Covered Bond Quarterly

Covered bond ratings stable despite selective pressure on sponsor banks from Covid-19. Opportunistic longer-dated public issuance expected for remainder of the year as ECB-targeted retained issuance dominates.

Covered bonds, Scope Ratings GmbH

Executive summary

The credit quality of covered bonds remains untarnished – for now. Unprecedented Covid-19 fiscal and monetary support measures have so far shielded covered bond issuers from any deterioration in asset quality. Increases in IFRS 9 provisions made by issuing banks remain model driven and are not yet an indication of widespread contagion. With only moderate pressure on certain issuer ratings, covered bond ratings have not moved either.

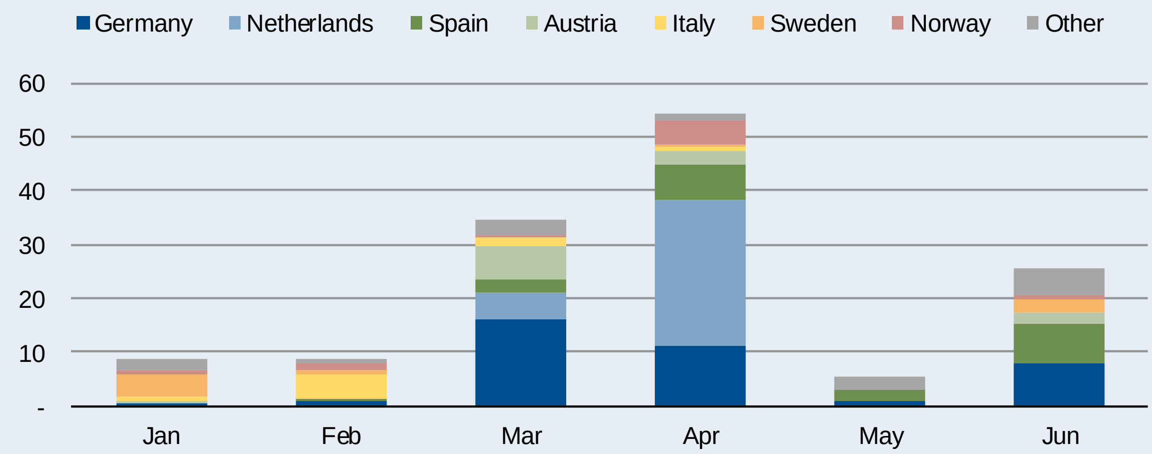
TLTRO 3.4 and auxilliary ECB activity under the purchase programmes remains the single most important factor for the covered bond market in 2020. With abundant liquidity, investors need to grapple what is left over after the ECB has siphoned bonds from the market. Issuance this year remains dominated by ECB-focused retained covered bonds.

As a credit positive, public issuance of covered bonds will shift to longer-dated NSFR-driven activity – helping to reduce maturity mismatches. We also expect further buybacks. Reducing the average coupon of outstanding covered bonds can increase excess spread, which ultimately can reduce the rating supporting over-collateralisation.

ESG-themed covered bonds will gain further traction. Covid-19-themed social covered bonds have appeared and will likely gain further traction. Government guarantees could generate additional collateral for public-sector covered bonds. However, guarantees are short-term – for now – and will not support sustained public-sector issuance.

EU covered bond harmonisation has been put on the back burner: only the Irish Ministry of Finance presented a new consultation in Q2. Only one year is left to transpose the Directive – which for some countries will be ambitious simply because of the timing of legislative processes. See Appendix I for further details.

Retained covered bond issuance for H1 2020



Scope Covered Bond Ratings

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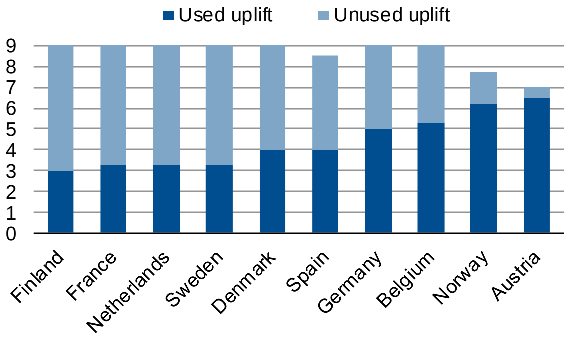
Covered bonds hold steady

Since the onset of Covid-19, the credit quality of covered bonds has held steady. Protection levels, both in terms of unused notches as well as available over-collateralisation, remain strong for most issuers. The risk of a bank downgrade directly translating into a covered bond downgrade remains remote.

