CREDIT MARKETS SPECIAL | FINANCIALS & COVERED BONDS | EUROZONE

Covered Bond Outlook 2024

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Contents

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Sub-Sovereigns & Agencies
Ralf Burchert, CEFA

Financials & Covered Bonds
Heiko Langer
Carmen Riefler-Kowarsch

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Covered bond market on the way to normalization

We expect issuance activity on the covered bond market to normalize further in 2024. This means a further moderate decline in issue volumes compared to 2023 and, above all, compared to the record year 2022. This will affect both the overall market, where we expect a volume of EUR 170-180bn, and the Austrian market, which should reach an estimated issue volume of EUR 11-13bn.

One of the main reasons for the expected decline in issuance volume is the dwindling influence of TLTRO3. Only around EUR 450bn of TLTRO3 tranches will be due next year. Part of this will also be refinanced by covered bonds in the coming year. However, we expect the impact of TLTRO3 maturities on the covered bond issue volume to gradually decline until the facility is repaid in full in December 2024.

Since the interest rate turnaround, credit growth at banks in the eurozone has slowed noticeably. Both a lower demand for credit and a tightening of lending rules have been observed. We expect credit growth to remain at a low level in the coming year. This should also have a dampening effect on issuing activity in the covered bond market.

The issue volume in the ESG covered bond segment has shown steady growth since 2021. The issue volume has also increased to EUR 21bn in 2023. We expect further moderate growth in the ESG segment of the overall covered bond market in 2024, with stable development expected for the Austrian market.

The trend towards higher risk premiums has continued in 2023. Covered bond swap spreads have widened continuously since the beginning of the year, with an increase in momentum after the summer break. In addition to increased risk aversion on the part of investors, we see the relatively high volume of new issues as the main reason for the widening of spreads.

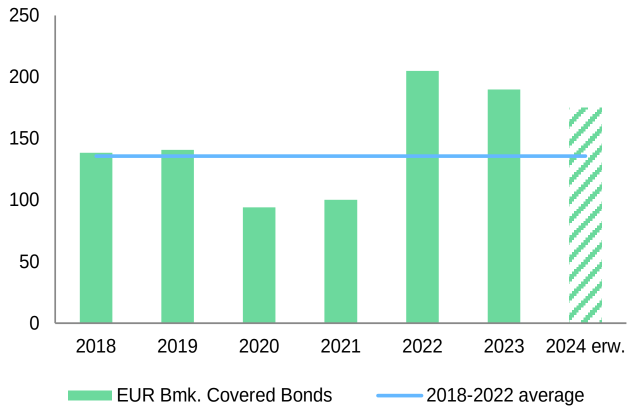
In view of the expected lower supply of covered bonds and the already comparatively high risk premiums, we see a limited risk of a further significant widening of covered bond spreads in the coming year. A more stable interest rate trend should also limit the risk of wider spreads

Primary market

Market normalization expected for 2024

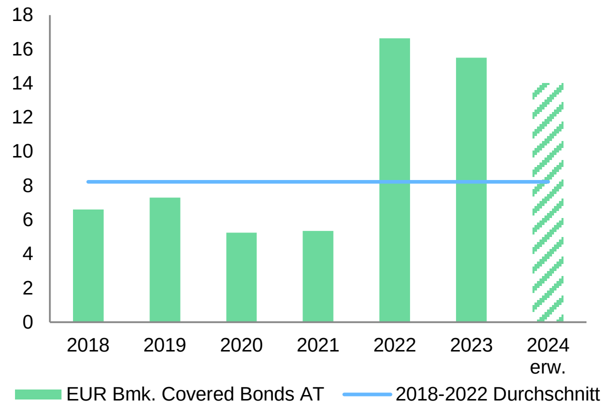
We expect issuance activity on the covered bond market to normalize further in 2024. This means a further moderate decline in issue volumes compared to 2023 and, above all, compared to the record year 2022. This will affect both the overall market, where we expect a volume of EUR 170 - 180bn, and the Austrian market, which should reach an estimated issue volume of EUR 11-13bn. Despite an expected decline of around 7% for the overall market and 20% for Austria, the total volumes should remain well above the average for the years 2018 - 2022.

