Covered Bonds Outlook Midyear 2024: Growth And Rates Support Performance

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This report does not constitute a rating action.

S&P Global
Ratings

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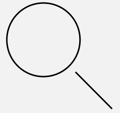
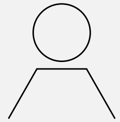
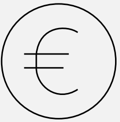
Key Takeaways



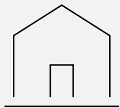
Our covered bond rating outlook remains stable, underpinned by the ample credit enhancement available to most of the programs that we rate and the presence of unused rating notches, both of which reduce the risk of downgrades.



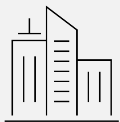
We expect that eurozone GDP growth will gradually recover toward the potential on the back of an increase in consumer spending in the second half of 2024 and investments in 2025. Job vacancies are still plentiful, and we expect unemployment rates to remain at, or close to, record lows in all major European economies.



Eurozone headline inflation should move back to the 2% target by mid-2025, enabling the European Central Bank (ECB) to cut rates by 25 basis points (bps) per quarter until the deposit rate bottoms out at 2.5% in the third quarter of 2025.



Despite higher interest rates and inflation, residential mortgage performance is still stronger than before the COVID-19 pandemic, thanks to a tight labor market, household saving buffers, and the switch to fixed-rate mortgages. Easing interest rates and a return to economic growth will limit the risk of further deterioration.



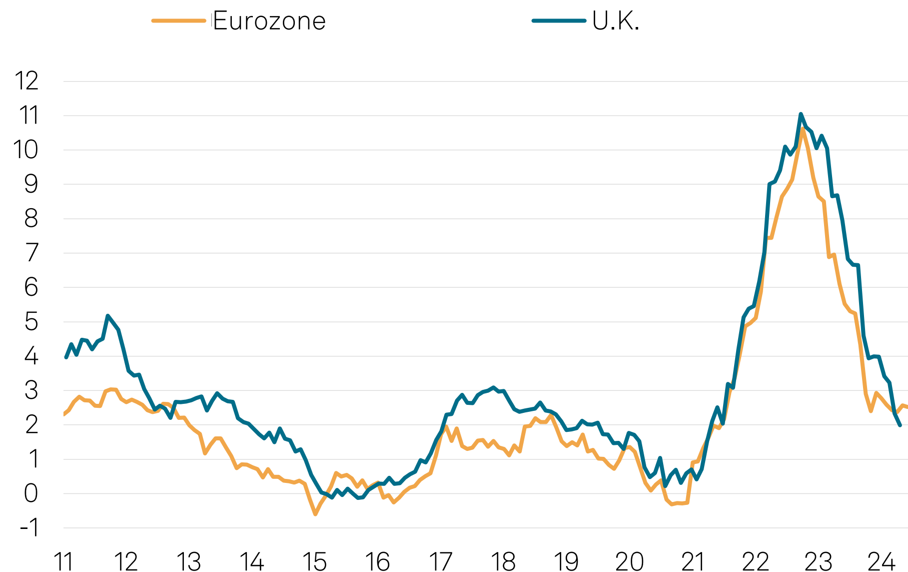
Higher interest rates and a structural drop in the demand for commercial real estate (CRE) since the COVID-19 pandemic, particularly in more vulnerable segments such as nonprime offices, is affecting valuations, and we are starting to see the first signs of asset quality deterioration. But a return to growth and lower interest rates should ease the downward momentum in valuations and thereby stabilize credit quality.

Economic Conditions | Growth Returns, Rates Fall

- Eurozone GDP growth will likely accelerate to 1.4% in 2025, from 0.7% this year, as lower commodities prices, especially energy prices, allow terms of trade to rebalance, disinflation to continue, and real incomes to recover.
- The 2% inflation rate that the ECB targets will likely occur by mid-2025 thanks to a rebound in productivity, moderating profit margins, and slower wage growth. This will permit the ECB to cut rates by 25 bps each quarter until the deposit rate bottoms out at 2.5% in third-quarter 2025.

Disinflation continues as energy import costs fall

Year on year Consumer Price Index (%)



Source: S&P Global Ratings.

S&P Global Ratings' European economic forecasts

	Eurozone	Germany	France	Italy	Spain	Netherlands	U.K.
GDP (%)							
2023	0.6	0	1.1	1	2.5	0.2	0.1
2024	0.7	0.3	0.9	0.9	2.2	0.5	0.6
2025	1.4	1.2	1.4	1.2	1.9	1.5	1.2
2026	1.4	1.2	1.4	1.1	2	1.4	1.7
2027	1.3	1.1	1.3	1	2	1.5	1.7
Unemployment rate (%)							
2023	6.5	3	7.3	7.7	12.2	3.6	4
2024	6.5	3.3	7.6	7.3	11.6	3.8	4.4
2025	6.5	3.2	7.7	7.4	11.4	4	4.6
2026	6.4	3.1	7.5	7.4	11.3	3.9	4.4
2027	6.3	3.1	7.4	7.4	11.2	3.8	4.4

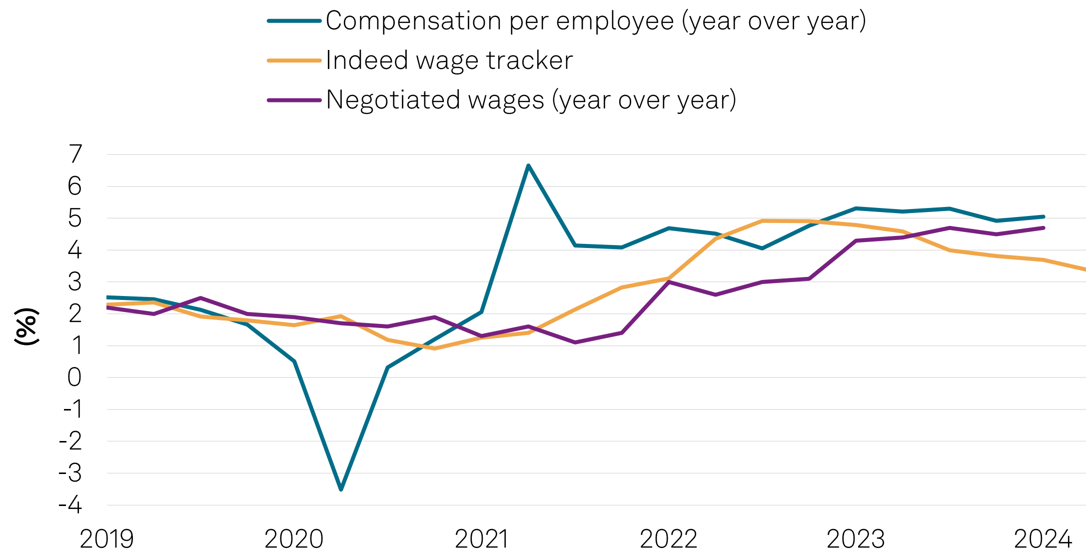
Source: S&P Global Ratings. See "Economic Outlook Eurozone Q3 2024: Growth Returns, Rates Fall," published on June 24, 2024.

S&P Global Ratings

Economic Conditions | Wages Are Growing Faster Than Inflation

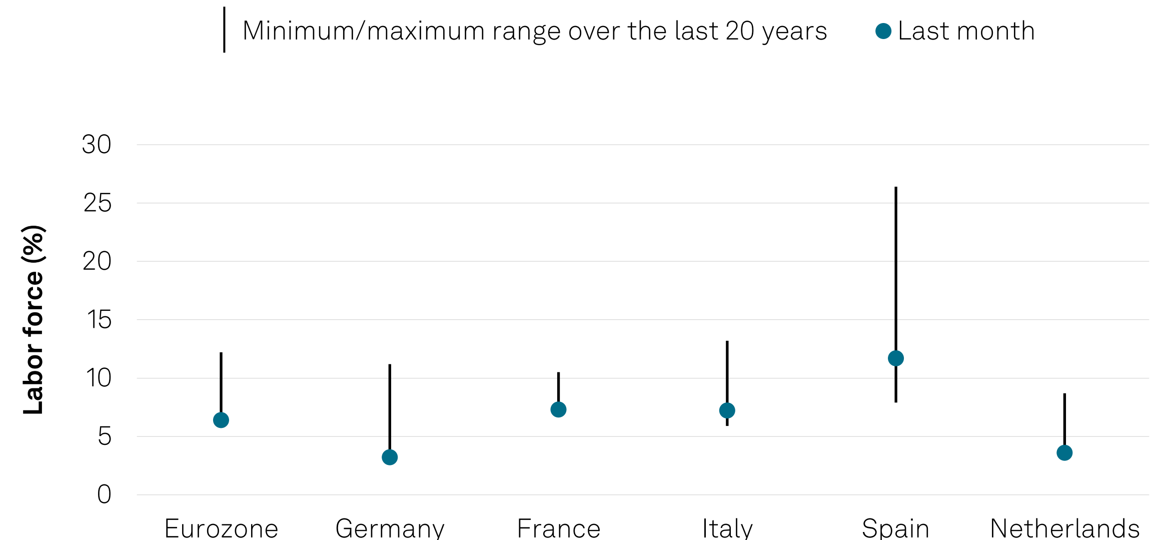
- Even if the wage agreements in place for 2025 point to a deceleration in wage growth compared to this year, inflation will remain lower than wage growth. This means that households should continue to regain the purchasing power they lost during the energy crisis.
- Although job vacancies have peaked, they are still plentiful, representing 3% of the workforce in the first quarter of 2024. This level of vacancies is still too high to push up the unemployment rate.

Forward-looking wage tracker suggests that compensation per employee will decelerate slowly



Source: S&P Global Ratings.

