Chapter 7

Covered Bond Ratings

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§ 7:1 Importance of Ratings for Issuers and Investors

§ 7:1.1 Generally

One of the reasons why covered bonds have enjoyed such popularity and have been considered euro SSA\(^1\)-surrogates stems from the fact that almost 90% of European covered bond issuances are rated triple-A. Despite this overwhelming predominance, it must still be noted that ratings methodologies have been subject to increased volatility over the past few years. Until just a few years ago, the norm was that covered bond ratings were notched up from the issuer’s senior unsecured ratings. However, the covered bond asset class has since expanded—both in geographic terms and in respect of issuance volumes. This recent growth has resulted in less homogeneity among covered bonds, and has led the rating agencies to consider more specific ratings approaches, reflecting the particular risk-drivers of these instruments.

The dual-recourse nature of covered bonds brings quite a unique combination of risk exposures into the rating analysis—one being directly linked with the issuing bank’s creditworthiness, and another reflecting the capacity of the cover pool to provide for full and timely payments of interests and principal on the bonds in a post-issuer insolvency scenario. The pivotal point lies in the fact that, for as long as the issuer can meet its obligations under the covered bonds, investors do not have to worry about the performance of the cover pool, which will, eventually, only come into the picture if the first line of exposure is defaulted. The substantial role played by the issuer in these transactions may then be magnified by its performing additional ancillary roles within the program (that is, servicer, account bank, swap counterparty, etc.). The dynamic and revolving features of most cover pools also add to the picture, as do the asset/liability guidelines that are implemented within each particular program. The combination of all these elements must be factored by the rating agencies into their analysis to come out with a synthetic assessment of a program’s capacity to provide triple-A protection to the investors.

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1. “SSA” stands for “sub-sovereigns and agencies.”
§ 7:1.2  Leading Agencies’ Approach to Ratings

[A]  Convergence of Methodologies

From a theoretical point of view, there seems to be an increasing convergence in the way the three leading agencies approach covered bond ratings, with a particular emphasis on the dependence on the issuer’s creditworthiness. While both Moody’s (2005–2010) and Fitch’s (2007–2013) methodologies have explicitly recognized a link between covered bond and Issuer Default Ratings, Standard & Poor’s (S&P) historically stood out for relying on a more structured finance type of analysis, provided the legal analysis of the framework and of the particular structure does not suggest any moratorium, acceleration, restructuring, or similar risk (in which cases a notch-up analysis was applied based on the agency’s “well secured debt approach”). It was only in February 2009 that S&P published (in the form of an exposure draft) a proposal [since adopted in revised form] for a revised covered bond methodology that, among other things, moved away from the traditional delinked approach and tied the ratings of a covered bond to, among other factors, the ratings of the issuing financial institution.\(^2\)

[B]  Differences in Methodologies

Substantial differences still exist among the three major agencies despite the linked approach to rating covered bonds. These differences produce triple-A ratings that have different meanings and analytical implications depending on their source.

[B][1]  Moody’s

Moody’s rating approach for covered bonds is based on a “joint-default analysis,” which takes into account not only the credit strength of the issuer but also, upon “issuer default,” the value of the cover pool.

A Moody’s covered bond rating is primarily determined by its expected loss. Moody’s expected loss rating model first assesses whether the issuer is still performing. If the issuer is performing, there should be no loss to covered bond holders. It is only following an issuer default that Moody’s expected loss model switches to the analysis of the value of the cover pool. The key factors affecting the value of the cover pool include:

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The credit quality of the collateral in the cover pool;

• Refinancing risk in the event that funds need to be raised to finance the cover pool at the time of issuer default; and

• Any interest or currency rate risks to which the cover pool is exposed.

Each of these factors is taken into account in the stressful environment that is expected to follow an issuer default.

Moody’s also assesses the likelihood of a covered bond to receive timely payments following an issuer default and assigns a timely payment indicator (TPI). The TPI creates a “linkage” to the underlying issuer and may constrain a rating where the risk of a late payment following issuer default is considered to be too high.

[B][2] Fitch

Fitch’s covered bond methodology is centered on the so-called “Discontinuity Cap” (“D-Cap”), which indicates the likelihood that payments under a covered bond could be “discontinued” or interrupted on or following a default by the issuing entity. The D-Cap provides an indication of the number of notches above the relevant Issuer Default Rating (IDR) potentially achievable by a covered bond on a pure probability of default basis. D-Caps range from 8, reflecting pass-through programs with sufficient liquidity protection, down to 0, indicating full discontinuity. In addition, Fitch considers additional IDR uplift based on the treatment of covered bonds under the applicable jurisdiction’s bank resolution framework. Although the combination of these elements provides a cap, the cap can be breached and exceeded by the final ratings of a covered bond thanks to an additional benefit that is given to the prospects of recovery from the cover pool. Fitch determines the recovery percentage for the cover pool by dividing the net present value of stressed future cash flows, including payments expected from swap counterparties, by the net present value of the residual liabilities, including payments owed to swap counterparties.

[B][3] S&P

S&P’s historical structured finance approach also put a particular emphasis on timeliness of payments and on the capacity of the cover pool to generate sufficient cash flows to cover all payment amounts due under the bonds after an issuer event of default. This approach has allowed S&P to minimize ratings volatility. Even under the new covered bond methodology, these elements seem to play highly crucial roles, with only those structures with virtually no risks of payment interruption (for example, pass-through bonds, etc.) qualifying for AAA ratings irrespective of their sponsor’s bank creditworthiness.
S&P’s approach introduces a strong link between the issuer’s senior, unsecured ratings and those of the covered bonds, which is then combined with so-called “risk categories.” Allocation to a particular risk category depends, for each covered bond program, on a number of factors, ranging from the regulatory strength of the covered bond framework and support for covered bonds to the historical and systemic importance of covered bonds within a particular jurisdiction. That being said, the crucial determinant under the S&P approach seems to be related to the maturity mismatches between assets and liabilities, and to the assessed liquidity of the assets comprising the cover pool. Depending on how a given program scores with respect to the projected duration gaps and liquidity shortfalls, the relevant covered bonds would be assigned to a specific risk category. While passthrough structures and covered bonds benefiting from committed liquidity lines would not be subject to any rating constraints, the ratings for all other programs would be capped at a given maximum of notches above the issuer’s senior, unsecured ratings.

Furthermore, the most recent criteria introduced (one covered bond-specific set of criteria still remains in the proposal phase) may reduce a covered bond program’s rating to reflect the dependence on derivative counterparties. Well-rated and committed counterparties are necessary to avoid degradation of the program’s rating, as well as contractual language ensuring that a counterparty would be replaced should its own rating drop below a specified level relative to the covered bond program. Generally, the reduction goes only to a specified floor level—typically, the higher of the issuer’s credit rating (ICR) or that of the lowest-rated derivative counterparty.

[C] Ratings Analysis During the Financial Crisis

All of the rating agencies reevaluated their ratings analyses during the financial crisis. As a result of the liquidity constraints experienced by financial institutions, the rating agencies became focused on refinancing risks. One area where the agencies have been particularly active relates to the capacity of cover pools to refinance their liabilities in a hypothetical scenario where the issuing bank has defaulted and all payment obligations on the covered bonds have shifted to the portfolio. The existence of mismatches between bullet notes and amortizing assets is increasingly seen as a critical risk factor. The crisis led the rating agencies to question the ability of a cover pool to execute large disposals of assets in the private or public markets, even in extremely severe recessionary environments. While the agencies have historically heavily relied on the feasibility of this exit strategy, the reduced liquidity in ABS markets and the explosion of spreads on mortgage-backed transactions has clearly lead to a general rethinking. In this context, an increasingly prominent role is being assigned to the potential
access to the refinancing facilities of the national Central Banks, which have established themselves as the main provider of liquidity against collateral in the recent financial crisis. Although each rating agency came to different conclusions, all three concluded that higher overcollateralization levels would be required going forward.

§ 7:2 Moody’s—Rating Covered Bonds

§ 7:2.1 Framework

[A] Generally

Moody’s covered bond ratings address the loss that an investor can expect to incur [expected loss] over the life of the assets in the cover pool and during any subsequent recovery period. In addition, as the sponsor bank’s default probability increases, the expected loss rating may be constrained by the risk that investors will not be paid on a timely basis following a sponsor bank default. A covered bond receives a letter rating [the rating], which ranges from the highest rating of “Aaa” to the lowest rating of “C.” Moody’s also assigns a separate indicator for each covered bond program, which is known as a timely payment indicator [TPI]. The TPI describes the likelihood that an investor will be paid on a timely basis following a sponsor bank default. There are six different TPIs, ranging from a high of “Very High” to a low of “Very Improbable.” The rating is primarily driven by the expected loss, but also takes into account issues of timeliness in that it may be constrained by the TPI, as described below.

[B] Expected Loss

Moody’s expected loss model assesses the probability of a default on the covered bonds, as well as the severity of loss following a default. Since covered bonds are dual recourse debt instruments, this analysis looks at both sources of recourse: the sponsor bank and the cover pool. The primary obligor of the covered bonds is the issuing entity, which is almost always a bank [the sponsor bank]. If the sponsor bank defaults on its obligations, then the covered bond investor has recourse to a pool of assets [the cover pool] to satisfy the debt. For losses to occur, two events must occur: (1) the sponsor bank must default on its obligations to pay the covered bonds, and (2) the recovery from the cover pool and any unsecured claim on the estate of the sponsor bank must be insufficient to pay the covered bonds in full.

