S&P Global Ratings

Covered Bonds Outlook 2025

Lower rates, higher uncertainty

Dec. 6, 2024

This report does not constitute a rating action

Contents

Key Takeaways

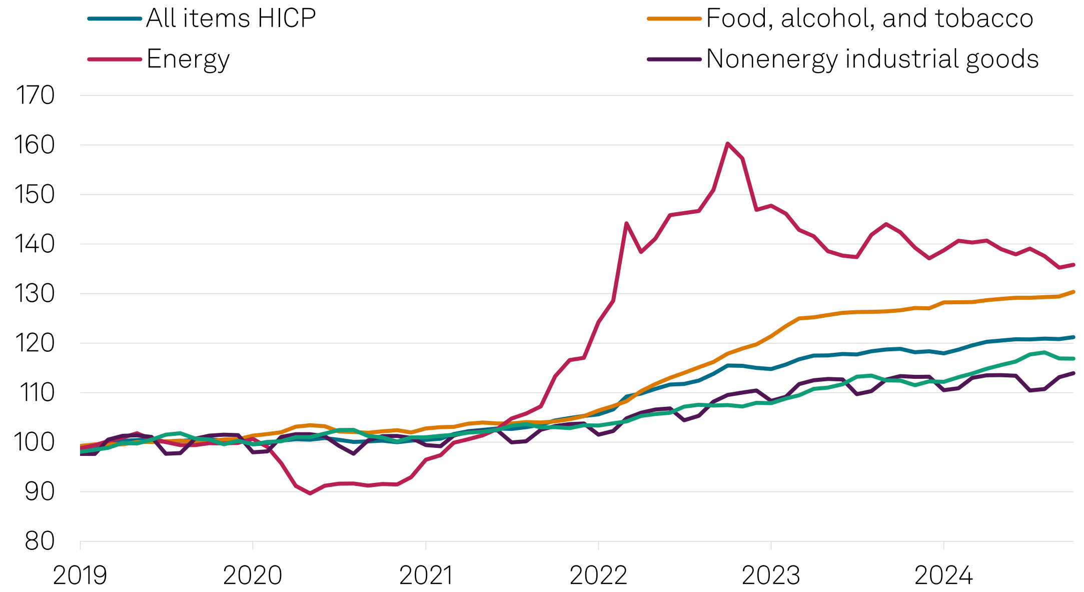
- Lower rates will underpin asset and covered bond performance, but a long period of very stable macroeconomic forecasts might come to an end as new leaders in the U.S., the EU, and Germany could take decisions early next year on tariffs, defense, and general spending that could reshape the economic outlook.
- In our base-case scenario, eurozone GDP will grow 1.2% in 2025, with Germany's GDP growth falling short of eurozone peers', while Spain will continue to outperform. We expect inflation to fall to 2.1% and the European Central Bank (ECB) to cut rates to 2.5% before midyear.
- Benchmark European covered bond issuance ebbed slightly in 2024 but remained close to recent highs. The drivers of new supply look slightly weaker in 2025, as scheduled covered bond redemptions remain flat and bank deposits bounce back while lending remains lackluster. We therefore expect European benchmark covered bond issuance of about €140 billion.
- House price corrections and increasing income have returned affordability to 2015 levels. Higher-for-longer mortgage rates are taking their toll on residential mortgage performance, but it remains strong thanks to tight labor markets. Easing interest rates and a return to growth will limit the risk of further deterioration.
- High interest rates, e-commerce, and working from home have produced unprecedented levels of stress in European commercial real estate (CRE). Some sectors now face market value declines that exceed those during the global financial crisis. While we believe that overall CRE asset performance will remain weak in 2025, the availability of significant excess credit enhancement remains a key strength for programs we rate.
- 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.

Economic Conditions | Monetary Policy Could Become Less Restrictive

- We expect eurozone inflation to decrease to 2.1% in 2025, with prices potentially stabilizing over the near term.
- Disinflation will enable central banks to continue gradually easing their monetary policy, with the ECB deposit rate landing at 2.5% before the summer of 2025.

Inflation has eased, but price levels remain high, particularly for energy and food

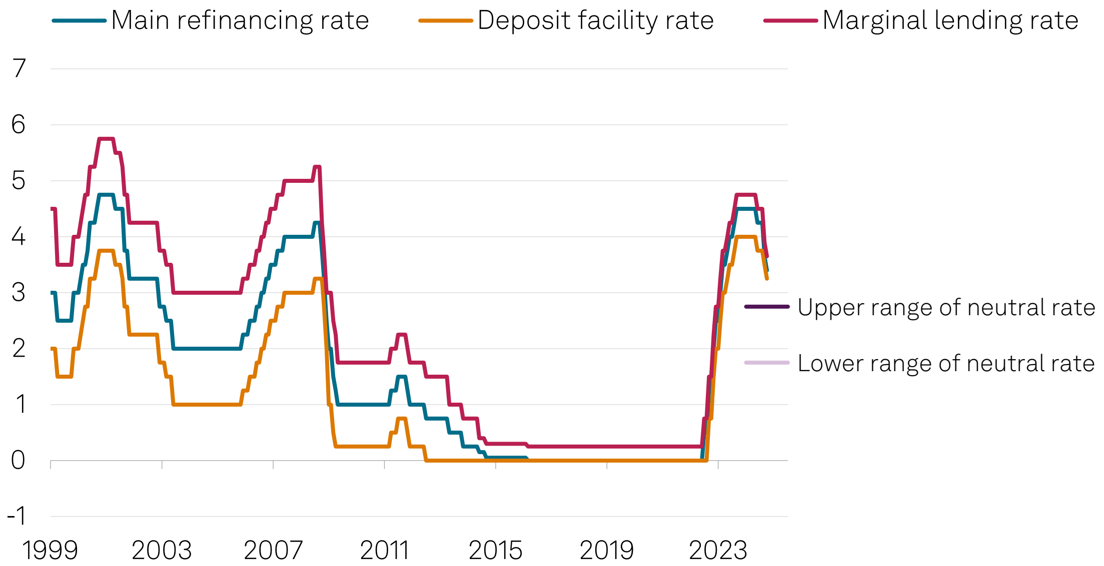
Price level, NSA (2019=100)



Breakdown of HICP level for the eurozone. HICP--Harmonized index of consumer prices. NSA--Not seasonally adjusted.
Sources: Eurostat, S&P Global Ratings.

ECB key policy rates will not turn neutral any time soon

(%)



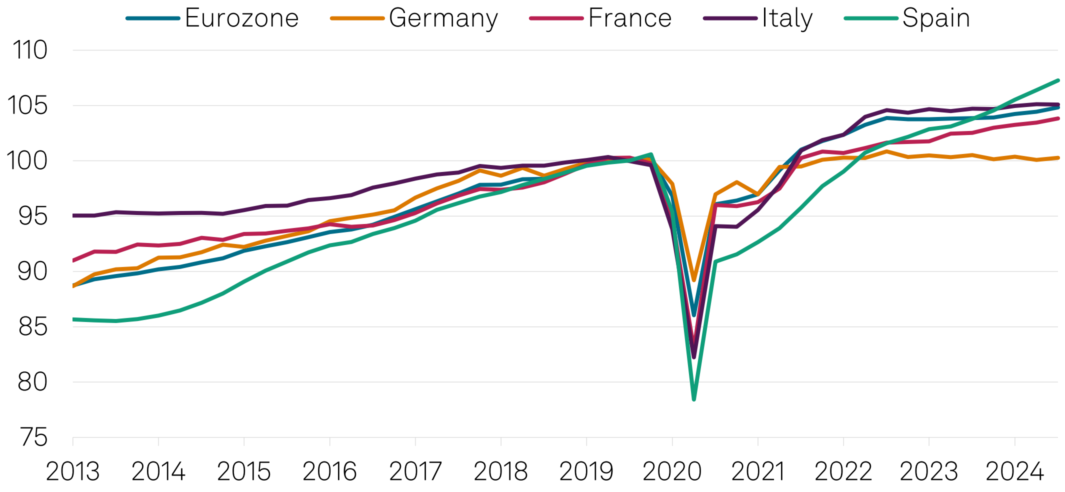
Sources: ECB, S&P Global Ratings.

Economic Conditions | Labor Markets Appear More Fragile

- Economic growth will pick up in 2025 as consumer spending strengthens, supported by real income growth and full employment. We forecast eurozone GDP growth of 1.2%, with Germany lagging and Spain outperforming.
- Despite strong disinflation, the unemployment rate in the eurozone has reached a new multi-decade low. But job vacancies have declined close to a level that preempted a rise in unemployment rates in previous cycles.

Spain has turned from laggard to forerunner in the eurozone recovery

GDP in real terms (2019=100)



Sources: Eurostat, S&P Global Ratings.

S&P Global Ratings' European economic forecasts

(%)

	Eurozone	Germany	France	Italy	Spain	Netherlands	U.K.
GDP							
2023	0.5	-0.1	1.1	0.8	2.7	0.1	0.4
2024	0.8	-0.1	1.1	0.5	3.1	0.9	0.9
2025	1.2	0.9	1.0	0.9	2.5	1.6	1.5
2026	1.3	1.1	1.2	1.1	2.0	1.3	1.6
2027	1.2	1.1	1.1	1.0	2.0	1.4	1.5
Unemployment rate							
2023	6.6	3.0	7.3	7.7	12.2	3.5	4.5
2024	6.4	3.4	7.5	6.7	11.5	3.7	4.3
2025	6.5	3.5	7.7	6.4	11.4	3.8	4.1
2026	6.4	3.4	7.6	6.6	11.3	3.9	4.1
2027	6.2	3.2	7.5	6.5	11.2	3.8	4.2

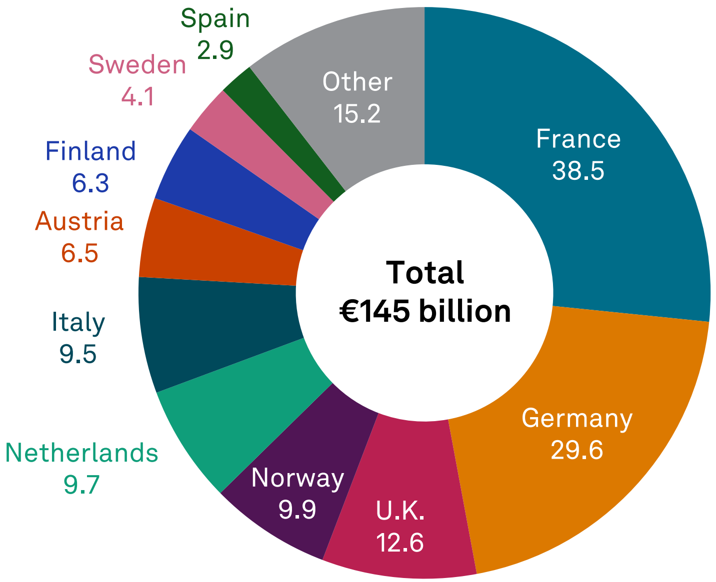
Source: S&P Global Ratings. Economic Outlook Eurozone Q1 2025: Next Year Will Be A Game Changer, Nov. 26, 2024.