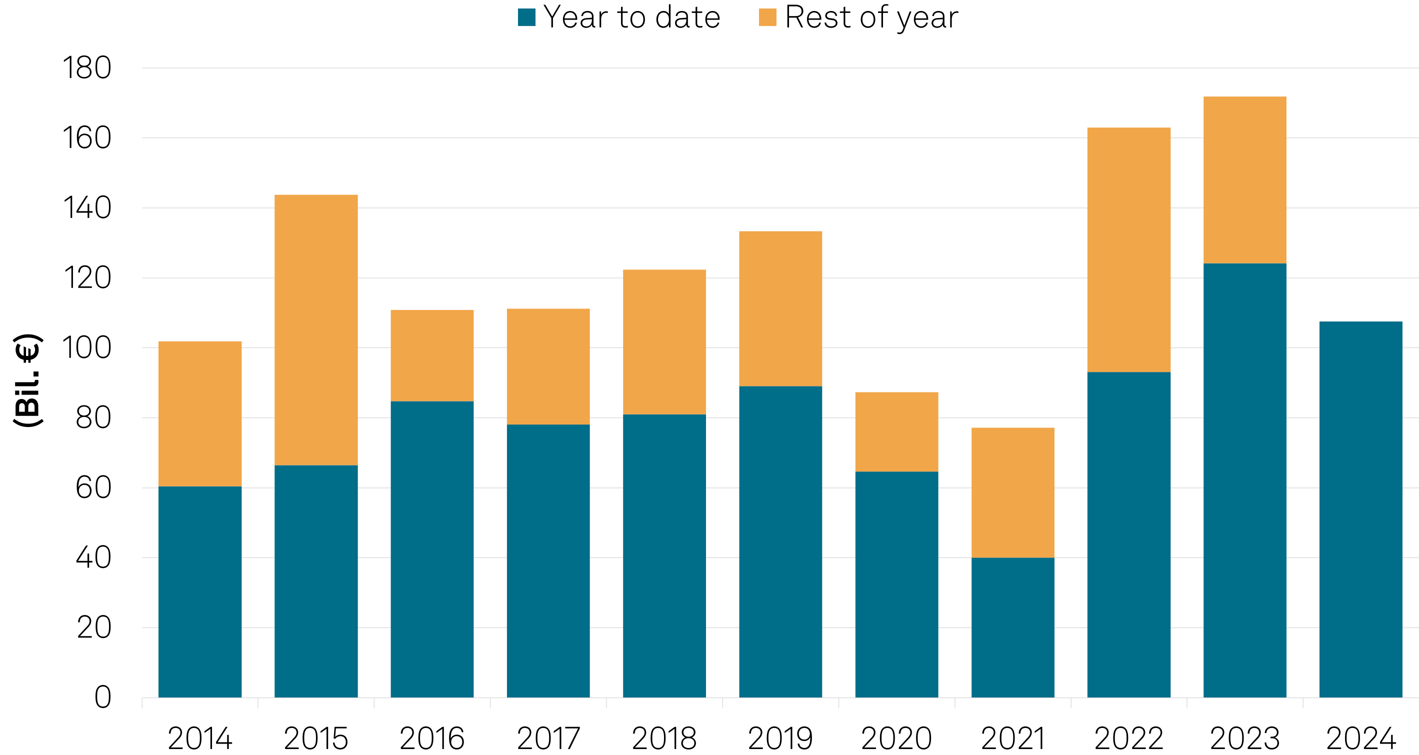
Unemployment rates are still close to record lows



Source: S&P Global Ratings.

Issuance | European Volumes So Far This Year Exceed €100 Billion, But Are Down On 2023

European investor-placed benchmark covered bond issuance



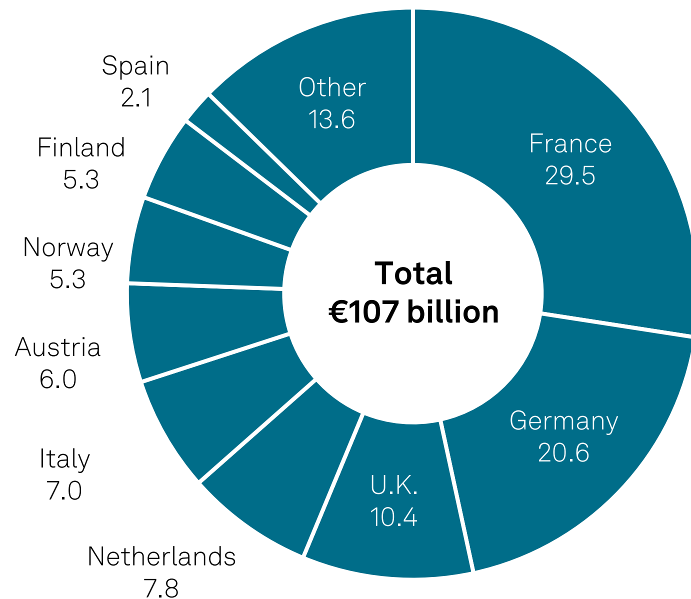
Year-to-date figures as of June 30 each year. Source: S&P Global Ratings.

- Investor-placed benchmark issuance in the first half of 2024 was down 13% from the record high in the same period in 2023.
- The factors driving strong covered bond supply continued into early 2024, including subdued growth in banks' deposit funding and the repayment of their earlier borrowings under the ECB's targeted longer-term refinancing operations.
- The ongoing widening of covered bond spreads early in 2024 has also brought some new investors into the market.
- That said, these supportive trends are likely to weaken, and volumes are also exposed to geopolitical risks.
- Issuance slowed substantially in June 2024, for example, due to the market volatility sparked by the French snap election.

Issuance | Core Market Issuance Has Slowed But Remains Diverse

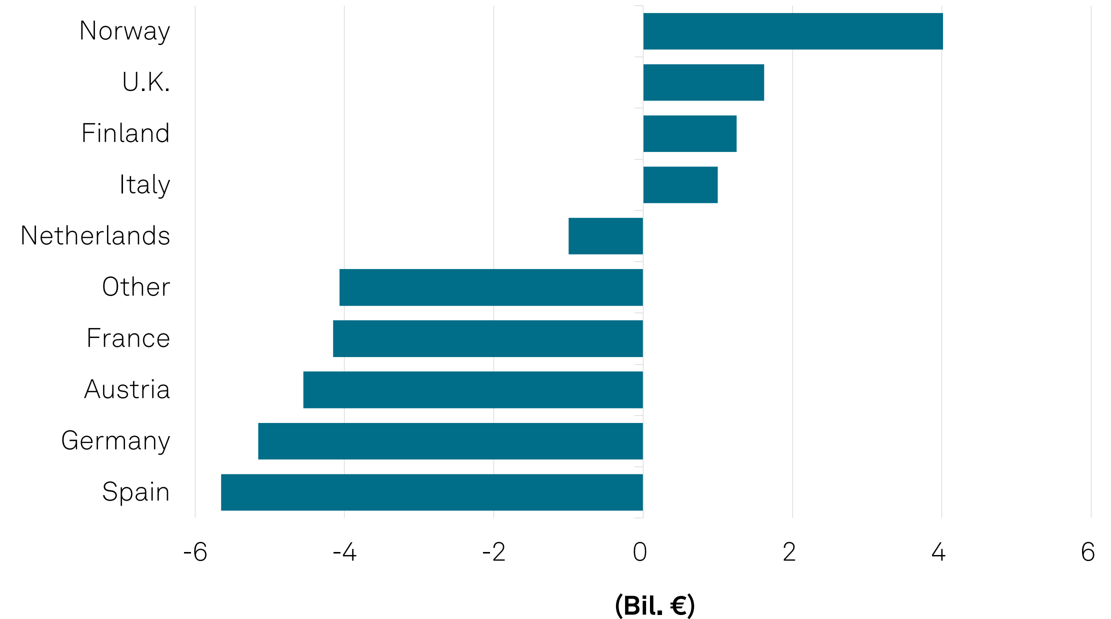
– So far in 2024, increased activity in some smaller covered bond markets has partly compensated for relative weakness in the core countries of France and Germany. For example, year-to-date U.K. covered bond issuance has reached a five-year high, partly due to upcoming maturities of funding from the Bank of England's liquidity scheme.

2024 YTD European benchmark issuance, by country



Based on 2024 issuance as of June 30, 2024. YTD--Year to date. Source: S&P Global Ratings.

Change in YTD issuance, 2024 versus 2023, by country

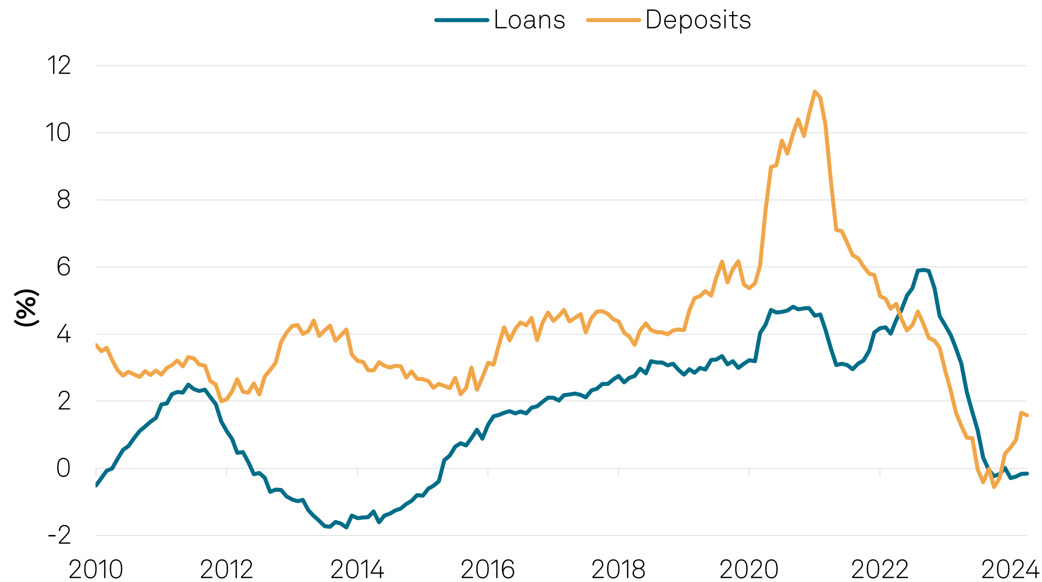


Based on issuance as of June 30 each year. YTD--Year to date. Source: S&P Global Ratings.

