The Association of Swedish Covered Bond Issuers

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Standard & Poor's

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Final Comments on Standard & Poor's Request for Comments on Covered Bonds Rating Methodology

1. Executive summary

- The Association of Swedish Covered Bond Issuers (ASCB) supports in general terms an approach for rating of covered bonds that, together with other factors, takes into account features such as the incorporation of jurisdiction-related factors such as existing systemic support from the central bank and/or the government, systemic importance of the domestic covered bond market, its functionality and track record and any covered bond legislative framework. We also believe there should be flexibility to assess and take into consideration any individual structural elements existing in a specific covered bond programme thus enabling a covered bond issuer to obtain a AAA rating even if the above mentioned factors per se are deemed to be insufficient.
- We oppose the strict post-insolvency analytical approach for assessing liquidity risks in the proposal. The proposal is silent on liquidity risk mitigation factors available pre-insolvency which undermines the value of the approach and makes assessment of the proposed approach very difficult. We also strongly object to the rigid division of jurisdictional categorization as well as the highly prescriptive nature of the proposal.
- We strongly argue that Swedish covered bonds should merit a significantly better treatment regarding accessing and managing liquidity than is currently proposed. Arguments for this include long track record of uninterrupted functionality and liquidity in the Swedish domestic covered bond market, the specific and flexible functions of the Swedish mortgage market which enables a mortgage lender to adjust the terms of a mortgage during the contractual period and even declare a mortgage

due for repayment on certain conditions, the flexibility offered via the tap-issue system and the market practise of doing switches to manage liquidity and duration without using supplementary assets, eligibility of Swedish covered bonds as collateral with Swedish Riksbank, overall importance of Swedish covered bonds as the financing tool for Swedish housing market with strong governmental systemic support evidenced in the past as well in present times and strong asset quality with exceptionally low credit losses historically as well as in recent years. The successful outcome for Swedish covered bonds from the financial crisis in the early 90’s served as a very strong stress test for the business model, both in terms of asset quality and in terms of funding capacity.

- To address the liquidity situation for a covered bond issuer post bankruptcy the Swedish Banker's Association will shortly make a proposal to the Swedish Ministry of Finance regarding a clarification of the Swedish Covered Bonds Act. The clarification relates to the insolvency of the issuing institution and would give the bankruptcy administrator an explicit mandate to enter into liquidity facilities and other agreements on behalf of the bankruptcy estate in order to maintain the matching requirements. After due consideration of the proposal the Swedish Ministry of Finance is expected to circulate the memorandum for comments as part of the normal legislative process in preparation of a draft bill.
- The recent turmoil in the financial markets has proven that a too detailed pre-defined rating model is not the appropriate way to achieve solid ratings. It is more suitable to have a dynamic approach that puts emphasis on and also takes into account qualitative aspects that exist pre-bankruptcy.
- We strongly advise S&P to return to the market with a substantially revised proposal with a subsequent consultation period in due course.
- The comments will hopefully serve as a basis for a constructive dialogue with S&P where our expectation is that S&P will engage in a discussion with a view to revise its proposal at large and also take into account a more correct treatment of Swedish covered bonds.

2. Introduction and general comments on the proposal

ASCB welcomes S&P’s initiative to change its current covered bonds rating methodology with regard to liquidity-related factors and the opportunity to supply comment on the same.

We support a new approach for rating of covered bonds that, together with other factors, takes into account features such as the incorporation of jurisdiction-related factors such as existing systemic support from the central bank and/or the government, systemic importance of the covered bonds market and its track record, and any covered bond legislative framework. We also believe there should be flexibility to assess and take into consideration any individual structural elements existing in a specific covered bond programme thus enabling a covered bond issuer to obtain AAA rating even if the above mentioned factors per se are deemed to be insufficient.

However, we strongly object to the current proposal’s rigid division of jurisdictional categorization as well as the highly prescriptive nature of the proposed approach. Instead, we would encourage S&P to seize this opportunity to move away from its current post insolvency/securitization-oriented analysis focus when analyzing ratings of covered bonds and rather put more emphasis on and to a greater extent recognize factors existing pre-insolvency for issuers of covered bonds. The recent turmoil in the financial markets has proven once again that a too detailed pre-defined model defining whether a covered bond deserves AAA is not the appropriate way to achieve solid ratings. Rather it is more suitable to have a dynamic approach that puts emphasis on and also takes into account qualitative aspects that exist pre-bankruptcy.