Issuance | European Covered Bond Volumes Remained Healthy In 2024

- In 2024, activity declined in most European covered bond markets, resulting in an overall year-on-year reduction of about 15% to €145 billion, not helped by occasional bouts of market volatility following geopolitical developments, for example.
- However, benchmark covered bond issuance remained elevated relative to most years over the past decade.

2024 YTD European benchmark issuance, by country

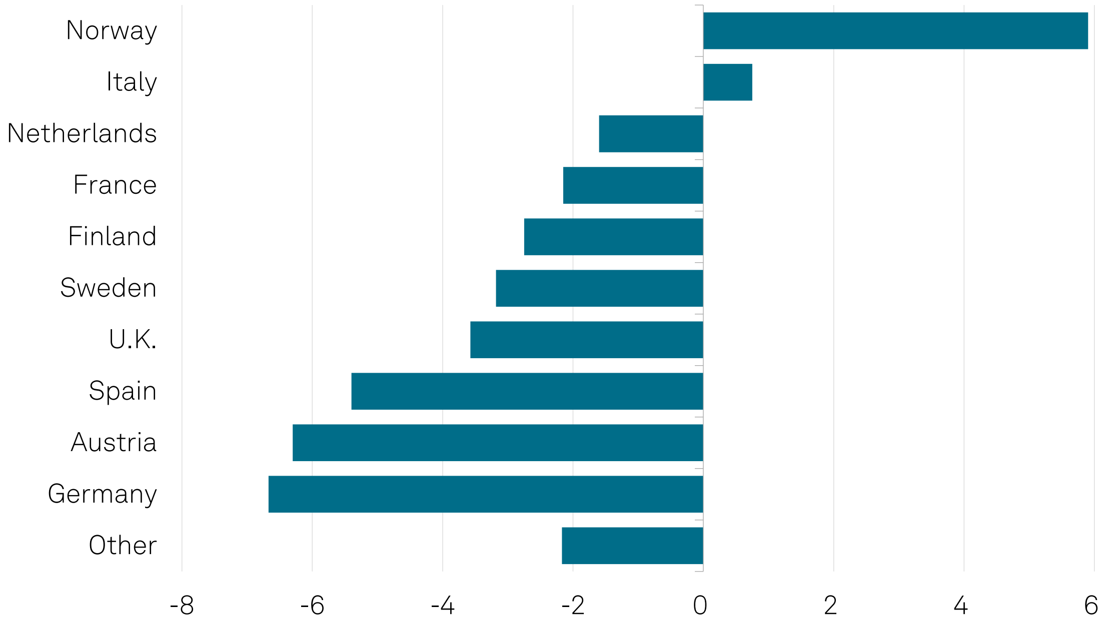
(Bil. €)



YTD--Year to date. Based on 2024 issuance as of Dec. 1, 2024. Source: S&P Global Ratings.

Change in YTD issuance, 2024 versus 2023, by country

(Bil. €)

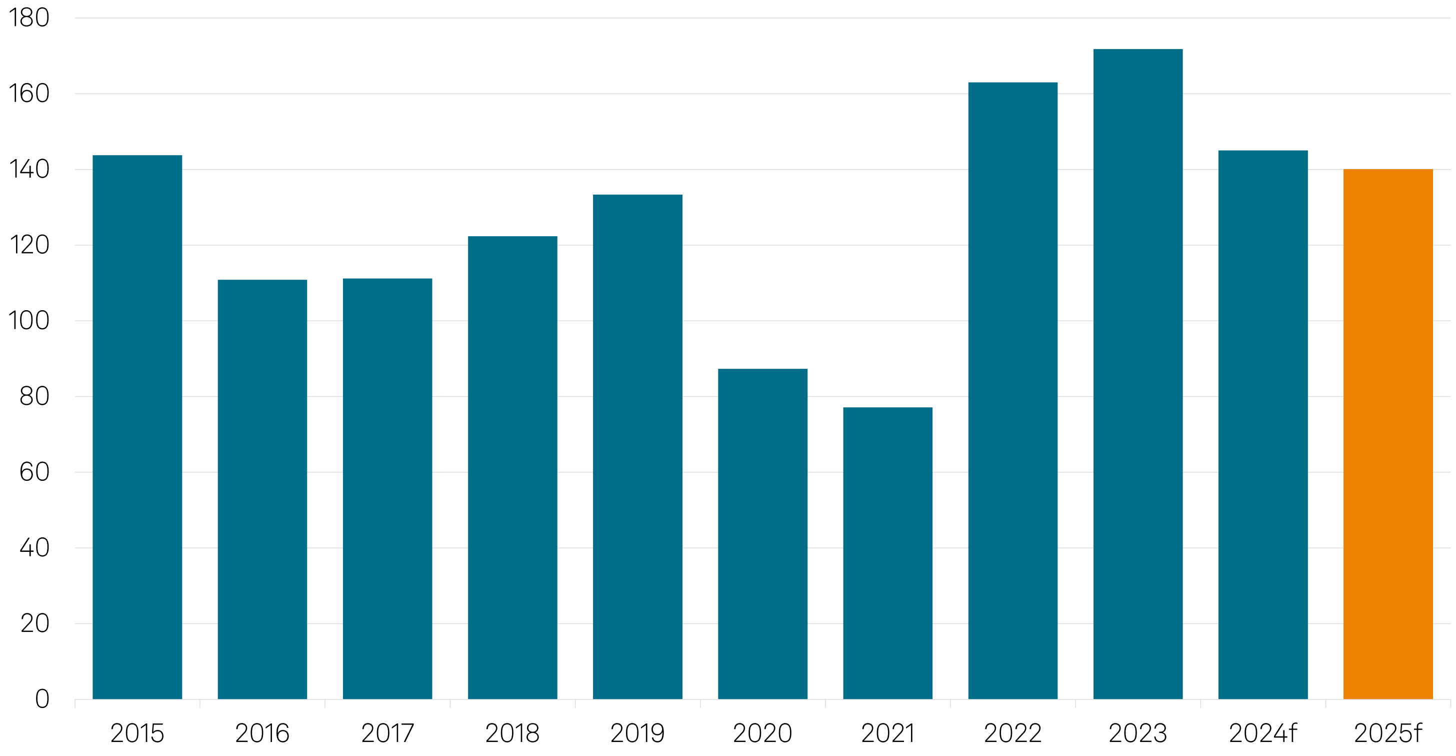


YTD--Year to date. Based on issuance as of Dec. 1 each year. Source: S&P Global Ratings.

Issuance | Covered Bond Volumes Could Steady In 2025 But Remain Elevated

European investor-placed benchmark covered bond issuance

(Bil. €)



f--Forecast. Source: S&P Global Ratings.

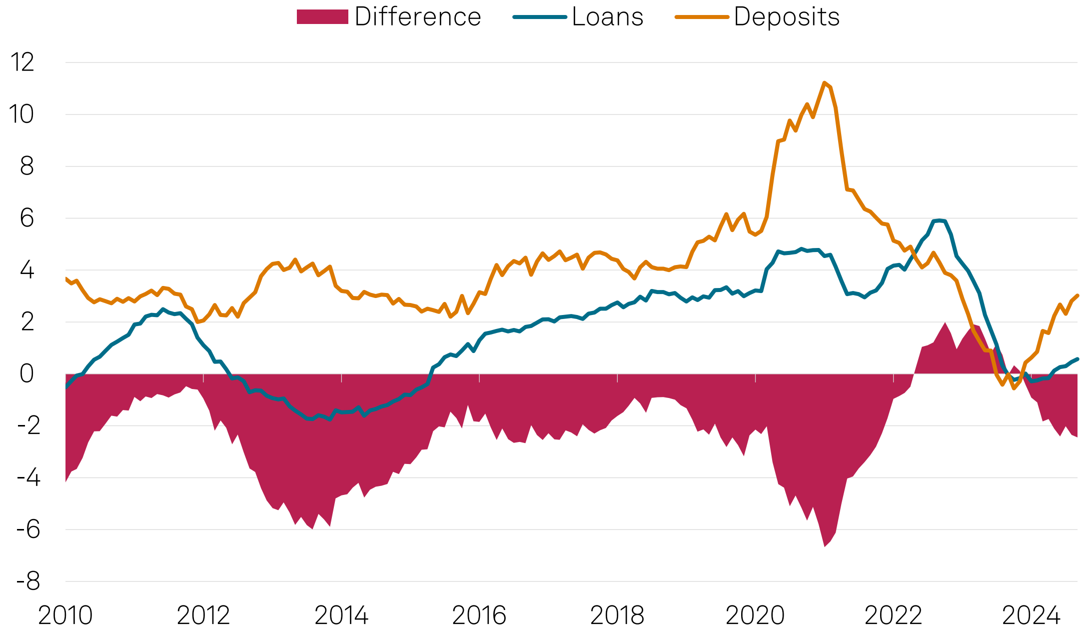
- Scheduled European covered bond redemptions are set to remain flat in 2025, adding little pressure for increased issuance.
- Rising real wages have also led to a bounce-back in the growth of banks' deposit bases, while lending levels have remained subdued.
- At the same time, earlier borrowings from the ECB's targeted longer-term refinancing operations have now matured, potentially reducing some issuers' new funding needs.
- These trends will likely constrain banks' incentives to incrementally tap covered bond markets in 2025, keeping supply steady.
- That said, our forecast of about €140 billion European benchmark covered bond issuance, would still be above the average of the past ten years.

Issuance | Loan And Deposit Growth Trends Are Negative For Supply

- While the growth rate of eurozone banks' loan books is close to a ten-year low, deposit growth is picking up, likely due to stabilizing consumer prices and higher wages. The difference between these two rates has been decreasing.
- Covered bond issuance is historically correlated with this measure, suggesting more subdued supply than in 2022 and 2023.