Issuance | Loan And Deposit Growth Trends Are Consistent With Slowing Supply

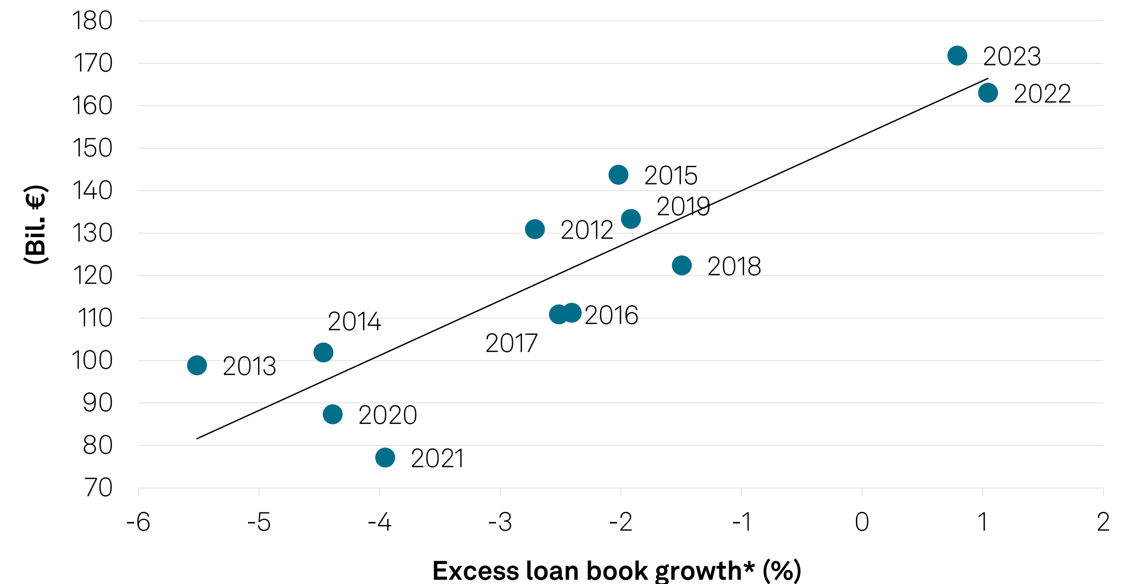
- Growth in eurozone banks' loan books is close to zero; deposit growth also remains below the historical average but is picking up, so the difference between these two rates--excess loan book growth--is falling.
- Covered bond issuance is historically correlated with this measure, suggesting lower supply if the effect continues.

Lending/deposit growth, Eurozone households and NFCs



NFCs--Nonfinancial corporates. Source: European Central Bank.

European covered bond issuance versus excess loan growth*



**Defined as 12-month loan growth minus deposit growth at mid-year. Source: European Central Bank, S&P Global Ratings.*

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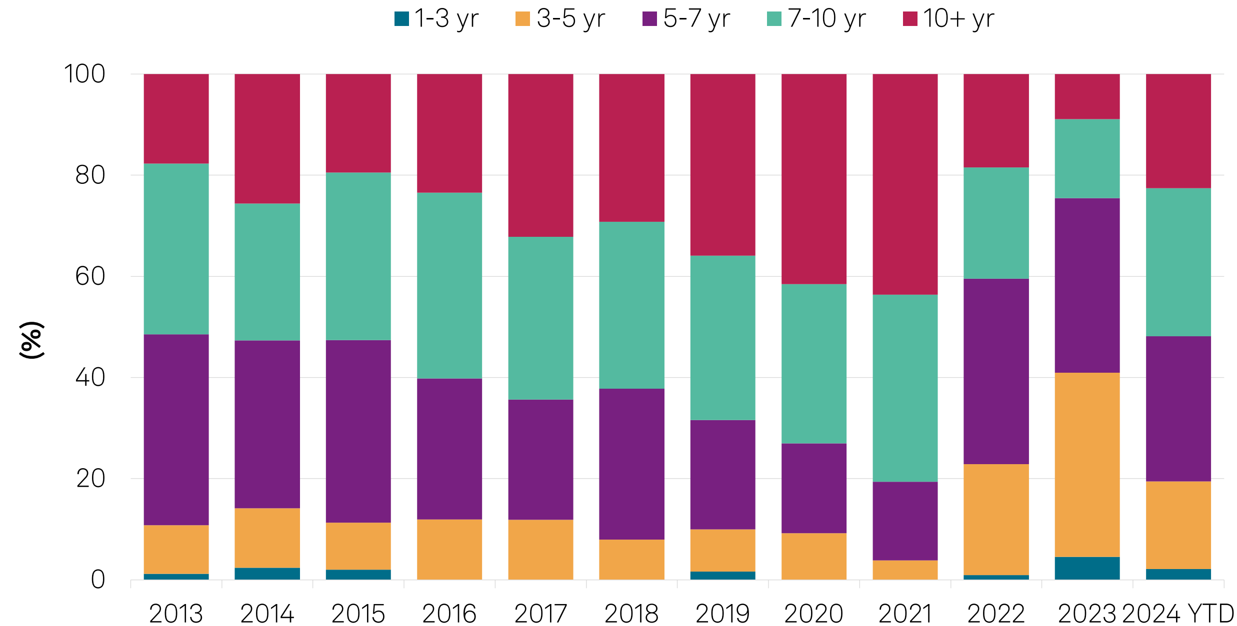
Issuance | Longer-Duration Funding Has Returned In 2024

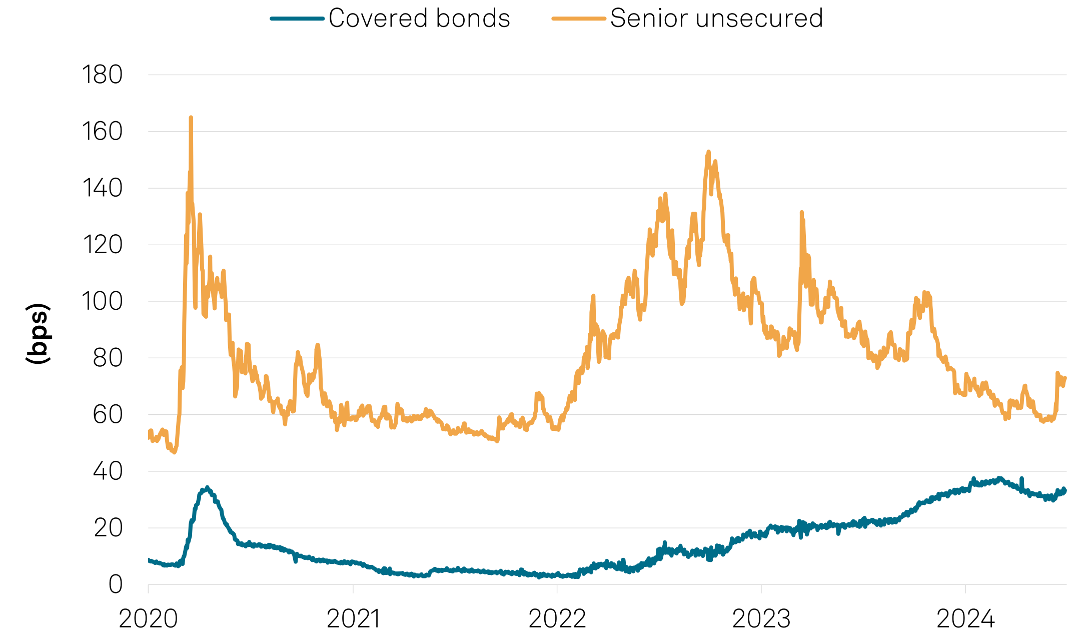
- More than 20% of volumes so far in 2024 are bonds with a maturity of more than 10 years. This represents a normalization in the maturity profile of new issuance following high investor demand for short maturities in 2023.
- Covered bond spreads have remained stable compared with unsecured funding, for example, following the French snap-election call.

Benchmark European covered bond issuance, by maturity



2024 figures based on year-to-date issuance as of June 30. YTD--Year to date. Source: S&P Global Ratings.

Indicative funding spreads for financials



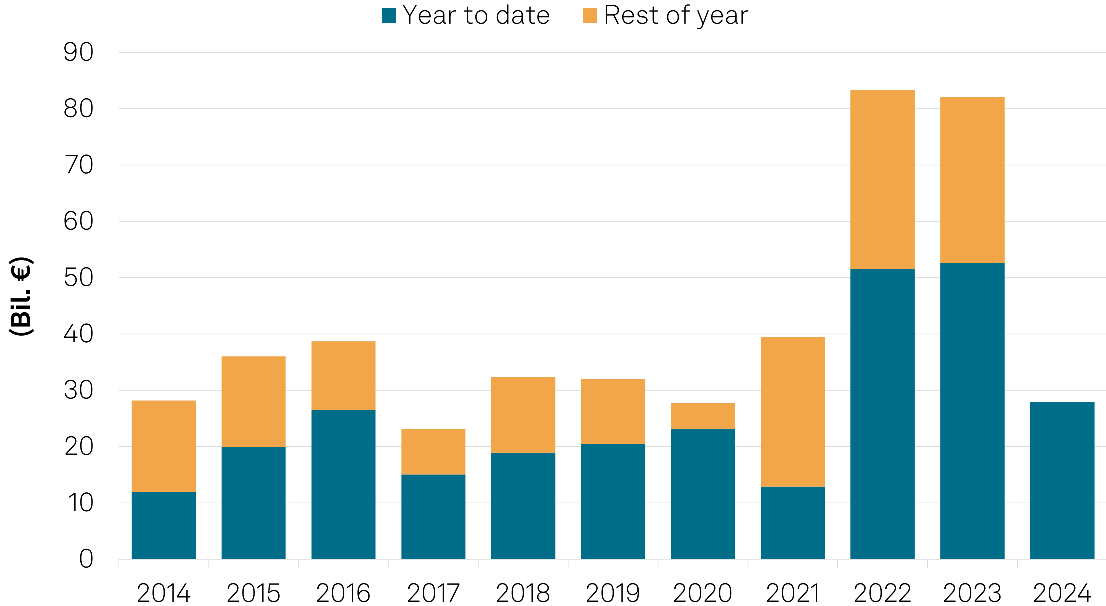
Senior unsecured based on five-year iTraxx Senior Financials. bps--Basis points. Source: Bloomberg, S&P Global Ratings.

Issuance | Volumes Have Slowed Outside Europe

– Benchmark covered bond issuance by non-European banks has slowed from the elevated levels of 2022 and 2023.

