, while switches from longer-term fixings at fixed rates are becoming more of a trend. Residential house prices have remained agnostic when it comes to the pandemic. Apart from lower transaction volumes, growth trends remain untarnished.

Deconstructing covered bond ratings 1: issuer ratings

The capital, liquidity and asset-quality metrics of many banks still look healthy – even better today than at the start of the pandemic. Rather than being seen as pariahs, the banking sector has received significant support from supervisors, central banks and politicians. We did not observe any shakeouts or failed banks in 2020; nor do we expect any structural problems in the banking sector that were not already on the radar.

Within Scope's coverage – which spans more than 100 European banks – we made less than a handful of rating downgrades and around 24 negative outlook changes. Negative rating changes were not generally driven by Covid but by pre-existing financial health issues e.g. an unsustainably low level of pre-provision profitability, still-high levels of NPLs or high risk concentrations, including to domestic sovereign debt. Most ratings (two thirds) remained stable. On the positive side, 10 ratings saw positive adjustments and there were some limited upgrades.

Figure 2: Bank rating changes 2020

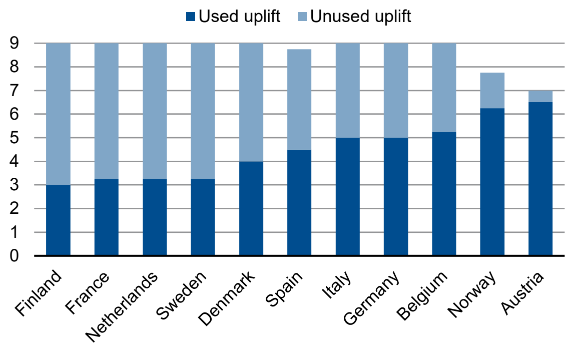


Source: Scope Ratings

Deconstructing covered bond ratings 2: fundamental credit support

Unchanged and mainly strong issuer ratings in our covered bond ratings coverage means that most covered bond programmes have recourse to unused notches of support. On average, four notches of buffer mean that covered bonds will not directly be impacted in case bank ratings start to migrate downwards.

Figure 3: Covered bond ratings well protected against issuer downgrades



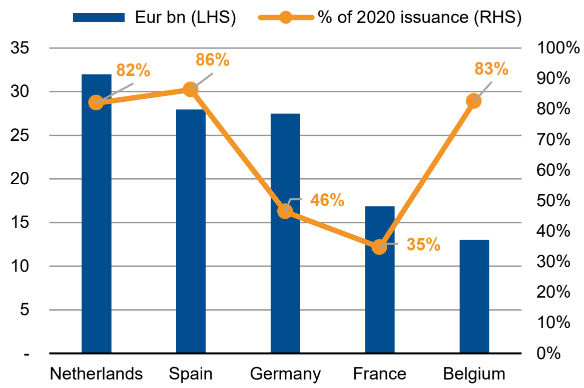
Source: Scope Ratings

With the EU covered bond harmonisation still in its implementation phase (see below) it is not surprising that we did not see changes to the support granted by legal frameworks in 2020. Similarly, implementation is not expected to impact the supplementary support provided by the resolution regime and assessment of systemic importance.

Dutch covered bond issuance took pole position, taking advantage of low-cost funding

Euro Area banks alone drew roughly EUR 1.5trn from the TLTRO auctions of June and September. With covered bonds as the preferred collateral used by banks tapping into the TLTRO, it is not unimpeded access to market funding that has corroborated strong stakeholder support but the ability to use covered bonds to generated low-cost central bank funding.

Figure 4: 2020 issuance highest in The Netherlands – mostly retained



Source: Refinitiv, Scope Ratings

TLTRO-targeted issuance in 2020 meant that the usual pecking order in terms of annual issuance volumes have changed. For the first time ever, Dutch covered bond issuance took pole position – clearly pushed by an 82% share of retained issuance (ABN AMRO alone amassed approx. EUR 18bn, followed by ING EUR 9bn and Rabobank EUR 5bn).

