

Moody's on European Covered Bonds

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What I will address today

- ▶ **What is a covered bond ?**
- ▶ **Choosing between a fundamental or a structured approach**
- ▶ **Moody's *fundamental rating approach* to covered bonds: the "notching approach": confronting myth and reality**
 - **Where do we notch from ?**
 - **What do the notches capture ?**
 - **When might we NOT award the full notches ?**
 - **When can an issuer obtain more than the notches ?**
 - **The floor concept**



Moody's definition of a covered bond

A covered bond is **a full recourse debt instrument** secured against a pool of

- (1) eligible mortgage assets and/or
- (2) claims against public sector entities



What is a covered bond ?

- ▶ “plain vanilla” covered bonds
 - German mortgage banks

- ▶ “structured” covered bonds Type I
 - indicate that the issuer is **contractually committed** to managing itself more tightly than prescribed by the covered bond framework
 - this is only possible when these covenants are legally enforceable
 - Compagnie de Financement Foncier and CIF Euromortgage in France
 - some of the Danish mortgage credit institutions

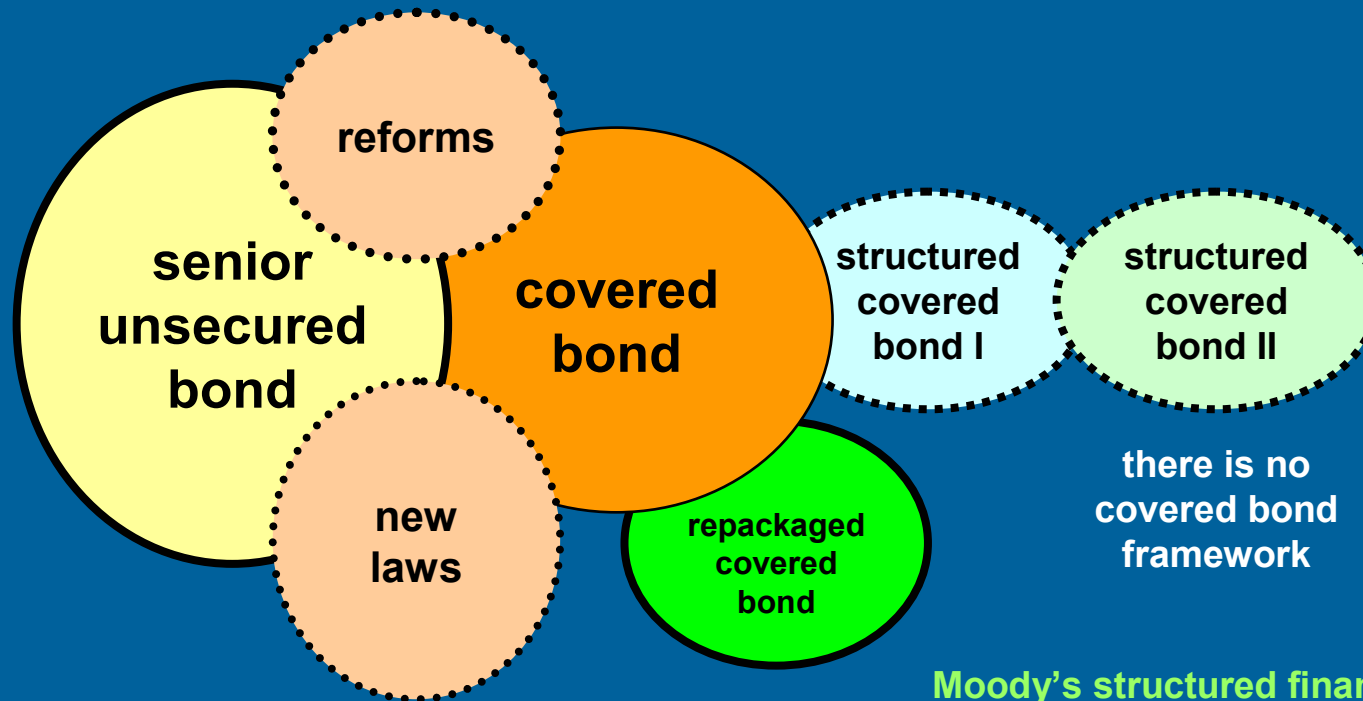
- ▶ “structured” covered bonds Type II
 - indicate that the issuer is **not using a covered bond framework**
 - HBOS Treasury Services Plc, ABN Amro Bouwfonds and WMG

