S&P proposes new covered bond rating methodology
How would the Danes fit in?

13 October 2014

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- The Danes fit in nicely – Danish covered bonds are expected to remain AAA rated
- Date for implementation, and final wording, of updated covered bond criteria still unknown
- Ceteris paribus, required OC may increase due to updated criteria on assessing the credit risk of reserve funds

**S&P’s jurisdictional support assessment and notching**

<table>
<thead>
<tr>
<th>Assessment of jurisdictional support</th>
<th>Notching</th>
</tr>
</thead>
<tbody>
<tr>
<td>Very strong</td>
<td>3 notches</td>
</tr>
<tr>
<td>Strong</td>
<td>2 notches</td>
</tr>
<tr>
<td>Moderate</td>
<td>1 notch</td>
</tr>
<tr>
<td>Weak</td>
<td>No uplift</td>
</tr>
</tbody>
</table>

S&P assesses each of the three following categories individually:
1. Strength of legislative framework
2. Systemic importance of covered bonds in their jurisdiction
3. Credit capacity of sovereign to support covered bonds

S&P’s assessment of the jurisdiction as a whole is then equal to the lowest of the three individual assessments made.

**Source:** S&P

**Jurisdictional support assessment by country**

<table>
<thead>
<tr>
<th>Weak</th>
<th>Moderate</th>
<th>Strong</th>
<th>Very strong</th>
</tr>
</thead>
<tbody>
<tr>
<td>US (M)</td>
<td>Australia (M)</td>
<td>Ireland (PS)</td>
<td>Austria (M and PS)</td>
</tr>
<tr>
<td>Belgium (M)</td>
<td>Italy (M)</td>
<td>Denmark (M)</td>
<td></td>
</tr>
<tr>
<td>Canada (M)</td>
<td>Luxembourg (PS)</td>
<td>Finland (M)</td>
<td></td>
</tr>
<tr>
<td>Italy (PS)</td>
<td>UK (M)</td>
<td>France (M and PS)</td>
<td></td>
</tr>
<tr>
<td>Portugal (M and PS)</td>
<td>Germany (M and PS)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>UK (PS)</td>
<td>Ireland (M)</td>
<td>Netherlands (M)</td>
<td></td>
</tr>
<tr>
<td>Singapore (M)</td>
<td>weak/moderate</td>
<td>Norway (M)</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>Spain (M and PS)</td>
<td>Sweden (M)</td>
</tr>
</tbody>
</table>

M = mortgages
PS = public sector

Ten out of the 22 countries assessed are deemed to have very strong jurisdictional support. All four Nordic countries are included in the very strong category.

**Source:** S&P

**The story so far**

On 15 April 2014 the European Parliament approved the EU Bank Recovery and Resolution Directive (BRRD). The directive was introduced to better prevent and manage a bank crisis in member states and to move away from bail-outs towards bail-ins. The idea is to allow for the orderly winding down/reconstruction of banks with minimum recourse to taxpayers.

The BRRD allows for the bail-in of senior unsecured bank debt, which is not surprisingly a credit negative for bank debt. The systemic support currently incorporated in many European banks (and incorporated in many bank ratings) will not be permissible post implementation of the BRRD in national legislation, which is why we expect bank ratings to be downgraded prior to the legislative introduction of bail-in on 1 January 2016. In response to the approval of the BRRD and in lieu of implementation at national levels, the rating agencies have assigned negative outlooks to the majority of European bank ratings.

Prior to the approval of the BRRD, rating agency methodology encompassed the belief that covered bond ratings were linked to issuer’s senior unsecured ratings/issuer ratings. However, post approval of the BRRD, this has changed. Covered bonds are generally exempt from bail-in and are further protected by the possibility that issuers can be reconstructed and so stave off transferring payment of the covered bonds from defaulted issuers to cover pools.

**Fitch**

Fitch responded first, and on 10 March 2014 Fitch introduced the IDR (issuer default rating) lift which is expressed in notches. The IDR lift reflects Fitch’s assessment of the degree of covered bond protection in the event of reconstruction of the covered bond-issuing bank. Effective immediately Fitch’s covered bond rating methodology was applied to the IDR plus the IDR lift, as opposed to “just” the IDR.

Three of the five Danish cover pools rated by Fitch have an IDR lift of two notches and the remaining two are not eligible for an IDR lift.

**Moody’s**

Two days later on 12 March 2014 Moody’s introduced cover bond anchor ratings (CB anchor ratings) to their European and Norwegian covered bond programmes, which also with immediate effect, became the “anchor” for Moody’s covered
bond ratings. CB anchor ratings are typically higher than issuers’ senior unsecured ratings/issuer ratings.