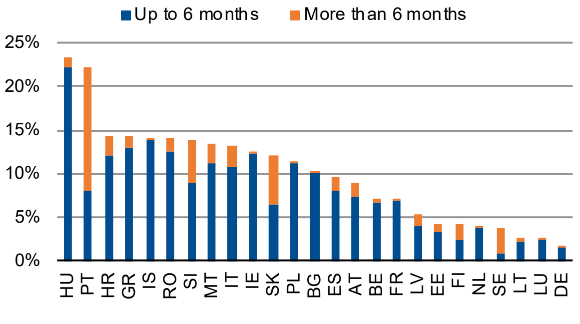
Spanish banks have been absent from these issuer league tables for quite a while and only the staggering 86% share of retained issuance pushed volumes up. The grandfathering of existing issues also played a part, as Spanish covered bond harmonisation will likely be the most complex and take most time to implement. Grandfathered covered bonds will mean that Spanish banks cannot only use them for retained issuance. With more than two thirds of issues going well beyond the three-year TLTRO horizon, they can also be re-used for market placed funding – in case transition to the new European covered bond framework takes longer.

The only permanent residents in the top five countries are German and French issuers – with German issuance for the first time also boosted by retained covered bonds.

Deconstructing covered bond ratings 3: Cover pool support – credit quality remains untarnished

From the onset of the crisis, all eyes have been on cover pools as payment holidays were the preferred tool of choice to support borrowers' debt affordability. According to EBA data, loan moratoriums accounted for over 20% of loans in Cyprus, Hungary, and Portugal and over 10% of loans in Italy, Greece, and Ireland.

Figure 5: Loans to HHs and NFCs granted moratoriums as a percentage of total loans to HHs and NFCs by country – June 2020



Source: EBA, Scope Ratings

Initially, only EBA numbers could be used as a proxy for what is happening on the covered bond side, but we also now observe increasing transparency as part of regular Harmonised Transparency Template (HTT) reporting. Covered bond issuers have started to provide cover-pool-specific disclosures on impacted borrowers. While we applaud this voluntary transparency, we do not believe this is a valid representation or a very sound basis for credit-quality comparisons of cover pools.

The static numbers will not provide guidance on how active cover pools are being managed. Some issuers might proactively remove such borrowers – just to have a 'clean' cover pool whereas others will top up their pools with additional collateral.

As long as EBA guidance persists that loans under moratorium do not qualify as defaulted and can still count as eligible collateral it is more the active management that is important to assess the development in credit metrices. In any case, low interest rates mean that affordability remains high. Borrowers have often used moratoriums opportunistically to preserve cash (see below).

With strong banks able to replenish when needed (or wanted) it is the development of unemployment rates that need to be watched. In combination with social safety nets, this will be a proxy to assess potential credit quality developments, in particular a borrower's likelihood to default.

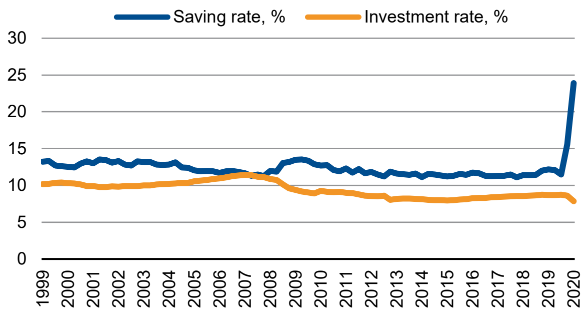
Record high savings – further pushing real estate demand, maintaining high recoveries?

With the first coronavirus wave, expectations rose that property prices would correct, even slump after record highs. House prices had been accelerating for a decade, fed by the ultra-low interest rate environment. It appears that the pandemic may not have impacted property prices. On the contrary; growth is persisting in almost all of Europe (see: European house prices hinge on managing support measures as growth moderates).