- ▶ “repackaged” covered bonds
 - indicate that **the issuer is a Special Purpose Vehicle** issuing structured notes backed by collateral in the form of “plain vanilla” covered bonds
 - Ayt Cedulas Cajas I through IV where the collateral consists of cédulas hipotecarias emanating from a large group of Spanish savings banks
 - Duke 2002 Ltd. where a portion of the collateral consists of public sector (Öffentliche) Pfandbriefe of Westfälische Hypothekenbank AG



What is a covered bond: a graphic illustration

Moody's fundamental approach



Moody's structured finance approach

collateral consists partly or fully of covered bonds



Moody's approach to rating covered bonds

A cohesive and all-encompassing analytical approach to rating European covered bonds in the face of growing geographical and structural diversity



Choosing between a fundamental and a structured finance approach

We use a fundamental approach for covered bonds when:

- ▶ covered bondholders have a full recourse claim against the issuer, but **no direct and separate claim** against any specific asset subset within the cover pools and
- ▶ there are **no contractual provisions** adopted by the issuer beyond the scope of existing legal requirements

In the absence of these criteria, our rating approach is the one applied to structured finance transactions



Where do we notch from ?

First, we assess the credit quality of the issuer itself

- ▶ in the case of stand-alone entities, we apply our traditional bank rating methodology, while
- ▶ in the case of affiliates, we consider the **links with the parent:**
 - its strategic importance to the refinancing of its parent(s)
 - the existence and likelihood of support in terms of liquidity and capital
 - the origination criteria and yield on the assets ceded to the affiliate
 - the terms of any management contract

While we typically notch subsidiary ratings down from their parents', covered bond issuers may merit a different treatment...



Features which bolster a CB issuer's rating

- ▶ the 'Specialist Bank Principle'
 - sets **restrictions to the issuer's nature of business**
 - which has broadly positive credit quality implications
 - we also take into account self-imposed restrictions
- ▶ legal or regulatory prescriptions on ALM
 - the **Danish 'Balance Principle'** ensures comparatively very strict matching of cashflows due to bondholders with those receivable from the mortgages. It also strictly limits FX and interest rate mismatches
 - **Ireland's NPV test** is applicable to the DCI as a whole
- ▶ bankruptcy-segregation: **the issuer is not included in the bankruptcy estate of its parent** upon the latter's insolvency
 - in the Nordic area, this is inherent to local bankruptcy codes
 - in France and in Ireland, a special exemption from bankruptcy law

! Some features of covered bond frameworks have positive implications for ALL creditors of a CB issuer. As such, we may rate CB issuers as high as or higher than their parents



Bankruptcy segregation and remoteness

- ▶ **bankruptcy segregation may result in a lower default risk**
 - a strong affiliate will be **at least partially protected from credit risk contamination** from the financial distress of a weaker parent
- ▶ **no issuer of covered bonds is bankruptcy-remote**
 - bankruptcy proceedings can be initiated against those issuers
 - **what is crucial upon insolvency is whether the covered bonds themselves will be allowed to continue performing** with respect to both interest and principal payments **according to contractual dates**
- ▶ **cover asset pools are not bankruptcy-remote either**
 - covered bond payments will however accelerate should cover assets no longer meet eligibility requirements
 - at that moment, the key rating factor rests with the **nature and enforceability of covered bondholders' privilege**



What do the notches capture ?

The notches take into account ONLY those risk mitigants which specifically benefit the covered bond holders

- ▶ **the generally good quality of the collateral and substitute assets**
 - where applicable, Moody's makes a distinction between the ratings of public sector covered bonds and those of mortgage bonds of a given issuer
- ▶ **mandatory over-collateralization (OC)**
 - in **Denmark, Spain** and in **Latvia**; soon in **Germany** also
- ▶ **market/liquidity risk mitigants** which protect only bondholders
 - Germany's NPV test only addresses Deckungsstock and Pfandbriefe
- ▶ whether the cover pools and covered bonds would be **segregated from the rest of the bank** in case of bankruptcy
- ▶ the **enforceable priority of claim** which covered bondholders benefit from and which translates into a lower severity-of-loss



Notching practices for covered bonds

- ▶ for a given issuer, the covered bond rating(s) will be notched up from the senior unsecured debt rating
- ▶ today, **Moody's notches up between one and four notches**
- ▶ the number of notches reflects the additional protection provided to covered bondholders by the security structure, collateral and cashflow matching of each framework
- ▶ the notching gap may widen if the credit quality/senior unsecured rating of a covered bond issuer deteriorates
 - a principle now illustrated by **the introduction of rating floors at Aa3 for mortgage Pfandbriefe and Aa2 for public sector Pfandbriefe**