The expected loss of a covered bond can be expressed by the following formula:

\[ EL = \sum_{i=1}^{n} P_i \cdot L_i \cdot df_i \]
Where:

\[ i = \text{number of periods until legal final maturity (n)} \]
\[ P_i = \text{probability of the sponsor bank's default for period } i \]
\[ L_i = \text{loss given default in period } i, \text{ materialized at refinance or liquidation of the cover pool} \]
\[ d_{ti} = \text{discount factor for period } t_0-t_i \]

To determine the probability of the default of the sponsor bank, Moody’s looks to the credit strength of the sponsor bank, which is measured by Moody’s senior unsecured rating.

Loss is primarily determined by assessing (a) the value of the cover pool in relation to the outstanding covered bonds, and (b) the expected recovery, if any, from an unsecured claim for any remaining shortfall against the sponsor bank’s estate, or from a swap counterparty, if any. To determine the value of the cover pool, the following factors\(^3\) are assessed:

- Credit quality of the cover pool (credit risk),
- The ability to sell or refinance the cover pool to raise cash (refinancing risk, sometimes called market value risk in some Moody’s publications pertaining to U.S. covered bonds), and
- Interest and currency risks (market risk).

**[C] Timely Payment Indicator (TPI)**

As the probability of default by a sponsor bank increases, the rating of a covered bond may be constrained by the TPI. The TPI is an assessment of the likelihood of a covered bond to receive all of its payments in a timely manner following a sponsor bank default. Although covered bond programs are structured so that cash flows and the asset value of the cover pool are segregated for the benefit of covered bond holders after a sponsor bank default, those cash flows or other amounts realized may be delayed for a number of reasons, including the inability to sell assets in the cover pool in a timely manner to pay the covered bonds, the failure of hedging arrangements to survive the sponsor bank default, delays in the administration process of the sponsor bank, and the potential for legal claims of the sponsor bank’s creditors to delay payments on the covered bonds.

The default probability of a covered bond is a function of the probability of a sponsor bank default and the probability of timely

\[^3\] Each of these factors is discussed in *infra* section 7:2.2.
payment given a sponsor bank default. Therefore, if the sponsor bank’s rating decreases (and its default probability increases), then the default probability of the covered bond increases. Moody’s covered bond ratings take into account that a high default probability for a covered bond may not be consistent with the highest rating levels.

This is mainly due to the high volatility Moody’s perceives regarding refinancing risk.

Figure 7-1 below shows the maximum rating a covered bond can achieve given a particular sponsor bank rating (on the y axis) and TPI (on the x axis). For example, the maximum ratings on a covered bond with a TPI of Improbable are shown in the column under “Improbable.” If the sponsor bank in that example were rated less than A1, then a covered bond from the sponsor bank could not achieve a Aaa rating, regardless of the expected loss analysis. This rating constraint acts as a linkage between the rating of the sponsor bank and the rating of the covered bonds. Covered bond programs with a high TPI have less linkage to the sponsor bank’s rating than programs with a low TPI. Under certain circumstances, a covered bond program may be delinked from the rating of the sponsor bank.4

Figure 7-1

Timely Payment Indicators

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§ 7:2.2 Main Drivers of the Rating

Moody’s covered bond expected loss model takes into account the factors summarized below to determine the expected loss of a covered bond.5

4. The main drivers of the TPI as well as the conditions required to achieve de-linkage are discussed in MOODY’S INVESTOR SERVICE, MOODY’S APPROACH TO RATING COVERED BONDS (Mar. 12, 2014), infra Appendix A1.

5. Id.
[A] **Strength of the Sponsor Bank**

During the life of the covered bond, Moody’s expected loss model calculates the probability of sponsor bank default based on the Moody’s senior unsecured rating of the sponsor bank.\(^6\) If the sponsor bank is performing, there should be no loss to covered bond holders. In addition, while the sponsor bank performs, it will also typically manage the cover pool, for example, by replacing defaulted assets with performing assets if required.

In addition, the strength or weakness of the sponsor bank can affect the performance of the covered bond transaction in other ways. Aside from being the primary obligor of the covered bonds, the sponsor bank often performs other functions in connection with a covered bond transaction, such as servicing, cash management, or hedging. A deterioration in the strength of the sponsor bank could impair or endanger its performance of these functions, adding risk of delays in cash flows or deterioration of collateral. Transfer of these functions to a replacement party may mitigate this risk, but could also have a negative effect on the credit quality of the covered bonds depending on the identity of the replacement party and the success of the transition.

[B] **Credit Quality of the Cover Pool**

Moody’s measures the credit quality of the cover pool by assigning a collateral score. The collateral score is the percentage of credit support required to protect a rated Aaa security from credit losses on the cover pool. The collateral score is generally determined in accordance with the methodology for rating structured finance securitizations of assets in the same jurisdiction and of the same type as those in the cover pool. For example, the collateral score for a cover pool containing U.S. residential mortgage loans would be determined in a similar manner as that used to determine the level of Aaa credit enhancement for a U.S. residential mortgage-backed securitization transaction involving the same type of assets. The collateral score assumes that there would be no forced sale of the assets prior to their maturities, that there are no interest rate or currency mismatches between the assets in the cover pool and the liabilities, and that the sponsor bank does not provide support to the cover pool (such as replacing delinquent assets with current ones). As a result, the collateral score measures only loss due to credit deterioration. In Moody’s expected loss model, the collateral score determines the loss due to the credit deterioration on

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\(^6\) For covered bonds issued out of the European Union (EU) or Norway, we use a potentially higher anchor point to determine the probability of default, based on an EU directive that excludes covered bonds, but not senior unsecured debt, from a “bail in.”
the assets in the cover pool that would be expected to be incurred following a sponsor bank default. The higher the credit quality of the cover pool, the lower the collateral score and, hence, the lower the level of losses due to credit deterioration that will impact the cover pool at the time of a sponsor bank default. For investment grade sponsor banks, Moody’s may reduce the stress (or collateral score) imposed on the cover pool below a Aaa-stress. Among Moody’s reasons for calculating these “haircuts” to the collateral score is that most sponsor banks are likely (and in some cases, obligated) to support the cover pool, for example, by replacing defaulted assets with similar performing assets. Accordingly, prior to a sponsor bank default, some of the losses that would have otherwise arisen in the cover pool will have been made whole by the sponsor bank.

[C] Refinancing Risk

Moody’s assesses the amount of loss that can be expected to be incurred by the cover pool due to having to sell or finance assets in the cover pool in the market. The maturities of most covered bonds are shorter than the maturities of the assets comprising the cover pool. Following a sponsor bank default, the natural amortization of the cover pool is unlikely to be sufficient to repay the bullet principal payments that are due under most covered bonds. Therefore, cover pool assets will most likely need to be sold or pledged in order to raise cash to pay principal on the covered bonds. This subjects the cover pool to refinancing risk. Moody’s refinancing risk analysis tries to gauge the discount to the par amount of the cover pool where the cover pool is sold. Recent events have highlighted that this risk is extremely volatile. It is refinancing risk that is arguably one of the defining features of the current “credit crunch.”

The amount of refinancing risk will vary from deal to deal based on a number of factors including:

- The type of assets included in the cover pool. Some asset types are more easily sold than others;
- The time period available to complete the sale or financing of the cover pool. The shorter the time period to refinance, the greater the refinancing risk;
- The credit quality of the assets;
- The strength or weakness of the market for the type of assets comprising the cover pool in the particular jurisdiction in which the assets will be sold or financed;
- The particular refinancing margins observed in these jurisdictions;
The portion of the cover pool exposed to refinancing risk. This will depend on the amount of principal collections received from the natural amortization of the cover pool. The more principal available from the cash flow of the assets in the cover pool, the smaller the portion of the cover pool that will need to be sold or financed to pay down the covered bonds;

- The amount of assets that need to be sold or financed. If there are multiple series of covered bonds outstanding from a single covered bond issuance program, it is usually the case that the program documentation will require the refinancing of only that portion of the cover pool necessary to pay off the next series of maturing covered bonds. Other programs, like the existing U.S. covered bond programs, currently require a sale of the entire cover pool within a short time period following a sponsor bank default; and

- Legislation and contract-specific considerations. Some jurisdictions are more supportive than others of the process of selling assets in the cover pool following a sponsor bank default.

[D] Market (Interest Rate and Currency) Risk

Moody’s assesses the risk of loss due to interest rate and currency mismatches between the assets in the cover pool and the covered bonds. Interest rate risk and currency risk arise when the collections on the cover pool are determined by one type of interest rate and/or currency, and the payments owed on the covered bonds are determined by reference to another type of interest rate and/or currency. For example, there could be an interest rate mismatch if the assets in the cover pool bear interest at a floating rate and the interest due on the covered bonds is determined on a fixed rate basis. Moody’s analyzes market risks that arise in two time periods: [1] after a sponsor bank default and prior to any refinancing of the cover pool, and [2] upon refinancing of the cover pool.

