

CRITERIA FOR ASSESSING SOVEREIGN RISK IN COVERED BONDS

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1. ABOUT THIS METHODOLOGY

1.1 Scope

The criteria described in this report apply to covered bonds rated by Capital Intelligence Ratings (hereinafter CI Ratings or CI) and should be read in conjunction with CI's Covered Bond Rating Methodology.

1.2 Effective Date and Impact on Existing Ratings

The criteria are effective immediately and will apply to all new Covered Bond Ratings (CBRs). CBRs are a new asset-class specific addition to CI's rating services. Consequently, no current ratings are affected by the introduction of this criteria.

2. SOVEREIGN RISK AND COVERED BONDS

2.1 Overview

CI's bank rating framework recognises that banks and sovereigns have a symbiotic relationship, that the sovereign is a source of systemic risk, and that sovereign distress and the accompanying crisis-induced policy response can have serious repercussions for the financial system and ultimately the default risk of individual banks. Consequently, the issuer credit rating CI assigns to a bank is generally constrained by the credit rating of the sovereign of the country in which the bank is domiciled.

At the issue level, while CBRs may also be constrained by sovereign risk factors, we see more scope for loosening – though not removing – the link between the two. In particular, we recognise that there are certain structural credit enhancements (e.g. over-collateralisation and liquidity reserves) that may make the credit quality of a covered bond more resilient than the issuing bank to stressed economic conditions, as well as other enhancements (e.g. offshore payment mechanisms) that may enable certain types of sovereign risk – particularly transfer and convertibility (T&C) risk – to be mitigated, possibly to a significant degree.

Under our criteria, a local currency covered bond could potentially be rated up to six notches above the sovereign rating, while a foreign currency covered bond could be rated up to three notches higher than the sovereign, unless sovereign interference risk is mitigated.¹ If sovereign interference risk is mitigated, a foreign currency covered bond could be rated as high as a local currency covered bond.

2.2 Why Sovereign Risk Matters for Covered Bonds

Sovereign risk is an important consideration in the rating of covered bonds due to the direct and indirect impact of sovereign distress on the credit quality and liquidity of covered bond programmes and on the financial strength of issuing banks.

¹ CI may assign either a public rating or an internal shadow rating to the sovereign. Shadow sovereign ratings are not intended for publication and are used to ensure that sovereign risk factors are adequately reflected in the ratings of non-sovereign issuers and issues.

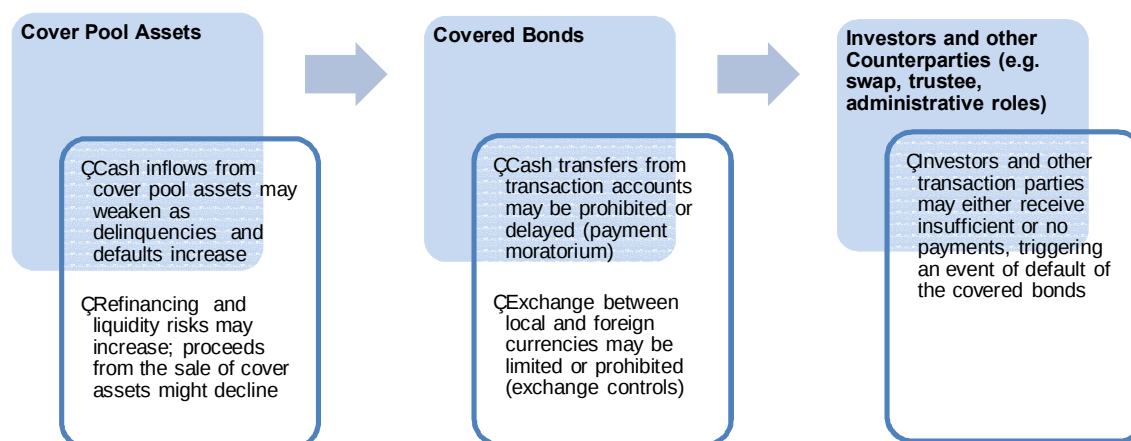
In terms of indirect impacts, heightened sovereign default risk typically triggers, or is accompanied by, a marked deterioration in economic and financial conditions, including a deceleration in real output growth (or worse, a recession), a sharp currency depreciation, interest rate hikes, financial market dislocation, and declines in customer confidence and investor sentiment. The weakening of economic fundamentals may adversely affect the credit strength of covered bonds by weakening the debt servicing capacity of the issuing bank's borrowers and pushing down the market value of collateralised properties. In a high stress scenario, the credit quality of cover pool assets might worsen significantly, with increased delinquencies and defaults adversely impacting cashflows and potentially resulting in delayed payments of interest and/or principal.

