CREDIT MARKETS SPECIAL | FINANCIALS & COVERED BONDS | EUROZONE

Covered Bond Outlook 2025

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Covered bond market expected to stabilize

After a sharper-than-expected decline in issuance volume this year, we expect the covered bond primary market to stabilize in 2025. We expect new issues in the total market to amount to EUR 150-160bn.

In 2024, the growth trend in the ESG covered bond segment was broken for the first time. While the issuance volume still showed significant annual growth from 2019 to 2023, the volume has since fallen to just under EUR 17bn (previous year: EUR 22bn).

We assume that the further development of risk premiums for covered bonds will continue to depend largely on the development of swap spreads in the SSA segment in the coming months. It is therefore possible that risk premiums in the covered bond segment could remain at their current high level for the time being despite the limited supply of new issues.

Although the residential real estate market will remain under critical observation throughout Europe, the decline in residential real estate prices in the euro area appears to have bottomed out. In the area of commercial real estate (CRE), however, a sustainable recovery is not yet in sight. In addition to cyclical factors, the segment continues to struggle with structural problems (work from home, e-commerce).

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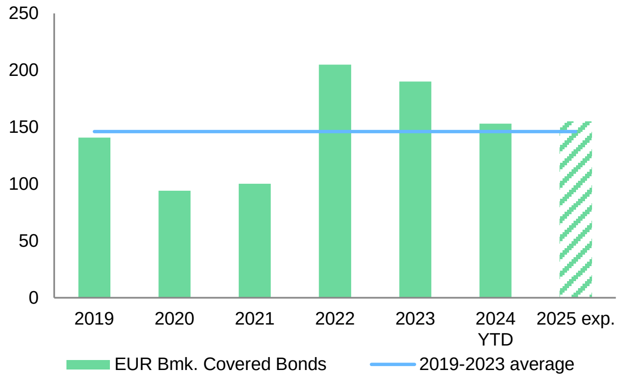
Note: Information on past performance is not a reliable indicator of future performance.

Primary market

Issuance volume should stabilize in 2025

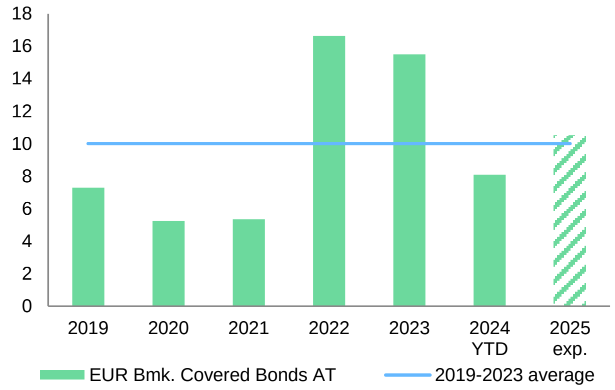
After a sharper-than-expected decline in issuance volume this year, we expect the covered bond primary market to stabilize in 2025. We expect new issues in the total market to amount to EUR 150-160bn. This is roughly in line with the 2024 level. The main reasons for the barely changed issuance volume are the hesitant growth impulses from the lending business and only slight changes in the volume of covered bonds maturing in 2025. In Austria, we expect an issuance volume of EUR 10-11bn in 2025, which would represent a slight increase compared to 2024. Here, we expect that the issuance activity of new issuers in recent years will support the growth in issuance volume.

EUR Benchmark Covered Bond supply
In EUR bn



Source: Erste Group Research

EUR Benchmark Covered Bond supply AT
In EUR bn

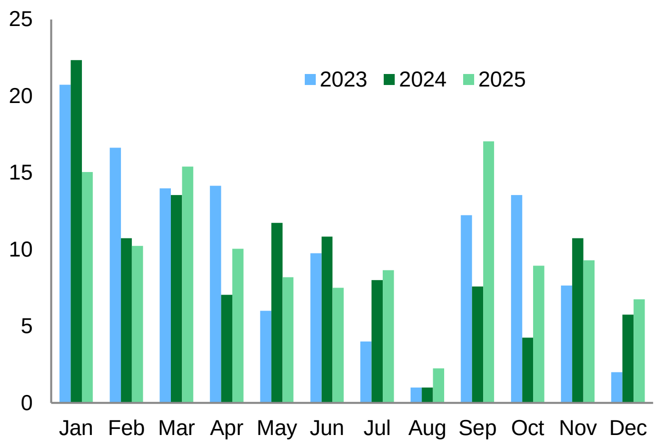


Source: Erste Group Research

The start to the new year could be more subdued than usual

It remains to be seen whether January 2025 will see similarly strong primary market supply as in previous years, when the EUR 40bn mark was exceeded in both 2023 and 2024. Recently, high risk premiums in the SSA segment have dampened demand for covered bonds.