We find the tiering of covered bond issuers into three categories by jurisdiction rather than issuer specifics too rigid and not reflective of dynamic factors in markets, cover pools, issuer programs and jurisdictions. It will cause specific problems in certain jurisdictions where more than one type of covered bond exists, most noticeably France and Denmark. Furthermore, it does not take account of potentially significant differences within programs of the same type in the same country. For example it gives no scope for higher levels of over-collateralisation, better asset quality, lower weighted average LTV of the portfolio, better rated swap counterparties, etc. We appreciate that these and other credit features are relevant when rating a covered bond program but fear that the proposed broad categorization, made primarily on nationality, will make it unlikely that structural features or higher credit quality in the pool will receive any rating credit. It can not be in the interests of investors or the market as a whole to remove an incentive to upgrade a covered bond program. Also, the concept of tiering the market via the proposed three categories will also cause confusion as to the extent that this is a value judgment over and above the rating itself. For example, is a Category 2 AA+ better or worse than a Category 3 AAA?

Therefore, we strongly advise S&P to return to the market with a substantially revised proposal with a subsequent consultation period in due course.

3. The unique functionality of the Swedish covered bond market

On a general note, there can be no doubt that access to a covered bond market with decades of track record demonstrating functionality, transparency, depth and successful responses to external shocks should be of significant value when analysing liquidity risk for an issuer. We are of the firm opinion that this should also be recognized when a rating agency assesses the liquidity situation of a covered bond issuer!

We do not agree with putting Swedish covered bonds in Category 3, in fact we do not agree with the proposed categorization at all. First, the model does not seem to give sufficient credit to the fact that Swedish covered bonds enjoy the support of a well functioning domestic market in SEK with a long track record. The Swedish domestic covered bond market, sized SEK 950bn (EUR 90bn) as per end of 2008, has a long history starting with the first establishment of a mortgage bank in 1861. This marked the start of the use of long bond issuance for financing of mortgage and public loan books. The mortgage bond market developed further after the deregulations of the financial markets during the 1980's where the formal standards for market making and issuance formats, the benchmark tap-market largely in place today, were established. The domestic bond market has withstood the external shocks of the last decades, including the Nordic financial crisis in the early 90's, the LTCM crisis, the Asian and Russian crisis and the 9-11, by remaining open and providing functionality to issuers and investors in terms of two-way pricing on outstanding benchmarks including repos.

The present deteriorating financial landscape, starting in 2007 and accelerating in the fall of 2008, is likely the biggest test of the Swedish domestic covered bond market to date. It is very comforting to note that the Swedish covered bond market, in strong contrast to the international covered bond market, has remained open for business with interbank functionality and two-way screen pricing throughout this extreme period. This has enabled Swedish covered bond issuers to continue to tap the Swedish market for medium to long term funds, albeit at higher spreads, during a time when financing alternatives for many European covered bond issuers were severely impaired or shut.

The key distinction of the Swedish domestic covered bond market is the tap issuance format via contracted market makers. It allows issuers on, a frequent basis, to tap the market in small to medium sizes. These taps can be made on a daily basis if needed with a settlement and documentation structure that is highly efficient. All transactions are executed via markets makers supported by separate market maker agreements regulating terms of the trades such as size, bid-offer spreads, repo functionality of outstanding benchmarks, communication to the market and remuneration to the dealers. For issuers the tap market means easier asset and liability management through the ability to match assets and liabilities on a small scale without having to fully resort to infrequent, and sometimes uncertain, benchmark issuance as is common in the international market. The obligation of the market makers to quote two-way pricing arises when an issue reaches SEK 3bn in outstanding volume. The tap-issuance format, has proven very reliable in times of external shocks which is also evident by the increased used of taps by some issuers in the EUR market. As S&P states in its report from December 2007, “Nordic Bank’s High Reliance On Wholesale Funding Partly Offset By Depth Of Domestic Mortgage Bond Markets”, the domestic covered bond market in Sweden is a very reliable source of long term funding for Swedish financial institutions. We are surprised that there seems to be no credit given to the role of the domestic Swedish market in the current proposal. Historic turnover and issuing volumes in the SEK domestic covered bond market are shown in two graphs in Appendix 1.