Rating notches for covered bonds

Country	Name	Notching
Germany	<i>Öffentliche Pfandbriefe</i>	➤ up to 4 notches
	<i>Hypotheken Pfandbriefe</i>	➤ up to 3 notches
Denmark	<i>Realkreditobligationer</i>	➤ up to 3 notches
France	<i>obligations foncières</i>	➤ up to 3 notches
Spain	<i>cédulas territoriales</i>	➤ up to 3 notches
	<i>cédulas hipotecarias</i>	➤ up to 2 notches
Finland	<i>kiinteistövakuudellinen joukkovelkakirja</i>	➤ up to 2 notches
	<i>julkisyhteisövakuudellinen joukkovelkakirja</i>	➤ up to 3 notches
Austria	<i>Pfandbriefe</i>	vehicle rating
Switzerland	<i>Pfandbriefe</i>	vehicle rating
Ireland	<i>public sector asset covered securities</i>	➤ up to 3 notches
	<i>mortgage asset covered securities</i>	➤ up to 2 notches
Luxembourg	<i>lettres de gage publiques</i>	➤ up to 2 notches
	<i>lettres de gage hypothécaires</i>	➤ up to 2 notches
Latvia	<i>hipotekārā kīlu zīme</i>	➤ up to 1 notch
Hungary	<i>jelzáloglevél</i>	➤ up to 1 notch
Poland	<i>publiczny list zastawny</i>	➤ up to 1 notch
	<i>hipoteczny list zastawny</i>	➤ not rated



When might we NOT award the full notches ?

- ▶ when there is evidence of **below-average credit quality**
 - less strong credit quality, material concentration, or both
- ▶ **lack of visibility** over the evolution of the cover asset mix
- ▶ issues related to **foreign asset origination**
 - lack of standardized property valuation practices across countries
 - originators' underwriting and servicing skills in countries with respect to which they may have a lesser degree of commercial expertise
 - the uncertain enforceability of bondholders' privilege outside the home market
- ▶ **high liquidity risk**
 - no legislation formally requires an alternative liquidity provider (as is the case in structured transactions) or the maintenance of backup liquidity
 - in case of high prepayment risk
 - would concern those frameworks **where ALM guidelines remain minimal**
- ▶ **questionable management**



When can an issuer obtain more than the notches ?

When the natural credit enhancement provided by a covered bond framework does not allow an issuer to achieve its targeted rating level, further enhancing may be possible provided that

Any voluntary OC present* at the time of issuer bankruptcy is conclusively protected by law and therefore enforceable and available in clear priority for the benefit of covered bondholders

Then it is possible to further reduce residual risk levels

We have established that such is the case in **Denmark, France, Ireland, Finland and Luxembourg**

The pending amendment of the German Mortgage Act targets a clarification of what happens in a bankruptcy scenario

* defined as OC in excess of (1) mandatory requirements and/or of (2) OC created by NPV cover



When can an issuer obtain more than the notches ? (cont'd)

Using securitisation techniques, it is possible to calibrate additional protection levels with a view to a specific rating level. Calibrating the additional protections stems from the analysis of the various sources of risk remaining at each individual issuer