Monthly Covered Bond maturities
In EUR bn.



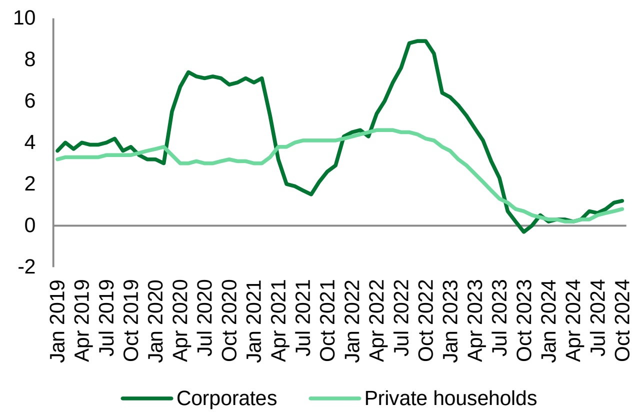
Source: Erste Group Research

In addition, the volume of maturing covered bonds in January 2025 is comparatively low. This could lead some issuers to take a rather wait-and-see attitude at the beginning of the year in the hope of better market conditions.

Credit demand has bottomed out

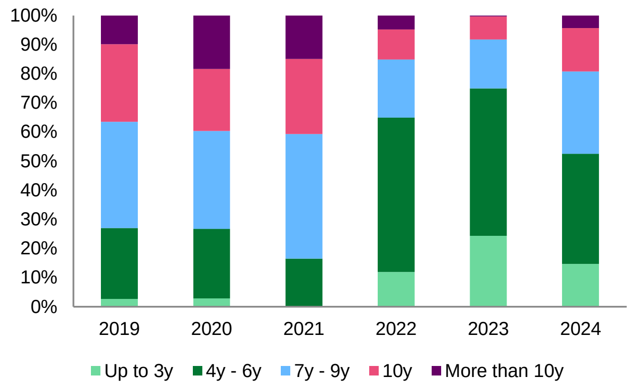
The credit growth of European banks has left its low point of late 2023/early 2024 behind it and is on a slow recovery path. Further interest rate cuts by the ECB could reinforce this trend in the coming year. The fact that most banks' lending policies are still relatively restrictive despite some easing argues against dynamic growth. A weak economic outlook and a continued increase in risk costs are likely to cause most banks to continue to act cautiously in the future. Overall, we expect the recovering demand for credit to provide only a small boost to the volume of issues in the covered bond market.

Credit demand is slowly recovering
European banks' loan growth, y/y in %



Source: ECB, Erste Group Research

Issues with longer maturities have made a comeback
EUR Covered bond issues by maturity



Source: Erste Group Research

Proportion of covered bonds with longer maturities is rising again

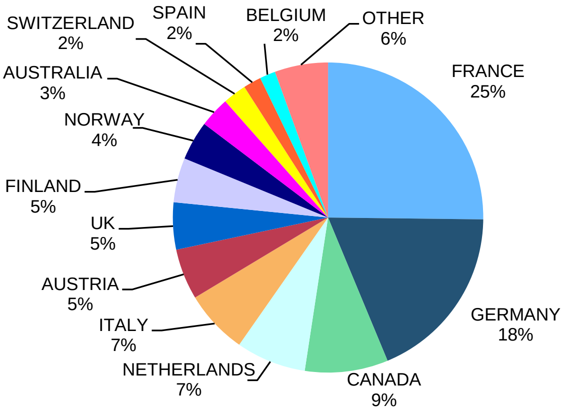
The ECB's change of course in June 2024 and the expectation of a further decline in interest rates has led to more covered bonds being issued in the medium and long-term maturity segments again this year. In 2023, the share of covered bonds with an original maturity of seven years or more was still 25%. Since then, this share has risen again to 47%, although it is still well below the 83% share achieved in 2021. We expect the share of long-dated covered bonds to increase further in 2025.

France is expanding its market share.