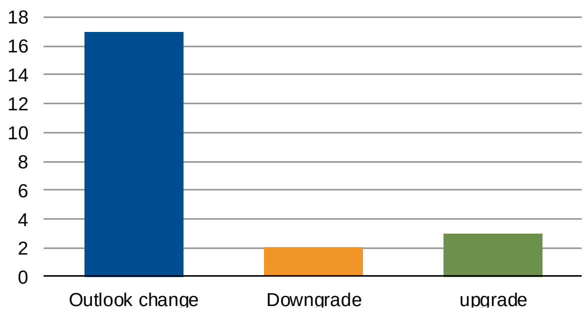
Figure 1: Covered bond rating buffers



Source: Scope Ratings

To-date, bank ratings have held steady. Scope banks ratings[1] have only seen moderate negative adjustments to their credit quality since the end of 2019. Whereas 15% of Scope's bank ratings have seen outlook revisions (mostly to negative) there have been more upgrades than downgrades (3:2)), many of them before the pandemic broke out in March.

Figure 2: Bank rating actions YTD



Source: Scope Ratings

The as yet unchanged credit quality of banks reflects the fact that the impact of lockdowns and economic slowdowns have been averted by the swift and bold support measures provided by governments[2]. Last but not least, the massive EUR 750bn support measures from the European Union will help mitigate the first-round shocks of the pandemic.

For banks, increased provisioning needs to-date mostly reflect model-driven generic IFRS 9 provisions – not hard credit impairments.

Support measure as well as moratoriums, which have been granted throughout most of Europe, have shielded bank balance sheets. At the same time they have finite dates and wake-up calls will come.

The expiry of debt moratoriums combined with increased infection rates from Q3 onwards have the potential to eat up the meagre profitability of traditional lending-focused banks. With credit quality deteriorating, someAbank ratings could start trending downwards as reflected by the negative outlook on several issuers.

Figure 1 shows that most covered bond ratings have sufficient headroom to buffer for mild or even strong bank downgrades. Unchanged from last quarter, bank ratings in Finland, France, Netherlands and Sweden could on average deteriorate by up to six notches without endangering highest covered bond ratings.

Covid-19 insight for cover pools to come from Q2 2020 onwards

The recent update of the ECBCs covered bond reporting template (HTT 2020 which now includes a Covid-19 impact tab) will prompt covered bond issuers, providing a first insight into the amount of impacted cover-pool assets.

Conclusions and comparisons from reporting will need to be taken with a pinch of salt, however. Cover pool management as well as legal or structural provisions might just prompt a replacement of impacted cover assets and a shift back to the residual balance sheet. This might allow "infection rates" to be shown as close to zero. At the same time, bank balance sheets might become burdened with higher levels of impacted borrowers.

Static SPV-type cover pools will show higher levels – even though we do not expect Covid-19 levels of around 20% as, for example, seen for UK RMBS.

The only country that will stand out with regards to borrowers impacted by Covid-19 is Spain. Reflecting full recourse to the mortgage book, only here will the full onset of pandemic-driven moratoriums become visible – provided issuers voluntarily opt for the additional dicslosure.

We understand that borrowers have opportunistically opted for moratoriums as a way of preserving cash rather than avoiding default. Short-time work schemes or even unemployment coupled with standard or likely Covid-19 government support measures do not directly endanger the affordabiltiy of mortgage loans. This will particularly be the case in floating-rate mortgage markets where borrowers are also benefiting from ultra-low mortgage rates.

We therefore expect high cure rates of cover pools impacted by Covid-19. Even when some borrowers ultimately migrate towards default, covered bond investors remain well protected because of issuers'

[1] The complete list of Scope's bank and covered bond ratings are available for subscribers at Scope's credit intelligence platform ScopeOne accessible here.

[2] See Annex II of our Sovereign Update Q3 2020 here

replenishment obligations. Also, when in arrears or in default, such loans only account for a very low percentage (as per programme-specific asset-coverage tests) or not at all.