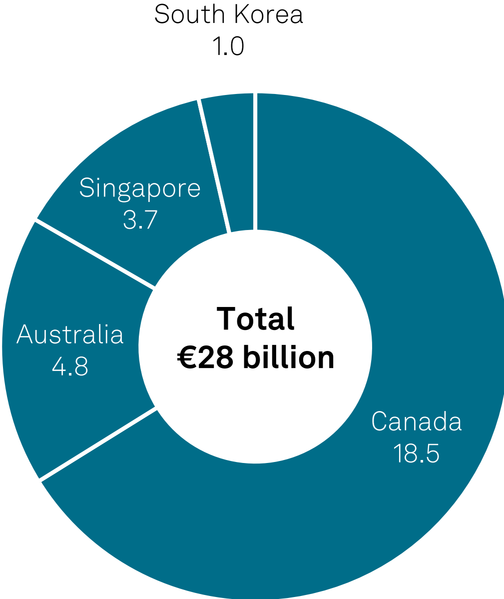
– A large portion of the 2023 activity was likely due to a high volume of redemptions among outstanding Canadian covered bonds. This trend has subsided in 2024. That said, Canadian issuance still makes up the largest share of this activity.

Non-European benchmark covered bond issuance



Year-to-date figures are as of June 30 each year. Source: S&P Global Ratings.

2024 YTD non-European benchmark issuance, by country

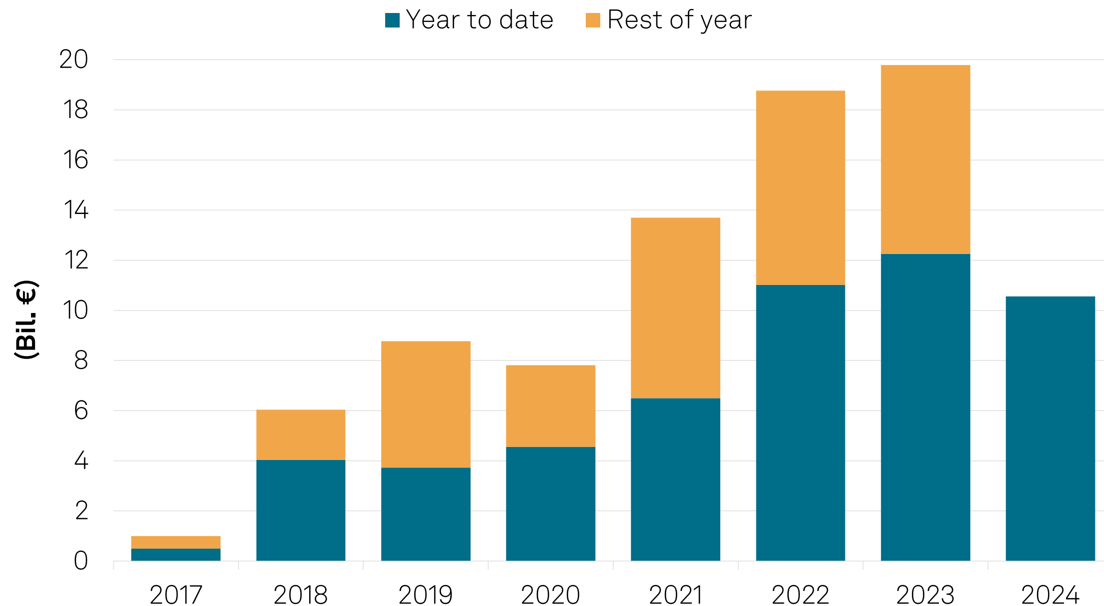


Based on 2024 issuance as of June 30. YTD--Year to date. Source: S&P Global Ratings.

Sustainable Covered Bonds | Labeled Issuance Is Steady

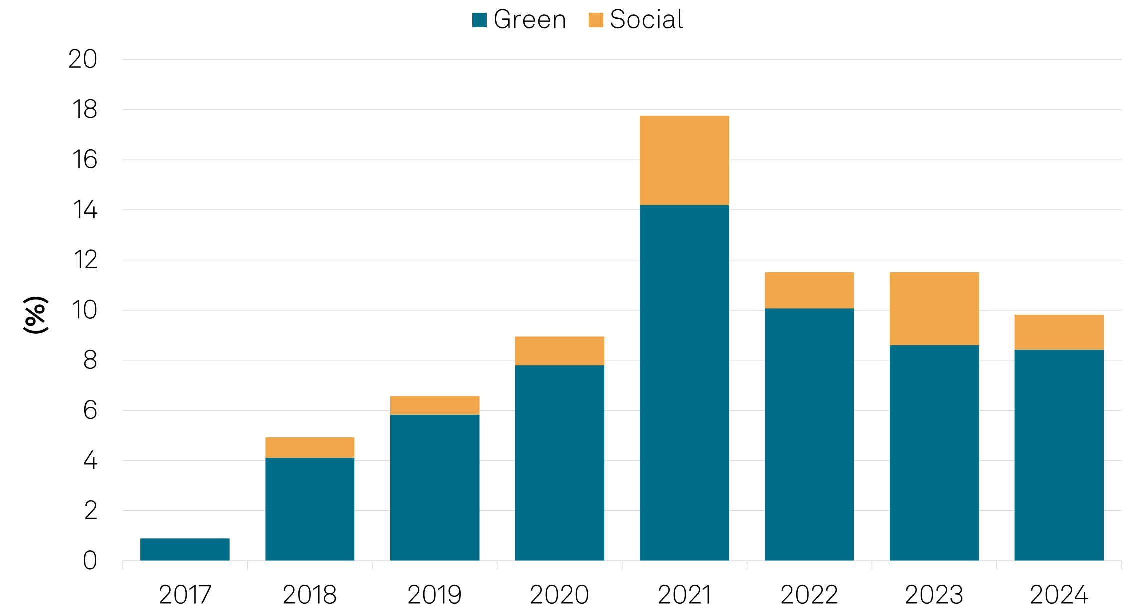
- Issuers have labeled about €10 billion of new covered bonds either "green" or "social" so far in 2024.
- This corresponds to about a 10% share of overall issuance, down from the peak of 18% in 2021.

Sustainable benchmark covered bond issuance



Year-to-date figures as of June 30 each year. Source: S&P Global Ratings.

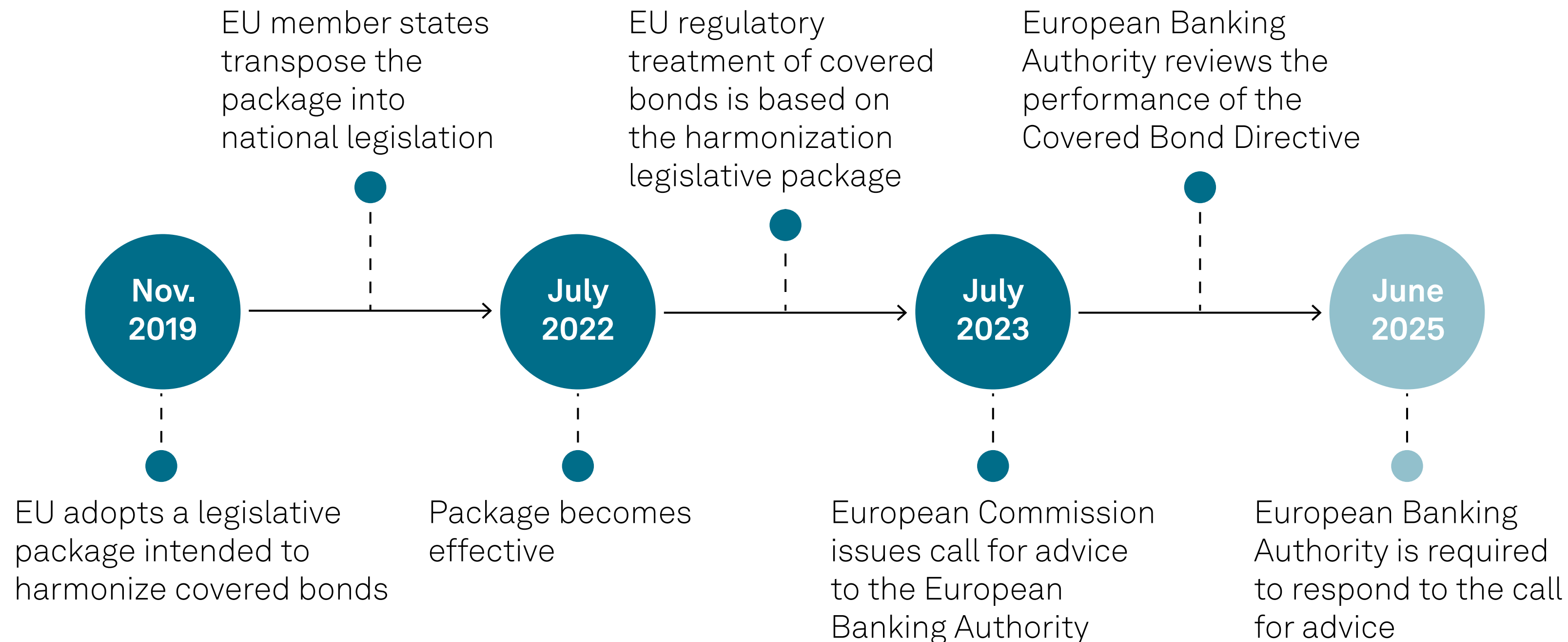
Sustainable share of benchmark issuance



2024 figures are year to date as of June 30, 2024. Source: S&P Global Ratings.

Harmonization | Limited Need For Further Changes

The EU sustainable finance framework calls for greater disclosure



Source: S&P Global Ratings. See "EU Covered Bond Harmonization: Next Steps," published on June 26, 2024.