Issuers from France, Germany and Canada continued to dominate the primary market in 2024, with a share of over 50%. French banks in particular stood out with a market share of 25%. Furthermore, the very sharp decline in issues from Sweden was striking. The share of Swedish issues in euros fell from 5% in 2023 to less than 1%. More attractive financing conditions in SEK led to Swedish banks almost completely staying away from the euro covered bond market. The market share of Austrian issuers fell noticeably in 2024 and is now at the 2021 level. We see this as a sign of normalization after two years of shifting from TLTRO3 to covered bond refinancing. However, the market share could rise again slightly in 2025 due to the new issuers in Austria in recent years.

French banks dominate

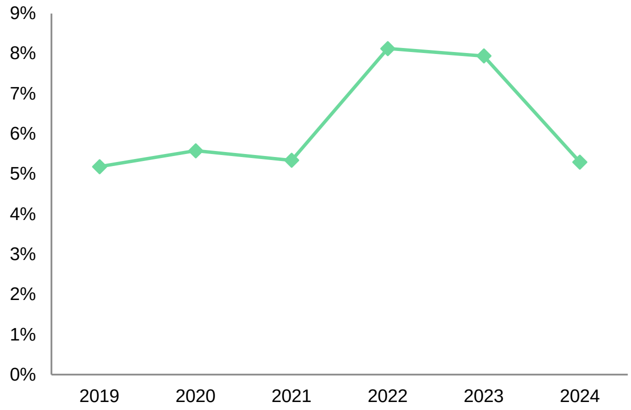
Covered bond issues by country of origin



Source: Erste Group Research

Market share of Austrian banks normalizing

Austrian banks' share of new issues in the total market



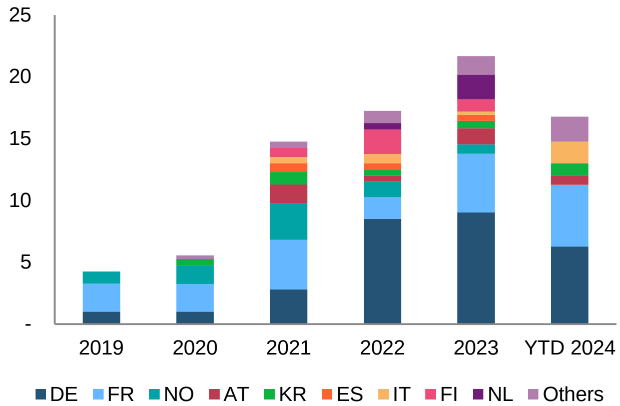
Source: Erste Group Research

ESG

Decrease in ESG covered bond issues in 2024

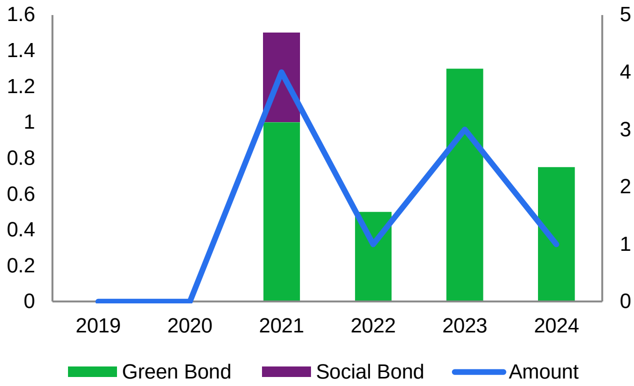
In 2024, the growth trend in the ESG covered bond segment was broken for the first time. While the issuance volume still showed significant annual growth from 2019 to 2023, the volume has since fallen to just under EUR 17bn (previous year: EUR 22bn). An equally, albeit not as pronounced, downward trend could be observed in the ESG senior segment. By contrast, there was growth in the issuance volume of subordinated bonds in the ESG segment. From an overall perspective, this resulted in a distribution of 73% (previous year: 72%) in ESG senior bonds, 20% (previous year: 26%) in ESG covered bonds and 6% (previous year: 3%) in subordinated ESG bonds. Thus, the ESG covered bond segment showed the strongest relative decline in the overall market

Decline in ESG issuance volume 2024
EUR ESG Covered Bond Issues in EUR bn



Source: Market data provider, Erste Group Research

Green issues dominate ESG segment in Austria
EUR ESG Covered Bond Issues AT in EUR bn