House prices not impacted – for now

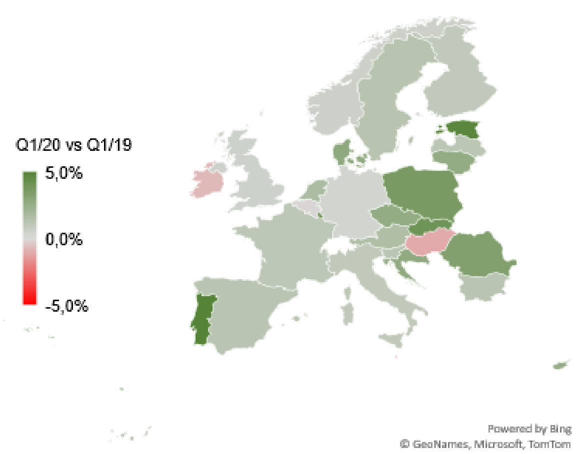
Even if higher proportions of borrowers were to default and not be replenished, workouts would still support high recoveries.

Average cover-pool LTVs have remained broadly unchanged. This is not surprising as Q1 2020 house prices, such as those provided by Eurostat, do not incorporate the full impact of lockdowns.

When looking at Q1 20 House Price Indices (HPIs), it is important to take into account that the first lockdowns in Lombardy only occured in late February. Turnover in housing markets only halted for all of Italy when the lockdown expanded in the second week of March.

At the same time the majority of European countries remained open for business in Q1; only four countries showed negative HPI developments.

Figure 3: Change in European House Price Indices



Source: Eurostat, Scope Ratings

On average, year-on-year Q1 HPI changes across Europe actually show an increase of about 1.6%.

The impact of Covid-19 will only become visible in Q2. We expect growth in house prices to moderate. To-date we do not expect a severe slump as seen during the last crisis.

Issuers feeding ECB purchase programmes but starving investors

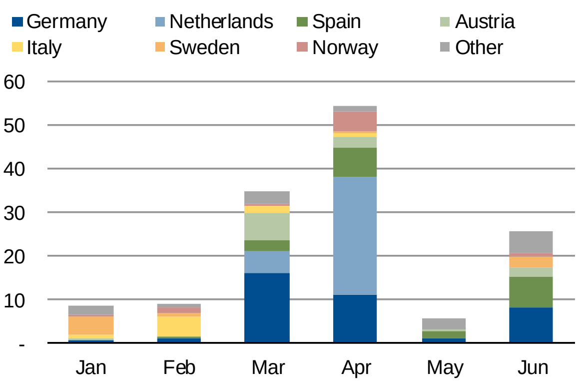
The ECB significantly stepped up its purchase programmes, which means that eligible financial and non-financial enterprises are awash with liquidity.

Unlike the global financial crisis, banks are not in the eye of the storm and are not facing problems in accessing the capital markets. This time, it is investors having problems replenishing maturing covered bond holdings.

For banks, there is no stigma attached to participating in ECB repo operations. Even German State-owned KfW has participated in TLTRO 3.4 with a whopping EUR 13bn despite being rated AAA/ S-1+.

Favourable terms almost make participation a must to mitigate profitability pressure. Not surprisingly, this means that banks strongly reverted to retained issuance. EUR 52bn of non-benchmark covered bonds were issued in Q1. Q2 added another EUR85bn. With lockdowns in full swing, April alone saw EUR 54bn of retained issuance. The significant drop in May suggests that confidence had already returned. The revival in June might simply suggest that more banks decided to jump on the repo bandwagon.

Figure 4: Retained CB issuance in 2020



Source: Thomson Reuters, Scope Ratings

Across all TLTROs, Italian banks are the biggest users. For TLTRO 3.4 this will look different. Assuming that retained issuance in H1 20 was primarily geared to producing efficient collateral, TLTRO usage statistics could show significant changes in the usage of the tender by countries.

Figure 5: H1 20 retained CB issuance by country

Country	EUR bn
Germany	37.4
Netherlands	32.0
Spain	18.8
Austria	10.7
Italy	8.3
Sweden	7.9
Norway	7.8
Belgium	6.5
Others	8.1
Grand Total	**137.4**[3]

Source: Thomson Reuters, Scope Ratings

[3] We calculate the amount of retained covered bonds by identifying all newly-issued covered bonds minus benchmark covered bonds placed in H1 minus bonds with issue sizes below EUR 100m.

The very large covered bond issues by ABN AMRO (totalling EUR 18bn), ING (EUR 9bn) and Rabobank (EUR 5bn) in March and April were expected to have pushed Dutch issuers into pole position.

But public comments on those issues might have been a wake-up call for German issuers. With a strong finish in Q2, they overtook the Dutch banks. With EUR 37.2bn of retained issuance, they ranked first at the end of H1 20. This is different to the end of Q1 20 when German banks had only issued EUR 17.5bn, of which Commerzbank had taken the lion's share (EUR 6.8bn).