In addition, covered bonds with maturity mismatches may be exposed to greater refinancing risk, as issuers encounter difficulties accessing markets in order to raise funds against cover pool assets or face problems liquidating those assets (other than at fire-sale prices) to meet covered bond payments.

At the issuer level, since banks often have relatively large exposures to the government, a sovereign debt default will generally result in direct losses on holdings of the defaulted instruments and the erosion of capital positions. Asset quality may deteriorate significantly as non-performing loans rise (possibly reducing the supply of eligible cover assets), while higher interest rates and risk premia are likely to translate into higher funding costs and adversely affect the income position of banks. Moreover, in cases of severe stress, a sovereign crisis can trigger large deposit withdrawals, the interruption of interbank credit lines, and the loss of access to capital markets.

Even if a covered bond is able to withstand severe sovereign and related economic stresses, it could still default should the government decide to interfere with the ability of the issuing bank (or cover pool administrator) to service financial obligations by imposing highly restrictive measures, such as exchange controls and payments moratoria. We refer to this direct impact as sovereign interference risk.

Box 1: Potential Impact of Sovereign Crisis on Covered Bonds



2.3 Rating Above the Sovereign: General Considerations and Assumptions

A covered bond may be rated above the sovereign when we believe investors would continue to receive timely payments of interest and principal in the event of a sovereign crisis characterised by a severe deterioration in economic and financial conditions and a government default on its own debt obligations.

In addition, in determining whether, or how far, a covered bond could be rated above the sovereign, we would need to be satisfied that in a crisis scenario the government would not impose restrictive measures that impede the covered bond's ability to meet its obligations in full and on time, or that the covered bond's structure includes mechanisms that would enable any such risks to be mitigated.

That said, even for the strongest covered bonds, we would still generally cap the maximum differential between the CBR and sovereign rating due to the inherent uncertainty concerning the scope and severity of a future crisis and the behaviour of the authorities in a situation of severe stress.

We may, however, deviate from this general approach and permit a larger differential between the CBR and sovereign rating in cases where the government is either in default or likely to default in the short term (the latter usually indicated by a rating of $\leq C+$ or below) and we are better able to evaluate with greater certainty the likelihood of the covered bond surviving the associated stress.

The criteria for rating covered bonds above the sovereign, outlined below, reflect the following assumptions, which in turn draw on the tendencies observed in actual sovereign default episodes over the past 20 years:

- Sovereign interference risk is higher in foreign currency than in local currency;
- In a crisis, sovereigns are more likely to cause banks to default by imposing extended bank holidays and deposit freezes as opposed to preventing the servicing of debt securities by enforcing a payments moratorium; and
- Actions taken by sovereigns in a crisis (other than payments moratoria) will ñ directly and indirectly ñ have a greater adverse impact on a bank's overall creditworthiness, and ability and financial capacity to service senior unsecured debt obligations than on the credit quality of certain types of structured finance transactions and covered bonds, provided the credit risk of the latter is delinked, at least to some extent, from the issuer.

3. COVERED BONDS IN LOCAL CURRENCY AND SOVEREIGN CONSTRAINTS

The following considerations are relevant in cases where, after applying our covered bond criteria (including for Issuer Credit Strength, Legal and Regulatory Framework, and Cover Pool Adequacy), we arrive at a potential CBR that is higher than the sovereign rating.

3.1 Potential Maximum Rating Differential in a Jurisdiction

Covered bonds issued in local currency may achieve ratings up to six notches (i.e. two rating categories) higher than the sovereign's foreign currency rating.² Consequently, a local currency covered bond issued in a country where the sovereign is non-investment grade would not typically be rated higher than **A+** under our approach.

The higher maximum potential rating above the sovereign compared with the limits for issuer ratings reflects our general view that governments are increasingly less likely to actively prevent banks servicing local currency bonds in a crisis – even though they may restrict access to foreign and local currency bank deposits in order to forestall large-scale capital flight.

3.2 Adjustments to Determine the Actual Maximum Rating Differential in a Jurisdiction

We may restrict the maximum differential between the CBR and sovereign rating to fewer than six notches to reflect country-specific political, economic and legal risk factors that are not adequately addressed elsewhere in our framework but are deemed relevant by rating committees.

We may also lower the maximum rating differential in some jurisdictions to take into account the risk of sovereign interference in local currency. In particular:

- We will generally limit the maximum rating differential to two notches for covered bonds where we assess sovereign interference risk at the issuer level to be **High** (see Appendix 1). However, we will constrain the CBR at the sovereign level if we consider there to be a reasonable chance that the government will intervene in a way that impedes or significantly constrains the ability to service the instrument; and
- We will deduct one or two notches from the maximum rating differential – depending on analytical judgement – where we assess sovereign interference risk at the issuer level to be **Moderate**.