**S&P**

S&P announced on the 29 April 2014 that they also would be updating their covered bond criteria in response to BRRD, and on 4 September 2014 S&P published a request for comment (RFC) regarding their proposed updated covered bond methodology.

The table below summarises the proposed criteria set out in the RFC. The deadline for the market to respond to S&P’s RFC was extended a week to 13 October 2014 from 6 October 2014, after which time S&P will review the comments and start preparing their response.

S&P has not given any indication as to when the revised methodology will be implemented, or indeed if it will be implemented in its current form, however, we expect a response before Christmas, and we are not expecting any significant changes to the proposal, although clarifications are expected.

Assuming the proposed methodology is implemented, we do not expect any downgrades of Danish covered bonds. Furthermore the maximum achievable covered bond rating (last line of the table below) indicates that five of the six Danish issuers would have the benefit of unused uplifts (downgrade buffer). For example, BRFkredit A/S’s ICR (Issuer Credit Rating) can be revised down by one notch (in addition to losing the one notch of uplift due to systemic support - second line of the table) without the covered bonds following suit.

### Assessing credit risk of reserve funds

In addition to the proposed criteria set out in the table below S&P also proposes new criteria for the assessment of credit risk embedded in reserve funds. Cover pools may include assets other than mortgages known as reserve funds or substitute assets, which in turn may include covered bonds. The new criteria are more conservative than the current criteria and are by S&P’s own estimates broadly expected to increase OC requirements. Since we do not have insight into individual cover pool reserve funds, and given it is not possible to replicate S&P’s OC calculations, it is not possible to estimate by how much OC will increase. Note though that an issuer can manage the level of required OC generated by a reserve fund by changing the composition of the reserve fund.

### Where will Danish S&P covered bond ratings land after implementation of new proposed covered bond methodology?

<table>
<thead>
<tr>
<th>ICR (Issuer Credit Rating)</th>
<th>NYK</th>
<th>RD</th>
<th>NDA</th>
<th>BRF</th>
<th>DB</th>
<th>DLR</th>
</tr>
</thead>
<tbody>
<tr>
<td>Systemic support for issuer</td>
<td>-2</td>
<td>-2</td>
<td>-1</td>
<td>-1</td>
<td>-2</td>
<td>-1</td>
</tr>
<tr>
<td>Systemic support for CB programme in accordance with BRRD</td>
<td>+2</td>
<td>+2</td>
<td>+2</td>
<td>+2</td>
<td>+2</td>
<td>+2</td>
</tr>
<tr>
<td>Adjusted ICR</td>
<td>A+</td>
<td>A</td>
<td>AA</td>
<td>A</td>
<td>A</td>
<td>A-</td>
</tr>
</tbody>
</table>

**Jurisdictional support**

- Legislative framework  
  - Very strong
- Systemic importance  
  - Very strong
- Sovereign credit capacity  
  - Very strong

**JRL (Jurisdictional Rating Level)**

<table>
<thead>
<tr>
<th>JRL (Jurisdictional Rating Level)</th>
<th>AA+</th>
<th>AA</th>
<th>AAA +1</th>
<th>AA</th>
<th>AA</th>
<th>AA-</th>
</tr>
</thead>
</table>
**Collateral support**

- AAA credit risk + 25% refinancing costs  
  - +1
- AAA credit risk + 50% refinancing costs  
  - +1
- AAA credit risk + 75% refinancing costs  
  - +1
- AAA credit risk + 100% refinancing costs  
  - +1

**Collateral support analysis**

<table>
<thead>
<tr>
<th>AAA +3</th>
<th>AAA +2</th>
<th>AAA +5</th>
<th>AAA +2</th>
<th>AAA +2</th>
<th>AAA +1</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
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<td></td>
<td></td>
</tr>
</tbody>
</table>

**Adjustments**

- Liquidity support (for soft bullets and callables)  
  - 0
- OC commitment  
  - -1

**Max achievable covered bond rating**

<table>
<thead>
<tr>
<th>AAA +2</th>
<th>AAA +1</th>
<th>AAA +4</th>
<th>AAA +1</th>
<th>AAA +1</th>
</tr>
</thead>
</table>

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1. To achieve AAA 100% of refinancing costs must be covered
2. It is assumed that a AAA covered bond rating is wanted and that there is sufficient OC to achieve AAA.
3. There must be sufficient liquidity in place to cover the next six months of covered bond payments, S&P looks to final covered bond maturity as opposed to expected maturity, giving soft bullets an advantage over hard bullets. If liquidity support not in place, S&P will notch down.
4. It is assumed that OC is voluntary, ie the issuer has not made a public statement of commitment of OC or a legal or contractual statement of commitment of OC.