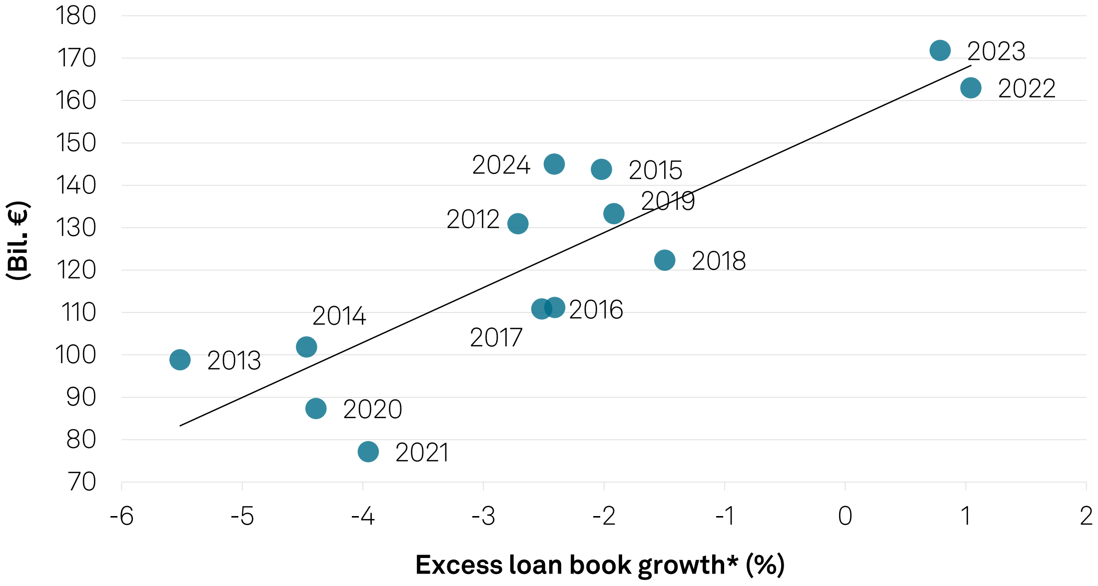
Lending/deposit growth, Eurozone households and NFCs

(%)



NFCs--Nonfinancial corporates. Difference is loan growth minus deposit growth. Source: European Central Bank.

European covered bond issuance versus excess loan growth



*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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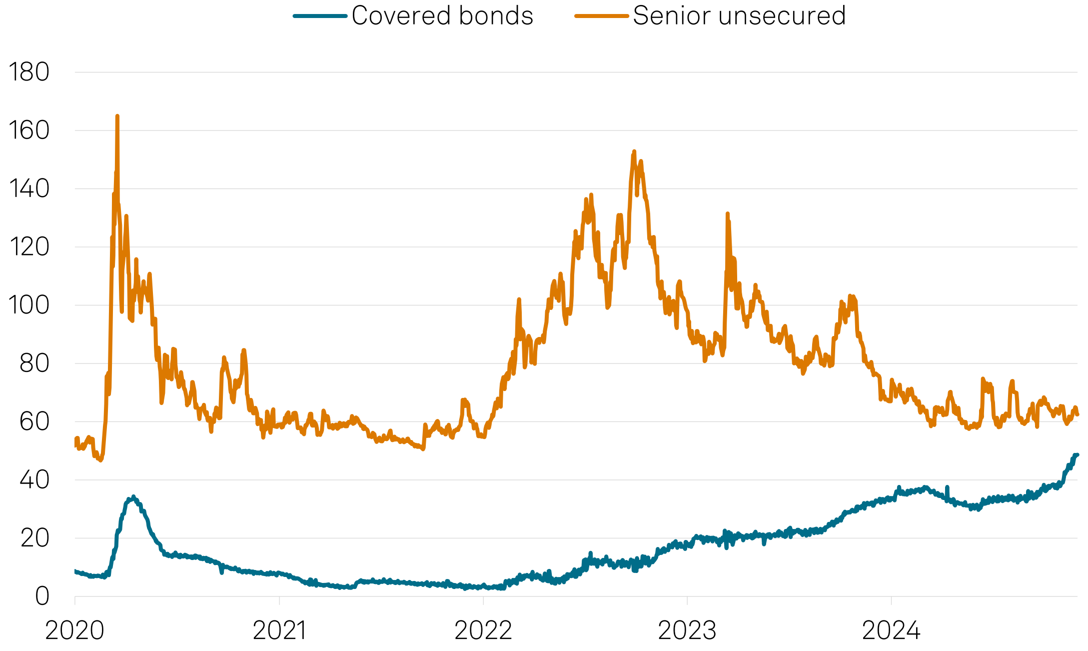
Issuance | Spread Trends Unsupportive For Covered Bonds In The Near Term

- Covered bond spreads have trended wider since rates began to rise, and the gap relative to pricing of unsecured financials has closed. This could be a negative for supply in the near term, as banks could favor other funding options.
- The sector's investor appeal has also taken a recent hit as government bonds have cheapened relative to covered bonds.

Indicative funding spreads for financials

(bps)



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

Bund-swap spread

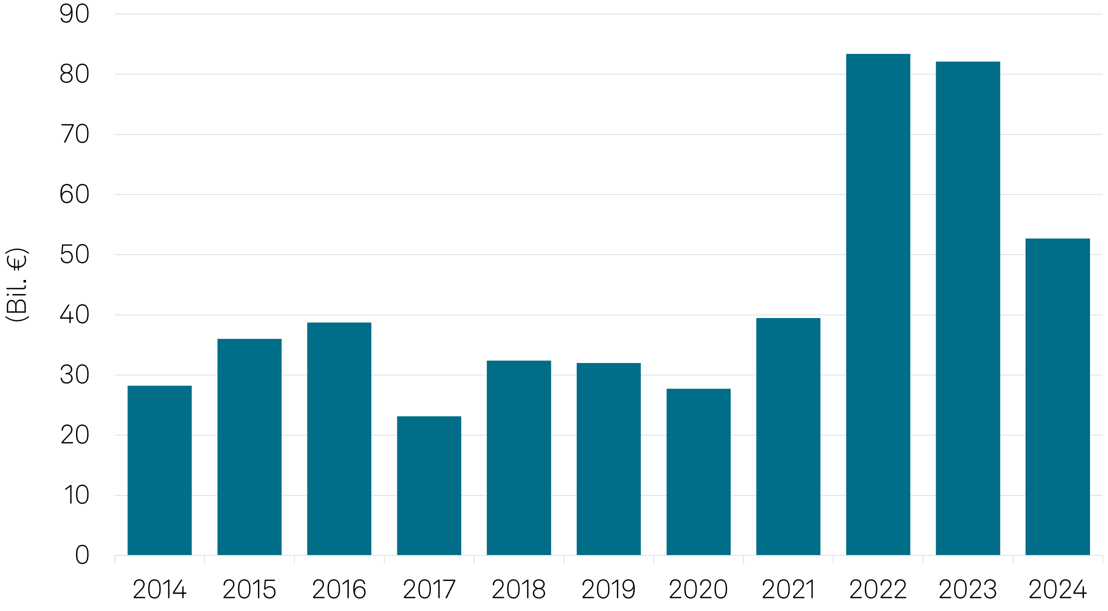
(bps)

Bps--Basis points. Based on generic five-year government bond yields and euro swap rates. Source: Bloomberg, S&P Global Ratings.

Issuance | Outside Europe, 2024 Saw A Return To More Normal Volumes

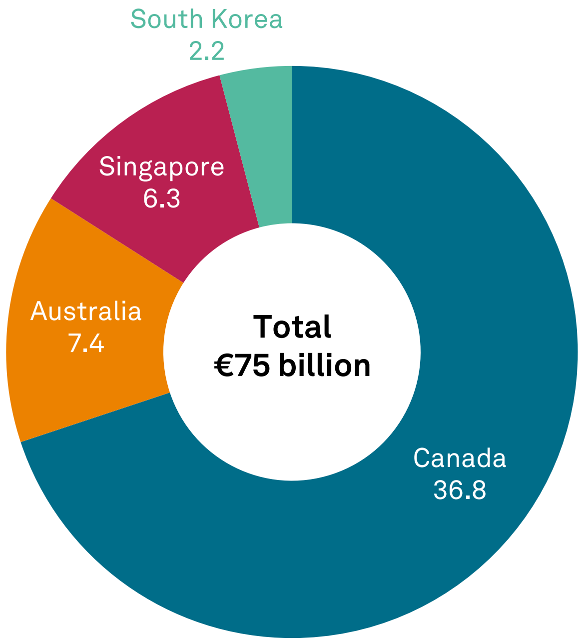
- Benchmark covered bond issuance from non-European banks fell considerably in 2024, after two years of unusual highs.
- Issuance volatility in these markets has partly been due to large changes in the volume of covered bond redemptions from one year to the next. In 2025, scheduled redemptions look set to rise sharply again for Australian and Canadian issuers.

Non-European benchmark covered bond issuance
(Bil. €)



2024 figures based on issuance as of Dec. 1. Source: S&P Global Ratings.

2024 YTD non-European benchmark issuance, by country
(Bil. €)



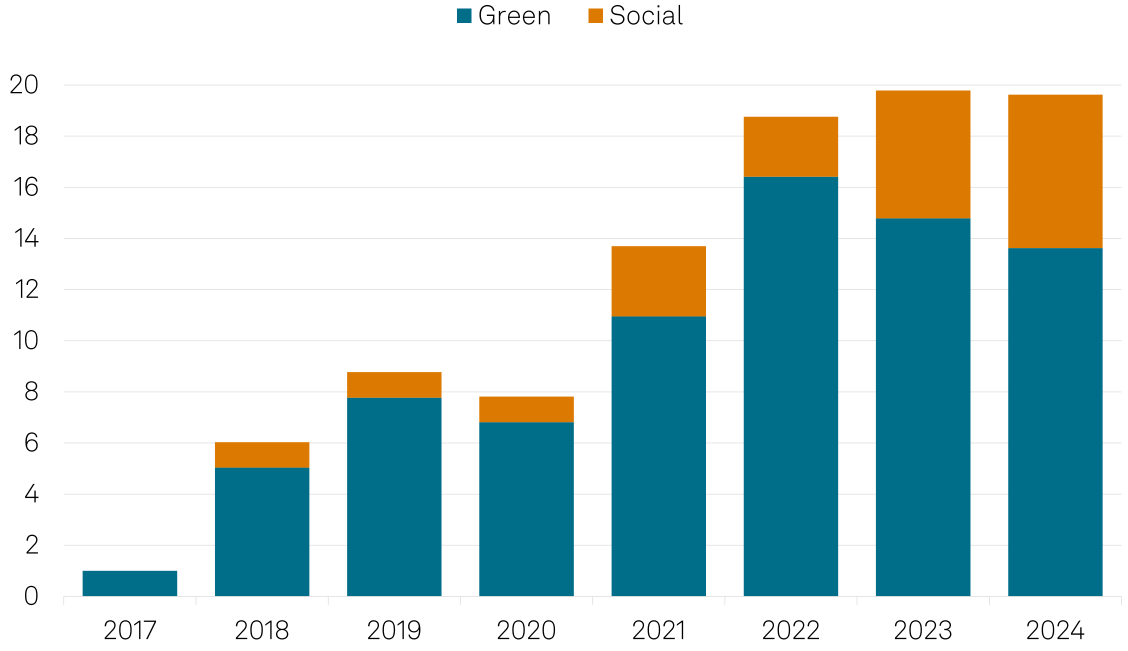
YTD--Year to date. Based on 2024 issuance as of Dec. 1. Source: S&P Global Ratings.