Following a sponsor bank default, but prior to a refinancing of the cover pool, market risks can cause the interest collections on the cover pool to be insufficient to pay the interest due on the covered bonds. Following a sponsor bank default, payments to the covered bonds will be made from collections on the assets in the cover pool. If interest rates go down, the assets, which bear interest at a floating rate, may not generate enough interest to pay the required interest on the covered bonds, which bear interest at a fixed rate. This could lead to a default on the covered bonds. Likewise, if the assets pay in U.S. dollars and the covered bonds are issued in Euros, there is a risk that following a sponsor bank default, the cash generated by the cover pool in U.S. dollars would not be sufficient to pay the covered bonds in Euros.
Upon a refinancing of the cover pool, market risks can lower the
value of the cover pool. With respect to interest rate risk, depending on
the interest rate environment at the time of refinancing, the cover pool
could be more or less valuable, depending on the composition of the
cover pool or the covered bonds. For example, in a rising interest rate
environment, loans in the cover pool with fixed rates and long
maturities, and covered bonds with short maturities or floating rates,
will be less valuable. Currency risks can arise if the loans in the cover
pool are denominated in one currency, while the covered bonds are
denominated in another. For example, the value of a cover pool
denominated in U.S. dollars would diminish relative to covered bonds
issued in Euros in an environment where the Euro is increasing in
value against the dollar.

Moody’s expected loss model examines the impact of both increas-
ing and decreasing interest rate scenarios on the expected loss of the
covered bonds, and calculates an expected loss due to market risks
based on the path of interest rates that leads to the more severe result
on the expected loss on the covered bonds. Similarly, in case of
currency mismatches, the expected loss model examines the potential
impact of exchange rate movements.

Moody’s also takes into account hedges designed to mitigate
interest rate and currency risk. Many covered bond programs
utilize hedges to mitigate these risks. Moody’s evaluates the strength
of these hedges to determine the likelihood that the hedges will be
in effect when they are needed most. To date, there has been no
instance in which Moody’s has assumed that swaps used to hedge
interest and currency risk completely remove these risks from a
covered bond.7

§ 7:2.3 Issues for U.S. Covered Bonds

[A] Generally

Although covered bonds have long been issued in many European
markets, they were first issued in the United States fairly recently.
Currently, there are only two existing U.S. covered bond programs,
sponsored by Bank of America (BOA) and JPMorgan Chase Bank
(“JPMorgan Chase”) [acquired from Washington Mutual Bank
(“WaMu”)], respectively.8 However, regulators and various market

7. For details on how Moody’s assesses hedges, see MOODY’S INVESTORS
   SERVICE, MOODY’S RATING APPROACH TO COVERED BONDS (Mar. 12, 2014),
   infra Appendix A1.
8. For a detailed discussion of the WaMu and BOA covered bonds programs,
   see infra chapter 10, U.S. Covered Bond Case Study and Regulatory
   Framework.
participants have expressed interest in the expansion of the U.S. covered bond market as a potential source of funding and liquidity for the residential mortgage market. During the term of the previous U.S. administration, the Federal Deposit Insurance Corporation (FDIC) published its “Covered Bond Policy Statement” on July 15, 2008, which was intended to “facilitate the prudent development of the U.S. covered bond market.”

During the same time, the U.S. Treasury published its “Best Practices for Residential Covered Bonds” on July 28, 2008, which was intended “to give market participants the tools to build a market that will benefit U.S. families and the U.S. economy.” Since these releases, no new covered bonds have been issued in the United States, and it still remains to be seen what developments, if any, will occur in the U.S. covered bond market.

This section examines the potential scenarios for U.S. covered bonds, under the current regime, following a sponsor bank default and the exposure to refinancing risk for U.S. covered bonds. Moody’s rating analysis relating to these issues is discussed in infra section 7:2.4.

[B] Scenarios Following a Sponsor Bank Default

For U.S. covered bonds, what happens following a sponsor bank default will, in large part, depend on the actions of the FDIC. Unlike many European countries, the United States does not have specific covered bond legislation. Instead, U.S. covered bonds rely on the contractual obligations embodied in the transactions' governing legal agreements within the existing U.S. legal and regulatory framework. Under U.S. law, the insolvency of insured banks is administered by the FDIC, rather than through the bankruptcy court system. According to the FDIC Policy Statement, the FDIC would have three options in dealing with a covered bond program whose sponsor banks become insolvent:

10. Id.
13. Moody’s analysis is based primarily on the FDIC Policy Statement and the transaction terms of the current U.S. covered bond transactions.
1. Continue to pay the covered bonds in accordance with their terms [affirm the covered bonds];

2. Repudiate the contracts underpinning the covered bonds and instead pay “actual direct compensatory damages” [as determined below] to the covered bond investors [repudiate the covered bonds]; or

3. Allow the trustee of the covered bond transaction to liquidate the cover pool to pay off the covered bond investors [allow self-help].

Under the first option, the FDIC would continue to pay the covered bonds. The FDIC would most likely choose this option if the FDIC was seeking a buyer for the failed bank’s covered bond program. In such a case, it would continue to pay the covered bonds for a limited period of time until it could find a buyer. We witnessed something similar to this when the FDIC sold WaMu’s covered bonds to JPMorgan Chase on September 25, 2008. In that case, the FDIC sold WaMu’s covered bonds to JPMorgan Chase simultaneously with the FDIC’s appointment as receiver of WaMu, so there were no payments on the covered bonds made by the FDIC. However, in a different scenario, if there were no ready buyer available when the FDIC became receiver, then the FDIC would have the ability to keep the covered bonds current while it sought a buyer.

Under the second option, repudiation, the FDIC would be permitted to terminate the insolvent bank’s obligation to pay the covered bonds and keep the collateral in the cover pool so long as it paid “actual, direct compensatory damages” to holders. According to the FDIC Policy Statement, the measure of these damages means that the FDIC would pay off the covered bonds in cash up to the value of the pledged collateral. If the FDIC’s valuation of the cover pool were less than the amount owed on the covered bonds, the FDIC would pay cash equal to the value of the cover pool, and the covered bond trustee would have an unsecured claim against the estate of the sponsor bank for the deficiency.

If the FDIC neither affirmed nor repudiated the covered bonds, the trustee would be obligated to liquidate the cover pool. In its Policy Statement, the FDIC stated that “it would be essential that the secured party liquidate the collateral in a commercially reasonable and expeditious manner taking into account the then-existing market conditions.” If the proceeds of the sale of the cover pool exceeded

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15. See infra section 10:1.2.
the par amount of the covered bonds plus accrued interest to the date of the appointment of the FDIC as receiver or conservator, such excess would be returned to the FDIC. If the proceeds were less than that amount, the covered bond trustee would have a claim against the estate of the sponsor bank for the deficiency.

Both of the existing U.S. covered bond programs are structured so that following a payment default by the sponsor bank, the entire cover pool would need to be monetized within a short period of time. In other words, if the FDIC did not affirm the covered bonds, the trustee would have a maximum of 120 days to realize a sufficient amount of cash (roughly equal to the U.S. dollar equivalent of the covered bonds at the exchange rate set at the inception of the program) so that the covered bonds could continue to be paid until their maturity. A failure to realize that amount of cash within 120 days would lead to a default and an acceleration of the covered bonds. This monetization could come either from a repudiation payment made by the FDIC or a sale of the entire cover pool.

An additional timing constraint is a statutory automatic stay that goes into effect upon the insolvency of a sponsor bank. This stay would prevent the covered bond trustee from seizing the cover pool following a sponsor default without the consent of the FDIC. For covered bond programs meeting the eligibility criteria set forth in the FDIC Policy Statement (such as restrictions on the types of loans that may be included in the cover pool, or that the covered bonds represent no more than 4% of the sponsor bank’s total liabilities), the FDIC would decide either to repudiate the covered bonds or give consent to the trustee within ten business days following a payment default by the sponsor bank. For covered bond programs that do not meet the eligibility requirements, the FDIC could take longer to make this decision and the trustee would be unable to seize the cover pool without the FDIC’s consent for up to ninety days.

[C] Exposure to Exacerbated Refinancing Risk—Rating Implications

Based on the above discussion, Moody’s believes that the existing U.S. covered bond programs are particularly exposed to refinancing risk. While it is true that the FDIC has the ability to support the covered bonds in the form of an affirmation—and in fact we saw that the FDIC did so in the case of the sale of the WaMu covered bond program to JPMorgan Chase—nevertheless, since there is no obligation for the FDIC to provide such support, Moody’s must evaluate the other scenarios. In both of the other scenarios—repudiation and self-help—the entire cover pool would be subject to market conditions existing at the time of a sponsor bank default.
Under adverse market conditions, like those existing during the financial crisis, a forced sale of over $10 billion in mortgage loans may obtain an exceptionally low price or may not be able to be completed at all. Even in a repudiation scenario, the up-front payment by the FDIC would be equal to the value of the collateral in the cover pool. The FDIC would take into account the market value of the pool under the market conditions existing at the time.