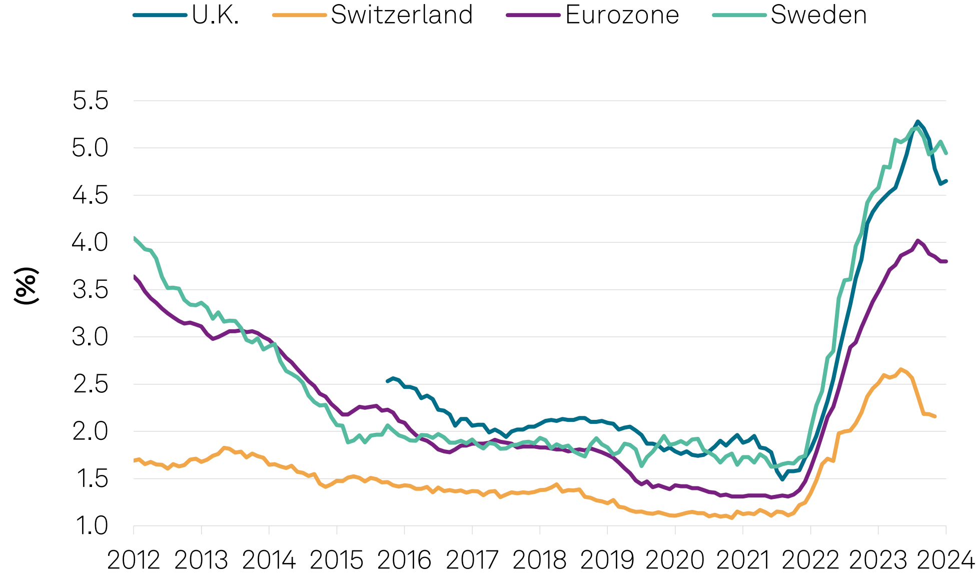
- Two years after the EU's Covered Bond Directive became effective, the sector is readying itself for proposals that may emerge from the European Commission's assessment of the implementation process.
- Extensive intervention by central banks over the past few years has made it more difficult to isolate the market impact of the new framework, but we consider that it has been broadly credit positive.
- Potential developments could include introducing a third-country equivalence regime or a new type of covered bond backed by loans to small and midsize enterprises. Despite industry interest, we consider that both options are subject to considerable uncertainty.
- We see limited scope for further harmonization, although there are still discrepancies in how local covered bond markets treat extendible note features.

Credit Performance | A Tight Labor Market Supports Residential Mortgages

- Despite higher interest rates and inflation, residential mortgage performance is still stronger than before the COVID-19 pandemic, thanks to a tight labor market, household saving buffers, and the switch to fixed-rate mortgages.
- Easing interest rates and a return to growth will limit the risk of further deterioration.

Mortgage rates are starting to decline in Europe

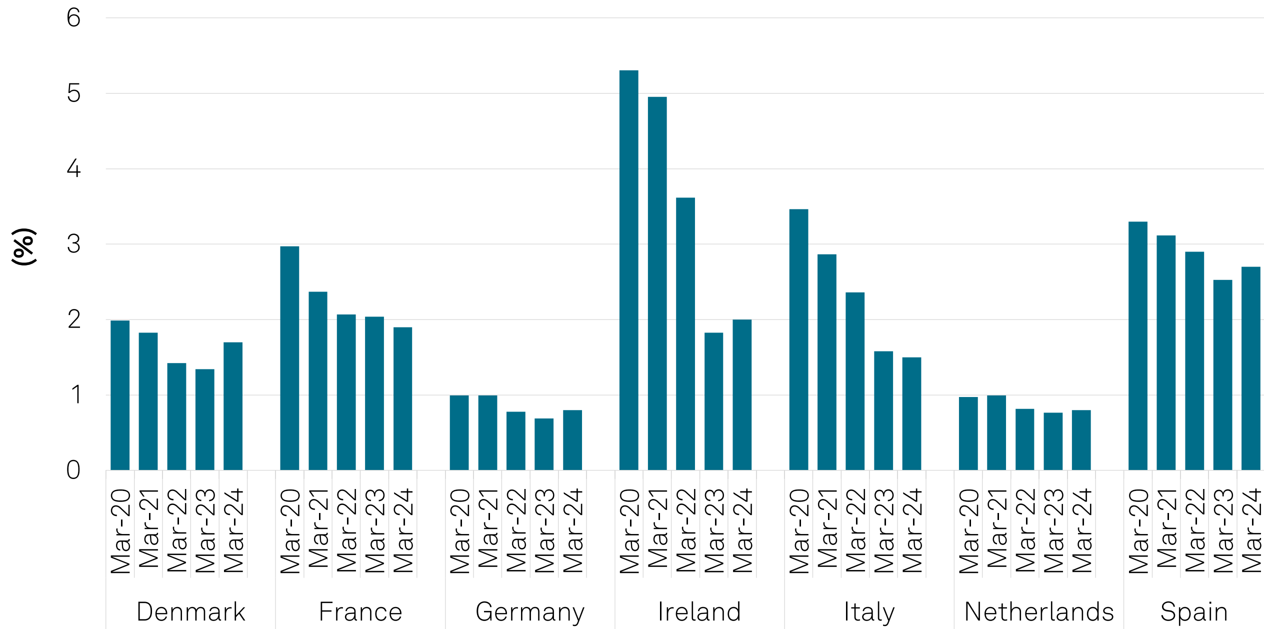
Rates on new mortgage loans



Sources: European Central Bank, Swiss National Bank, Bank of England, Refinitiv, S&P Global Ratings.

Mortgage performance is stable despite higher-for-longer rates

Nonperforming loan ratio of residential mortgage loans

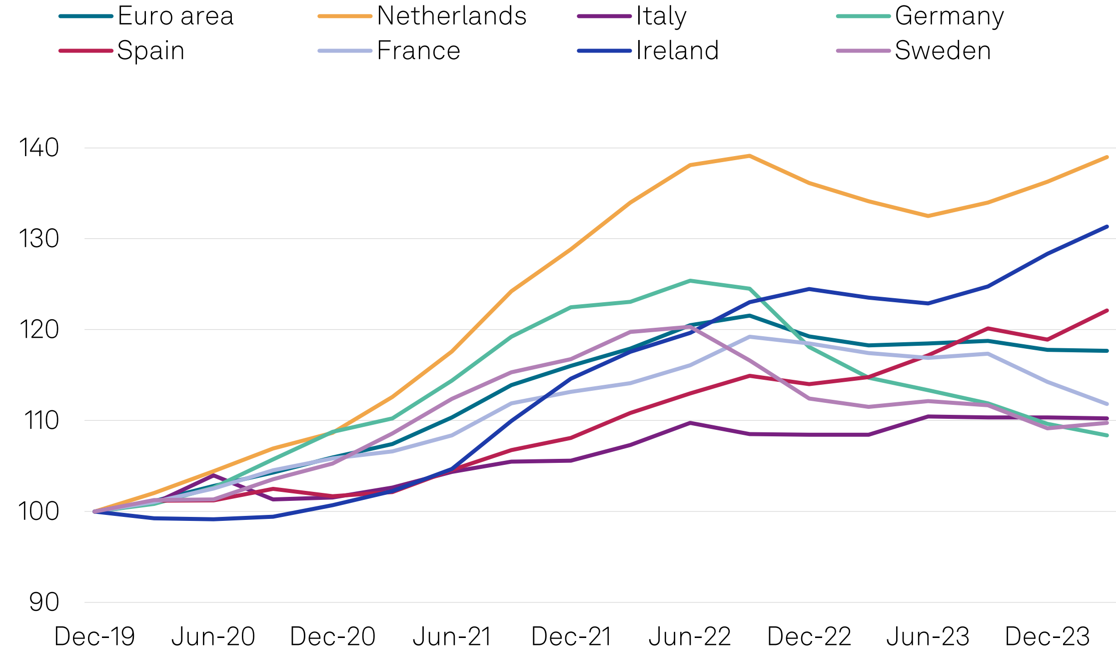


Sources: European Banking Authority, S&P Global Ratings.

Credit Performance | Economic Growth And Lower Rates Will Help House Prices And Loan Origination Recover

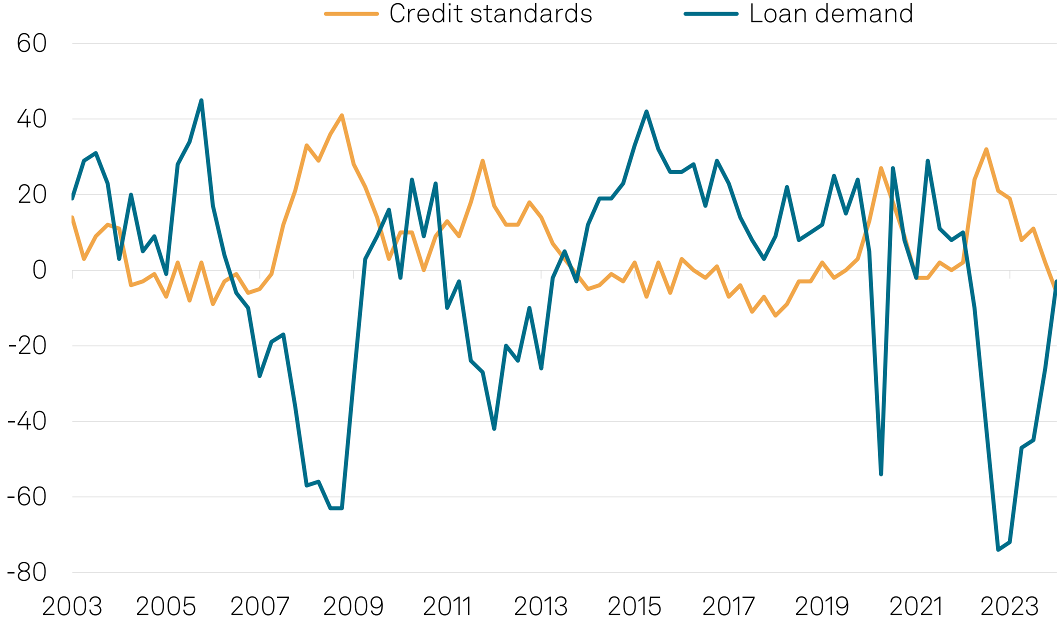
- House prices are now stable or increasing in most European countries, but still weakening in Germany and France.
- A likely economic rebound and gradual decrease in interest rates will support house prices and a rebound in loan origination.

House prices are stabilizing or growing across most of Europe



Sources: Eurostat, European Central Bank, S&P Global Ratings.