In the early 90’s the Swedish banks faced material challenges in the midst of the then existing financial crises caused by deregulation of the financial market and an inflated property sector. The graph in Appendix 2 illustrates the total credit losses per year for the Swedish mortgage benchmark issuers. In contrast to the material credit challenges faced by Swedish banks at the time, the accumulated loan losses for the Swedish benchmark covered bond issuers peaked in 1993 below 0.8% of total loan portfolio which must be deemed very low given the external environment. The experiences and outcomes of the Swedish financial crisis was a strong test of the business model, including funding, for the Swedish mortgage industry. Please note that losses during this period were mainly related to commercial real estate assets. Commercial real estate assets in today’s cover pools are of marginal volume. At December 31 2008 they amounted to 1.1% of total cover pool assets compared to approximately 8 % in 1990 and 1991.

Swedish covered bonds are eligible for collateral with Sveriges Riksbank. Each covered bond issuer can use its own covered bonds in this operation.

Finally, there is little doubt that the Swedish covered bond market and the ability for Swedish mortgage lenders to access financing are of prime importance for the Swedish government. In the early 90's the Swedish government took an active role in the then prevailing financial crisis resulting in direct guarantees of mortgage bonds and the takeover of a failed bank. During 2008 the authorities have taken a very pro-active stance by launching a government guarantee package covering both bank debt and covered bonds as well as establishing liquidity facilities. The above demonstrates the strong and likely systemic support on offer should any covered bond issuer or its parent bank face refinancing difficulties in the markets.

4. *Comments on the treatment of Swedish covered bonds in the proposal*

a) Liquidity management in the Swedish market using Swedish domestic covered bonds

According to the proposed methodology the weighted average maturity gap is a key factor in determining a covered bond program's risk category. We appreciate that asset-liability mis-matches are an important consideration in the rating of a covered bond program. However we strongly oppose S&P's method of calculating the weighted average maturity gap for Swedish covered bond programs and we believe that it is of great importance that S&P understands the specific functions and dynamics of mortgage markets in different jurisdictions. S&P's calculation of the weighted average maturity gap is based on the contractual maturity of the assets. The contractual maturity for a Swedish mortgage is, according to S&P, the amortization period, that is around 30 years (in line with for example Germany). However, under the Swedish Consumer Credit Act and the terms and conditions prevailing on the Swedish residential mortgage market for fixed rate mortgages with a term/amortization period of at least 30 years, a Swedish mortgage lender may adjust (increase) the interest rate on each interest reset date (*i.e.* every three months or such other period as is applied between the lender and the borrower). If the mortgage lender faces serious financial or funding difficulties, it may also declare such a mortgage due for repayment on the next interest reset date. This means that the contractual maturity in practice is close to the interest rate fixing period and that the weighted average maturity gap in Swedish covered bond pools is low and in line with for example jurisdictions classified in Category 2 by S&P.

Apart from being a major and reliable source of funding, the distinct features and functionality of the Swedish covered bond market (and its clearing system) enables Swedish covered bond issuers to actively manage its outstanding maturity profile well ahead of an upcoming larger redemption. This is done by conducting a number of "switches", typically initiated around a year ahead of the relevant maturity date, where the issuer's partial buy-back of a bond approaching its maturity date is exchanged for a tap issue of a longer dated bond. These switches are conducted and cleared simultaneously, thus avoiding unnecessary usage of extra over collateralization or substitute assets in the cover pool. Therefore, as a direct result of the tap functionality, Swedish covered bond issuers dramatically reduce their respective liquidity risk well ahead of an upcoming large redemption. As a result, the typical outstanding amount of a Swedish covered bond on the actual redemption date, in relation to its outstanding amount at its peak, is normally 15-30%. By gradually reducing the outstanding volume of a benchmark as it draws close to maturity the issuer effectively reduces its refinancing risk but without having to build up a sizable portfolio of liquid bonds at potentially higher cost and additional mark to market risk. S&P's proposed approach fails to recognize this important liquidity risk mitigating feature. We strongly believe that it is a very relevant feature for any rating agency to take into account when rating Swedish covered bonds, particularly when assessing liquidity risk. Please also bear in mind that Swedish cover pools typically consist of homogenous pools of high quality Swedish mortgage assets which offer investors an excellent opportunity to acquire a clean exposure to Swedish mortgage risk. Should S&P continue to primarily recognize the existence of liquid substitute assets in the cover pool as the primary way of mitigating liquidity risk, this could, in our view, lead to unnecessary artificially created dilution of previously clean mortgage cover pools.