Sustainable Covered Bonds | Labeled Issuance Still Close To Highs In 2024

- Close to €20 billion of new covered bonds were labeled either "green" or "social" by issuers in 2024--similar to the record level set in 2023. This corresponded to almost a 14% share of overall issuance, second only to the peak of 18% in 2021.
- Some issuers now clearly have established programs and annual volume expectations for labeled issuance.

Sustainable benchmark covered bond issuance

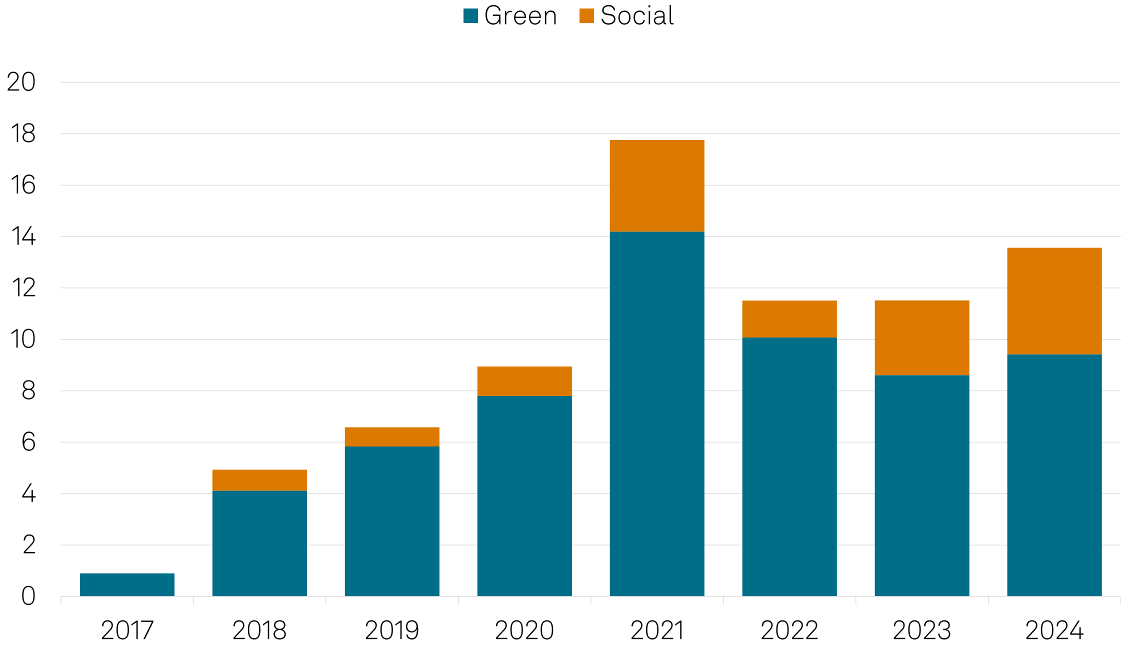
(Bil. €)



2024 figures based on issuance as of Dec. 1. Source: S&P Global Ratings.

Sustainable share of benchmark issuance

(%)



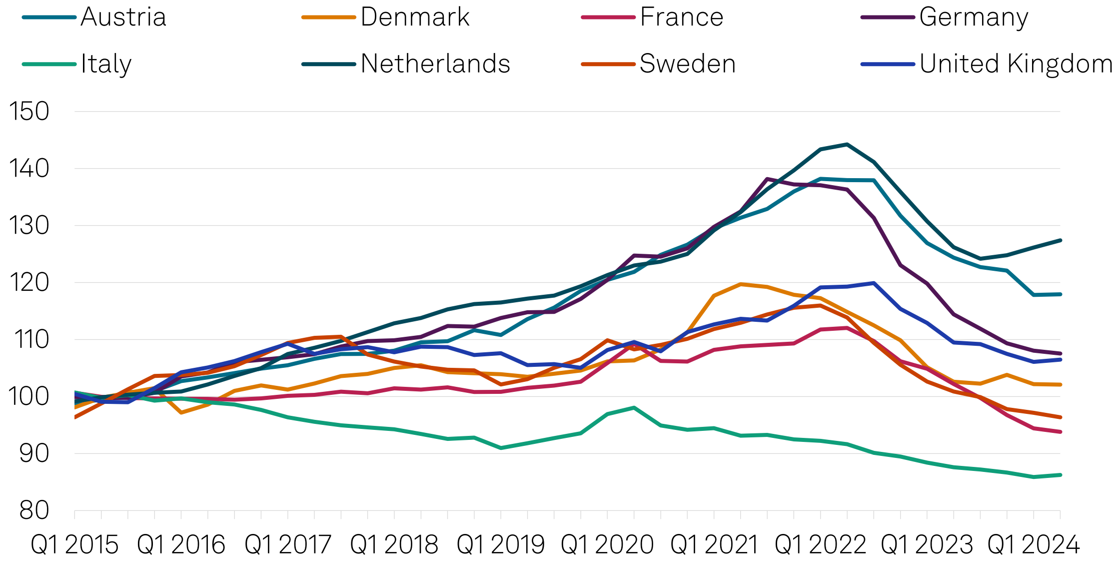
2024 figures based on issuance as of Dec. 1. Source: S&P Global Ratings.

Credit Performance | Falling House Prices Support Affordability

- House prices corrections, falling mortgage rates, and increasing salaries have returned housing affordability to 2015 levels. House prices are now stable or increasing in most European countries, but still weakening in Germany, Finland, and France.
- Higher-for-longer mortgage rates are taking their toll on residential mortgage credit performance, but it remains strong, 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.

Income has caught up with declining house prices in Europe

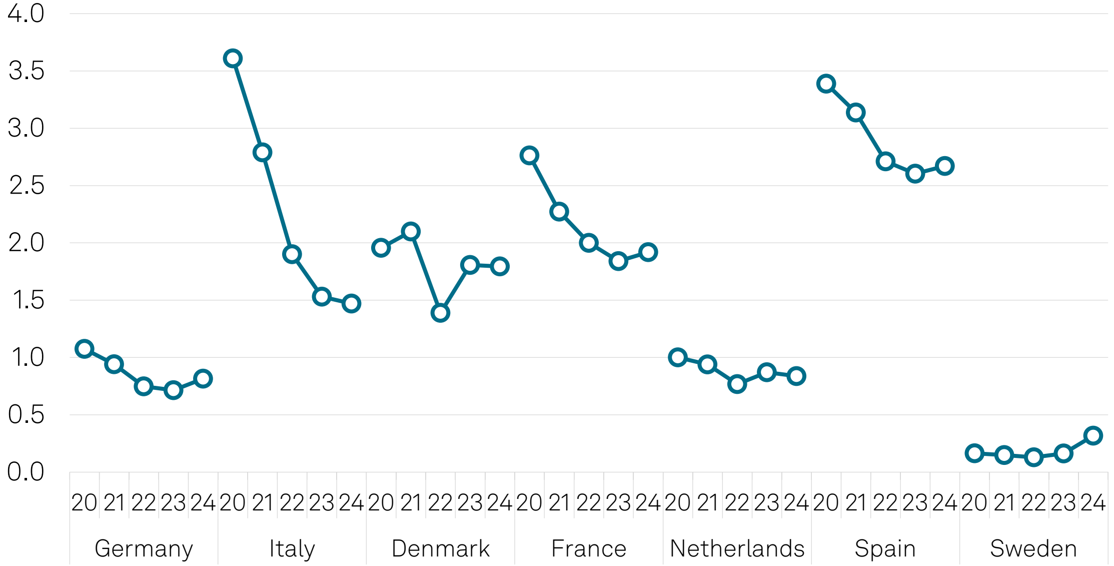
Price to income (2015=100)



Sources: OECD, S&P Global Ratings.

Mortgage performance is stable despite higher-for-longer rates

Nonperforming loan ratio of residential mortgage loans (%)



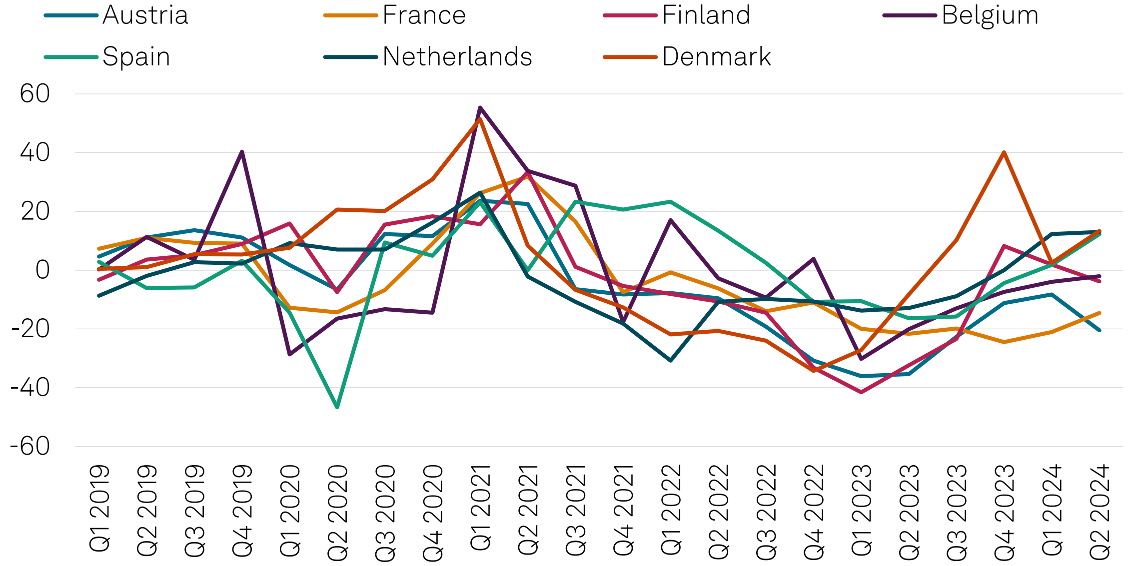
Data as of June each year. Sources: European Banking Authority, S&P Global Ratings.