EUR Benchmark Covered Bond supply
In EUR bn.



Source: Erste Group Research

EUR Benchmark Covered Bond supply AT
In EUR bn.

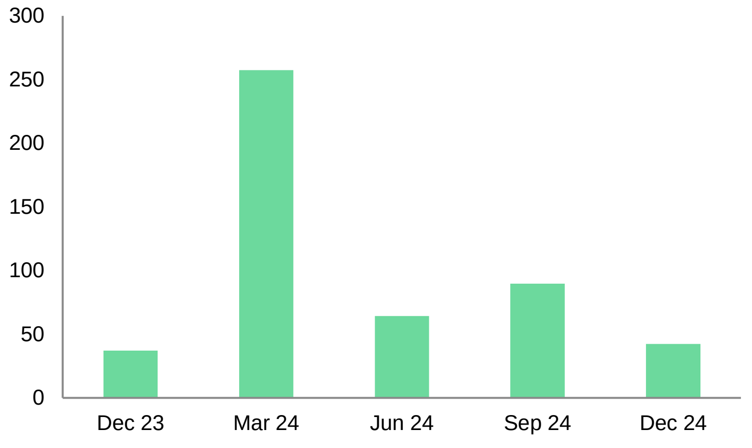


Source: Erste Group Research

Dwindling influence of TLTRO3 on the primary market

One of the main reasons for the expected decline in the issue volume is the dwindling influence of TLTRO3. In 2023, around EUR 1,500bn in TLTRO3 loans were repaid by the banks to the ECB. Part of this was also refinanced by issuing new covered bonds.

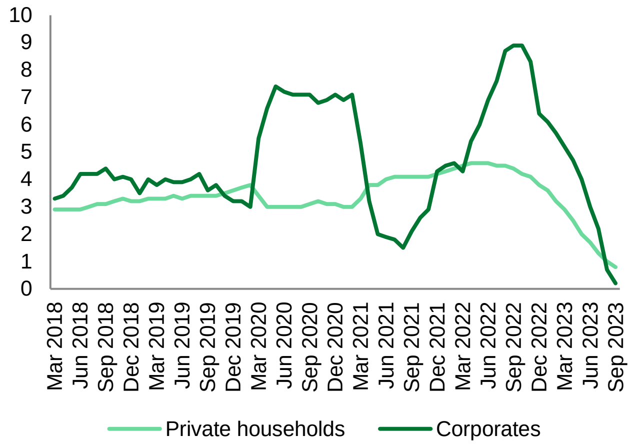
Outstanding TLTRO3 tranches by maturity
In EUR bn.



Source: ECB, Erste Group Research

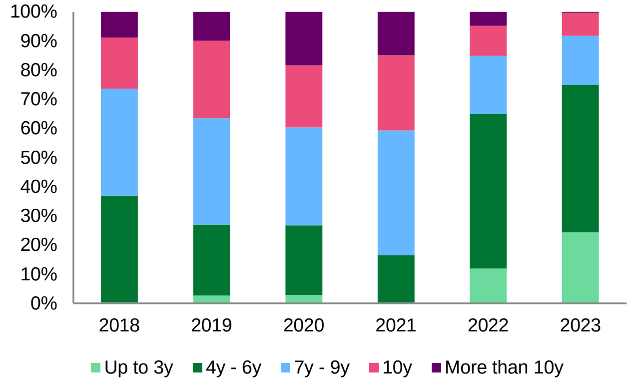
As of November 2023, only around EUR 450 bn of TLTRO3 tranches will fall due next year. A portion of this will also be refinanced by covered bonds in the coming year. However, we expect the impact of TLTRO3 maturities on the covered bond issue volume to gradually decline until the facility is repaid in full in December 2024.

Rising interest rates depress demand for credit
Loan growth of European banks in %



Source: ECB, Erste Group Research

Issues with short maturities have dominated since the interest rate turnaround



Source: Erste Group Research

Low loan growth should have a dampening effect on issuing activity

Since the turnaround in interest rates, loan growth at banks in the eurozone has slowed noticeably. Both a lower demand for loans and a tightening of lending rules have been observed. We expect loan growth to remain at a low level in the coming year. This should also have a dampening effect on issuing activity in the covered bond market.