Regarding CPR assumptions for Swedish mortgage portfolios ASCB's collective assessment covering the past two decades is that the CPR level has been around 10 to 15%. Therefore we think that S&P's stressed assumption of a 0% CPR level is overly conservative relating to Swedish mortgage portfolios.

The proposal specifically refers to the current state of the RMBS market as a justification for significant increases in OC-levels. Leaving aside the facts that these spread levels are based on secondary trading levels which are exceptionally volatile and that they say little about either the possibility or the level of a primary market transaction, they are almost certainly not the refinancing route that a bankruptcy administrator would chose. From a Swedish perspective, bearing in mind that refinancing levels for Swedish covered bond issuers (and bank unsecured funding) are far below the 400bps referred to in the proposal, it can be argued that the asset percentage for Swedish covered bonds would be far better. We think it's very misleading to make reference to illiquid secondary pricing of UK RMBS when making calculations of OC levels for Swedish covered bonds. There is a big difference between US and UK mortgage assets and Swedish mortgage assets including different kind of market practices and underwriting criteria.

We would strongly encourage S&P to introduce corresponding changes in its approach to acknowledge and reflect the above facts.

b) Homogenous Swedish mortgage cover pools and ease of sale of mortgage portfolios

As you are well aware, the Swedish mortgage lending market is highly developed, creditor friendly and surrounded by a transparent credit infrastructure with on-line retrievable information regarding inter alia credit- and collateral information used by the lenders when granting mortgages to their borrowers. Furthermore, the lenders share similar lending criteria regarding terms and conditions for the loans and assessment of the borrowers´ stand alone credit worthiness. Mortgage lending is viewed as a core business by all the Swedish covered bond issuers and its respective sponsoring financial institutions, and therefore the mortgage lending market, is characterized by fierce competition.

As a consequence of the above, the mortgage cover pools of Swedish covered bond issuers are very similar in nature creating homogenous cover pools that would be very attractive for competitors to acquire should for example one Swedish covered bond issuer run into difficulties or enter into insolvency and need to liquidate assets.

ASCB's collective opinion is therefore that it is highly likely that a clear majority of the Swedish covered bond issuers, each on an individual basis, would be interested in acquiring all of, or parts of, the mortgage portfolio of another Swedish covered bond issuer who might be in need of disposing all of, or parts of its cover pool independently of whether such Swedish covered bond issuer is in insolvency or not.

A number of portfolio trades involving Swedish mortgage assets have taken place in the past two decades. For specification of these please refer to Appendix 3.

Given the historical evidence of mortgage portfolio acquisitions and the estimated time period for such sales of four weeks, as provided by Advokatfirman Vinge (please refer to memo that will be sent separately), we think that S&P’s current assumption of a capacity limitation of EUR 2.5 bn within any given 180 day period is overly conservative in relation to potential disposal of Swedish mortgage portfolios. We are also of the strong opinion that the likely price achieved at a public auction would be far better than S&P’s proposed assumption of current stressed RMBS levels. *c) Systemic support*

The Swedish covered bonds are benefiting from a strong systemic support due to the Swedish covered bonds’ massive importance for the financial stability and the link to the households borrowing costs. Issuance of covered bonds is an integral part of mortgage lending and a key pricing parameter to customers. Its role in mortgage business model stands undisputed among lenders, investors, customers and regulators. The systemic importance of Swedish covered bonds is further underlined by the fact that the Swedish guarantee programme includes an explicit possibility to issue government guaranteed covered bonds with maturities up to five years and with a fee structure lower than for senior unsecured debt. Some of the initiatives taken by Swedish authorities during the last months provide strong evidence for this:

- Swedish Riksbank

  During the autumn of 2008 the Riksbank removed the limit of 75 per cent applying to the share of covered bonds issued by the borrowing institution, or by an institution with close links to the borrower that can be used as collateral. Since the start of the crisis the Riksbank has increased the number of loan auctions and prolonged the tenors to three and six months in order to improve the access to short term funding for Swedish banks.