Credit Performance | Subdued Market Activity Despite Increasing Loan Demand

- The number of transacted dwellings decreased in half of the EU member states covered, while the other half increased.
- A likely economic rebound and gradual decrease in interest rates will support house prices and loan origination. Euro area banks reported a further net easing of credit standards for household mortgages in the third quarter of 2024. The aggregate picture masks substantial diversity between banks in Germany and France, and the remaining euro area.

Transacted dwellings decreased in half of the 14 EU Member States covered

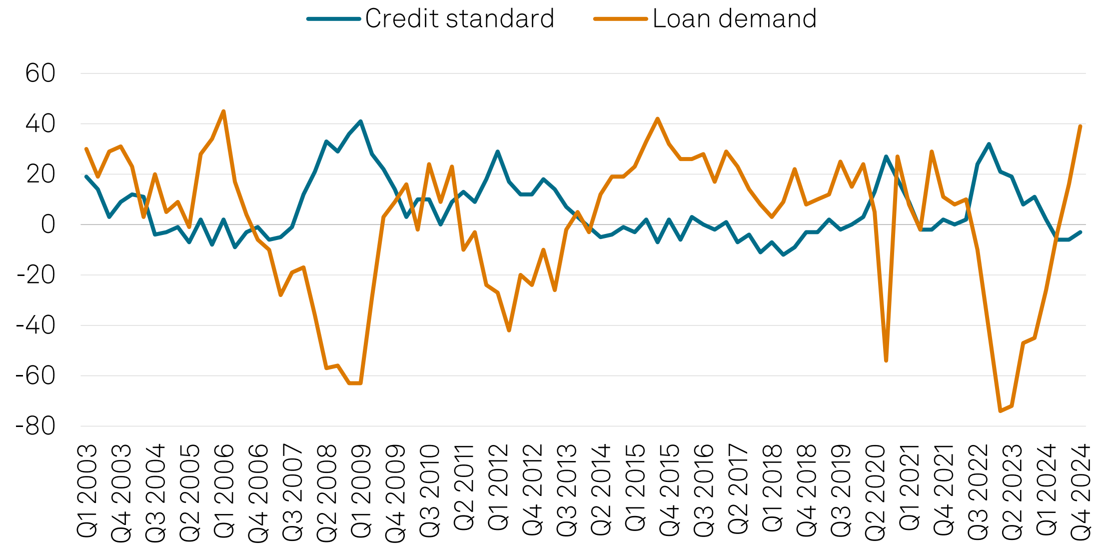
Year-on-year change (%)



Source: Eurostat, S&P Global. House sales indexed number of transactions (Y on Y) (2015=100).

Loan demand continues rebound as lending standards remains supportive

(%)



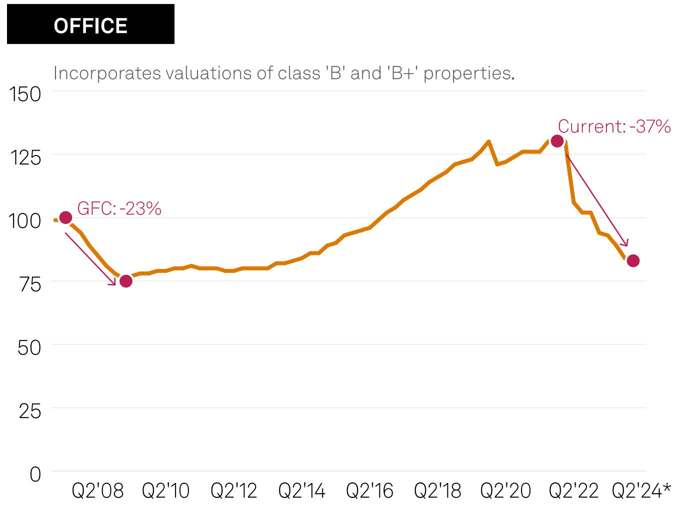
Net proportion of banks reporting credit standards for household mortgages tightening, and of banks reporting an increase in housing loan demand. Source: ECB lending survey Q1 2024.

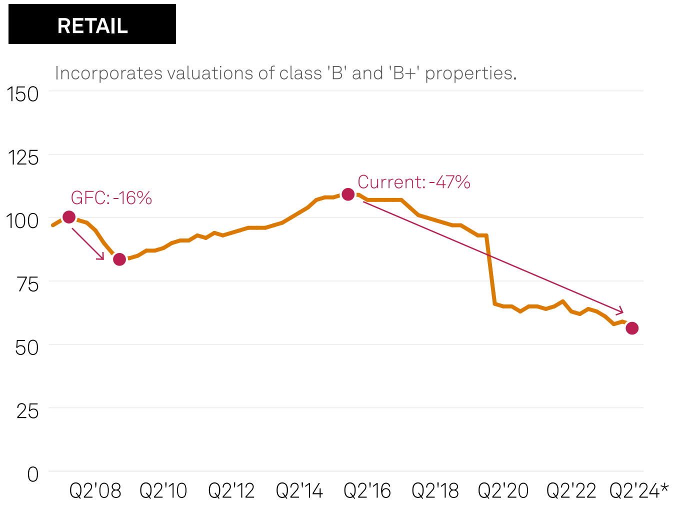
Credit Performance | CRE Performance May Deteriorate Further

- Higher interest rates, e-commerce, and remote working have produced unprecedented levels of stress in European CRE. Some sectors now face market value declines that exceed those during the global financial crisis.
- Despite falling prices, CRE performance in covered bonds has remained relatively stable, although the European Banking Authority has reported a meaningful deterioration recently. While we believe that overall CRE asset performance will continue to deteriorate in 2025, as valuations bottom out, we see little effect on our rated covered bond programs. The availability of significant excess credit enhancement remains a key strength for the programs we rate.

European commercial real estate value indices, by sector

Index points

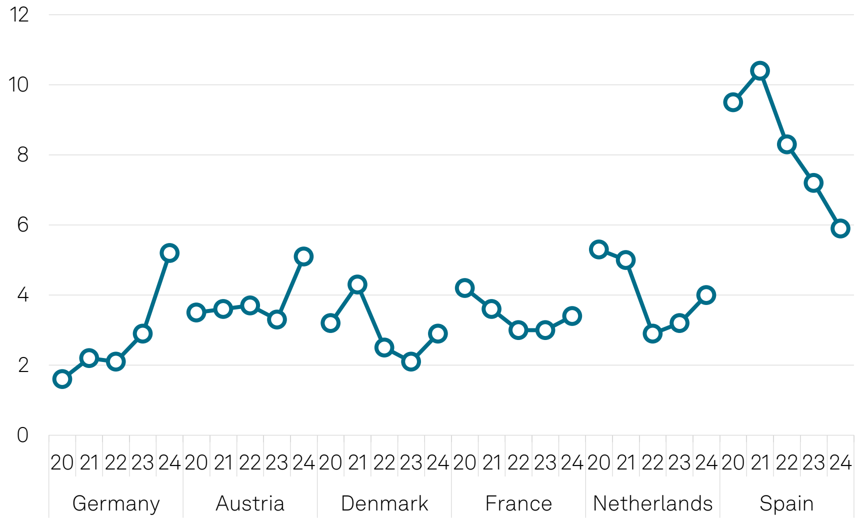




Data as of Q1 2024. Green Street pan-European commercial property price indices.
Sources: Green Street UK, S&P Global Ratings.

CRE performance is deteriorating but NPLs remain low

Nonperforming CRE loan ratios (%)



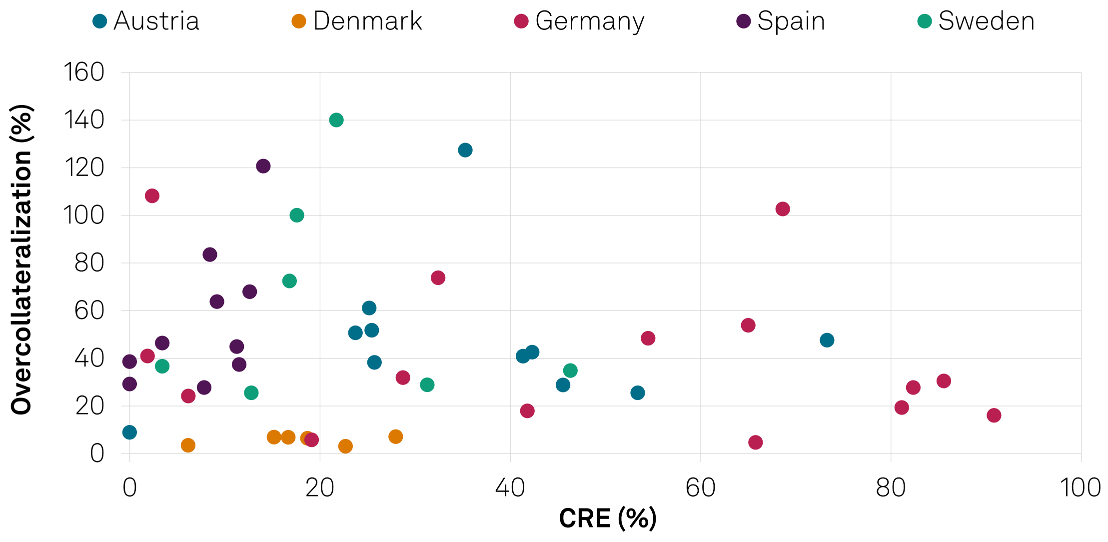
Data as of June each year. CRE--Commercial real estate.
Sources: European Banking Authority, S&P Global Ratings.

Credit Performance | Important Differences In CRE Exposure Exist

- Most cover pools consist of a combination of residential and commercial assets, and the dual recourse nature of covered bonds enables investors to benefit from the overall strength of banks' balance sheets. European banks' balance sheets have relatively low exposure to CRE.
- While we generally believe that CRE exposure is manageable on European banks' balance sheets, certain cover pools exhibit higher loan concentration. The ongoing CRE repricing, low levels of new origination, and frequent regulatory requirements to update valuations may cause cover pool compositions and risk profiles to change.