With regional and/or countrywide lockdowns, retail and hospitality closures and curfews, private consumption has been significantly hit. This hit the EU household investment rate; defined as gross investment (mainly dwellings) divided by gross disposable income. As of Q2 2020, the rate fell by 10% year over year. This underpins a decline in housing demand. But property prices have remained constant or have even grown, as supply also fell as a consequence of the pandemic.

Even more striking: the average savings rate of EU households almost doubled and have reached 23.9% which is an all-time high since the data was compiled in 1999. On average, savings were always around 30% higher compared to household investments. Nowadays they are three times the level of investments.

Figure 6: EU saving and investment rate



Source: Eurostat, Scope Ratings

The increase in saving rates is not uniformly distributed among EU states, however. Countries hit most during the first wave of the pandemic on average also show a higher increase in savings.

The UK has the highest increase in saving rates – up 330% compared to 2019 figures. The UK was and remains to be hit strongly by the virus and corresponding government measures, but savings may also have been a consequence of growing uncertainties around the likelihood of a "no deal Brexit". Spain follows next, with growth of 260%, underpinned by the severe and long-lasting lockdowns in the country.

Figure 7: EU saving rate growth (compared to 2019)

Source: Eurostat, Scope Ratings

Only Sweden has broken ranks. Sweden is the only country in the EU that shows a lower savings rate (and consequently higher consumption) compared to the pre-corona situation. The reason is clear: Sweden has been following a different method to face the pandemic and decided not to lock down its economy. Savings may have dropped during the third quarter 2020 but are expected to increase again in the fourth quarter of 2020 with new or extended lock downs all over Europe. Even Sweden toughened up restrictions from November as coronavirus cases rose. Issuance activity has been heavily impacted by central bank actions

Initially, programmes were only expected to last only a few months in most countries, but several countries such as Italy and Portugal have extended them.

Increased savings means that spending will likely return in 2021 when restrictions can be loosened following vaccination. It will not only stimulate postponed consumption in consumer goods, travel, or other services; it will also increase investments. Especially as households with above-average income were able to increase savings. For these, it is most likely that additional savings will be used for asset accumulation.

Consequently, demand in real estate will likely remain high as investment alternatives are limited in light of the ultra-low interest rates which will most likely remain.

Even when unemployment and ultimately default rates for mortgage loans start rising, recovery of defaulted loans will likely remain high and will ultimately not impair the expected loss stemming from the credit quality of cover pools.

Deconstructing covered bond ratings 4: Cover pool support – changes to market risk on average neutral; retained issuance to be watched

With credit quality historically and even now a lesser concern, the question is whether the risk structure within cover pools has significantly changed over the year.

On average, we did not observe higher risk profiles in 2020 compared to previous years. Typically, more than three-quarters of the rating supporting over-collateralisation (OC) are needed to mitigate this risk component making it the predominant risk and protection driver.

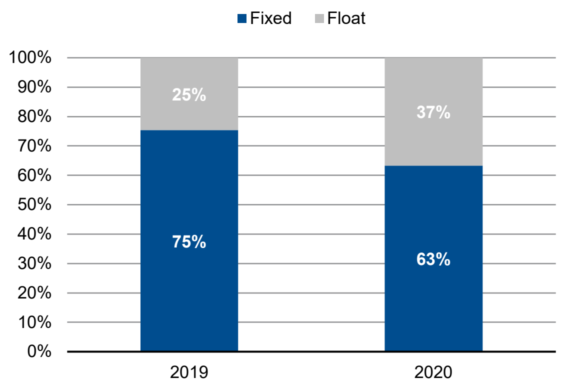
On average, risks remained broadly unchanged. On a pool specific basis, it is mostly levels of retained issuance that can drive changes in risk and consequently changes to the rating supporting OC.

We observe that origination patterns for the terms and conditions of new mortgage loans have remained relatively stable. The only observable tendencies are increasing longer-term and fixed-rate mortgages, increasingly in floating-rate countries.