3.3 Adjustments at the Transaction Level for Sovereign-Related Stresses

In addition to adjusting the maximum rating differential permitted within a particular jurisdiction, we also impose additional constraints at the issue (transaction) level to capture the increased risk to the performance of cover pool assets and the covered bond programme arising from sovereign distress and the attendant increase in event risk.

Specifically, in order to achieve the highest possible rating above the sovereign, we require that as part of our Cover Pool Adequacy (CPA) assessment the covered bond passes stresses associated with the rating grade three notches (i.e. one rating category) higher than the limit implied by the maximum rating differential. For example, assuming a sovereign foreign currency rating of **BBB-** and a permissible maximum rating differential of six notches, a local currency covered bond could potentially be assigned a rating of **AAA** – provided it can withstand **AAA** CPA rating stresses. More generally, a CBR above the sovereign but below the limit implied by the maximum rating differential would still have to pass CPA rating stresses associated with the rating grade three notches higher.

² We use the sovereign foreign currency rating as an anchor because sovereign default risk is typically higher in foreign currency than in local currency, and a sovereign foreign currency default would likely trigger, or be associated with, significant economic and financial stresses in the local economy.

Under this approach, a downgrade in the sovereign's rating would not necessarily trigger a downgrade of covered bonds rated below the maximum rating limit. Building on the previous example, if the sovereign rating is lowered by two notches to **BBB** (with the maximum CBR declining to **AAA** for covered bonds that can withstand CPA rating stresses of **AAA** and higher), a covered bond previously assigned an **A**-rating would continue to be rated **A** provided it is still able to pass **AA**-stresses.

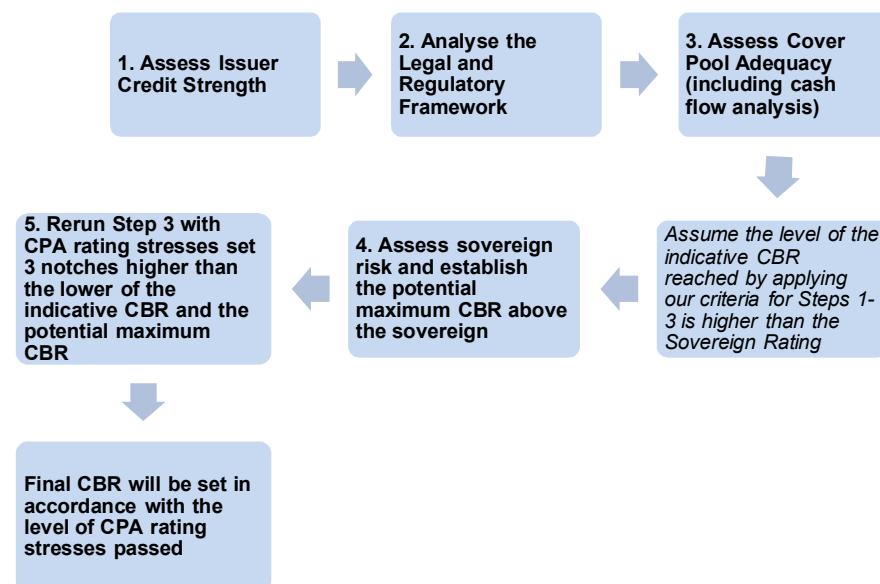
Of course, such a "no-change" outcome presupposes that the deterioration in the sovereign's creditworthiness and associated weakening in macroeconomic performance, financial market conditions, and asset markets (real and financial) have little or no impact on the assumptions and input parameters we use when assessing CPA.

While we would generally expect our base assumptions and rating-grade stress scenarios to be robust to moderate changes in both sovereign credit risk and the broader operating environment, larger changes could potentially warrant a re-assessment of base assumptions and stress scenarios, potentially affecting the CBR.

The above notwithstanding, covered bond programmes and cover assets that are particularly vulnerable to adverse changes in sovereign creditworthiness, or which are reliant on the performance of the sovereign, are unlikely to be rated more than two notches above the sovereign rating.

Finally, in cases where a financial institution issues covered bonds in both local and foreign currency, and the joint default probability of the bonds is high due, for example, to the inclusion of cross-default provisions in the bond indenture, the local currency CBR will be no higher than the foreign currency CBR.