As a result of this exacerbated refinancing risk, Moody’s views the ratings of the existing U.S. covered bond programs as closely linked to the ratings of their sponsor banks. This is reflected in the TPI of “Improbable” for the U.S. programs. It has also been reflected in rating actions taken on both programs. In 2008, while WaMu was the sponsor of its covered bonds, Moody’s downgraded the ratings of the covered bonds several times in connection with the downgrade of WaMu. In addition, Moody’s downgraded BOA’s covered bonds from Aaa to Aa2 in a series of rating actions from March 2009 to November 2009.

The structural features of future U.S. covered bond transactions may differ from those of existing transactions, so their refinancing risk exposure may also differ. However, it remains uncertain what kind of mechanisms designed to mitigate refinancing risk would be compliant with the FDIC Policy Statement. For instance, while the FDIC has the option of allowing the trustee of a covered bond transaction to use the pledged collateral to pay off the covered bond holders following a sponsor’s insolvency, the Policy Statement only considers a liquidation of the collateral. In comparison, some covered bond programs in other jurisdictions allow covered bonds to be paid off from the cash flows generated by the cover pool. For future deals, Moody’s will consider if, and how, this exacerbated refinancing risk is mitigated.

§ 7:2.4 Rating Process

The following are some of Moody’s principal steps in the process of rating a covered bond transaction:

Sponsor bank rating. In order for Moody’s to rate a covered bond transaction, the sponsor of the transaction would need to be rated by Moody’s (either a public rating or a private monitored rating).

Cover pool review. In order to determine the collateral score for a cover pool, Moody’s evaluates the credit quality of the assets in the

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17. Currently, in the United States, Moody’s rates only the BOA-sponsored covered bonds. Moody’s withdrew its ratings on the JPMorgan Chase-sponsored covered bonds in June 2009 for business reasons. At the time of withdrawal, the JPMorgan Chase-sponsored covered bonds were rated “Aaa” and the TPI was “improbable.”
cover pool using a loan loss model. Sponsors will need to complete Moody’s standard data template and provide their loan level or other appropriate detail to input into Moody’s models. These inputs depend on asset type and jurisdiction, but typical information would include credit characteristics, such as credit bureau scores, loan to value ratios, and property and occupancy types. Moody’s would also conduct a review of the originator and its origination procedures, which may include independent third-party due diligence of a sample of the loans.

Review of transaction documents and legal opinions. Prior to the closing of the transaction, Moody’s would need to review the transaction documents and legal opinions delivered in connection with the transaction. In jurisdictions where there is specific covered bond legislation, Moody’s may ask legal counsel to answer questions posed in a legal checklist. 18

Pre-sale or new issue report. Prior to, or shortly after, the closing of the transaction, Moody’s would publish a report describing the transaction and detailing its credit analysis. The report would include a provisional rating (in the case of a pre-sale report) or a definitive rating (in the case of a new issue report) and a TPI.

Rating. Upon the closing of the transaction, Moody’s would publish a definitive rating of the covered bonds.

Monitoring/Performance reports. Moody’s monitors the covered bonds on an ongoing basis following the closing of the transaction. Moody’s asks to be provided with all trustee reports as well as other information on the cover pool in the form of specified templates on a quarterly basis; Moody’s aims to publish performance overviews on a regular basis.

§ 7:3 Fitch—Rating Covered Bonds

§ 7:3.1 Background

In Fitch’s view, covered bond ratings cannot be seen as completely independent from an assessment of the issuer’s creditworthiness. Financial institutions manage their cover pools over time, and may issue covered bonds right up until their insolvency or withdrawal of their license. Whereas, historically, covered bonds were solely understood as secured debt benefiting from a preferential ranking in insolvency, modern covered bond frameworks strive to preserve the integrity of scheduled payments on the covered bonds, whether or not the issuer defaults.

Covered bonds are generally issued in successive series, all under a common issuance program. Under the existing U.S. covered bond programs, each covered bond series is collateralized by the same cover pool and the bonds have an equal pro-rata claim against the cover pool assets. The insolvency of the originating financial institution does not automatically trigger a covered bond event of default. In the event of the issuing bank’s default, the cover pool becomes static and the cover pool assets are likely to be sold. Proceeds from the sale of the cover pool are deposited into a guaranteed investment contract (GIC) account. If the proceeds in the GIC account are sufficient to support principal and interest payments due to the covered bond holders, then the covered bonds do not accelerate. The only form of credit enhancement available to covered bond investors comes from overcollateralization (OC).

As a result of the dual recourse nature (against a regulated financial institution and a cover pool of assets), the rating on a series of covered bonds is usually higher than that of the issuer. Approximately 60% of covered bonds rated by Fitch carry a rating of “AAA” as of February 2014.

§ 7:3.2 Summary of Rating Criteria

Fitch Ratings’ covered bonds ratings mainly address the probability of default (PD) of a series of covered bonds. The ratings also incorporate an element of recovery expectation. Covered bonds may survive the insolvency of the financial institution acting as main debtor, and, therefore, obtain a rating, on a PD basis, that is higher than the applicable Issuer Default Rating (IDR). In order to determine the maximum achievable rating of the covered bonds on a PD basis, Fitch utilizes a two-stage approach that considers (1) the treatment of covered bonds under the applicable jurisdiction’s bank resolution framework and (2) the likelihood of an interruption (or discontinuity) of payment on the covered bonds as a direct result of the default of the issuer as assessed via the agency’s Discontinuity Cap (D-Cap). This dual-step analysis replaced Fitch’s prior methodology, which considered uplift over the issuer’s IDR based solely on the D-Cap, upon the implementation of the agency’s revised Covered Bonds Rating Criteria in March 2014.

The IDR uplift assigned to covered bonds issued out of programs in jurisdictions where the covered bonds are exempt from bail-in resolution in the event of bank failure depends upon the

- relative ease and motivation for resolution methods other than liquidation;
- importance of covered bonds to the local financial markets; and
• buffer, if any, provided by the issuer’s senior unsecured debt.\textsuperscript{19}

The D-Cap is based on the highest risk assessment of the following five discontinuity risk components:

• segregation of the cover pool assets;
• solutions to overcome liquidity gaps upon default of the debtor and vulnerability to systemic risk;
• the framework that governs the transition to alternative cover pool management;
• ease of the transferability of relevant data to a third-party manager given an issuer’s IT systems and technology infrastructure; and
• materiality and replaceability of privileged hedging arrangements.

Separately, recoveries from the cover pool in case of a covered bond default are given credit according to Fitch’s Recovery Rating methodology.

In addition, Fitch assigns Outlooks to covered bond ratings to give an early indication of the potential future direction of a covered bond rating. Outlooks (which may be Positive, Stable, Negative, or Evolving) indicate the likely direction of a rating over a one- to two-year period, but do not provide absolute certainty that a rating action will or will not occur. The main drivers of covered bond rating Outlooks are the relevant sovereign rating Outlook, the Long-Term IDR Outlook of the issuer, the economic and/or sector outlook associated with the assets comprising the cover pool, and the outlook for the maintenance of OC within a program.

\textbf{§ 7:3.3 Maximum Achievable Rating on a PD Basis}

To determine how far the covered bonds rating may go above the issuer’s IDR, Fitch employs a two-stage process which includes (1) setting the IDR uplift, if any, and (2) defining the applicable D-Cap for the program.

\textbf{[A] Step 1—Setting the IDR Uplift}

Fitch will apply an uplift above the IDR of up to two notches for programs of issuers rated at least “BB-”, and up to three notches for programs of issuers rated below “BB-” for covered bonds issued out of jurisdictions with an advanced bank resolution regime, that includes a bail-in tool from which covered bonds are exempt. The IDR uplift depends on: relative ease and motivation for resolution methods other

\textsuperscript{19. See Fitch Ratings, Covered Bonds Rating Criteria (Sept. 10, 2012), infra Appendix A11.}
than liquidation; the importance of covered bonds to the financial market in a jurisdiction; and the level of an issuer’s senior unsecured debt available for bail-in.

A two-notch uplift will be granted if at least two of the three factors are present; a one-notch uplift will be granted if at least one of the three factors is present; and no uplift will take place if none of the three factors is present. The three-notch uplift for issuers rated “B+” or below is only expected to apply when idiosyncratic issues result in a low IDR for the issuer, rather than broader operating environment factors affecting all financial institutions in a given country. Such uplift is also dependent on issuer-specific considerations, such as whether a clear resolution path is in place for the issuer.

[B] Step 2—Defining the D-Cap

The D-Cap assigned to programs rated by Fitch is driven by the highest risk resulting from five published discontinuity risk components: asset segregation, liquidity gap and systemic risk, systemic alternative management, cover pool-specific alternative management, and privileged derivatives.

Within these components, Fitch also considers if limited additional credit should be given in jurisdictions for which Fitch assesses the regulator as providing significant oversight protection and where there is a high likelihood of support for regulated covered bonds.

In addition, the rating of the sovereign in which the issuer and/or the cover assets are domiciled may serve as a constraint on the uplift the covered bonds ratings can achieve from the issuer IDR. Since systemic risk issues are more likely to develop in lower-rated sovereigns, the link between the issuer IDR and the covered bond rating becomes tighter for lower sovereign ratings, particularly those rated below “A+”.