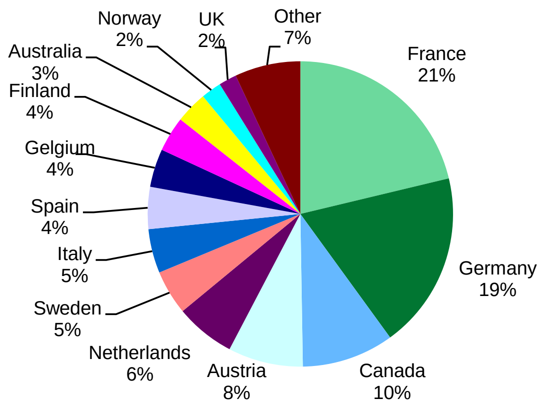
Strong focus on shorter terms could decrease

Text Market participants' interest rate expectations should also have an impact on the primary market. Since the start of the interest rate turnaround, there has been a noticeable shift in issuing activity towards shorter maturities. In 2021, the proportion of new issues with an original term of seven years or more was still 83%. This year, the same maturity segment only accounted for 25%. We believe this is primarily due to investors' preference for shorter maturities in times of rising interest rates. The expectation that interest rates will not rise any further or even fall for some market participants should lead to at least a partial weakening of the very strong focus on shorter maturities in the coming year. As a result, we could see slightly more issues with medium and longer maturities on the primary market again. Inter 9pt 48/48/48, one line spacing after headline

Regional diversification in issue volume increases

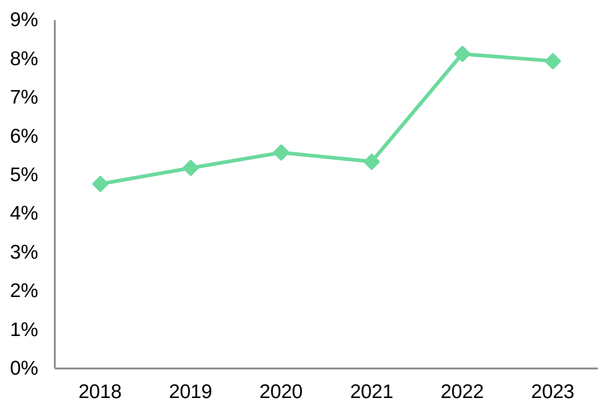
The dominance of issuers from France, Germany and Canada decreased slightly in 2023 compared to the previous year, which was mainly due to a decline in Canadian covered bond issues. Together, issues from these three countries accounted for 50% of the total volume (2022: 56%). In contrast to the previous year, Italian banks also played a greater role on the primary market again this year. We expect this trend to continue in the coming year. For Austrian issuers, 2023 marks the end of another very active year, even if the market share was slightly below that of the previous year. In line with our expectation of a declining issue volume from Austria, the relative share of issues is also likely to fall further in 2024.

Issue volume 2023 distributed more evenly
Covered bond issues by country of origin



Source: Erste Group Research

Market share of Austrian banks remains high
Share of AT banks in the total market