Easing credit standards support loan demand rebound

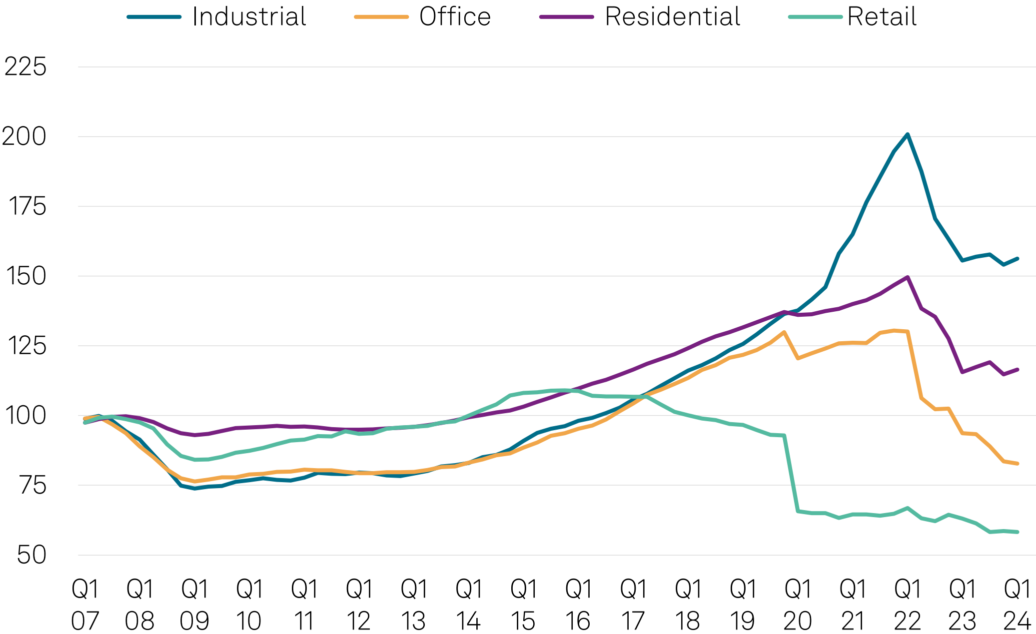


Net proportion of banks reporting credit standards for household mortgages tightening, and of banks reporting an increase in housing loan demand. Source: ECB lending survey Q1 2024.

Credit Performance | CRE Performance May Deteriorate Further

- Higher interest rates and a structural drop in the demand for CRE, since the COVID-19 pandemic, particularly in more vulnerable segments such as nonprime offices, is affecting valuations. We are starting to see the first signs of asset quality deterioration.
- But a return to growth and lower interest rates should ease the downward momentum in valuations and tenant demand and thereby stabilize credit quality.

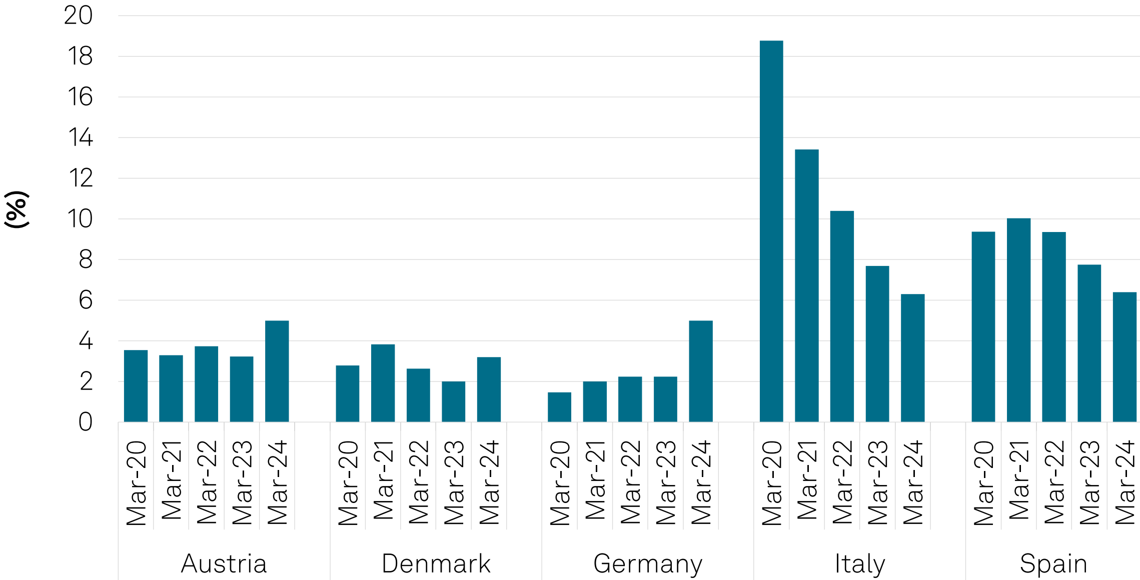
Valuations are stabilizing outside the office sector



Green Street pan-European commercial property price indices. Sources: Green Street UK, S&P Global Ratings.

CRE performance has started deteriorating

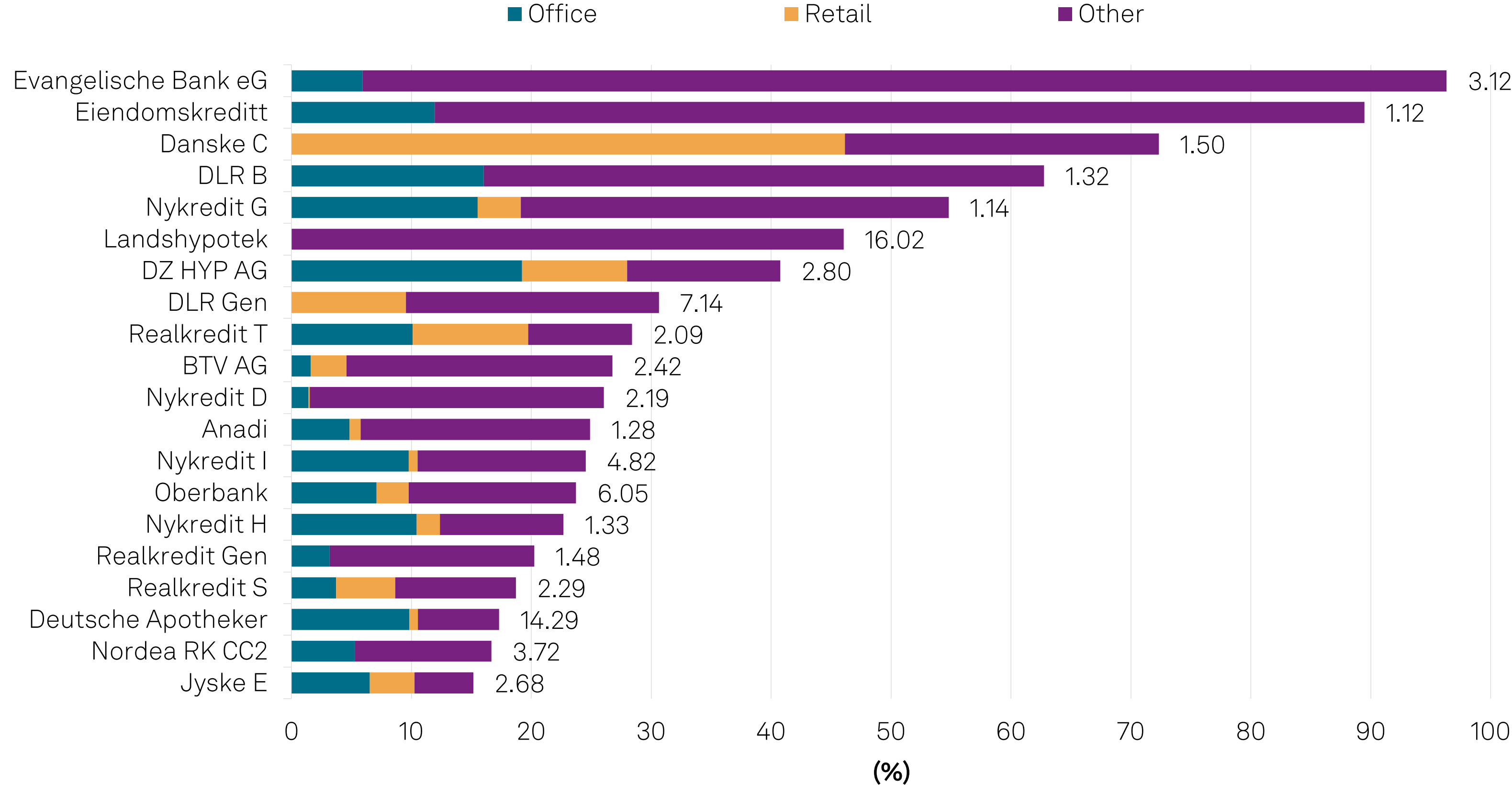
Nonperforming CRE loan ratios



CRE--Commercial real estate. Sources: European Banking Authority, S&P Global Ratings.