More movements were observable for covered bonds issued in 2020. The impact of retained issuance is clearly visible. This is not surprising as for collateral efficiency with the ECB, floating-rate and shorter tenors are the preferred choice for issuers.

Indeed, floating-rate issuance increased significantly to 37% in 2020 from 25% in 2020. Looking just at retained issuance, the fixed/floating split was almost equal.

Figure 8: Retained issuance pushes share of floating-rate covered bonds to new highs

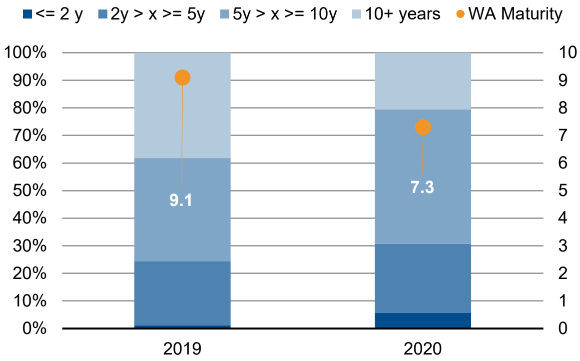


Source: Refinitiv, Scope Ratings

The ECB focus also becomes visible when looking at average issue tenors: overall, they dropped to 7.3 years in 2020 from 9.1 years in 2019.

The tenor of market funding was almost unchanged (8.1 years in 2020 vs 8.3 years in 2019). But tenors for retained issuance clearly show the focus on efficiency, as they almost halved to only 6.8 years in 2020 from an average of about 12 years in 2019.

Figure 9: Retained issuance also results in more short-dated issuance



Source: Refinitiv, Scope Ratings

However, the significant swings again highlight the management discretion issuers have to change the risk and protection structure of a covered bond. For floating-rate mortgage markets, higher shares of floating-rate covered bond issuance can be credit-positive as it can improve resilience to interest-rate changes.

This does not hold true for traditional fixed-rate mortgage markets or markets where re-fixing tenors are increasing. Here, sensitivities to rising interest rates, as unlikely as they currently seem, will require greater protection. Generally, investors remain well insulated against market risks as available protection (OC) remains well above levels needed to support ratings.

ECB – the EUR 900bn whale

Changes to the ECB's collateral policies can disrupt the covered bond market more than any other single activity by industry bodies or regulators. It reflects the fact that by the end of 2020, the ECB had access – directly or indirectly – to holdings of EUR 900bn, more than one third of the global market.

The ECB holds approximately EUR 610bn in covered bonds as collateral for banks' standard liquidity measures as well as for TLTROs. The three purchase programmes have led to holdings of more than EUR 290bn. With TLTRO collateral tied up for the next three years and CBBP holdings 'until further notice', this means that liquidity in the covered bond market has significantly dried up as a result.

Even though it can typically be tendered with the central bank, limited liquidity could trigger a review of whether covered bonds are really a highly liquid instrument and whether its high HQLA value for LCR purposes is warranted.

Investors will continue to have a hard time investing in covered bonds. With expectations of EUR 90bn-EUR 110bn of benchmark issuance in 2021, CBPP maturities of EUR 30bn (that the ECB will reinvest) also means that price discovery will heavily be skewed by ECB activities. Spread differentials for covered bonds will, again, not reflect differences in credit but rather whether bonds are eligible for the ECB or not.

To that extent, changes to the ECB's collateral framework – regarding both the CBPP and standard monetary operations – must be closely watched as they have the potential not just to shape but also ripple the market.

The ECB already has started to shape the market to its liking. Since 1 January 2021, structured covered bonds that do not benefit from a supporting framework (such as Deutsche Bank or Credit Suisse covered bonds) have already have fallen off the cliff as no longer counting as eligible collateral with the ECB.

The ECB has repeatedly expressed its preference for plain vanilla, bullet, and legislation-based covered bonds. With the ECB harmonisation train rolling, we do not think the ECB will be able to stem the tide of soft-bullet covered bonds.