Box 2: Process for Determining CBRs Above the Sovereign Rating (Simplified)



4. COVERED BONDS IN FOREIGN CURRENCY AND SOVEREIGN CONSTRAINTS

4.1 Limiting CBRs by the Foreign Currency Country Limit

For covered bonds issued in foreign currency, we will generally cap the maximum potential CBR at the foreign currency country limit (FCCL) established for the country of the issuer.³ The FCCL will generally be set at, or up to three notches above, the sovereign foreign currency rating. The cap we apply in a particular jurisdiction will depend on our assessment of sovereign interference risk – particularly the likelihood of T&C restrictions being imposed in the event of severe sovereign stress. Sovereign interference risk is strongly correlated with sovereign default risk. It follows that where T&C risk is high, the CBR would be no higher than the respective sovereign credit rating, unless the covered bond contains structural enhancements that enable T&C risk to be mitigated.

Where T&C risk is moderate or low, the covered bond could potentially be rated one or more notches higher than the sovereign, as shown below. The general criteria we use for assessing whether sovereign interference risk is high, moderate or low is provided in Appendix 1.⁴

Sovereign Interference Risk	Maximum Differential Above the Sovereign (in notches)
High	0
Moderate	1 or 2*
Low	3

*Depending on analytical judgement.

To be assigned the highest possible rating above the sovereign, the covered bond must be able to withstand stresses associated with the rating grade three notches above the FCCL (similar to local currency covered bonds).

For example, assuming a sovereign foreign currency rating of BBB- and low sovereign interference risk, the covered bond could potentially be assigned a rating of A- (i.e. at the FCCL) provided it can withstand AA- CPA rating stresses. If instead sovereign interference risk was moderate the maximum CBR would be BBB+ for transactions that were robust to rating stresses at the A+ level and above.

4.2 Foreign Currency CBRs when T&C Risk is Mitigated

The above examples do not take into account the use of credit enhancement techniques to mitigate certain sovereign-related risks, in particular the risk of the government imposing restrictions on the conversion of local currency to foreign currency and on the transfer of funds to non-resident creditors.

Where CI believes that a transaction's structure provides investors with a reasonable degree of protection against such risks, we will not cap the CBR at the FCCL. Instead, we may potentially rate the covered bond up to the limit we would apply to local currency covered bonds in the relevant jurisdiction (i.e. to a maximum of six notches above the sovereign's foreign currency rating).

³ Or at the lower of the country of the issuer and the country of the cover pool assets, in cases where they differ.

⁴ When assigning bank issuer ratings we generally restrict the space around the sovereign rating to one notch where sovereign interference risk is moderate and two notches where it is low. The tighter constraint reflects our general assumption that sovereign interference risk is higher for foreign currency deposits compared with foreign currency covered bonds, and that any restrictive measures imposed by the sovereign (other than T&C restrictions) could potentially trigger additional, second-round stresses to the issuer's general creditworthiness, including by worsening risk perceptions and further reducing confidence.

However, we may assign a final CBR below that level depending on our assessment of the likely strength and effectiveness of these structural mitigation mechanisms at a time of sovereign stress.

Examples of structural mitigants include:

- Offshore bank accounts and liquidity reserve funds, serviced by independent offshore security agents (typically governed by English law).
- Cross-currency swap arrangements with offshore counterparties (typically international banks with strong creditworthiness) which, for example, require the swap counterparty to make payments directly to the offshore paying agent should the government impose T&C restrictions.
- Offshore third-party debt-service payment guarantees.
- Political risk insurance covering, inter alia, currency inconvertibility and transfer restrictions (used more in structured finance transactions).

The ratings benefit of such mitigants is assessed on a case-by-case basis taking into account the nature and comprehensiveness of the arrangements/agreements, their survivability in the event of attempted sovereign interference (e.g. swaps should not terminate if there is a T&C event), and ñ where more than one enhancement is built into the transaction's structure ñ how well they work together to safeguard timely payment of principal and interest on the rated covered bond.

We also consider the expected duration of sovereign restrictions and whether the covered bond's enhancement mechanisms would provide sufficient protection to investors throughout the entire course of the T&C event.

A related but secondary consideration is whether structural mitigants to T&C risk would continue to provide protection in the event of an issuer default, or whether they would likely terminate, thereby exposing the covered bond programme to the capital and exchange controls that are in force.

Based on the evidence of the past 30 years, we observe that payments moratoria are generally enforced for a limited period and rarely for more than one year, while capital and exchange controls that may impede debt service, but do not necessarily cause a payments default (e.g. requiring central bank authorisation to make foreign transfers), have seldom lasted for more than two years.

Our general assumption is that the more restrictive types of measures will be in force for up to one year, and we would therefore expect structural enhancements to safeguard timely foreign-currency debt service for at least 12 months in order to consider rating a covered bond more than one notch above the FCCL.