Important differences in CRE exposure and excess OC exist

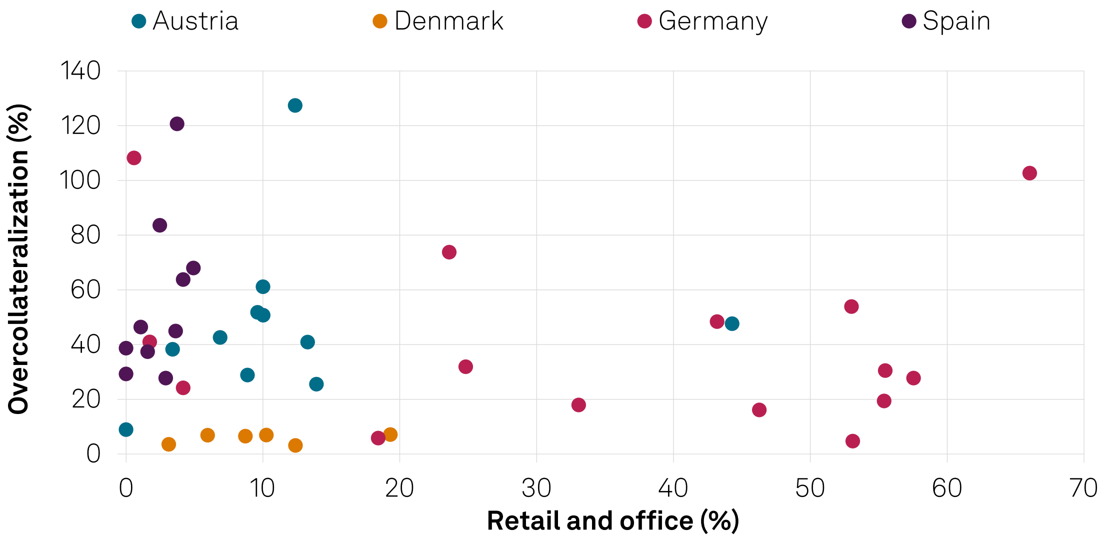
OC versus CRE exposure (% of cover pool assets)



CRE--Commercial real estate. OC--Overcollateralization. Sources: S&P Global Ratings.

Limited exposure to the office sector outside Germany

OC versus retail and office exposure (% of cover pool assets)



OC--Overcollateralization. Sources: S&P Global Ratings.

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Banks Outlook | European Overview

What we expect for the next 12 months

- **European banks will remain solid**, with banks in Southern Europe showing some ratings upside.
- Banks' **active hedging strategies** and **increased focus on fee income and cost control** will help lessen the effect of declining interest rates, with banks posting sound returns in 2025.
- Signs of increased lending demand from households amid lower interest rates suggest **the return of loan growth in 2025**.
- **Credit costs will normalize** but remain affordable for banks, with commercial real estate (CRE) exposures still requiring higher provisions.
- Excess capital and better valuations could lead to **more mergers and acquisitions**, but **attractive distributions to shareholders** will continue.

Downside risks...

- **Market turbulence** caused by adverse geopolitical events or unexpected monetary policy decisions.
- **Subdued economic growth**, leading to more corporate insolvencies and higher unemployment.
- **Increased risk-taking by some banks** as interest rates decline.
- **Insufficient resilience against increasing cyber risks**.

...and what they mean for the sector

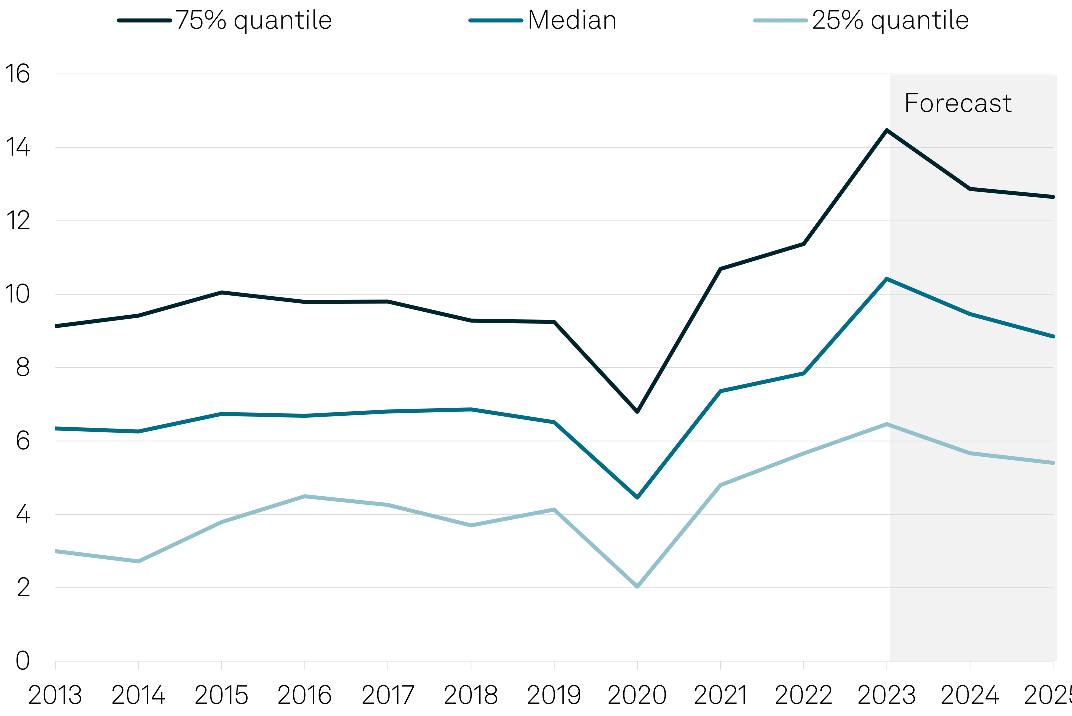
- Increased volatility and market turbulence could **destabilize financial institutions** with weaker funding structures, especially nonbank financial institutions with high refinancing needs, and **expose banks to higher counterparty credit risks**.
- Weak economic growth could undermine the financial health of corporates and households, particularly the more vulnerable ones, **weakening banks' asset quality** and clouding business prospects.
- As interest rates decline and banks face earnings pressure, some may be tempted to **undertake undue risks**.
- Failure to build resilience against cyber risk could **test the long-term viability of some institutions**.

Source: Global Banks Outlook 2025: Cautiously Confident, Nov. 14, 2024.

Banks Outlook | Profitability Will Remain Solid

Profits will decline but remain solid in 2025

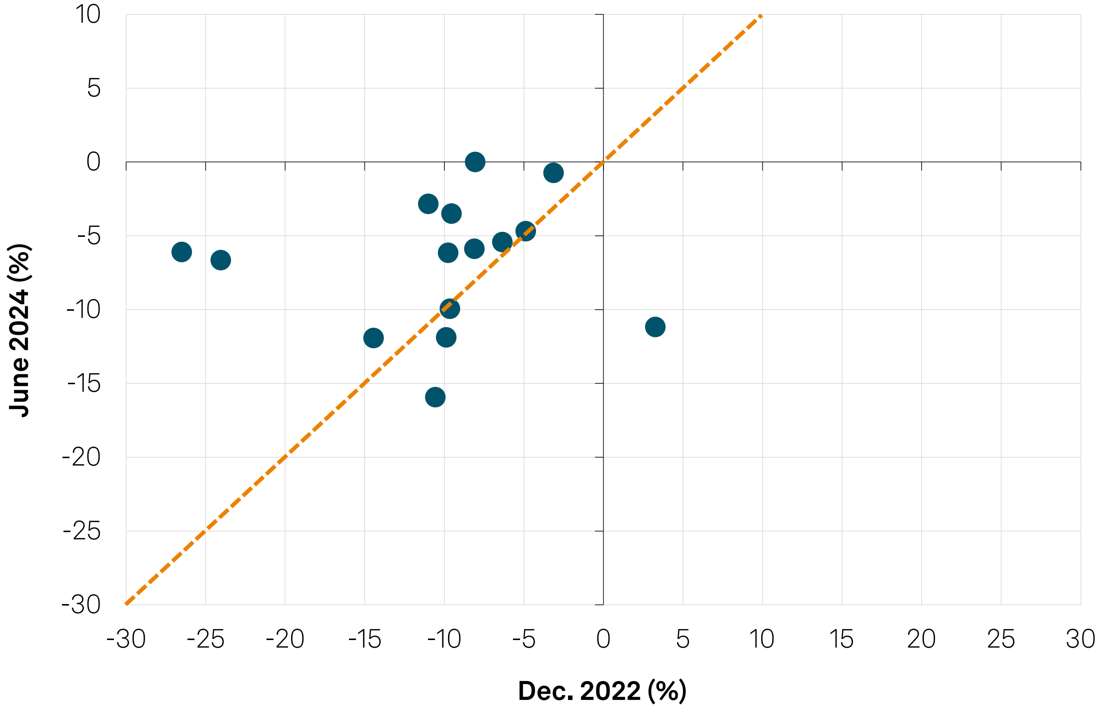
Evolution of return on average common equity (%)



Sample includes rated European banks with a stand-alone credit profile. f--Forecast. Source: S&P Global Ratings.

Banks are taking measures to limit revenue declines resulting from lower rates

Banks' net interest income sensitivity to lower rates

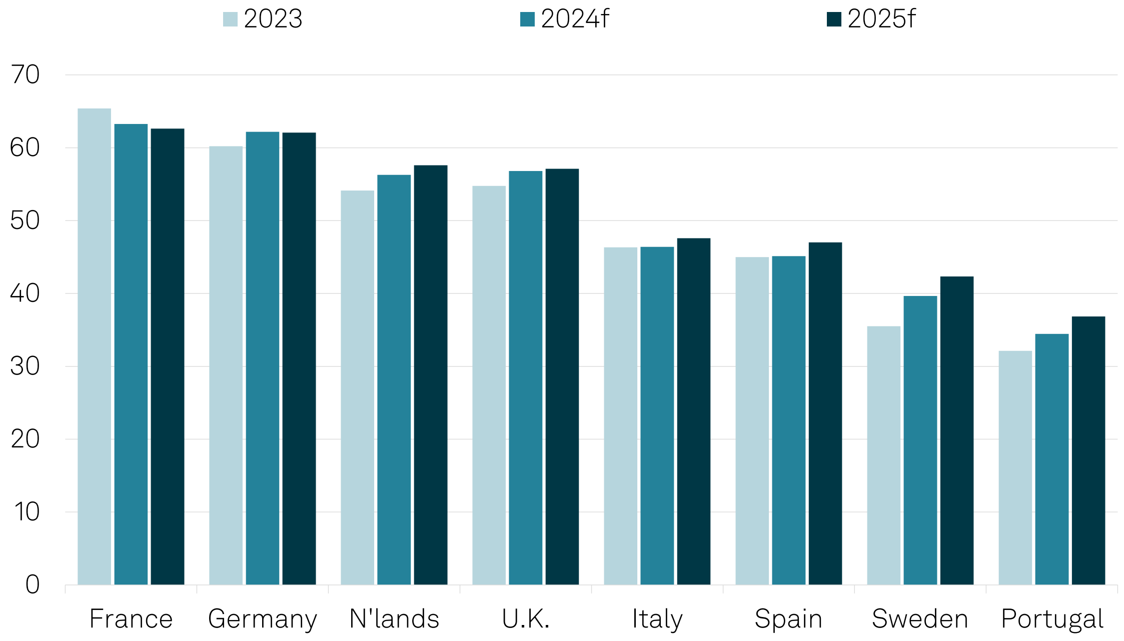


Reported impact on the net interest income of a 200-basis-point decline in interest rates at end 2022 and in June 2024. Sample includes 15 large European banks. Sources: Banks' Pillar 3 reports, S&P Global Ratings.