Source: S&P, Nykredit Markets
Increased OC will result from:

1. S&P’s general increase in assumed asset default probabilities in response to market developments
2. S&P’s lowering of recovery assumptions on covered bond assets
3. Additional tests for concentrated portfolios

**Recovery rates on defaulting covered bonds**

- 1. Asset-specific recovery assumptions on S&P rated bonds
- 2. Asset-specific recovery capped at 60% if loans not match-funded
- 3. For non-S&P rated covered bonds recovery assumptions are the same as for senior secure corporate debt, and are country specific

Assumed recovery rates are a function of whether a bond is rated by S&P or whether the loan is match funded.

Source: S&P, Nykredit Markets

In Denmark there are both granular and non-granular reserve funds.

**Determining credit risk in reserve funds**

1. **Granular reserve fund:** >10 different obligors
   - Stochastic calculation of scenario default rate
   - Increased probability of default on covered bonds issued by same issuer
   - Recoveries aligned with senior securitisations or senior secured corporate debt depending on OC commitment (ie voluntary OC, public statement based OC, contractually obligated OC) limited information regarding covered bonds

2. **Non-granular reserve fund:** ≤10 different obligors
   - 0 defaults if temporary investment criteria
   - Non-AAA covered bonds all default
   - Asset specific recoveries for S&P rated covered bonds

**Eg AAA stress for non-granular, mixed ratings reserve fund**

- Covered bonds from same capital centre do not default
- Other covered bonds issued by same issuer all default
- AAA covered bonds issued by other banks do not default
- Non-AAA covered bonds all default

Own covered bonds in reserve funds will be stressed harder leading to higher OC requirements for a given rating.

Source: S&P, Nykredit Markets
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Investment research
This material is produced by analysts in Nykredit Markets’s research functions and is considered investment research.

Recommendation and risk assessment structure for government bonds and bonds issued by financial institutions, including covered bonds and mortgage bonds

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BUY: In our view, the bond is fairly inexpensive relative to comparable alternatives in either the bond or derivatives markets. We expect that the bond will offer a higher return than alternatives on a horizon of usually three months.
SELL: In our view, the bond is fairly expensive relative to comparable alternatives in either bond or derivatives markets. We expect that the bond will offer a lower return than alternatives on a horizon of usually three months.

Recommendation on portfolio allocation
The recommendations of Fixed Income & Derivatives Research are based on a portfolio investor (long-only investor) in government bonds and bonds issued by financial institutions.

Overweight: In our view, the return on the bond segment will be higher than the return on the total Danish bond market (Danish government bonds and bonds issued by financial institutions) in the next three months.
NEUTRAL: In our view, the return on the bond segment will be in line with the return on the total Danish bond market (Danish government bonds and bonds issued by financial institutions) in the next three months.
Underweight: In our view, the return on the bond segment will be lower than the return on the total Danish bond market (Danish government bonds and bonds issued by financial institutions) in the next three months.

Distribution of recommendations
The distribution of the direct investment recommendations from Fixed Income & Derivatives Research within the past quarter is seen from Table 1 and Table 2, respectively. Proportion I is the distribution of our recommendations which sums to 100%. Proportion II is the share of issuers within each category above, for which Nykredit Bank A/S has carried out major investment bank transactions in the past 12 months.

Table 1: Recommendations – fixed income

<table>
<thead>
<tr>
<th></th>
<th>Proportion I</th>
<th>Proportion II</th>
</tr>
</thead>
<tbody>
<tr>
<td>Buy</td>
<td>56%</td>
<td>36%</td>
</tr>
<tr>
<td>Sell</td>
<td>44%</td>
<td>23%</td>
</tr>
</tbody>
</table>

Table 2: Recommendations – portfolio allocation

<table>
<thead>
<tr>
<th></th>
<th>Proportion I</th>
<th>Proportion II</th>
</tr>
</thead>
<tbody>
<tr>
<td>Overweight</td>
<td>33%</td>
<td>100%</td>
</tr>
<tr>
<td>Neutral</td>
<td>0%</td>
<td>0%</td>
</tr>
<tr>
<td>Underweight</td>
<td>67%</td>
<td>0%</td>
</tr>
</tbody>
</table>

Source: Nykredit Markets

Historical returns and price developments
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