- ▶ **Credit quality**
 - asset quality
 - counterparty risk

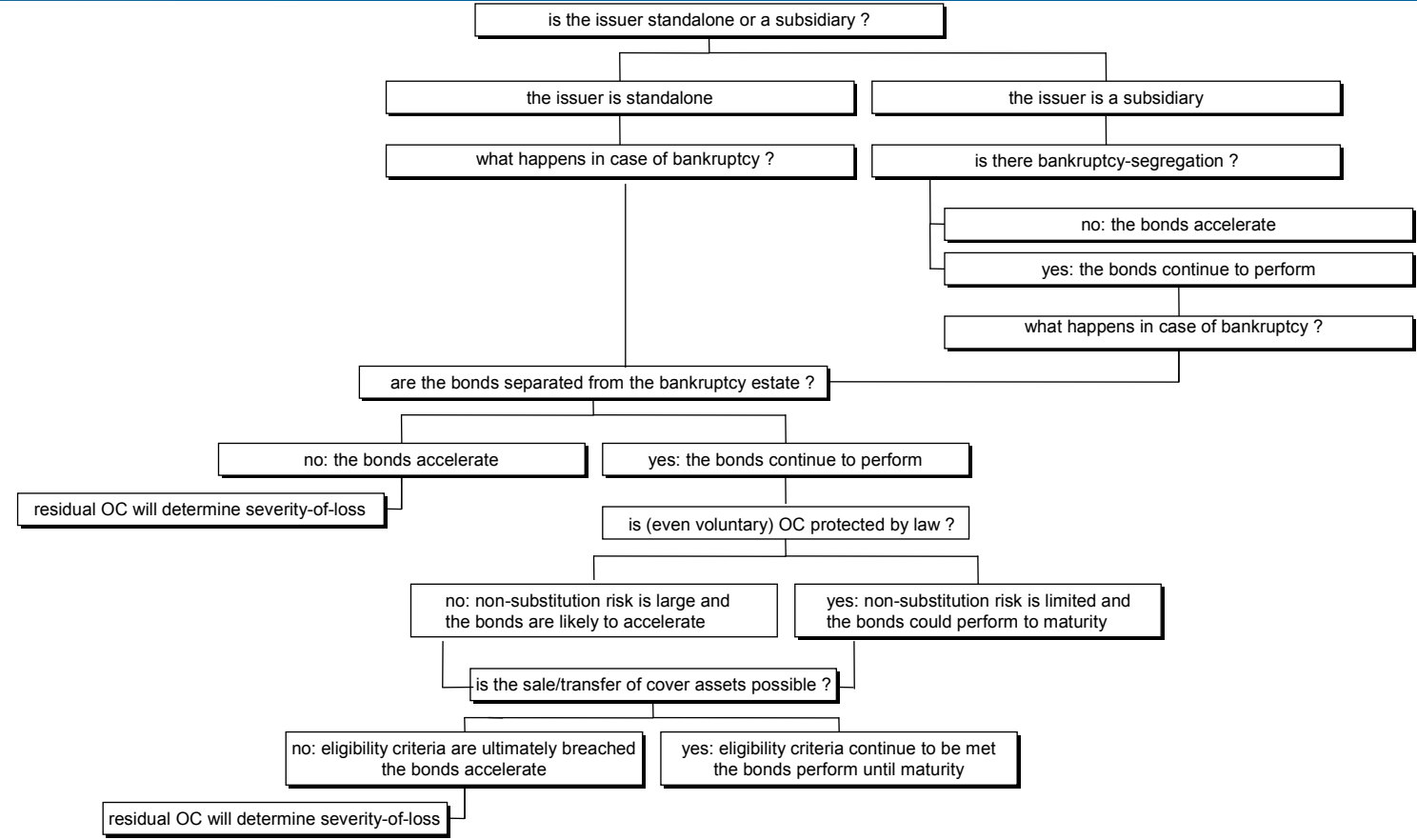
- ▶ **Cashflow mismatches**
 - interest rate
 - maturity dates
 - currency risk

- ▶ **Operational risk**
 - servicing
 - documentation risk



! covered bonds even structured are not the same as MBS or ABS

Charting covered bonds in financial distress



A few more words on non-substitution risk

- ▶ in case of issuer insolvency, it is **no longer possible (i) to substitute** healthy assets for non-performers **or to (ii) replenish** the cover pool as assets mature and loans repay
 - even the provision of a “manager” does not mitigate this risk
- ▶ as a result, asset eligibility criteria and/or ALM requirements will be breached: **covered bonds payments will accelerate**
- ▶ two factors help reduce non-substitution risk: (i) the use of substitute assets and (ii) the availability of large enough OC
- ▶ issuers whose legal frameworks protects voluntary OC can calibrate its level to ensure their bonds perform to maturity
- ▶ in addition, systemic support can ensure that all privileged items are transferred to/acquired by a solvent issuer. We expect that **systemic support would occur in Germany and in Denmark** owing to (i) the importance of the covered bond as a key refinancing tool and (ii) these markets’ breadth and depth



The floor concept

The floor concept contends that given what we know about the types and levels of risk mitigation embedded in each covered bond framework, it is possible to have a sense of the **minimum credit quality of each covered bond instrument** in each country

Increasingly detailed, the asset eligibility criteria provide a good indication of the minimum credit quality of the cover assets

The growing requirements addressing market and liquidity risks provide downside protection in terms of cover asset pool value(s)

The marked downgrades of some German mortgage banks in recent quarters prompted Moody's to explicit its position in this respect

The Aa3/Aa2 rating floors reflect our opinion of the basic credit quality of the mortgage and public sector Pfandbrief instruments respectively

The floor concept enriches and complements our notching approach