Source: Market data provider, Erste Group Research

Stable development of ESG-covered bond issuance volume expected

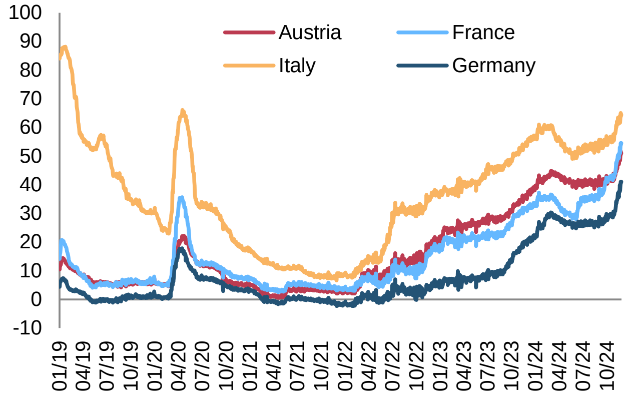
German covered bond issuers contribute the largest share of ESG volume at 37%, although the volume is declining in 2024, with French issuers expanding their share to 30%. This year, Austrian issuers contributed around 4% (PY 6%) of the total volume with one issue. We expect the ESG covered bond segment to remain stable in 2025. We see Austria here in line with the overall ESG covered bond market.

Secondary market

Rollercoaster ride of risk premiums

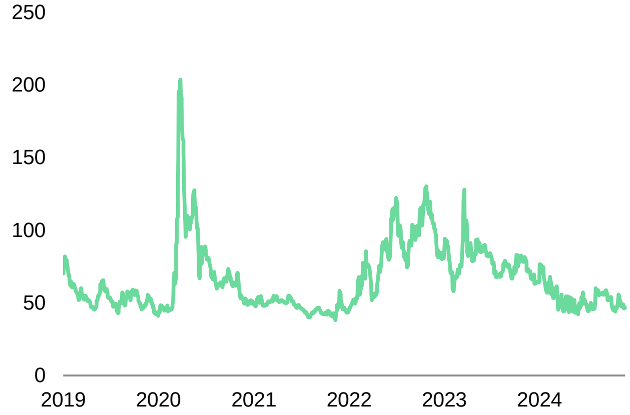
Covered bond swap spreads 2024 experienced a real rollercoaster ride. After spreads initially continued to rise in the first quarter, they reversed course at the end of March and tightened again. However, the trend toward lower asset swap spreads was stopped around mid-year with the onset of the ECB's interest rate cut trend. In the last few weeks of the year, risk premiums then rose sharply again, driven by higher swap spreads in the SSA segment. The significantly lower supply of new covered bonds was unable to contain the widening of spreads.

Covered Bond Swapspreads
In bp



Source: Market data provider, Erste Group Research

Swap spread-difference: Senior – Covered Bonds
In bp



Source: Market data provider, Erste Group Research

Covered bond spreads remain under the spell of the SSA segment

We expect that the further development of risk premiums for covered bonds in the coming months will depend to a large extent on the development of swap spreads in the SSA segment. Continued high SSA swap spreads would maintain the pressure on covered bond swap spreads.

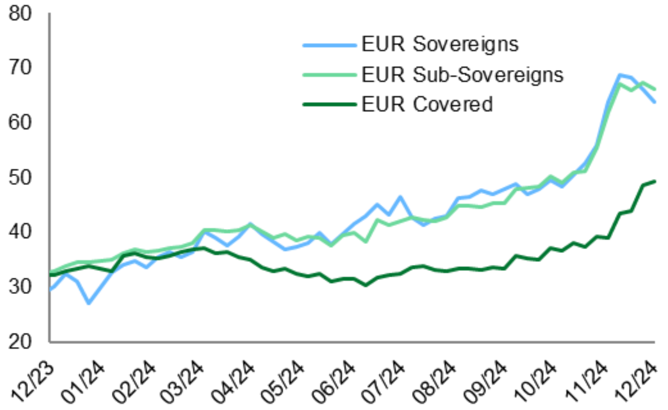
A somewhat lower volume of new issues at the beginning of the year could have a supportive effect on covered bond swap spreads, but a decoupling from the SSA market seems unlikely. It is therefore possible that risk premiums in the covered bond segment could remain at their current high level for some time despite the limited supply of new issues.