- The National Debt Office

  After the collapse of Lehman Brothers the National debt office introduced additional Treasury bill auctions. The proceeds from the auctions have been invested in reverse repos in covered bonds in order to support the covered bond market.

  At a Testimony for Congressional Oversight Panel in the US on March 19, 2009 Director General of the Swedish National Debt Office Mr Bo Lundgren made the following statements regarding conclusions from the experiences of the Swedish banking crisis in the early 90's;

- "Government intervention is unavoidable if you are facing a systemic crisis.
- Prompt action is important. A comprehensive approach is better than a piecemeal strategy."

- The Ministry of Finance

  During 2008 the authorities have taken a very pro-active stance by launching a government guarantee package covering both bank debt and covered bonds as well as establishing liquidity facilities demonstrating the strong and likely systemic support on offer should any covered bond issuer or its parent bank face refinancing difficulties in the markets.

  Minister for Local Government and Financial Markets Mr Mats Odell has according to Reuters earlier stated that the Ministry of Finance is ready to act upon the proposition by Standard & Poor's. "We are currently evaluating if there's need for government contribution and, if so, what" said Mr Mats Odell.

- To address concerns that third-party liquidity may not be available to support Swedish covered bonds in a post-insolvency scenario, the Swedish Bankers' Association and the Association of Swedish Covered Bond Issuers intend to propose to the Swedish Government that the following clarification be made to the Swedish Covered Bond Act:

  - A new Section added at the end of Chapter 4 (Insolvency of the Issuer) of the Covered Bond Act.

  - Providing an explicit and broad mandate for the issuer's bankrupcty administrator to enter into loan, derivative, repo and other transactions with a view to achieving matching (liquidity, currencies, interest rates and interest periods) between the cover pool, covered bonds and derivative contracts.

  - The mandate may only be used if it is clearly in the interest of covered bondholders and derivative counterparties to do so and provided that matching will be achieved as a result of the transaction(s) entered into. It is anticipated that the bankruptcy administrator would use the mandate primarily to raise short-term liquidity.

  - To ensure that the bankruptcy administrator can find willing counterparties at attractive terms, counterparties will be secured by the cover pool and rank senior to existing covered bondholders and derivative counterparties.

  - The proposed change will increase the likelihood of a matched cover pool post-insolvency and, consequently, the likelihood of continued timely payment of interest and principal under covered bonds.

- The existing mandate for the bankruptcy administrator to access liquidity by selling or securitizing assets in the cover pool remains unchanged.

5. Responses on specific issues

Questions raised by S&P in the RFC

- Do you agree that an explicit "soft-link" between the covered bond rating and the issuing bank's rating is appropriate?

  An explicit "soft-link" should not be addressed via the proposed rigid categorisation and associated notching approach as currently proposed. Please see section 2 for further comments.

- Do the proposed asset-liability mismatch guidelines appropriately capture liquidity risk?

  There are no explanations provided for why weighted average maturity mismatches must be limited to 18 months or liquidity needs maximised to 15% of cover assets. Due to non-disclosure of assumptions behind the proposals we find it not meaningful to comment.

- Do you believe that the proposed distinctions between jurisdictions are clear and appropriate?

  No. We object to this approach. Please see argumentation in this response.

- Are the proposed asset discount levels sufficient?

  They are not relevant for Swedish covered bonds. Please see section 4 a).

- Do the proposed categorizations adequately capture and appropriately differentiate the key credit and liquidity risk factors in covered bond?

  No. Please see argumentation in this response.

