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Criteria | Structured Finance | Covered Bonds:

Revised Assumptions For Classifying Swedish Covered Bonds

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Revised Assumptions For Classifying Swedish Covered Bonds

1. Standard & Poor's Ratings Services is revising its assumptions for the categorization of covered bond programs in Sweden, which is a part of its methodology for assessing asset-liability mismatch (ALMM) risk in covered bonds. We are publishing this article to help market participants better understand our approach to reviewing Swedish covered bonds. This article is related to our criteria article "Principles-Based Rating Methodology For Global Structured Finance Securities," which we published on May 29, 2007.

SCOPE OF THE CRITERIA

2. We are updating our criteria for assessing ALMM risk in covered bonds, to clarify one point: The program categorization of Swedish covered bonds.

SUMMARY OF CRITERIA UPDATE

3. This article partially supersedes the following criteria:

- Revised Methodology And Assumptions For Assessing Asset-Liability Mismatch Risk In Covered Bonds, Dec. 16, 2009
- Criteria For Rating Swedish Covered Bonds, June 20, 2006

4. With this article, we are making one change to our criteria. We are recategorizing Swedish covered bonds to Category 1, now allowing for the highest level of elevation from an issuer credit rating (ICR) under our covered bond rating criteria.

IMPACT ON OUTSTANDING RATINGS

5. The change has no effect on our current covered bond ratings, but will change the program categorization we use in the process of determining the rating of Swedish covered bonds from now on.

EFFECTIVE DATE AND TRANSITION

6. These criteria are effective immediately for all Swedish covered bonds that we rate. To date, all of them are on CreditWatch with negative implications. We placed them on CreditWatch on Dec. 16, 2009, and since then we have not applied the covered bond criteria that we revised on Dec. 16, 2009, to the ratings. When resolving these CreditWatch placements, we will apply the recategorization.

ASSUMPTIONS

7. In Step 2 of our covered bond rating criteria (see "Revised Methodology And Assumptions For Assessing Asset-Liability Mismatch Risk In Covered Bonds" in "Related Criteria And Research"), we categorize covered bond

programs in one of three distinct categories. The categorization represents our assessment of the programs' ability to obtain third-party liquidity or sell assets to fund any mismatch after the issuing bank fails. We believe the likelihood of a program addressing its ALMM is a function of two factors—firstly, the range of options available to the program to source external funding and, secondly, the likelihood of it being able to access funding via these options. A program that has a greater likelihood of accessing external financing is, in our view, more capable of satisfactorily addressing its ALMM. Therefore, we believe such a program should have the potential to exceed its ICR to a greater degree.

8. We now assign the Category 1 categorization to covered bonds issued by Swedish banks. Previously, we placed Swedish covered bonds in Category 2. The recategorization follows a review of the passing and implementation of the amendment to the Covered Bond Issuance Act (SFS 2003.1223) (the Act) on June 1, 2010. The amendment addresses the range of options available to the program to source external funding, which previously had been the constraining factor for our categorization of Swedish covered bond programs. The amendment has now allowed us to classify them under Category 1.

9. As covered bond programs within a country would typically have access to the same market or government-sponsored funding, the issuing bank's jurisdiction predominantly drives our program categorization. The program category, along with the ALMM percentage, then determines a covered bond program's maximum potential number of notches uplift over the ICR on the issuing bank. When using the term "issuing bank," we are referring to the financial institution behind the covered bond program.

10. According to our covered bond criteria, we are now able to assign up to seven notches above the issuing bank's rating to Swedish covered bond programs. This is the highest elevation possible under our covered bond criteria, in line with covered bonds issued by German, Danish, French (obligations foncières), and Spanish banks.

Range of external funding options available to the program

11. We believe the changes that the amendment to the Act introduce clarify the covered bond administrator's mandate to access liquidity—principally to repay existing covered bondholders—after the bankruptcy of the issuing bank. Before the amendment, the law mentioned the possibility of a sale and liquidation of assets but did not mention further means to create liquidity. The amended law now also provides the administrator with the option to enter into new loans, as well as new derivative and repurchase agreements, in order to create liquidity and benefit the covered bondholders.

Likelihood of a covered bond program to access funding

12. We consider that the systemic importance of covered bonds in a market determines how likely the program is to be able to access funding through its funding options, and in particular how governments and regulators are likely to respond to support financial stability. When we analyze a covered bond market, we view the systemic importance of covered bond programs as high when there is a combination of four features. For the Swedish market, we were able to positively conclude that the below factors are commensurate with such a classification, namely:

- The absolute size of the Swedish covered bond market is greater than €100 billion;
- The relative size of the Swedish covered bond market is sufficiently large. We have seen that the covered bond funding as a percentage of bank capital markets funding has been greater than 20% over many years;
- The covered bond market is integral in the provision of housing finance in Sweden. The share of mortgage-backed covered bonds as a percentage of GDP has been greater than 20% over many years; and
- Covered bond-style financing (which includes the predecessor product used prior to the introduction of the

covered bond legislation in 2004) has been a long-term feature of the Swedish funding market and there is no history of covered bond defaults.

13. We are of the opinion that the amended legislation which clarifies the increased number of funding options available to a Swedish covered bond program, coupled with our existing view of the high systemic importance of covered bonds in Sweden, now provides Swedish covered bonds with a broader range of funding options that we deem commensurate with a Category 1 program categorization.

RELATED CRITERIA AND RESEARCH

- Revised Methodology And Assumptions For Assessing Asset-Liability Mismatch Risk In Covered Bonds, Dec. 16, 2009
- Ratings On 98 Covered Bond Programs Placed On CreditWatch After Criteria Revision, Dec. 16, 2009
- Criteria For Rating Swedish Covered Bonds, June 20, 2006

14. These criteria represent the specific application of fundamental principles that define credit risk and ratings opinions. Their use is determined by issuer- or issue-specific attributes as well as Standard & Poor's Ratings Services' assessment of the credit and, if applicable, structural risks for a given issuer or issue rating. Methodology and assumptions may change from time to time as a result of market and economic conditions, issuer- or issue-specific factors, or new empirical evidence that would affect our credit judgment.