This might be different for conditional pass-through structures. CPT structures are typically credit positive as they can significantly reduce refinancing risk in cases where covered bonds have been decoupled from a failed bank.

Already today, CPTs are not eligible for the purchase programmes and some CPT covered bond issuers have started switching to soft-bullet structures. As such, we wonder whether or when the ECB will further tighten the rules regarding CPT structures for its standard operations.

Coupled with the low interest rates and mostly negative yields, the current strong involvement of the ECB restricts the appetite of other investors. Only those that must invest (i.e. bank treasuries) or lack alternatives because their mandates will be active. As such, covereds only remain attractive as they offer slightly less negative yields than other highly liquid and high credit-quality investments.

We are closely watching ECB activities as they can become credit negative in the medium term. It also should not be forgotten that it is not only the ECB but other central banks squeezing the markets. For example, the Swedish central bank is expected to increase its CBPP holdings to approximately EUR 25bn by the end of Q1 2021; other non-euro central banks are active as well.

With real money investors weaned off covered bonds (and eventually credit lines curtailed) it increasingly begs the question: how can the long-term attractiveness and the incentives for investors to support the market be maintained or restored?

EU Taxonomy: more a pesticide than a fertiliser for green covered bonds?

Covered bonds were among the first asset classes to embrace ESG-themed bonds. ESG is one way to restore lost investor appetite. We view positively the fact that the number of issuers ramping up ESG capabilities continues to increase. ESG covered bond issuance of EUR 7.75bn in 2020, following about EUR 6bn each in 2018/19, marked another record year.

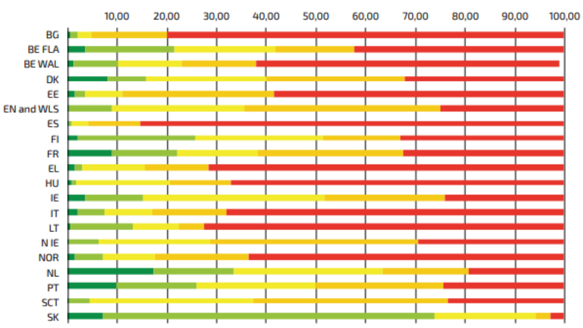
Scope remains constructive on ESG, as mortgage collateral is well suited to providing collateral for such bonds. However, industry and bank-specific efforts to provide data on credit quality impacts are not yet robust enough – mainly because of the benign environment and the lack of consistent reporting of necessary data.

Industry efforts to provide additional data i.e. the Energy Efficient Mortgages Initiative comprising the Energy efficient Mortgages Action Plan (EeMAP) as well as the Energy efficiency Data Portal & Protocol (EeDaPP) will hopefully not be short lived. The current proposal for eligible green collateral under the EU's taxonomy restricts eligible assets to mortgages that achieve an "A grade" Energy Performance Certificate (EPC).

If the current proposal is not modified, the covered bond industry might lack a strong incentive to progress its energy-efficiency efforts. Improving the energy efficiency of buildings can provide a strong lever to achieve a greener economy.

Leaving aside the fact that EPC grades (and efforts to achieve them) are not comparable across Europe, or that the full stock of buildings is not yet assessed, the below figure clearly shows that the sole focus on EPC A financings *(the dark green parts of the bars)* is unlikely to allow for big enough collateral pools to allow for a liquid green covered bond market. Less than 5% of available collateral[1] could be available for green covered bonds under the current definition.

Figure 10: Share of EPC ratings across the EU



Source: X-tendo.eu, Scope Ratings

Also, in light of the EC renovation wave as part of the Green Deal, it is surprising that the taxonomy has become so strict. Lifting an EPC D building to C reduces more emissions than the improvement of an B or C graded building to an A grade. Teething problems on an adequate definition are common and are well known, from the establishment of a common covered bond definition when the ECBC and the covered bond market started to gain traction.