The “weak-link” analysis does not apply to programs deemed to have minimal discontinuity risk [such as pass-through programs with three month's coverage of interest and expenses] as long as the assessment of the asset segregation, alternative management, and privileged derivatives components does not raise any particular concerns. This is because there should be no need to liquidate cover assets, which removes the majority of payment interruption risk for covered bonds after an issuer default.

The D-Cap obtained for a particular covered bonds program issued on behalf of a given financial institution can take on values from 8 through 0, where 8 reflects a minimal risk of discontinuity of covered bond payments upon an issuer default, and 0 reflects an automatic default of the covered bonds upon an issuer default. Figure 7-2 below outlines the full range of D-Caps and their associated discontinuity risk description.
Recognizing the unique nature of covered bonds (being dual-recourse instruments) compared to other structured finance products, Fitch’s criteria for addressing counterparty risk is tailored to the distinctive features of covered-bond programs.  

Fitch’s counterparty criteria explain the methodology applied in analyzing derivative, direct, and indirect counterparties in both structured finance transactions and covered bond programs, highlighting the differences in covered bond treatment, where applicable.

Fitch expects a counterparty to have a certain minimum Long-Term Issuer Default Rating (IDR) and Short-Term IDR to support a given covered bond program rating (for instance, “A”/“F1” to support an “AA-” or higher-rated covered bond program). These guidelines are less strict than the usual SF criteria to reflect the available recourse to both the issuer and to the counterparty, when the counterparty is an external third party. For internal counterparties, no benefit is given to the dual recourse as issuer and counterparty are identical or highly correlated. For programs with hedging arrangements whose collateral posting and replacement provisions are not in line with Fitch’s criteria, the risk assessment for the privileged derivatives component of the D-Cap is likely to be higher, which may increase the linkage between the covered bond ratings and the issuer rating [reducing the covered bond rating’s potential uplift over the issuer rating].

Fitch considers internal derivative counterparties (those related to the covered bond issuer) more vulnerable to an issuer default than external derivative counterparties.

The agency evaluates the ultimate impact on the ratings based on the following three elements:

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1. any program-specific structural mechanisms available;
2. any new mitigants proposed by transaction parties; and
3. the materiality of the counterparty exposure to the program performance.

Mitigation can take several forms, but Fitch primarily gives credit for increased OC. In the event of excessive risk and insufficient mitigation, Fitch may either constrain the covered bonds’ rating to that of the lowest counterparty rating or analyze the program without factoring in the support provided by the deficient counterparty.

### § 7:3.5 Example of a Covered Bonds Rating

Figure 7-3 below illustrates the steps Fitch takes in rating covered bonds. Each step is examined in the discussion that follows.

**Figure 7-3**

Covered Bond Rating Steps

[A] **Step 1—Determining the Maximum Achievable Rating on a PD Basis**

The applicable IDR of the issuing institution, combined with the relevant IDR uplift and D-Cap, indicates the maximum rating that the covered bonds can reach on a PD basis, provided OC between the cover assets and the covered bonds is sufficient to sustain the corresponding stress scenario. As an example, an issuer rated “BBB+” with an IDR uplift of 2 and a D-Cap of 4 would, in principle, be able to achieve a covered bond PD equivalent to a “AA+” rating.
Step 2—Stress-Testing Overcollateralization to Set the Covered Bond PD Rating

Due to the dual-recourse nature of covered bonds, the IDR constitutes a floor for the covered bond rating on a PD basis. The IDR, in conjunction with the IDR uplift and D-Cap analysis, results in a maximum covered bond rating on a PD basis above the IDR. Within this range of possible ratings for the covered bonds on a PD basis, Fitch selects the one corresponding to the highest level of stresses that the cover pool can withstand, factoring in the OC, while still enabling full and timely redemption of outstanding covered bonds in a wind-down scenario, should the issuer default. In order to test this, Fitch simulates the behavior of the cover pool in an economic downturn, and compares the stressed cash flows expected from the cover pool assets to the payments due on the covered bonds. Stresses include credit losses on the assets, the cost of bridging maturity mismatches by disposing of the assets or investing excess cash, adverse variation of interest and currency rates, and expenses of a third-party manager.

OC between the cover pool assets and the covered bonds is the only form of credit enhancement for covered bonds. It provides a buffer to protect investors, post issuer default, against the credit risks inherent in the cover pool and market risks resulting from the mismatches between the cover pool and outstanding covered bonds.

As the level of OC in covered bond programs can change over time as assets pay down and/or issuers actively manage their pools, Fitch gives credit, in decreasing order of comfort, to the following (when available) in its cash flow analysis:

- contractual commitments, if legally binding and enforceable against the issuer; and
- non-contractual public statements and/or covenants—such as undertakings given in the program’s investor reports, the bank’s annual reports or published on the investor relations section of the issuer’s web site; or
- lowest level of OC recorded during the preceding twelve months, provided that the issuer’s Short-Term IDR is at least at “F2” and the program is not in wind-down.

For issuers with a Short-Term IDR of “F3” or below, in the absence of valid contractual or otherwise public statements, the cash flow analysis will be run by giving credit only to the minimum level of OC, if any, required by the relevant covered bond legal framework. For programs Fitch believes to be in wind-down or dormant, in the absence of valid contractual or public statements, the cash flow analysis will be run by giving credit to the minimum level of OC, if any, required by the relevant covered bond legal framework.
[C] Step 3—Calculating the Recovery Uplift

Finally, should covered bonds experience a default post issuer insolvency, covered bonds may benefit from high recoveries stemming from the cover pool. Fitch recognizes this through a potential uplift above the covered bond’s rating on a PD basis. For recoveries estimated in the 91% to 100% range, the uplift can reach up to two notches if the covered bond’s rating on a PD basis is in the investment grade range, and three notches if the covered bond’s rating on a PD basis is in the sub-investment grade range. In some jurisdictions, notching up for recovery is only applied if stressed recoveries on covered bonds assumed to be in default reach 100%, particularly if some form of time subordination occurs.

Figure 7-5
Maximum Notching Above Covered Bond’s PD Rating

<table>
<thead>
<tr>
<th>Recovery prospects</th>
<th>Recovery range (%)</th>
<th>Investment grade</th>
<th>Non investment grade</th>
</tr>
</thead>
<tbody>
<tr>
<td>Outstanding</td>
<td>91-100</td>
<td>+2</td>
<td>+3</td>
</tr>
<tr>
<td>Superior</td>
<td>71-90</td>
<td>+1</td>
<td>+2</td>
</tr>
<tr>
<td>Good</td>
<td>51-70</td>
<td>+1</td>
<td>+1</td>
</tr>
<tr>
<td>Average</td>
<td>31-50</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Below average</td>
<td>11-30</td>
<td>-1</td>
<td>-1</td>
</tr>
<tr>
<td>Poor</td>
<td>0-10</td>
<td>-1/2</td>
<td>-2/3</td>
</tr>
</tbody>
</table>

Source: Fitch
The recovery prospects are assessed, at the time of a supposed default of the covered bonds, by calculating the stressed net present value of the cash flows expected from the cover pool and comparing them with the net present value of the privileged liabilities (that is, covered bonds and, if any, privileged swap agreements). The applied stresses correspond to the targeted rating of the covered bonds, incorporating the notching for potential recoveries. For instance, if the rating of the covered bonds is equivalent to “AA” on a PD basis, stressed recoveries from the cover pool would be calculated in an “AAA” rating scenario.

In many jurisdictions, an issuer default would generally mean that portions of the cover pool would need to be realized to repay covered bonds in time. Indeed, natural cash flows from the cover pool would generate shortfalls compared to payments due on outstanding covered bonds, since the cover pool assets are, on average, longer dated than the covered bonds’ residual maturity. A complete liquidation of the cover pool would generally only occur upon a covered bond default, or if the remaining cover assets were deemed insufficient to repay all outstanding covered bonds. In the United States, by contrast, unless the FDIC pays actual compensatory damages, the entire cover pool would have to be liquidated upon the issuer’s insolvency.

§ 7:3.6 Current U.S. Covered Bond Program Features

To date, the two covered bond programs that have been issued by U.S. depository institutions have adopted a “two-tier” model involving a special purpose vehicle (SPV) acting as issuer of the bonds placed with final investors. Although SPVs are used in some covered bond programs from other jurisdictions as well, the U.S. template is unique in the sense that the SPV is not holding the cover pool securing the covered bonds, but is there to protect investors from the acceleration risk associated with bank insolvency.

Under the U.S. two-tiered system, financial institutions wishing to issue covered bonds first issue mortgage bonds to the SPV, which in turn issues covered bonds to investors. The mortgage bonds constitute direct and unconditional obligations of the issuing financial institution, or mortgage bond issuer (MBI), and are issued in series, ranking pari passu and without priority among themselves. Each series of mortgage bonds is purchased by the SPV, or covered bond issuer (CBI), and posted as collateral to the related series of covered bonds.