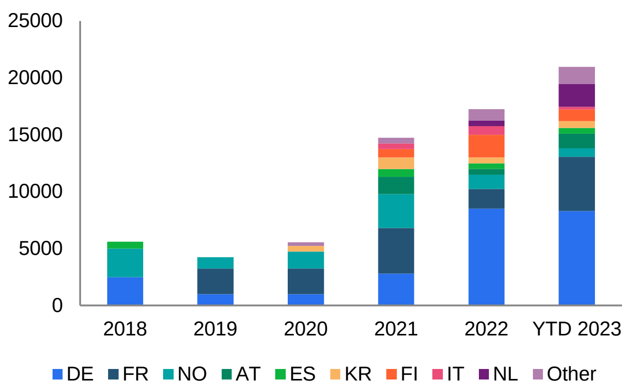
Source: Erste Group Research

ESG

ESG covered bond segment grew compared to senior

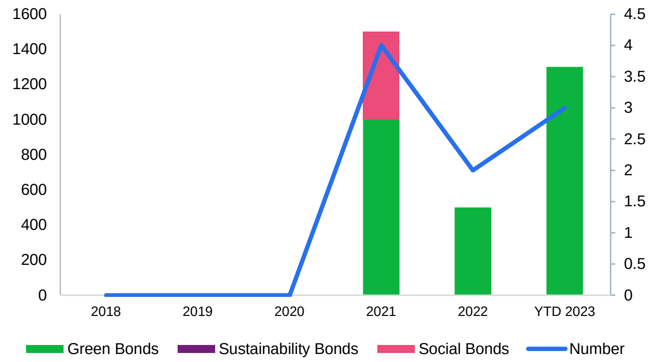
The issue volume in the ESG covered bond segment has shown steady growth since 2021. The issue volume has also increased to EUR 21bn in 2023. If the banks' total ESG issue volume is taken into account, there was a slight shift in 2023 from the ESG senior segment, which continues to dominate at 72% (previous year: 74%), to the ESG covered bond segment, which increased from 23% in 2022 to 25% in 2023.

Further increase in ESG issuance volume
EUR ESG covered bond issues in EUR mn



Source: Erste Group Research

Mainly green covered bond issues in AT
EUR ESG covered bond issues AT in EUR mn .



Source: Erste Group Research

Further growth expected in the ESG covered bond segment

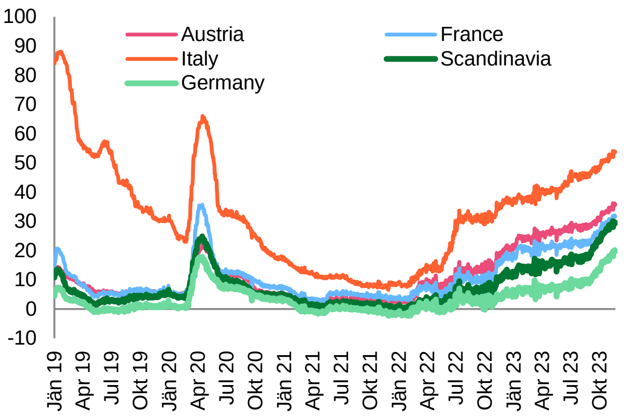
Germany continues to contribute the largest share of the ESG volume at 40%, although the volume in 2023 is declining and French issuers have increased their share to over 20%. Austrian issuers contributed around 6% of the total volume this year with three issues. We expect further moderate growth in the ESG segment of the overall covered bond market in 2024, with stable development expected for the Austrian market.

Secondary market

High supply main reason for spread widening

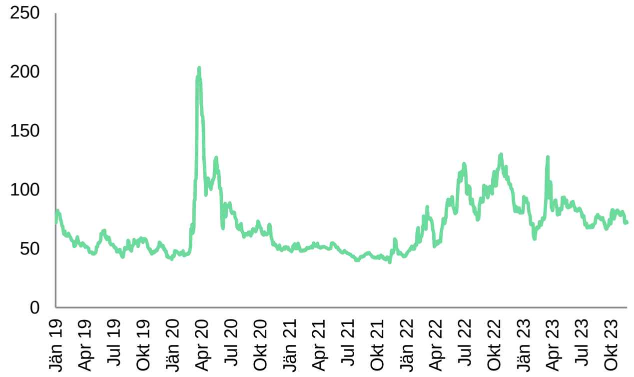
The trend towards higher risk premiums continued in 2023. Covered bond swap spreads have widened continuously since the start of the year, with a further increase in momentum after the summer break. Differentiation by country of origin of the issuer and between individual banks has also increased further. In addition to increased risk aversion on the part of investors, we see the relatively high volume of new issues as the main reason for the widening of spreads. Although there were no significant market congestions affecting new issues over the course of the year, oversubscription of issues decreased noticeably in the second half of the year despite rising new issue premiums. The end of the reinvestment of maturing covered bonds within the ECB's asset purchase programs in July of this year further increased the effect of the high volume of issues on spreads.

Covered Bond swap spreads
In BP



Source: Marktdatenanbieter, Erste Group Research

Swap spread-difference btw. Covered a. Senior Bonds
In BP



Source: Marktdatenanbieter, Erste Group Research

Greater risk aversion on the investor side

Falling real estate prices and concerns about the development of the commercial real estate market have increased risk aversion on the investor side. However, these concerns are not yet reflected in an increased swap spread difference between covered bonds and senior bonds. Greater market uncertainty usually causes risk premiums on senior bonds to rise more sharply than on covered bonds. However, the gap between the two bond classes narrowed slightly in the second half of the year and is well away from the level that prevailed after the collapse of Silicon Valley Bank in March 2023.