Credit Performance | Limited Exposure To The Office Sector

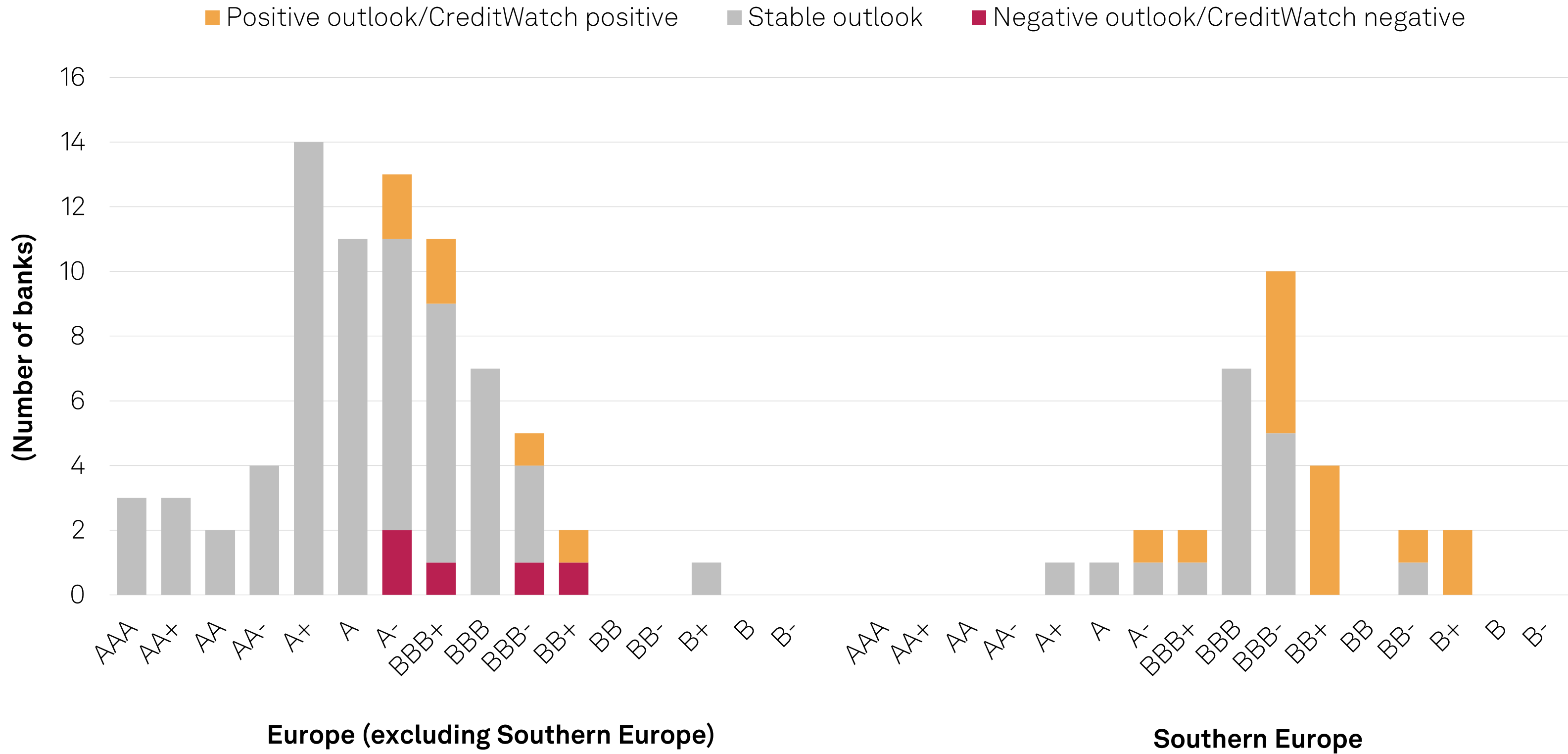
Exposure to the most vulnerable sectors is limited in cover pools



Data labels show the average ratio of available credit enhancement to credit enhancement required for the current ratings. Sources: HTT reports, S&P Global Ratings.

- Prime and nonprime office assets are at different stages of the repricing process. Overall, prime office assets benefit from higher occupancy and rent levels than their nonprime peers.
- Office exposures typically account for less than 20% of total CRE loans for ECB-supervised banks.
- While we expect a further deterioration in the credit quality of CRE assets, we believe that the credit enhancement available in rated programs will be sufficient to absorb the additional losses.

Banks Outlook | Resilient Ratings With A Positive Bias In Southern Europe



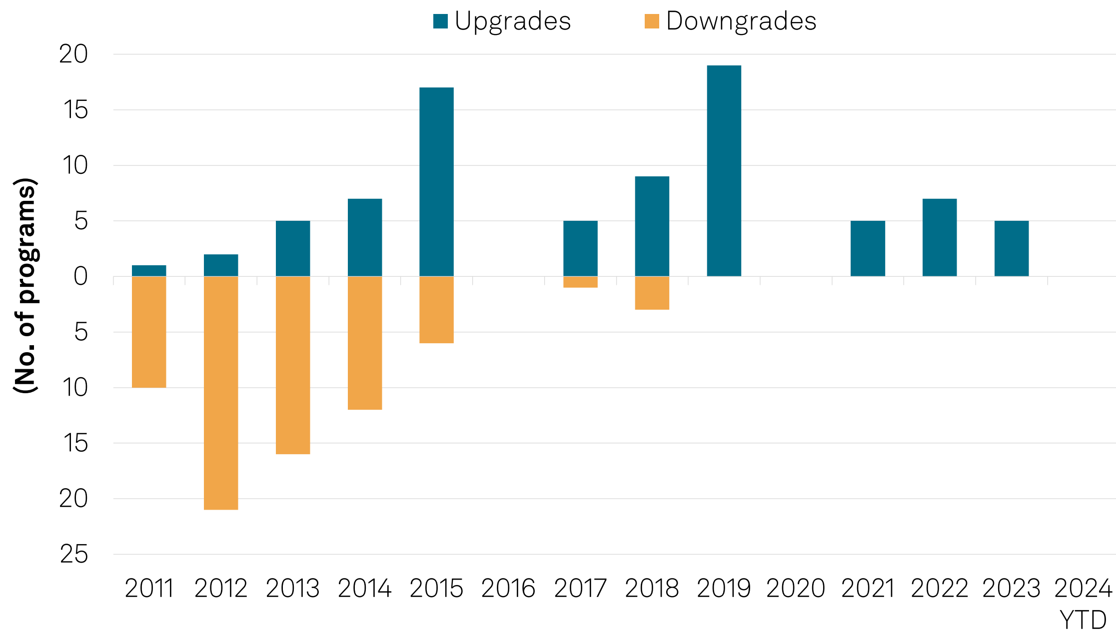
Data reflect the issuer credit ratings and outlooks at the level of the parent company. Source: S&P Global Ratings. See "Credit Conditions Europe Q3 2024: Keep Calm, Carry On," published on June 25, 2024.

- Solid capitalization and liquidity, improved profitability, and resilient asset quality continue to support the ratings on European banks.
- Lower interest rates and sluggish loan growth will put pressure on net interest margins and force banks to focus on cost-control measures. While asset quality remains resilient, a contained but manageable deterioration is likely in more vulnerable portfolios.
- Banks in southern Europe have benefited significantly from higher interest rates and several years of cost reductions and asset quality clean-ups. This, together with stronger economic growth, has led to positive outlooks on about 45% of Southern European bank ratings, compared with 8% in the rest of Europe.
- Key risks ahead include tighter liquidity conditions, market turbulence, and a harder economic landing that could intensify asset quality deterioration.

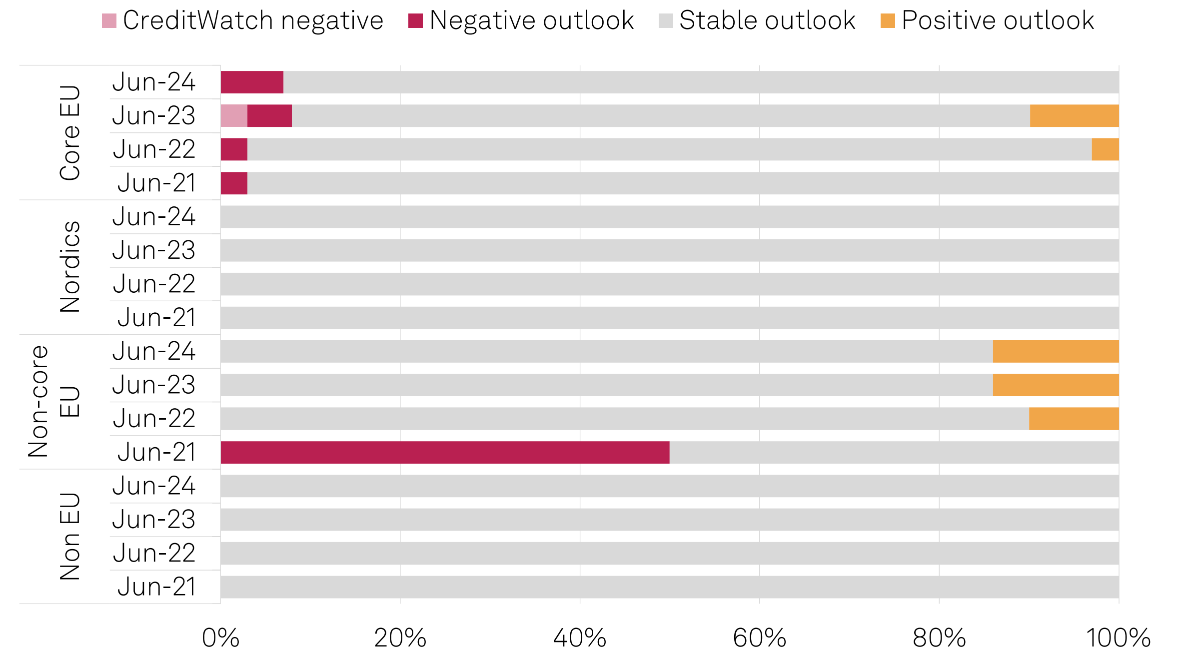
Ratings Outlook | Covered Bond Ratings Are Stable Despite Higher-For-Longer Interest Rates

- We have not downgraded any of the covered bond programs that we rate since 2019. We upgraded five programs in 2023, following rating actions on the issuing banks or related sovereigns, and revised our outlooks to positive on about 2% of them. During the first half of 2024, we revised the outlook on two French covered bond programs, one to negative and one to stable, following the actions taken at the issuer and sovereign rating level.
- Of the covered bond programs we rate that have outlooks, 97% are either stable or positive.