Repeating our comment from last year's outlook might help the taxonomy's bittersweet compromises for some help achieve a greener economy than remaining analytically pure. As such we remain constructive that a more market standard definition might be used (i.e. the 15% most energy-efficient benchmark).

Changing investment mandates finally resulting in a greenium?

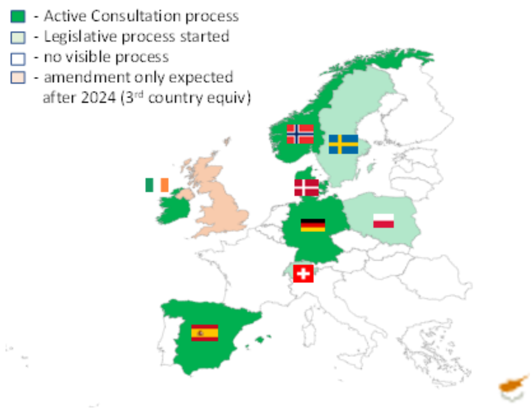
Issuers often embraced ESG covered bonds to widen the investor base and benefit from positive publicity. Costs to identify, adequately document and maintain collateral or adequately invest proceeds have been prohibitive for most and did not allow for a significant widening of collateral pools to issue ESG covered bonds so issuers were not rewarded with significant lower funding costs. This might start to change.

With central banks entering the ESG market and the ECB making ESG investments eligible for purchase programmes, and more investors seeking eligible investments, we observe more visible greeniums.

Harmonisation – a tale of two speeds

With six months left until the adoption/transposition of the EU covered bond directive into national frameworks, we have only seen seven consultations, including Poland, which published on 7 January 2021. Even in non-EU Switzerland, the harmonisation debate has prompted discussions about a more widespread overhaul of the current specialist mortgage bank set-up.

Figure 11: Covered bond directive harmonisation status



Source: Scope Ratings

While Covid vaccinations in Europe have started, lockdowns are still the norm. As such, we expect Covid to be the perfect excuse for member States not to have met the implementation deadline. As changes to preferential treatment only become effective in July 2022, we expect those that fail to implement to shorten the grandfathering period rather than rush execution.

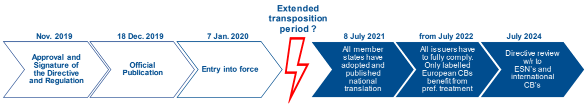
Not surprisingly Germany has again become the "Musterschüler", or model, for covered bonds and is setting the standards. The consultation took place, the

[1] https://x-tendo.eu/wp-content/uploads/2020/05/X-TENDO-REPORT_FINAL_pages.pdf, page 13

amended draft bill was presented and execution – including the technicals like reading and the 8 July 2021 enactment – is almost set in stone.

Countries that have already started consultations will likely follow and meet the deadline. For consultations to emerge in Q1 and Q2 2021, technical aspects of the law-setting process will likely prohibit amendments becoming decided, published and in force by 8 July 2021.

Figure 12: Covered bond harmonisation timeline – not all countries will make the initial cut



Source: Scope Ratings

Covered bonds will migrate to a soft-bullet world

Soft bullets mean that fire sales of cover assets might no longer become the main driver of the rating supporting OC, which can be a credit positive. However, we do not expect the harmonisation to result from sought-after uniformity on how a soft-bullet extension works. Differences will be subtle, but investors will have to do their homework to avoid being caught on the wrong foot – in particular when it comes to the pricing of soft bullets.

We have some sympathy for the notion of providing investors with clarity i.e. that they should expect a straight 12-month extension upon issuer default or even better once the cover pool is no longer able to honour upcoming redemptions in full and timely fashion.

A clear 12-month extension would provide cover pool administrators with sufficient breathing space to organise an orderly management following wind down of the cover pool.

The wish to accommodate investors' preference for hard bullets or the shortest possible extension can introduce unwanted complexities. The German Draft bill for example now makes it clear that once the extension is triggered, there will be a one-month moratorium in which only derivatives will be paid but principal and interest of maturing covered bonds will halt.