In Q2 20, an additional EUR 20bn of retained covered bonds were issued and larger German covered bond issuers followed Commerzbank's example.

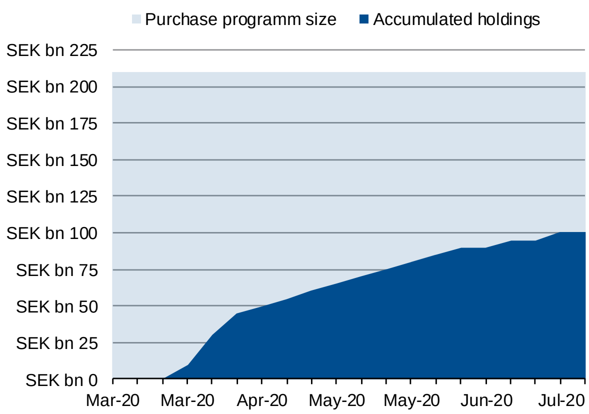
We observe that most of the largest European banks were active issuers of retained covered bonds – often also using their different national subsidiaries. In addition to what they already issued in Italy, for example, UniCredit also used its German and Austrian subsidiaries with about EUR 2bn each. The group even utilised its Czech subsidiary, issuing a significant euro-denominated repo-targeted volume of covered bonds.

The only notable difference with regards to the use of retained covered bonds is France. Only one bank issued a sub-benchmark of EUR 250m, which could even have been placed with investors.

While laggards for retained covered bonds, French banks took the top spot for public benchmark issuance. Out of the roughly EUR 66bn of benchmark covered bond issuance, French banks amassed one-third.

We also note that as a first, Swedish Riksbank also included covered bonds in its purchase programme. The covered bond purchase programme is expected to last until the end of 2020 with a maximum allocation of SEK 210bn. While the domestic covered bond market remained functioning, Riksbank's spring survey highlighted a perception by market participants that fixed-income markets had been impacted and liquidity dried up. Given the high reliance of Swedish banks to refinance via covered bonds, we view the Riksbank stepping in as positive. By the end of H1 20, less than half of the allotment has been used and it appears activities have achieved their goal as purchase activity has started to slow down.

Figure 6: Riksbank's covered bond purchases



Source: Sveriges Riksbank, Scope Ratings

Ample liquidity to spur further ESG themed issuance…

The pandemic has helped to establish a new theme in the ESG universe: Covid-19-themed social covered bonds. French public-finance borrower CAFFIL broke the ice, with use of proceeds pledged to the funding of hospitals. This was followed by Korean Housing Finance Corp, which committed to fund households hit by the pandemic, and by fellow Korean lender Kookmin Bank, whose sustainability covered bond may be used to mitigate effects of the pandemic. We expect further issuance in H2.

The majority of the ESG segment remained focused on classic environmental-themed covered bonds, however. Most of the new issues came from repeat issuers. The only new entrant in H1 20 was a green covered bond issued by the mortgage subsidiary of Norway's Sparebanken Vest.

With EUR 6bn of issuance, however, ESG only accounted for less than 10% of the benchmark segment. Once questions surrounding the European Commission's taxonomy are clarified, we expect issuance to gain pace.

…as well as buy-back tenders

At the beginning of the year, UK issuers were expected to return to the covered bond market given the expiry of the term funding scheme. However, the Bank of England maintained its funding support and introduced the SME-focused term funding scheme (TFSME).

As a result, the amount of UK covered bonds will further shrink. Not only because of maturing bonds but also because of buy-backs.

In May, UK Lloyds bank was one of the first this year to actively tender the buy-back of approx. EUR 6bn of outstanding covered bonds.

The four-year TFSME reduces UK banks' refinancing needs but the scheme also provides the ability to tap into funding close to the base rate.

In June, three German issuers followed (Berlin Hyp, pbb Pfandbriefbank and Hamburg Commercial Bank, the former HSH Nordbank).

We expect available liquidity to further spur further ALM management exercises as they can reduce average refinancing costs, which can ultimately benefit bank profitability. From a pure covered bond focus, ALM management will also help improve excess spread (which currently might even be negative). If combined with an active selection of maturities such activity will even allow supporting over-collateralisation to be reduced, which might provide an additional incentive for some.

At the same time investor appetite to participate might be limited. While investors might be able to realise market-value gains, they will lack the ability to re-invest into similar high-credit quality instruments.