Banks Outlook | Controlling Costs And Generating More Fee Income Will Be Top Priorities

Efficiency will worsen and continue diverging meaningfully across geographies...

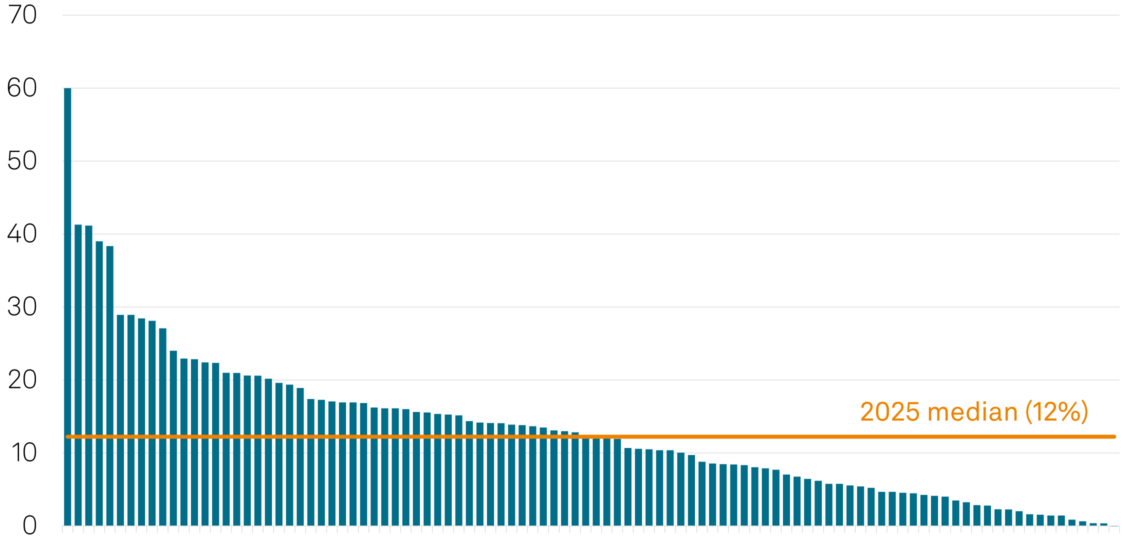
Rated European banks' cost-to-income ratios (%)



Values are weighted by total assets. Sample includes only banks that have data for all three periods (constant sample). f--Forecast. Source: S&P Global Ratings.

...but banks' capacity to absorb a normalized cost of risk will remain ample

Expected credit losses as a proportion of 2025 pre-provision earnings, top 100 European banks (%)



Source: S&P Global Ratings.

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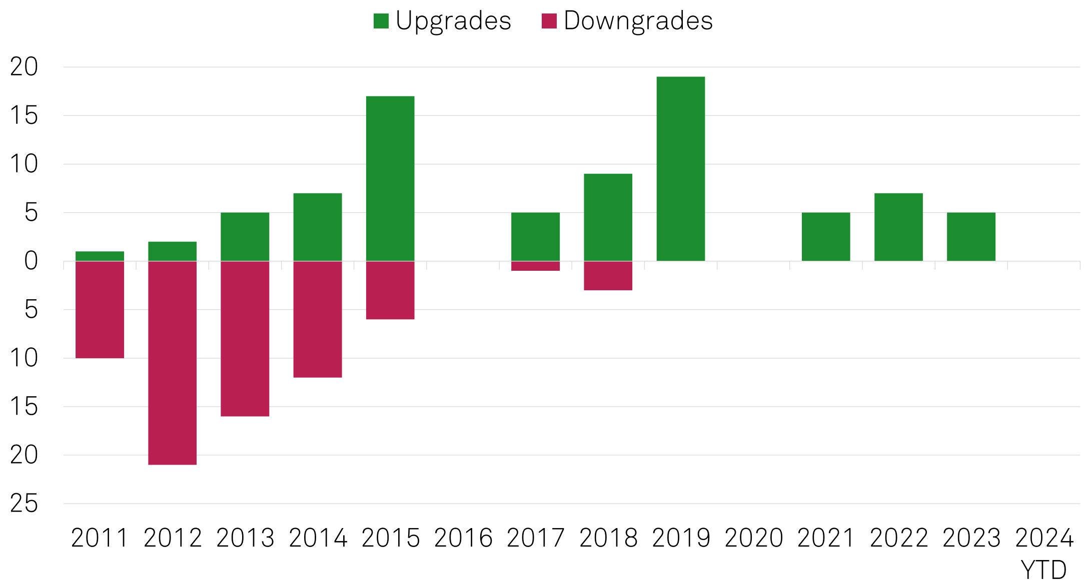
Ratings Outlook | Covered Bond Ratings Resilient And With A Stable Outlook

- In 2024, we made positive outlook revisions on three of the programs we rate. Following our downgrade of France in May, we did not downgrade any French covered bond programs, but we revised the outlook on two of them.
- Of the covered bond programs that we rate, all except one have stable or positive outlooks.

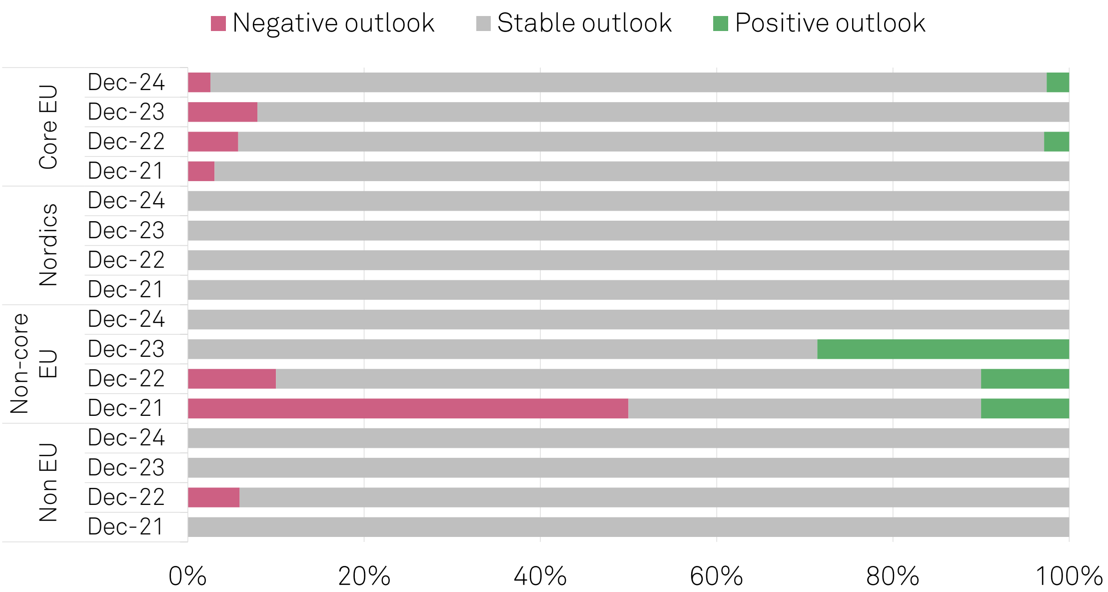
Covered bond ratings unchanged despite France downgrade

Rating actions (no.)



Outlooks are predominantly stable in all regions

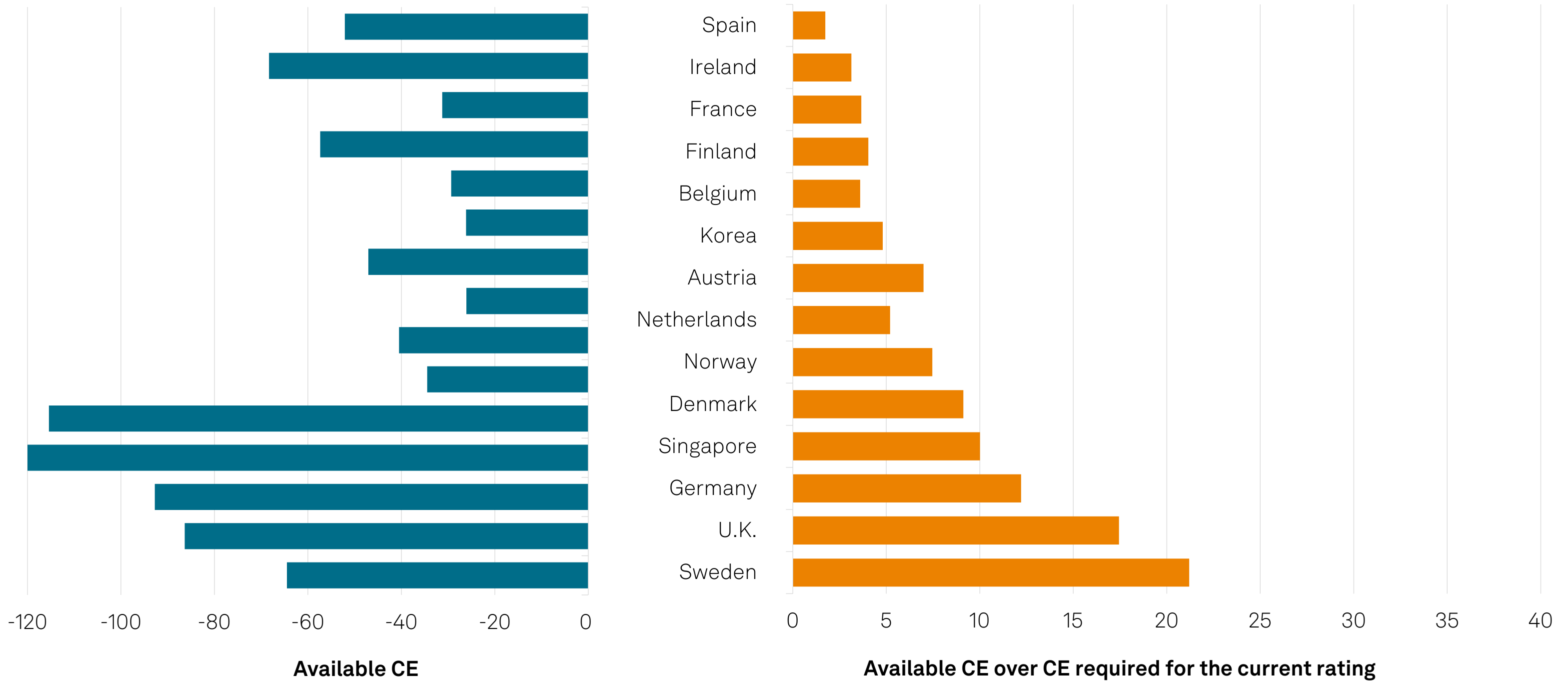
Distribution of outlooks (%)



YTD--Year to date, as of Dec. 7, 2024. 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.
Source: S&P Global Ratings.