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22. For a detailed discussion of the existing U.S. covered bond programs, see infra chapter 10, U.S. Covered Bond Case Study and Regulatory Framework.
bonds. The mortgage bonds will be backed by a dynamic pool of mortgages (that is, the cover pool) originated or acquired by the MBI, and segregated on the financial institution’s balance sheet. The cover pool secures, collectively, all series of mortgage bonds. Therefore, each series will be entitled to the payment of its pro rata share of the pool’s liquidation proceeds. In addition, if proceeds from the disposal of the cover pool assets prove insufficient to fully repay the mortgage bonds, the claims of mortgage bond holders will also rank pari passu with those of all the MBI’s other unsecured creditors and will have recourse to other bank assets. The mortgage bonds are issued as hard-bullet, U.S. dollar-denominated floating-rate bonds, which pay interest on a monthly basis. As long as the MBI is solvent, it will directly pay interest and principal on the mortgage bonds. Upon the insolvency of the MBI, the CBI would have recourse to the cover pool assets. Following a mortgage bond event of default, the outstanding mortgage bonds of all series will become due and payable. However, this will not result in the early amortization of the covered bonds issued by the CBI, which would remain due at their scheduled maturity date, subject to any applicable extension period.

Unlike most existing covered bond issuers, the CBI is a SPE, rather than a regulated financial institution. The CBI issues covered bonds in one or more series, which are direct and limited-recourse obligations of the issuer. Each series of covered bonds is secured by a separate, related series of mortgage bonds issued by and purchased from the MBI. Although different series of covered bonds are not cross-collateralized, they will receive a pro rata share of any collections on, or proceeds from, the cover pool, based on their entitlements to proceeds from the related series of mortgage bonds. The covered bonds are hedged by swaps that protect against interest rate, reinvestment, and currency risk. Prior to a mortgage bond event of default, interest and principal from each series of mortgage bonds is swapped to enable the issuer to pay interest and principal due on the relevant series of covered bonds. Following a mortgage bond event of default, any proceeds from the cover pool are invested by the covered bond indenture trustee in a specified instrument or a guaranteed investment contract (GIC) account for each series of outstanding covered bonds. The proceeds from each specified instrument, after payment of senior expenses, are paid to a swap provider to enable the issuer to pay the interest and principal due on each series of covered bonds.

§ 7:4 S&P—Rating Covered Bonds

§ 7:4.1 Background

S&P previously evaluated covered bonds based on the following four factors:
• legal framework pursuant to which covered bonds were issued;
• quality of the cover pool assets;
• effect on the cash flows of any maturity mismatches, currency mismatches, liquidity and interest rate risk; and
• degree of overcollateralization.

Based on its analysis of these factors, it was possible for a covered bond rating to be higher than the counterparty or unsecured debt rating of the issuer. If the rating agency was satisfied with its analysis of these factors, the rating for a covered bond could be “delinked” from the rating of the issuer and rated as high as currency convertibility risk would permit. The rating could go up to “AAA.” However, if there were uncertainties regarding the legal framework for post-insolvency workout and there was a lack of explicit legal mechanisms in the applicable jurisdiction designed to ensure timely payment in the event of an issuer insolvency, then the rating of a covered bond would remain linked to the issuer’s rating. It was also possible that in legislative covered bond jurisdictions, when certain overcollateralization levels had been reached, the covered bonds could be rated up to two notches higher than the counterparty credit rating of the issuer. The degree of rating enhancement would depend principally on the quality of the cover pool assets and would be determined on a case-by-case basis.

§ 7:4.2 Historic Analytical Framework

As discussed above, S&P had outlined the four key analytical factors it used in its covered bond ratings.23

[A] Legal Framework

In assessing the legal framework, the rating agency considered the following two questions:

(1) To what extent could a covered bond holder be affected by the insolvency of the issuing bank?

(2) Could the investor expect timely payment of interest (including post-insolvency interest) and principal in an insolvency scenario?

If the legal framework ensured uninterrupted payment on the covered bonds, even in an insolvency scenario, the rating agency would delink

23. STANDARD & POOR’S, EXPANDING EUROPEAN UNIVERSE PUTS SPOTLIGHT ON KEY ANALYTICS (July 16, 2004).
the rating of the covered bond from the rating of the issuer. In determining whether a delinked approach was justified, from a legal perspective, the rating agency considered the following five legal issues:

- asset isolation;
- payment acceleration;
- moratorium;
- forced restructuring; and
- an ability to create liquidity after insolvency.

Analysis of asset isolation focuses on ensuring that the cover pool is available only to meet the covered bond obligations until the obligations are repaid in full. If the cover pool assets are available to meet other obligations, then the rating agency would consider the magnitude of the obligations and whether these endanger the rights of the covered bond holders. S&P considered whether the jurisdiction of the covered bond issuer provided for acceleration of the issuer’s debt obligations, including the covered bonds, upon an issuer insolvency. Payment acceleration might result in losses for covered bond holders. As a result, payment acceleration would be inconsistent with high ratings. From a ratings perspective, it is also important that there not be any requirement for the institution of a moratorium upon an insolvency that would prevent secured creditors from enforcing their rights. Certain jurisdictions provide for a forced and legally binding restructuring (a forced restructuring) of an issuer’s obligations upon an insolvency. The analysis also considered the ability to create liquidity after the issuer’s insolvency.

**[B] Asset Quality of the Cover Pool**

The ratings analysis then requires an evaluation of the asset quality of the cover pool. S&P noted that “[w]hen the covered bonds are secured by a separate pool of mortgage loans, the aim is to assess the level of losses that will not be exceeded under stressed assumptions at the desired rating level.”²⁴ In this respect, the methodology is similar to that used for residential mortgage loan securitizations. The credit quality of the pool is assessed by assessing the credit risk associated with each loan by taking into account each loan’s probability of default leading to foreclosure and its loss severity. For the entire pool, potential losses are quantified by considering each loan’s

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²⁴. *Id.*
foreclosure frequency and loss severity, and weighting it by the percentage it represents of the total pool. A weighted average foreclosure frequency and a weighted average loss severity are calculated at each rating level. The product of these two variables estimates the required loss protection. In considering weighted average foreclosure frequency, the rating agency considers the overall size of loans granted, geographic concentration of the loans in the cover pool, the seasoning of the loans, and whether the cover pool includes any loans in arrears. In considering loss severity, the rating agency considers market value decline, foreclosure costs, the foreclosure period, and accrued interest.

[C] Cash Flow Analysis

S&P also evaluates the cash flows on a cover pool in order to determine whether, under stress scenarios, the cash flows generated by the cover pool assets would be sufficient to meet the payments due on the covered bonds. The cover pool would have to generate enough cash flows to permit timely payment of all liabilities, taking into account defaults arising as a result of credit risk, market risk (interest rate and currency risks), and liquidity risk. S&P considers the hedging arrangements entered into in connection with the covered bonds, prepayment risk for the loans, and access to liquidity. Access to liquidity will be impacted by the jurisdiction of the issuer.

[D] Overcollateralization

Overcollateralization may be necessary to achieve a rating for the covered bond that is higher than the issuer’s rating. According to S&P, overcollateralization is necessary in order to address the following risks: credit risk concentration and correlation embedded in the asset pool; interest rate risk that may arise from maturity mismatches between assets and liabilities; fixed and floating exposures; liquidity risk; currency risk; and the ability to remunerate an alternative servicer and other service providers should the need arise.

§ 7:4.3 Changes to Ratings Methodology

The historical framework has been discussed to underscore S&P’s underlying principles in analyzing covered bonds. The three major changes discussed next—updates to asset-liability mismatch risk criteria and two approaches to handling derivative counterparty risk—build upon the historical framework.

The 2009 Asset-Liability Mismatch Criteria (section 7:4.3[A] below) more strongly link the covered bond program’s rating to the issuer’s credit rating (ICR), in order to more accurately reflect the
issuer’s role in managing the cover pool assets and in providing continuous support. Effectively, the criteria cap the extent to which the covered bonds can achieve a rating that is higher than the ICR. The 2010 Counterparty Criteria of section 7:4.3[B] below apply to all structured finance securities (with the exception of most, but not all, covered bonds). Depending on the reliability and replaceability of the program’s derivative counterparties, these criteria may reduce the 2009 ALMM calculated program rating to reflect the quality of support given by the counterparties. For the majority of covered bonds, S&P has proposed counterparty criteria specific to covered bonds (section 7:4.3[C] below). These proposed criteria reflect covered bondholders’ unique dual-recourse to the issuer and the cover pool alike, as well as the typically high number of derivative counterparties. Like the 2010 Counterparty Criteria, the proposed criteria may lower a program’s rating below that calculated in the 2009 ALMM criteria.


[A][1] Generally

In February 2009, S&P proposed changes to its covered bond methodology in order to link covered bond ratings to the ICR. After revision based on comments received from market participants, S&P adopted the new criteria on December 16, 2009. Given that covered bonds typically have five- or ten-year maturities, but the underlying mortgage loans that comprise the cover pool have a much longer term (usually between twenty and thirty years), there is an asset-liability mismatch. In the case of an issuer default, given difficult market conditions, the rating agency was concerned that there would be limited market liquidity and, as a result, refinancing risk. In addition, the new methodology was meant to take into account the systemic importance of covered bond programs in the issuer’s jurisdiction and the likelihood of external support for struggling issuers.

S&P summarized the changes introduced by the proposal as follows:

• “We link the covered bond rating to the rating on the issuer if we believe a covered bond program has asset-liability mismatches [ALMM] that are not structurally addressed.