Following the one-month period, the special cover pool administrator (Sachwalter) can on its own discretion decide upon a necessary extension – with the caveat that it cannot exceed 12 months. Depending on available proceeds from the cover pool, bonds need not be repaid in full but following a complicated payment sequencing to ensure that the "original payment sequencing is maintained".

However, a potential extension is not a function of clear and predefined parameters but may or may not be triggered based on the administrator's discretion. Consequently, the extension may also be driven by concerns of the administrator being responsible for losses on the covered bonds from the decision made. Hence, the administrator may be inclined to take an active decision which may have negative impacts on outstanding bonds. Further, investors must be aware that during the one-month moratorium, payments may be suspended.

We fear that implementation in other countries will differ – or simply be silent on these technical aspects.

Hopes that legislators and regulators would have agreed upon a common interpretation of the directive have not materialised. As such, soft bullet implementation will differ across Europe.

180-day liquidity buffer: belts without braces for some (most)?

German covered bond issuers will provide investors with belts and braces, but this will not be the case in most other countries.

When the 180-day liquidity rule was introduced it was intended to reduce uncertainties that the cover pool administrator might not easily be able to monetise cover pool assets – in particular for Jumbo covered bonds maturing soon.

Maintaining significant pools of highly liquid assets that could be used proved costly and as such it was no surprise that soft bullets were introduced.

Combining the two (soft bullet with 180-day liquidity coverage) and allowing to account for the final legals i.e. extended maturity only provided lip service to enhanced liquidity buffers. At best, it only ensures that gaps between scheduled interest payments from cover assets to covered bond investors is provided for (currently foreseen in the Norwegian, Swedish, non-match-funded Danish as well as Irish covered bonds).

Germany's approach appears the most prudent for now. Ensuring sufficient liquidity based on scheduled payments, allowing for a one-month grace period to sort out financial as well as operational uncertainties and last but not least provide the option of an up to one year extension gives investors strong protection – even though the extension remains at the discretion of a single person.

The severity of a covered bond programme's liquidity problems is clearly highest the earlier problems occur. To help support highest ratings means that residual risks should be minimised as much as possible. In the end, however, what matters is the interplay of risks.

Harmonisation – what's next?

Latest in July 2024, we expect a comprehensive identification of differences in implementation, as well as guidance around how to further align. By then, the review of the Directive will have taken place, which also will include a review as to whether or not to include ESNs (see "Making the case for European Secured Notes as an EU safe asset").

It also needs to review third-party equivalence (particularly important for bringing back UK covered bonds). We hope that by then a standard interplay between soft-bullets and short-term liquidity can be established. Even more so, we hope that consistent management of market risk (identified early on by the EBA) will be further aligned.

The Capital Markets Union will only become reality when investors cease to be surprised by differences. As such, we hope that the Directive review takes German covered bond stakeholders as an exemplar. For German covered bonds, the passing of amended legislation always meant that this is the starting point to work on the next – and further improved – framework.

Mortgage and banking markets are constantly changing. Achieving and maintaining the highest credit quality for covered bonds should not only rest on the shoulders of issuers but should be equally and strongly supported by a recent and up-to-date covered bond framework.

Annex II: Related research

Sovereign Outlook 2021: global growth recovers amid high debt; changing fiscal, monetary frameworks, published Dec 2020, available here.

2021 European Banking Outlook: first real-life stress test since post-GFC sector de-risking, published Dec 2020, available here.

The Wide Angle: more opportunities than risks for European banks in 2021, Nov 2020 available here.

The regulatory outlook for European banks in 2021 and beyond, December 2020, available here.

Domestic bank consolidation wave gathers pace; cross-border outlook improves, published Nov 2020, available here.

Covered bond quarterlies, Q1 2020 available here, Q2 2020 available here, Q3 2020 quarterly, available here.

Making the case for European Secured Notes as an EU safe asset, published October 2020, available here.

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