Ratings Outlook | Overcollateralization Could Mitigate A Deterioration In Collateral Performance

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



CE--Credit enhancement. Source: S&P Global Ratings.

- Despite strong 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 the limited deterioration in collateral performance that we expect under our base case.

Ratings Outlook | Unused Notches Mitigate Bank Downgrade Risk

- Rated programs benefit on average from two unused notches--the number of notches the issuer rating can be lowered without resulting in a downgrade of the covered bonds.
- Belgian, Danish, German, French, and Dutch programs are more protected from the risk of bank downgrades.
- Spanish, Italian, 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.

Unused notches by country (number of notches)

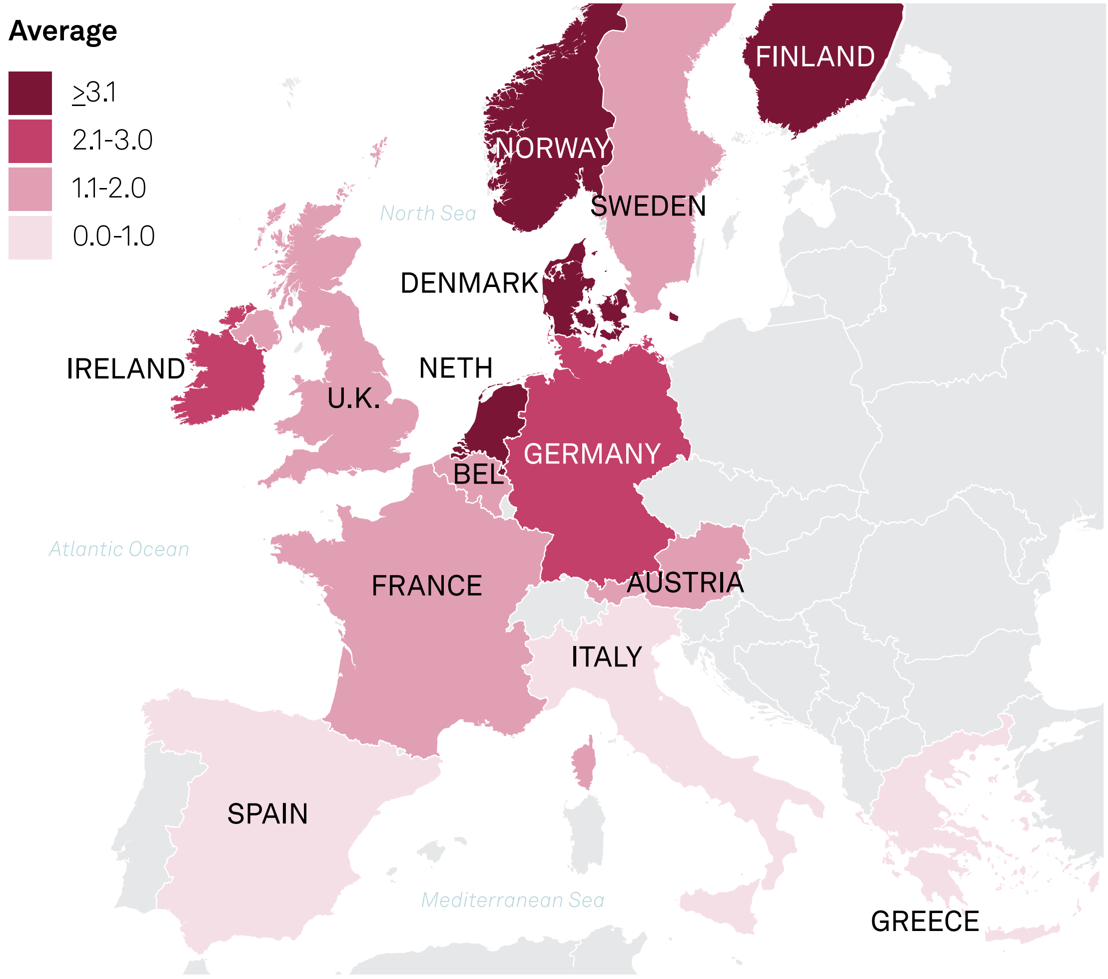
	Average	Range
Austria	0.8	0 - 3
Belgium	3.3	3 – 4
Germany	3.1	1 – 4
Denmark	3.3	1 – 5
Spain	0.5	0 – 1
Finland	1.5	0 – 5
France	3.2	0 – 5
Ireland	4.0	4 – 4
Iceland	2.0	2 – 2
Italy	1.0	1 – 1
Netherlands	2.7	1 – 4
Norway	2.7	0 – 4
Sweden	2.4	2 – 3
U.K.	1.8	1 – 2

Note: Conditional pass-through programs are excluded because the ratings are delinked from the issuer credit rating and do not benefit from unused notches. Source: S&P Global Ratings.

Ratings Outlook | Noncore European And Public Sector Programs Have More Exposure To Sovereign Risk

- Rated covered bond programs would, on average, maintain the current ratings if their respective sovereigns were downgraded by up to 2.5 notches, all else being equal.
- Dutch, Danish, Finnish and Norwegian programs are more protected from the risk of sovereign downgrades.
- Greek, Italian, and Spanish programs have no buffer to mitigate the effect of sovereign downgrades and would be immediately affected by such an event.

Sovereign downgrade sensitivity, by country



Map shows the average notches of sovereign downgrade that rated covered bond programs can withstand without affecting their own rating. Source: S&P Global Ratings.

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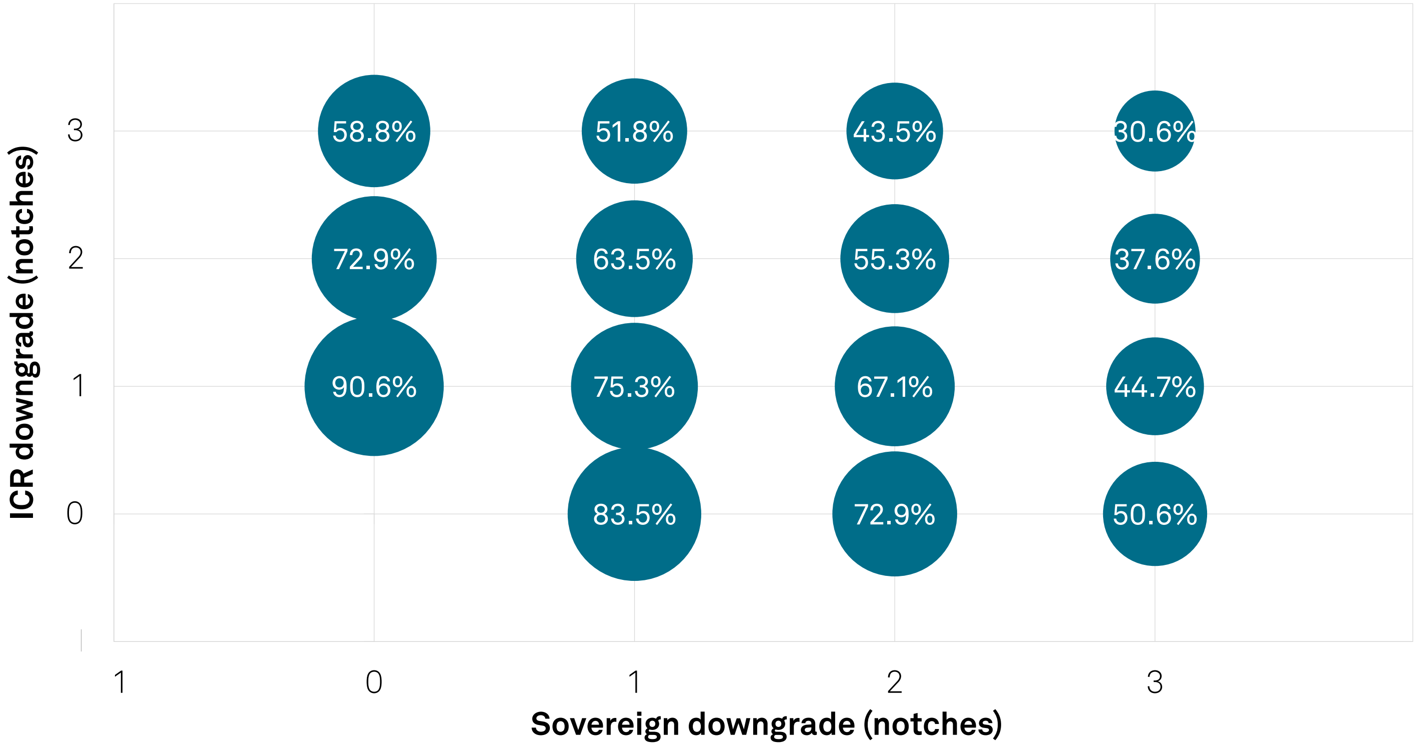
Ratings Outlook | Limited Issuer Or Sovereign Downgrades Would Not Affect Most Program Ratings

Percentage of covered bond ratings unaffected by an issuer or sovereign downgrade



ICR--Issuer credit rating. 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.
- The ratings on about 75% of the programs we rate would be unaffected by a one-notch downgrade of both the sovereign and the issuer.

Related Research

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