The gap between senior and covered bonds could widen

The spread between senior bonds and covered bonds tightened significantly in the course of 2024. We see the significantly improved earnings situation and risk costs that can still be managed as one of the main reasons for the appetite for unsecured bank bonds on the investor side. However, it should also be noted that the gap did not tighten further in recent weeks when covered bonds came under pressure. For the coming year, we see the possibility of a widening of the spread between senior and covered bonds if economic developments were to lead to a dynamic increase in credit defaults. In the short term, however, expectations of further interest rate cuts should continue to support demand in the senior segment.

Covered bond market affected by rising SSA swap spreads

Asset Swap Spreads: Sov., Sub-Sov. and Covered Bond Indices in BP



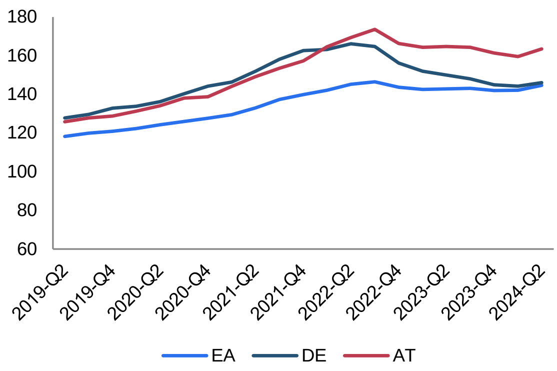
Source: Market data provider, Erste Group Research

Real estate market

Correction of the overvaluation of residential real estate

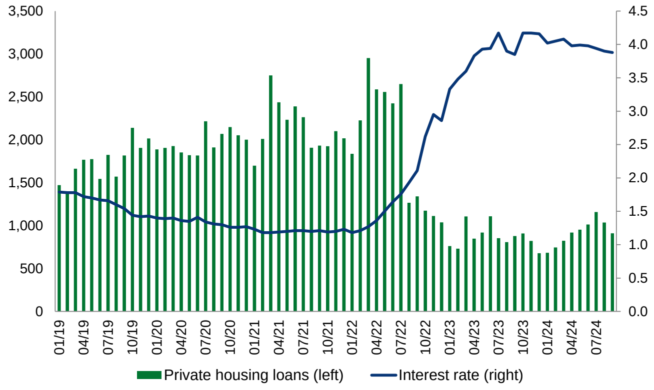
Although the residential real estate market remains under critical observation throughout Europe, the decline in residential real estate prices in the euro area seems to have bottomed out. In Austria, real estate prices have also proven to be more robust than in other European countries such as Germany. The decline in real estate prices had led to a correction of overvaluations, although some eurozone countries still show high valuations. In Austria, the fundamental price indicator of the Austrian National Bank has shown a significant decline in overvaluation, both in Austria as a whole and in the federal capital Vienna. Although values in Vienna remain above those for Austria as a whole, they have returned to pre-coronavirus levels in both cases.

Residential property prices have bottomed out
Real estate price index Eurostat quarterly figures



Source: Eurostat, Erste Group Research

Lending in Austria remains at a low level
New lending to private households for residential construction



Source: OeNB, Erste Group Research

New lending remained at a low level

The tightening of monetary policy had abruptly reduced the granting of new loans. In addition, banks in the euro area have tightened their lending standards. In Austria, too, lending was made more difficult by the stricter lending guidelines imposed by the supervisory authority (KIM regulation). It was also observed that the declining credit volume was accompanied for the first time by a stagnation in Austrian cover pool volumes.

Increase in lending and residential real estate prices expected

The latest surveys of eurozone banks showed a moderate easing of lending standards and an increase in credit demand in the first three quarters of 2024. In June 2025, the stricter lending guidelines are also to expire in Austria. The further expected interest rate cuts by the ECB should also support the demand for credit. This would suggest some potential for a recovery in real estate prices, provided that there is no drastic deterioration in the labor market.

Commercial real estate sector remains tense

In the area of commercial real estate (CRE), however, a sustainable recovery is still a long time coming. In addition to cyclical factors, the segment continues to struggle with structural problems (home office, e-commerce). Activity in the CRE market remains at a low level, although a slight recovery in investor interest is gradually being reported. However, a market recovery would probably initially lead to a downward price correction.

NPL ratios in commercial real estate continue to rise

In the Austrian banking sector, non-performing loan ratios in the commercial real estate segment continue to rise. The share of non-performing loans has flattened out, but there are no signs of a turnaround yet and none is expected in the near future. The Austrian Financial Market Stability Board (FMSB) has therefore come out in favor of the use of a systemic risk buffer (capital buffer) to contain the risks arising from commercial real estate financing.

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