Number of covered bond downgrades since 2019



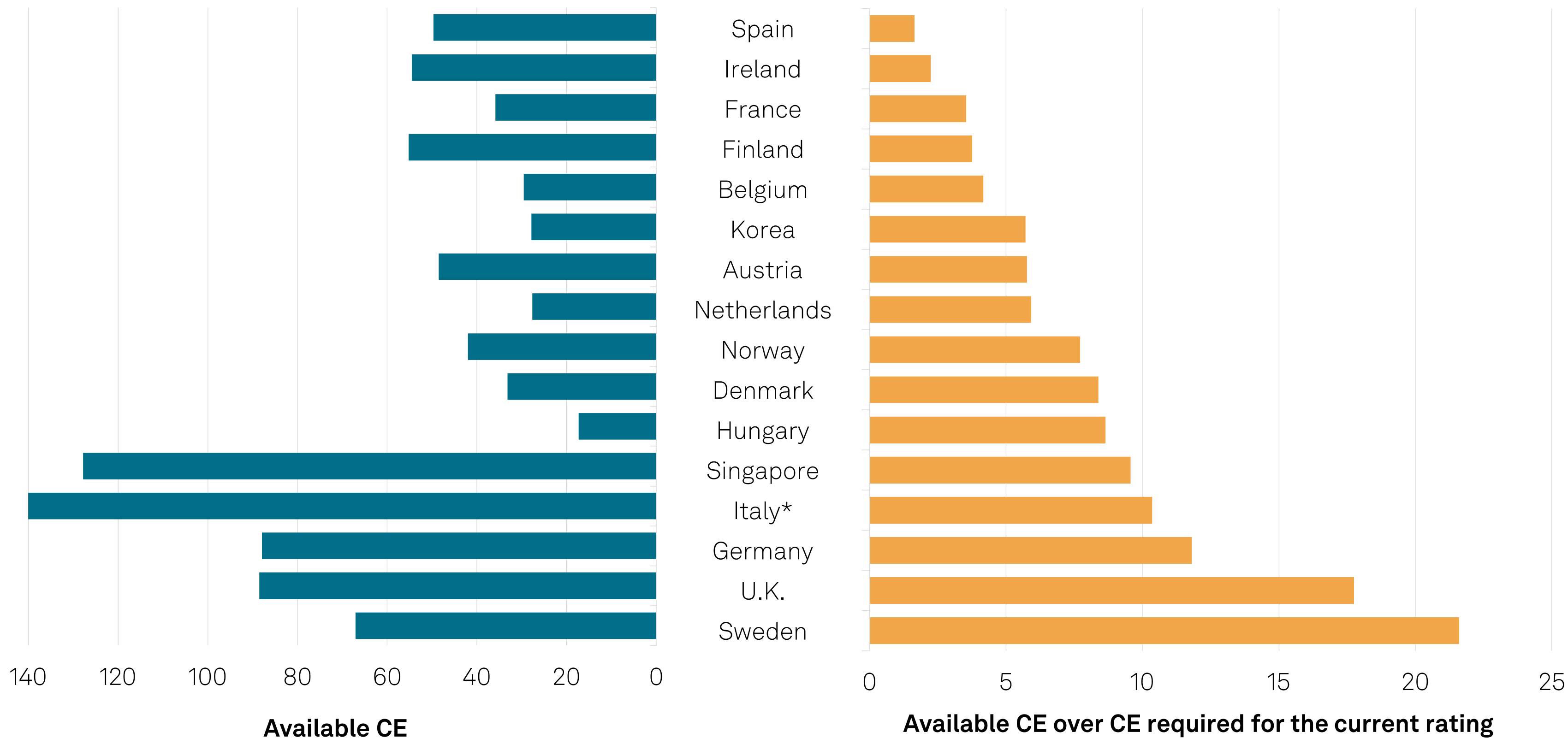
Outlooks are predominantly stable in all regions



Note: Core EU: Austria, Belgium, France, Germany, the Netherlands. Nordics: Denmark, Finland, Norway, Sweden. Non-core EU: Greece, Hungary, Ireland, Italy, Spain. Non-EU: Singapore, South Korea, U.K. YTD--Year to date. Source: S&P Global Ratings.

Ratings Outlook | Overcollateralization Could Mitigate A Deterioration In Collateral Performance

Available credit enhancement is on average eight times higher than what's required for the ratings



Italy's available CE is an outlier at 256%, so we cap the axis at 140%. CE--Credit enhancement. Source: S&P Global Ratings.

- Available credit enhancement for rated programs is, on average, about eight times higher than the level required to maintain the current ratings.
- Despite record-high issuance since 2022, issuers have generally maintained solid buffers of available credit enhancement that support covered bond ratings.
- Such buffers have, for example, supported the rating on French residential covered bond programs following the downgrade of the sovereign in May 2024.
- We believe that the available credit enhancement should cushion any deterioration in collateral performance arising from relatively high rates and persistent inflationary pressures.

Ratings Outlook | Unused Notches Mitigate Bank Downgrade Risk

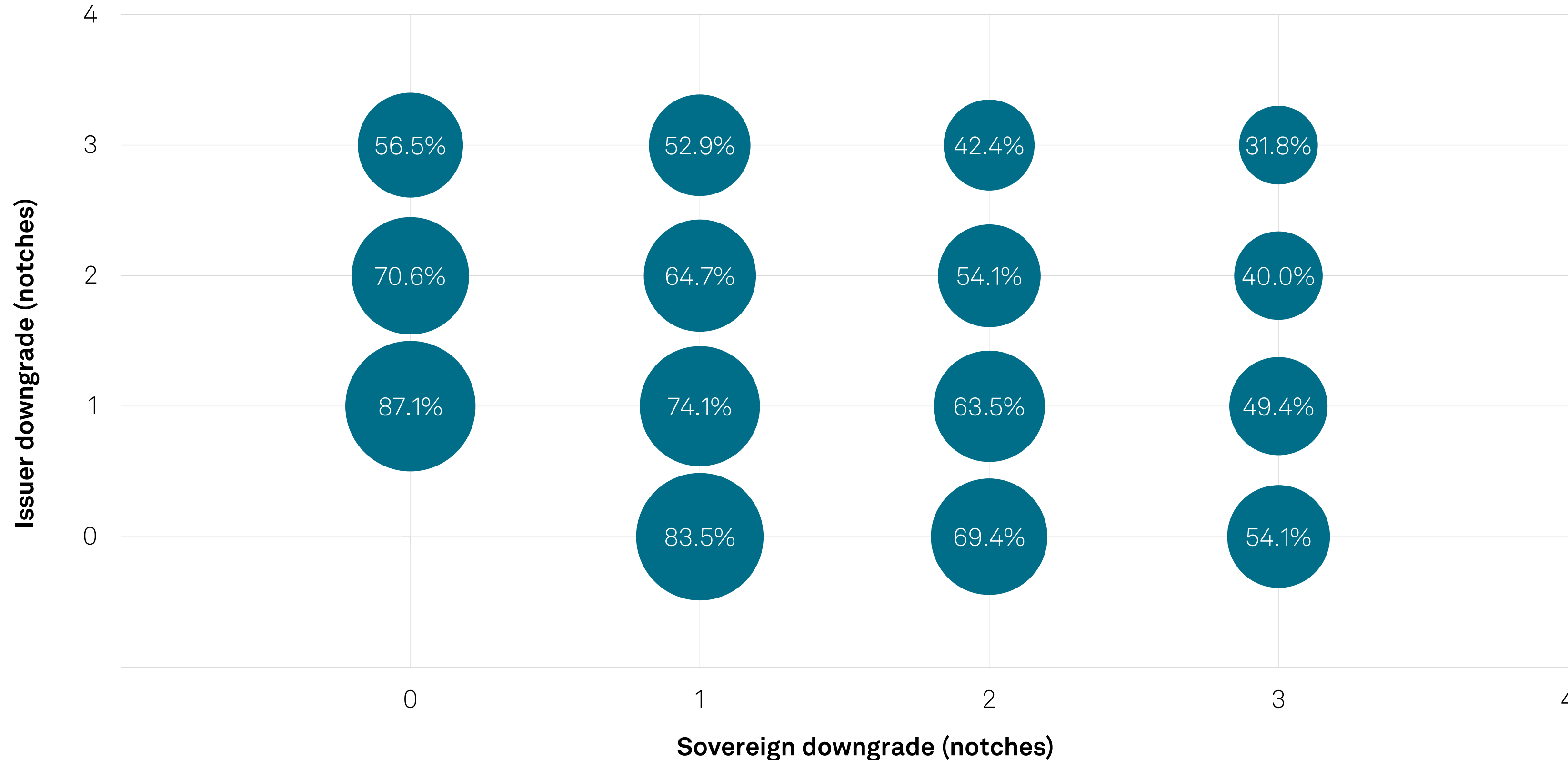
Unused notches, by country

AUT--Austria. BEL--Belgium. NED--Netherlands.

- Potential changes in sovereign or issuer credit ratings are the most likely triggers of changes to our covered bond ratings.
- Currently, rated programs benefit on average from two unused notches. This is the number of notches that we can lower the issuer credit rating without it resulting in a downgrade of the covered bonds.
- Belgian, Danish, German, Dutch, and French programs have more protection from the risk of bank downgrades.
- Spanish, Italian, Hungarian, and Austrian programs have less of a buffer to mitigate the effect of bank downgrades and could see an immediate effect from a sovereign downgrade.

Ratings Outlook | Noncore European And Public-Sector Programs Are More Exposed To Sovereign Downgrade Risk

Most covered bond ratings would be unaffected by a one-notch issuer or sovereign downgrade



Note: Percentage of covered bond ratings unaffected by an issuer or sovereign downgrade. Source: S&P Global Ratings.

- Covered bond ratings in most jurisdictions would not change due to a one-notch downgrade of the sovereign, with some exceptions.
- We would expect mortgage programs in Greece, Italy, and Spain, as well as programs backed by public-sector assets in Belgium, France, and the U.K., to be most sensitive to changes in the respective sovereign ratings. (See "Your Three Minutes In Covered Bonds: How The Downgrade Of France Affects French Covered Bonds," published on June 7, 2024.)
- A one-notch lowering of both the sovereign rating and the issuer credit rating would not affect the ratings on more than 74% of the programs we rate.

Related Research

- EU Covered Bond Harmonization: Next Steps, June 26, 2024
- Credit Conditions Europe Q3 2024: Keep Calm, Carry On, June 25, 2024
- Economic Outlook Eurozone Q3 2024: Growth Returns, Rates Fall, June 24, 2024
- U.K. Economic Outlook Q3 2024: A Cooling Labor Market Paves The Way For Rate Cuts, June 24, 2024
- EMEA Structured Finance Chart Book: June 2024, June 21, 2024
- Global Covered Bond Insights Q3 2024: Issuance Still On Solid Footing, June 18, 2024
- Your Three Minutes In Covered Bonds: How The Downgrade Of France Affects French Covered Bonds, June 7, 2024
- EMEA Financial Institutions Monitor 2Q2024: Robust Profitability, Resilient Performance, May 31, 2024
- Covered Bonds In New Markets: Issuance Holds Up In 2024, April 29, 2024
- Covered Bonds Primer, March 19, 2024

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