- Would the application of "outlooks" to covered bond issues provide additional insight that you would find useful?

  To be discussed based on a revised rating methodology.

6. Summary

We object to the current proposal's rigid division of jurisdictional categorization as well as the highly prescriptive nature of the approach. We strongly argue that Swedish covered bonds, based on the facts highlighted above - importance of Swedish covered bonds as the financing tool for Swedish housing market, strong governmental support if ever needed, liquid well functioning market, excellent access to liquidity, Swedish Riksbank eligibility, strong asset quality, among things - merits a better treatment of Swedish covered bonds than what is currently being proposed.

The above will hopefully serve as a basis for a constructive dialogue with S&P where our expectation is that S&P will engage in a discussion with a view to revise its proposal at large and also take into account a more realistic treatment of Swedish covered bonds. In the meantime, we remain at S&P's disposal to answer any questions that S&P may have.

Yours sincerely

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The Association of Swedish Covered Bond Issuers (ASCB) represents the interests of all Swedish issuers of covered bonds:
Landshypotek, Länsförsäkringar Hypotek, Nordea Hypotek, SBAB/SCBC, SEB, Stadshypotek and Swedbank Mortgage.

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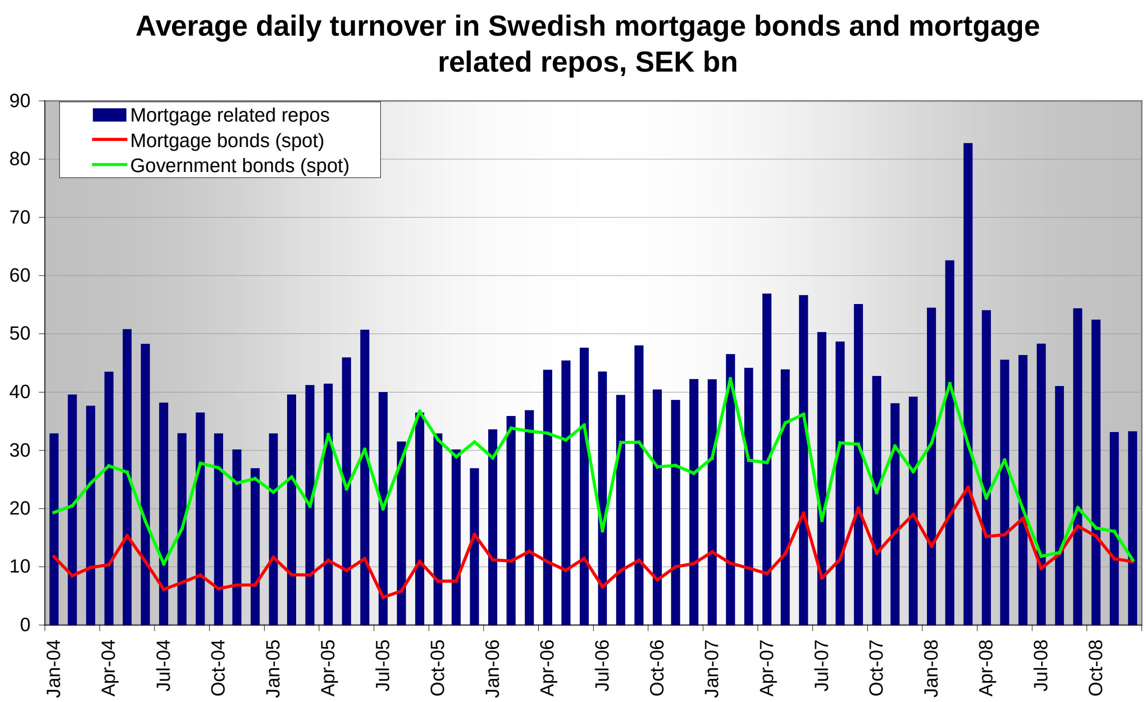
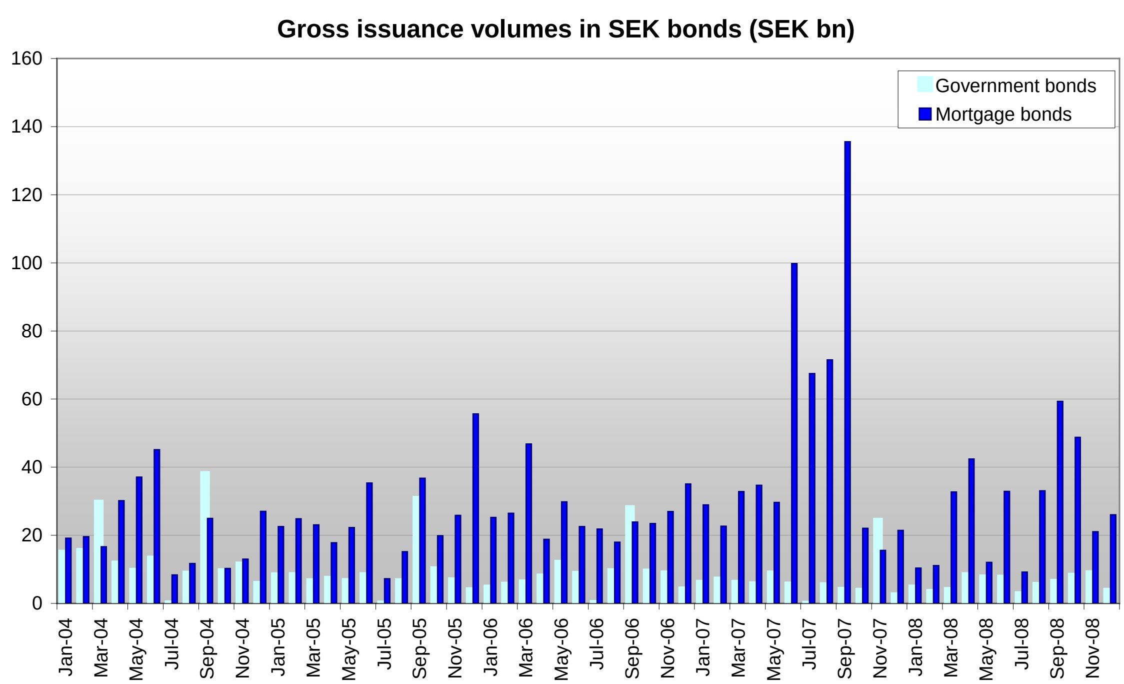
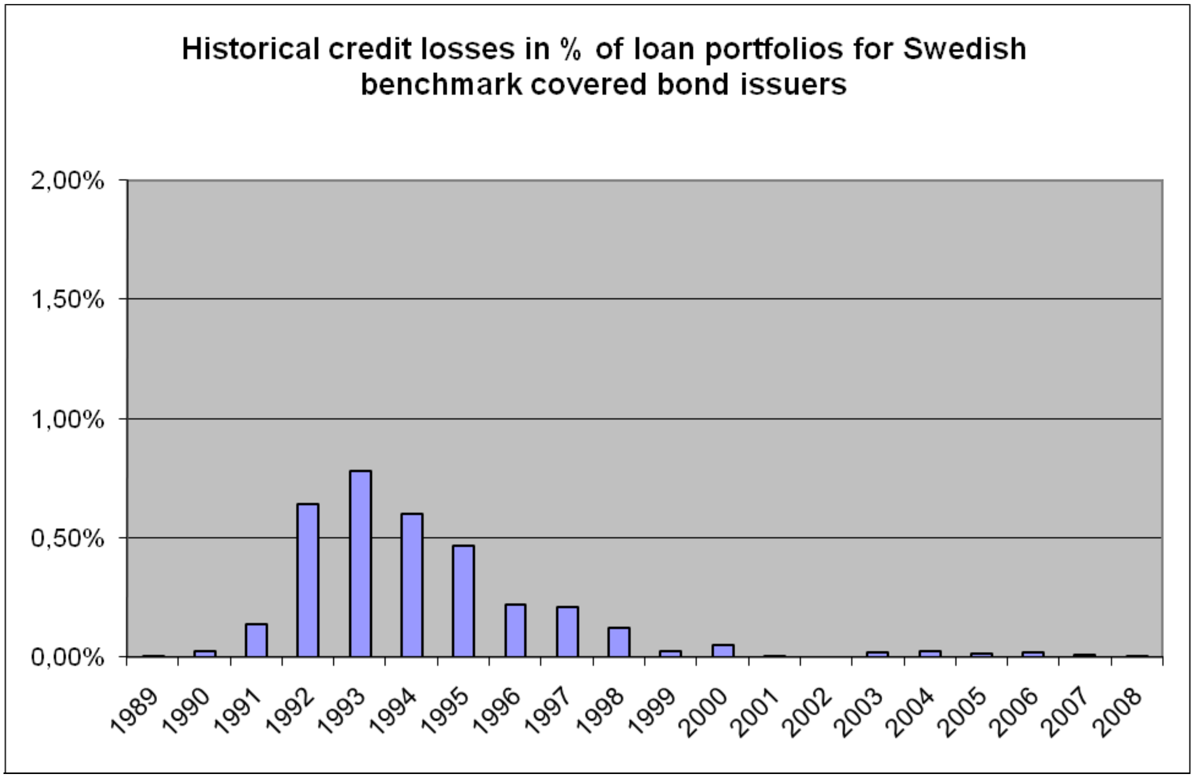
7. Appendices