• Under this criteria revision, the rating on the issuing bank, its financing strategies, and the timing and magnitude of asset-liability mismatches now play a more significant role in determining a program’s rating and its commensurate level of credit enhancement.

• We segment covered bond programs into three distinct categories that consider primarily the jurisdiction of a program and its ability to access external financing or monetize the cover pool.

• We model revised market value haircuts based on stressed asset spreads.”

[A]2 Basic Concepts

In describing the new methodology, S&P noted that to determine the extent of the rating linkage (between the covered bond rating and the ICR), the rating agency would assess each program based on the following risks:

• asset-liability mismatches;
• jurisdictional legal framework; and
• market value of the cover pool assets.

In brief, step one involves classifying the level of risk that the program’s asset-liability mismatch presents (in probability and magnitude). Step two categorizes the program based on its jurisdiction’s approach to covered bonds as well as the specific program’s flexibility. Step three combines the ALMM and jurisdiction categories to determine the maximum possible uplift of the program’s rating over the ICR. Step four analyzes the expected cash flows of the cover pool in the event of default to calculate a target level of credit enhancement. Step five compares the actual credit enhancement to this target level to determine the final uplift over the ICR.

26. Id.
Figure 7-6
Summary of 2009 ALMM Criteria

<table>
<thead>
<tr>
<th>Step</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Step 1: ALMM Classification</strong></td>
</tr>
<tr>
<td>1: <strong>Description</strong></td>
</tr>
<tr>
<td>Zero</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Step 2: Program Categorization</th>
</tr>
</thead>
<tbody>
<tr>
<td>Category 1</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Step 3: The Maximum Potential Covered Bond Rating (Notches of Uplift Above the ICR)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>ALMM Risk</strong></td>
</tr>
<tr>
<td><strong>Zero</strong></td>
</tr>
<tr>
<td><strong>Low</strong></td>
</tr>
<tr>
<td><strong>Moderate</strong></td>
</tr>
<tr>
<td><strong>High</strong></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Step 4: Cash Flow and Market Value Analysis</th>
</tr>
</thead>
<tbody>
<tr>
<td>Determine target credit enhancement to achieve maximum potential ratings uplift.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Step 5: The Covered Bond Rating</th>
</tr>
</thead>
<tbody>
<tr>
<td>Compare the target credit enhancement with the actually available credit enhancement.</td>
</tr>
</tbody>
</table>

Source: Standard and Poor’s, Revised Methodology and Assumptions for Assessing Asset-Liability Mismatch Risk in Covered Bonds (Dec. 16, 2009).

[A][2][a] **Step 1: Calculation and Classification of the ALMM**

In step one, the riskiness of a program’s ALMM is assessed by determining its ALMM percentage and classifying it as low, moderate, or high risk. First, the cover pool assets are analyzed under hypothetical credit stresses (for example: asset default risk; operation risk, such as trustee expenses; and derivative counterparty risk, such as interest or currency exposures). Next, the expected cash flows are adjusted to reflect liability payment structures and any other program features that may increase or decrease the ALMM.

The mismatch timing is also considered, with more imminent exposures having a more significant weighting than those in the relatively distant future, reflecting the difficulty of selling assets or obtaining third-party funds to pay the covered bondholders on short notice. No ALMM risk would allow the covered bond program rating to be entirely independent of the ICR. However, a low ALMM risk (0%–15%) allows 5–7 notches of upgrade, a medium ALMM risk
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(15%–30%) allows 4–6 notches of upgrade, and a high ALMM risk (above 30%) allows only 3–5 notches of upgrade.\footnote{27}

[A][2][b] Step 2: Program Categorization

Based primarily on the issuing bank’s jurisdiction, but also on specific program features, such as flexibility in raising funds through asset sales and/or borrowing from other banks, each program is then categorized as follows:

Category 1: high likelihood of obtaining external funding if necessary, long and well-established history of covered bonds in the issuer’s jurisdiction (for example, Denmark, Germany, and Spain); 5–7 notches maximum uplift.

Category 2: this broadest category indicates some ability to raise external funds if necessary, a limited covered bond history in the jurisdiction (for example, Canada, Italy, or the U.K.); 4–6 notches maximum uplift.

Category 3: restricted access to external funding (forcing sales of assets as the only option), a newly established and/or unreliable covered bond market (for example, Greece or the United States); 3–5 notches maximum uplift.

The range and strength of funding sources are significant, with legislative support for covered bond programs generally signifying greater access to funding. The history and importance of covered bond programs in the jurisdiction are also highly influential. Examples of relevant statutory concerns include a jurisdiction’s covered bond legislation regarding acceleration of payments upon a potential default, limits to overcollateralization, the treatment of hedging agreements, and regulation of cover pool management.

[A][2][c] Step 3: The Maximum Potential Covered Bond Rating

In step three, the ALMM risk and the program categorization are combined to determine the maximal potential uplift on the covered bond program rating over the ICR. Program category 1 corresponds to the greatest uplift described in step one and category 3 allows the least uplift.

[A][2][d] Step 4: Cash Flow and Market Value Analysis

In step four, market value stresses are applied to the collateral pool to determine whether the program is likely to be able to liquidate enough assets to meet its periodic asset-liability mismatches. Target asset spreads are calculated to model market value risk in terms of a “spread shock.” The net present value of the assets’ projected cash

\footnote{27. Id.}
flows is calculated using assumptions based on asset type and jurisdiction, as well as the relevant funding rate (EURIBOR, for instance). This results in a reduced asset value, used as an input in a cash flow analysis to calculate the proceeds the issuer could likely obtain by borrowing from a third party or by selling assets. The target level of credit enhancement to cover such asset value declines, among other risks, is then determined. 28

[A][2][e] Step 5: The Covered Bond Rating

Lastly, S&P looks at the actual available credit enhancement in the program compared to the target level of credit enhancement. If the available enhancement is at least as high as the target level, the maximum potential rating from step three may be assigned. However, if the available credit enhancement falls short of the target level, the covered bond program rating will be elevated above the ICR to a lesser extent (or even not at all).

Additionally, S&P began assigning outlooks to all covered bond ratings with the publication of these updated criteria. These outlooks indicate S&P’s view of the potential for a rating change and an issue’s current direction: “stable,” “positive,” “negative,” or “developing.”

[B] The 2010 Counterparty Criteria

[B][1] Generally

Further criteria assess the potential need to lower a covered bond program’s 2009 ALMM-calculated rating to reflect the influence of derivative counterparties. After a May 2010 Request for Comments, S&P published revised criteria entitled “Counterparty and Supporting Obligations Methodology and Assumptions” on December 6, 2010 (the “2010 Counterparty Criteria”). For most covered bonds, application of these criteria has been delayed pending finalization of covered bond-specific criteria proposed in a Request for Comment dated March 23, 2011.

The 2010 Counterparty Criteria focus on a counterparty’s ability and commitment to replace itself should its rating decline. Without such “replacement language” in the derivative agreement or other mitigating factors, S&P would not rate a structured finance security higher than the ICR of its lowest-rated counterparty. The 2010 Counterparty Criteria may lower a covered bond’s rating from that calculated under the 2009 ALMM criteria to a floor of the ICR of the lowest-rated counterparty.

28. Details can be found in S&P, ASSESSING ASSET-LIABILITY MISMATCH RISK IN COVERED BONDS, supra note 25, “the 2009 ALMM criteria.”
Basic Concepts

S&P believes that a counterparty may support a security rated higher than itself only if the counterparty agrees to replace itself on a ratings downgrade. S&P recognizes three primary types of counterparty risk: derivative obligations, direct support, and other support. For direct and other support obligations, an absolute replacement commitment is required. For derivative obligations, an absolute commitment or the use of “commercially reasonable efforts” to replace is acceptable, so long as a manifested failure to replace triggers an additional termination event.

Types of Counterparty Risk

“Derivative obligations,” under these criteria, include currency swaps, interest rate swaps, caps, floors, commodity swaps, puts, calls, options, and credit default swaps. Total return swaps, however, are classified as direct substantial obligations. Derivative obligations may be affected by collateralization, which is discussed further in section 7:4.3 below.

“Other support obligations” include those with an exposure amount of less than 5% of the original or current pool balance (whichever is higher) and a replacement period of up to thirty calendar days. Furthermore, S&P must believe either that such a counterparty’s failure to perform is not likely to directly disrupt payments on the rated security during the replacement period or that multiple events would be required in conjunction with counterparty default to adversely impact the security. These may include collection, payment, and servicer accounts; originator setoff and commingling; servicer and trustee advance; and liquidity reserves and liquidity agreements functioning as servicer advances (for liquidity purposes only).

“Direct support obligations,” such as partial support Lines of Credit, guaranteed investment contracts, total return swaps, or annual liquidity facilities with draw-to-cash provisions, are further divided into substantial and limited support. The substantial category entails exposures exceeding 5% of the original pool balance and lasting more than 365 days.