For the management of their NFSR ratios, issuers will likely opt for public longer-dated issuance, which might allow investors to receive a positive yield. However, even when on offer, they might be left out on the street as the ECB might snatch issuance for APP purposes.

As a credit positive, longer-dated public issuance will help banks reduce the mismatch. Similarly, to selective buy backs, new issuance could also help issuers reduce their supporting over-collateralisation.

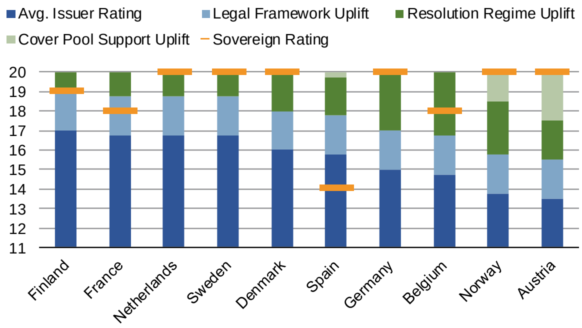
Scope's covered bond ratings information

As of Q2 2020, Scope rates 39 programmes from 25 issuers in 10 countries . We provide a comprehensive overview including: i) key rating metrices and ii) references to commentaries on the issuer and its covered bonds in an easy-to-use Excel format that can be downloaded here.

High bank ratings coupled with supportive legal and resolution frameworks (see Figure 7) provide 82% of covered bond programmes rated by Scope with sufficient support to reach the highest ratings. Most of these ratings are very resilient to issuer downgrades. Cover-pool support is only a secondary rating driver, but the strength of the cover pool can provide additional rating stability.

Only 18% of Scope-rated covered bond programmes are reliant on additional cover pool uplift to achieve the highest rating. The buffer against issuer downgrades is lower for such programmes, but strong cover-pool support can in most cases still mitigate a downgrade of the issuer rating.

Figure 7: Covered bond rating composition



Source: Scope Ratings

Scope rating monitoring notes

11 May 2020 – Scope affirms AAA ratings on Norwegian Verd Boligkreditt's mortgage-covered bonds – Outlook Stable

On 11 May, the ratings of Norwegian covered bonds (obligasjoner med fortrinnsrett) issued by Verd Boligkreditt were affirmed. Verd Boligkreditt is an investment vehicle used by its nine owner banks, primarily located in southern and western Norway. The covered bond rating reflects sound issuer credit quality. The granular, low-LTV and fully domestic residential cover pool is resilient to high credit stresses. Maturity mismatches remain the main driver of supporting over-collateralisation.

Click here to download the rating affirmation and here to access the performance update with key programme information.

19 June 2020 –Scope has completed a monitoring review on mortgage covered bonds issued by SSB Boligkreditt AS

On 19 June, SSB Boligkreditt's covered bond ratings were reviewed following the issuer upgrade to A-. Key rating drivers for the covered bonds remain unchanged. At the same time supporting over-collateralisation reduced to 4%, from 5% previously, and downgrade buffer increased to two notches.

Click here to download the monitoring note.

10 July 2020 – Scope affirms Bankia's cédulas hipotecarias at AAA/Stable following annual review

On 10 July, Bankia's covered bond ratings were affirmed. Sound issuer quality and unchanged cover pool support continue to uphold the rating. Additional fundamental credit factors shield the bank's covered bonds against adverse changes in the cover pool, limiting a potential downgrade.

Click here to download the rating affirmation and here to access the performance update with key programme information.

14 July 2020 – Scope Ratings affirms at AAA/Stable the Austrian mortgage-covered bonds issued by Wüstenrot

On 14 July, Salzburg-based Bausparkasse Wüstenrot AG's covered bond ratings were affirmed. The rating continues to reflect strong support from the cover pool. Maturity mismatches drive the rating-supporting over-collateralisation level. Market risk alone accounts for 15pp of the 17% supporting over-collateralisation

Click here to download the rating affirmation.

Bank and covered bond related research

Verd covered bond programme could size up after letter of intent signed with Lokalbankallianse: Eleven Norwegian savings banks organised under the Lokalbankallianse may become additional owners in Verd Boligkreditt AS, according to a letter of intent signed yesterday. While strengths could be bundled, the cover pool would remain relatively small. Click here to download the full comment.