Risk of significant spread widening limited

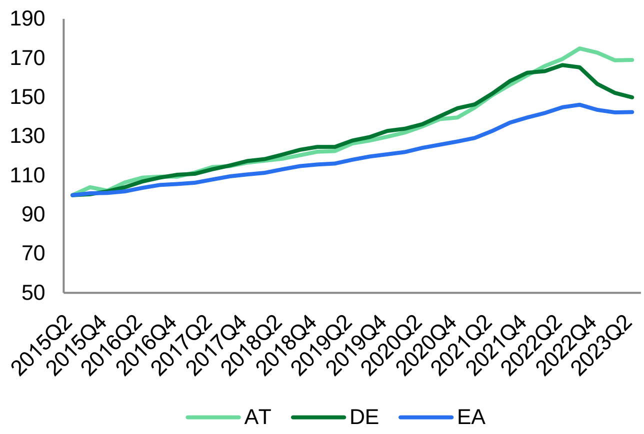
In view of the expected lower supply of covered bonds and the already comparatively high risk premiums, we see a limited risk of a further significant widening of covered bond spreads in the coming year. A more stable interest rate trend should also limit the risk of further spreads. Although a further deterioration in the economic situation would argue for higher risk premiums, the effect should be more noticeable for senior bonds than for covered bonds. This would argue for a wider spread between covered bonds and senior bonds than is currently the case.

Real estate market

No further drastic fall in residential real estate prices expected in Austria

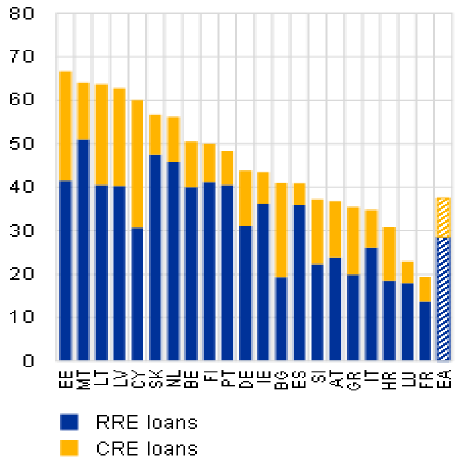
The residential real estate market remains in a tense phase across Europe and residential real estate prices are declining. In Austria, however, real estate prices have proved to be significantly more robust than in other European countries such as Germany. While inflation and construction costs are stabilizing, the economic weakness is proving to be a risk factor for the real estate market. The weak economy may have a negative impact on the labor market, which in turn could have a further dampening effect on property prices. On the other hand, a decline in completions coupled with a growing population is expected to lead to a shortage on the housing market in the medium term. This would support prices in Austria in the medium term, provided there is no drastic downturn in the labor market.

Price declines at a high level
Eurostat real estate price index quarterly figures



Source: Eurostat, Erste Group Research

Bank exposures highly diversified
4Q 2022 as % of total receivables



Source: ECB

Commercial real estate sector remains under pressure

The commercial real estate sector is currently a particular focus of the market and supervision. At banks in the eurozone, loan exposures in private residential construction account for almost 30% of total loans, well above those in commercial real estate at around 10%. Austria's banks' exposure to residential real estate is below the eurozone average in Q4 2022, while their exposure to commercial real estate is slightly above it. Commercial real estate naturally shows shorter-term financing than residential real estate. As a result, higher refinancing costs are already being reflected here. However, structural changes such as work from home and purchasing behavior have also increased the pressure on this sector significantly.

Further increase in NPL ratios expected

Austrian banks already reported an increase in NPL ratios from the commercial real estate segment in 1H 2023, although the ratios were at a historically low level. The Austrian supervisory authority does not currently see any systemic risk for the Austrian banking sector from the commercial real estate segment. However, it can be assumed that an increase in non-performing loans will also be observed in other credit areas due to the continued high level of interest rates and the economic weakness.

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