Replacement Framework

S&P lists the minimum counterparty ratings eligible to support a given structured finance security in its December 6, 2010, publication, “Counterparty and Supporting Obligations Methodology and Assumptions.” Table 1 therein further indicates the maximum potential uplift as well as the floor. To obtain the maximum potential rating, S&P must be assured that the replacement framework suffices for the particular type of counterparty risk.
[C] Proposed Covered Bonds Counterparty Criteria

[C][1] Generally

These counterparty criteria, supplementing the 2010 Counterparty Criteria, were proposed on March 23, 2011, in a Request for Comment entitled “Covered Bonds Counterparty and Supporting Obligations Methodology and Assumptions.” They are intended to apply to covered bonds where the 2009 ALMM criteria establish a linkage between the ICR and the covered bond rating, the derivative counterparties are entities unrelated to the issuer and the issuer’s creditworthiness, and the issuer and the derivative counterparties alike are rated at least at "BBB-" (investment grade).

These criteria would perform the same function as the 2010 Counterparty Criteria (allowing a covered bond rating to be downgraded relative to its 2009 ALMM calculated rating), but were drafted considering two unique aspects of covered bonds. First, covered bonds allow dual recourse by the bond holder to both the issuer and to the cover pool, increasing their reliability. Second, in countries with a legislative structure for covered bonds, these instruments tend to have a greater number of and longer-standing derivative counterparties. S&P estimates that 70%–80% of the covered bonds programs existing globally would be affected by these proposed criteria.

[C][2] Basic Concepts

The primary difference from the 2010 Counterparty Criteria is that for certain covered bond programs, the proposed criteria link the rating on the covered bonds to both the issuer credit rating [ICR] on the covered bond issuer and on the derivative counterparty(ies). Counterparty replacement, however, remains the overarching principle behind both frameworks.

Three factors would be considered: the number of counterparties, the weighted-average rating on the counterparties, and the ICR. The proposed criteria could result in a 0–3 notch downward adjustment from the 2009 ALMM criteria’s rating. The rating floor for a covered bond would be the higher of the issuer’s ICR plus one notch or the lowest derivative counterparty’s ICR plus one notch.

### Figure 7-7

**Adjustments to the Maximum Potential Covered Bond Rating**

<table>
<thead>
<tr>
<th>Step 1</th>
<th>Step 2</th>
<th>Step 3</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Number of Derivative Counterparties</strong></td>
<td><strong>Weighted-Average Rating on Derivative Counterparties</strong></td>
<td><strong>Covered Bond ICR</strong></td>
</tr>
<tr>
<td><strong>Bucket 1: &gt;10 counterparties and &lt;30% single counterparty concentration</strong></td>
<td><strong>AAA to A</strong> No Adjustment</td>
<td><strong>A- to BBB-</strong> No Adjustment</td>
</tr>
<tr>
<td></td>
<td><strong>AAA to AA-</strong></td>
<td><strong>A+ to A</strong></td>
</tr>
<tr>
<td></td>
<td><strong>AAA to AA-</strong> single counterparty concentration</td>
<td><strong>AAA to AA-</strong> Minus 1 Notch</td>
</tr>
<tr>
<td></td>
<td><strong>AAA to AA-</strong></td>
<td><strong>A+ to A</strong> Minus 2 Notches</td>
</tr>
<tr>
<td></td>
<td><strong>AAA to AA-</strong></td>
<td><strong>A+ to A</strong> Minus 3 Notches</td>
</tr>
<tr>
<td><strong>Bucket 2: &lt;10 counterparties or &gt;30% single counterparty concentration</strong></td>
<td><strong>No Adjustment</strong></td>
<td><strong>Minus 1 Notch</strong></td>
</tr>
<tr>
<td></td>
<td><strong>AAA to AA-</strong></td>
<td><strong>A+ to A</strong></td>
</tr>
<tr>
<td></td>
<td><strong>AAA to AA-</strong></td>
<td><strong>A+ to A</strong> Minus 2 Notches</td>
</tr>
<tr>
<td></td>
<td><strong>AAA to AA-</strong></td>
<td><strong>A+ to A</strong> Minus 3 Notches</td>
</tr>
</tbody>
</table>

Source: Standard & Poor’s, Request for Comment: Covered Bonds Counterparty and Supporting Obligations Methodology and Assumptions (Mar. 23, 2011).

[C][2][a] **Step 1: Differentiating by the Number of Derivative Counterparties**

In step one, the derivative counterparty structure is assigned to a “bucket” depending on counterparty distribution. Bucket 1 contains those covered bond programs which have more than ten derivative counterparties, none of which individually represent more than 30% of the total exposure. Bucket 2 contains those programs with ten or fewer counterparties, or those in which a single counterparty represents more than 30% of the total exposure.

Bucket 1 programs would receive a lesser downgrading, since S&P values the flexibility inherent in a large number of counterparties. Issuers of bucket 2 programs, having either one fairly large counterparty in the group, or ten or fewer in total, would presumably have more difficulty replacing the larger share of support and responsibilities taken on by each of their few counterparties (or by the one counterparty exceeding 30% of the total exposure).
Step 2: Calculating the Weighted-Average Rating on Derivative Counterparties

Next, the representative rating (calculation described below) for the counterparty group is placed into one of two groups: from “AAA” to “A” or from “A-” to “BBB-.”

For a bucket 1 program, the large number of counterparties makes a weighted-average calculation appropriate. Each derivative obligation is assigned a default measure based on the applicable counterparty’s rating and the remaining tenor of the obligation. These are averaged (weighted by each counterparty’s percent contribution to the program total), the closest S&P rating is found, and the group into which it falls is determined.

Bucket 2 programs are not considered diverse enough to warrant a “portfolio approach” in analyzing the exposure, as is done for bucket 1 programs. Instead, the pool of counterparties is assigned the rating on the lowest-rated counterparty.

Step 3: Determining the Adjustment to the Maximum Potential Covered Bond Rating by Reference to the ICR of the Covered Bond Issuer

In the third and final step, the proposed criteria classify the covered bond programs into one of three groups by the issuer’s ICR: “AAA” to “AA-”, “A+” to “A”, or “A-” to “BBB-”. In general, the higher the issuer’s ICR, the smaller the downward adjustment to the maximum potential covered bond rating. For highly rated covered bond issuers, there may be no adjustment at all since such institutions are presumed to have a strong ability to support the program, to find replacement derivative counterparties, or to replace the cover pool assets, as necessary.

As stated above in section 7:4.3[C][1], if the issuer has a speculative-grade rating (below “BBB”), the 2010 Counterparty Criteria apply. Also, the 2010 Counterparty Criteria apply to covered bond programs wherein the issuer must enter into pre-agreed forms of derivative contracts upon a specific event (for example, the issuer’s long-term ICR falling below a certain threshold). S&P believes derivative counterparties under such agreements are usually related to the issuer, which makes the program ineligible for the proposed criteria. If a covered bond program has a mix of related and unrelated derivative counterparties, each should be analyzed by the appropriate framework, and the lower of the resulting ratings should be applied to the program.

If termination payments are incurred towards a counterparty, many covered bond laws do not allow subordination of such payments (subordinating them to the claims of covered bond holders, for instance). S&P does not object to such claims lying on the same level
as those of covered bond holders so long as the issuer is at least rated “BBB-” and the counterparty contract includes replacement language.

[C][3] Comments on the Proposed Counterparty Criteria

S&P requested comments primarily regarding the following items:

- The proposal to establish a further link to the covered bond issuer’s ICR.
- The differentiation of counterparty distribution (more or less than ten).
- The calculation of the weighted-averaged rating for the derivative counterparties.
- The ICR groups as a reflection of the issuer’s flexibility in addressing derivative risk.
- The notching adjustments proposed in Table 1 of the Request for Comment.
- The rating floor (the higher of the issuer’s ICR + 1 notch or the lowest counterparty’s ICR + 1 notch).
- The treatment of derivative termination payments.

In summary, respondents considered the proposed criteria generally appropriate, but found some elements too harsh (such as the cut-off number of derivative counterparties for improved assessment and the treatment of counterparty termination payments) and requested clarification on others. Many requested finer differentiation in assessing various counterparties’ risks.

S&P’s active outreach was primarily to European market participants, including over 100 issuers and over thirty major investors. Notwithstanding a general welcoming of the proposed framework, the respondents’ major concerns included:

- Concerns that using a single weighted-average rating for all derivative counterparties, or using just the rating on the lowest-rated derivative counterparty, would not be accurate enough in describing each covered bond program’s situation.

• Many issuers expressed concern about insufficient differentiation between high/low investment-grade rated issuers in applying the proposed notching adjustments to a program’s maximum potential rating.

• Concern that a ten derivative counterparty cut-off for classifying programs is too high.

• Desire for further differentiation/analysis of the “varying strengths of the derivative documentation with third-party providers”—ones unrelated to the issuer.

• Issuers questioned the need for external mark-to-markets for derivatives.

• The respondents considered the proposed criteria to impose a disproportionate effect because covered bond derivatives tend to be more “plain vanilla” and more easily replaced than in other structured finance transactions.

• Investors would prefer more overcollateralization rather than more ratings-linked derivative counterparties (to reduce expected program rating volatility).

• Clarification of notching adjustment and other criteria requested.

S&P has yet to publish the finalized covered bond counterparty criteria, but notes that they may still be changed, clarified, or simply left the same.