Appendix 1.





Appendix 2.



Please note that losses during this period were mainly related to commercial real estate assets. Commercial real estate assets in today´s cover pools are of marginal volume. At December 31 2008 they amounted to 1.1 % of total cover pool assets to be compared with approximately 8 % in 1990 and 1991. Our assessment is therefore that if data for the stressed period of the early 90´s would have been available for pools of similar composition as today´s cover pools, the credit losses would most likely have been substantially lower than what is shown in the above graph.

Appendix 3.

Acquisition Date	Portfolio	Number of loans	Portfolio Volume	Asset Type
1988	BOFAB	65,000	SEK 20.0 Bln	Single Family Houses
1989	BANCO	50.000	SEK 20.0 Bln	Single Family Houses
1989	GIGAB	N/A	SEK 38.0 Bln	Single Family Houses Multi Family Houses
1995	SBAB/Venantius	N/A	SEK 23.0 Bln	Single Family Houses Multi Family Houses
1995	Venantius/SBAB	N/A	SEK 34.0 Bln	Single Family Houses Multi Family Houses
1997	Stadshypotek	N/A	SEK 284.0 Bln	Single Family Houses Multi Family Houses Tenant owned Ap.
1997	Föreningsbanken Kredit	N/A	SEK 37,7 Bln	Single Family Houses Multi Family Houses Tenant owned Ap.
1998	Trygg Hansa AB	15.000	SEK 3.0 Bln	Single Family Houses Tenant owned Ap.
1998	Folksam	N/A	SEK 2,4 Bln	Mulit Family Houses
2002	AP 1	N/A	SEK 1,2 Bln	Municipality
2004	HSB	N/A	SEK 6,0 Bln	Multi Family House Tenant owned Ap.
2004	Venantius/SEB	250	SEK 2.0 Bln	Multi Family Houses
2005	Venantius/SEB	130	SEK 1.5 Bln	Multi Family Houses

Appendix 3 (continued)

Securitisation Date	Portfolio	Number of loans	Portfolio Volume	Asset Type
1990	Osprey No. 1	5,500	SEK 1.0 Bln	Single Family Houses
1991	Osprey No. 2-6	18,500	SEK 2.5 Bln	Single Family Houses
1992	Osprey No. 7	13,000	SEK 2.0 Bln	Single Family Houses
1993	Osprey No. 8	9,000	SEK 2.0 Bln	Single Family Houses
1994	Fulmar No. 1	800	SEK 4.0 Bln	Multi Family Houses
2000	Osprey No. 10	40,000	EUR 1.0 Bln	Single Family Houses
2000	Morfun No. 1	5	SEK 1.0 Bln	Multi Family Houses
2000	SRM No.1	28,000	EUR 1.0 Bln	Single Family Houses
2001	SRM No.2	40,000	EUR 1.0 Bln	Single Family Houses Tenant owned Ap.
2003	SRM No.3	2,400	EUR 1.0 Bln	Multi Family Houses