UK banks – managing through challenging times with regulatory encouragement: Because of their earnings capabilities and stores of available capital, Scope expects the major UK banks to manage through the pandemic. The Bank of England arrived at a similar conclusion after performing a desktop stress test. Revenues will undoubtedly suffer, and credit losses will increase. But as long as banks play their part in supporting the economy, there is likely to be a great deal of regulatory support. Click here to download the full research report.

Italian banks – positive trend in asset quality could be about to go into reverse: Looking at reported Q1 numbers alone might have lulled credit investors into a sense that the Covid-19 recession is a non-event for Italian banks. But we see things getting worse from here. Additional IFRS 9 model provisions are likely in Q2 2020, specific provisions will start to creep into P&Ls in the second half of the year and more substantial asset-quality deterioration will hit the banks in 2021. Click here to download the full research report.

Spanish banks – cost of risk manageable in 2020 but watch the shape of any recovery: Spanish banks' reassuring Q1 results showed that they should be able to withstand rising cost of risk in 2020, thanks to strong pre-provision profits. But uncertainties abound, and the risk of a longer-than-anticipated economic contraction remains. Click here to download the full research report.

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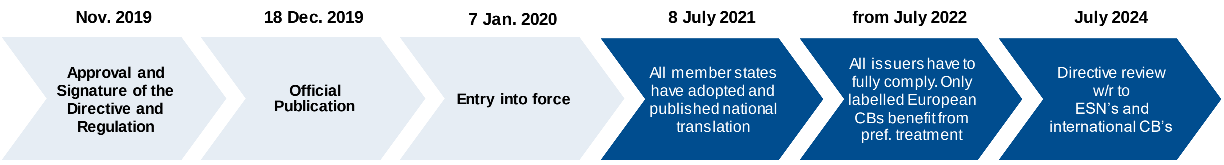
Annex I: What's new in the covered bond harmonisation

The Covered bond harmonisation clock has been ticking since publication of the harmonisation directive in December 2020.

Figure 8: Covered bond harmonization timeline



After a swift start in January (Norwegian proposal – click here) and Spanish authorities publishing their initial consultation on Cedulas 2.0 (Click here), Covid-19 took its toll. In the second quarter, only the Irish Ministry of Finance came up with a view on what changes might be needed to harmonise Irish Covered bonds[4].

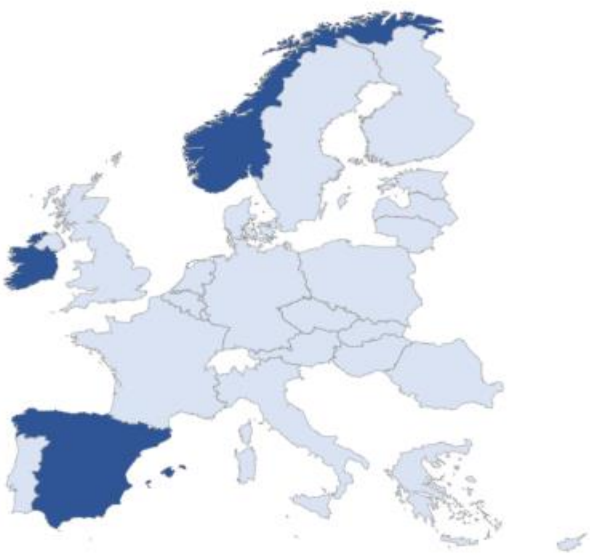
Translating the directive into all European countries will increasingly become challenging. Not necessarily driven by disagreements on the content rather by practical considerations governed by legislative processes. With the European holiday season already in full swing, Q3 might become another lost quarter. As such we envisage that calls for a postponement of the deadlines will soon emerge.

The Irish covered bond consultation…

In our view, the Irish covered bond framework is already one of the strongest. Similar to Germany, it uses not a market value concept for the LTV eligibility criteria but a prudent market value; its uses a net present value (NPV) based over-collateralisation concept, which also applies to market risk stresses as well as a unique duration matching. With mismatch risk being the main driver for the supporting over-collateralisation, we view the matching restriction as positive. Even though it does not eliminate mismatches it at least contains any mismatch risk present.

Some of the questions by the Irish MoF indicate that there could be a watering down of the framework, but the final wording is not yet available. For our view on the "Irish covered bond consultation: belts without braces" see our full commentary here.

Figure 9: Countries with initial consultations on the European covered bond harmonisation as of Q2 2020



Source: Scope Ratings

[4] https://www.gov.ie/en/consultation/d5567-covered-bonds-directive-public-consultation/

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