Given the possibility of more protracted sovereign interference, and since other risks to the performance of the covered bond and credit quality of the underlying assets are likely to increase the longer draconian restrictions remain in place, we would generally confine the maximum potential CBR to three notches above the FCCL unless structural enhancements support timely foreign-currency debt payments for at least 24 months.

APPENDIX 1: DETERMINING SOVEREIGN INTERFERENCE RISK

Sovereign interference risk is a function of a number of factors, including the likelihood of sovereign default and/or financial system instability, the propensity of the state to intervene in the economy, institutional strength, and effective lender-of-last resort (LOLR) capacity.

Government default and financial system stability risks aside, we would typically expect sovereign interference risk to be higher in countries where state involvement in the economy is already high, or where, based on current policies or past actions, it is reasonable to conclude that the government has strong interventionist tendencies.

Sovereign interference risk is also likely to be higher, all other things being equal, in countries where the rule of law and checks on the power of the executive are weak, as such institutional shortcomings arguably increase the risk of unpredictable changes in laws and regulations and may also give rise to arbitrariness in the enforcement of contracts and property rights.

In our opinion, a country is also more likely to resort to extensive capital controls in a crisis scenario when the central bank has insufficient capacity to provide extraordinary liquidity assistance to the banking sector. This is because perceived weaknesses in LOLR capacity are likely to amplify the loss in public and investor confidence arising from a shock to the financial system (such as a government debt default), potentially resulting in large-scale deposit outflows and capital flight and necessitating the imposition of emergency controls.

High interference risk⁵ ñ We would generally consider the risk of sovereign interference in the event of government or financial system distress to be high when one or more of the following apply:

- The government has a track record of resorting to highly restrictive capital controls and other prohibitive measures at times of stress.
- The financial system is already subject to extensive capital controls, although possibly not on the transfer of funds to foreign creditors.
- The economy is relatively closed to external trade or has limited linkages with the global financial system.
- Direct state involvement in the economy is pervasive, as indicated, for example, by significant state ownership of key sectors or extensive intervention via direct regulation or controls.
- Legal institutions are weak, laws and regulations are often applied inconsistently or discriminatorily. There may be a history of government intervention in the court system or of the enactment of legislation by executive decree, with limited constraints on the exercise of such power.
- LOLR capacity is greatly constrained by factors such as the high share of foreign currency liabilities in total banking system liabilities, the size of the banking sector in relation to the domestic economy, or the rigidity of the exchange rate regime (unless, for example, the banking system is relatively small or reserve adequacy is particularly strong).
- The net external debt of the country is very high and a stability concern.

Low interference risk ñ Conversely, we would generally consider the risk of sovereign interference to be low in a stress scenario when none of the above applies and instead the following hold true:

- The economy is open to trade and foreign investment, with no significant restrictions on current and capital account transactions, and where exports and inward investment are important for economic growth and job creation.

⁵ To be clear, high interference risk does not necessarily mean that CI considers it likely that restrictive measures will be imposed in the near future. Rather it means that we consider it reasonably likely that such measures would be imposed in the event of severe sovereign stress, however remote such an event may currently be.

- The corporate sector is integrated into global production and supply chains; the financial sector is well-diversified and has strong international linkages; domestic entities are highly active in international capital markets (all of which arguably increase the cost of imposing foreign transfer and other payment restrictions).
- Direct state involvement in the economy is relatively low.
- The legal system is sound; laws and regulations are transparent and uniformly applied.
- LOLR capacity is high: the country issues its own currency and operates an independent domestic monetary policy unconstrained by exchange rate objectives. Countries with high LOLR capacity tend to have floating exchange rates, diversified financial systems, deep and broad domestic capital markets, as well as credible and effective monetary policy frameworks. We may also include here countries that are member states of a strong and credible monetary union in which institutional mechanisms exist at the centre to provide liquidity support to solvent but temporarily illiquid banks in those countries, even in the event of government financial distress.

In addition, we are unlikely to view sovereign interference risk as low if the sovereign's long-term foreign currency rating is below **BBö**.

Moderate interference risk ñ We would generally classify sovereign interference risk as moderate in countries that do not satisfy the criteria for High or Low. Such countries may combine characteristics such as a reasonable degree of openness to foreign trade and investment with either significant state involvement in the economy or limited linkages with global economic and financial markets. Capital and exchange controls may be in place, but they are not very restrictive (we would generally include prudential controls adopted during the process of capital account liberalisation in this category). Monetary policy flexibility is likely to be moderate.

The above guidance notwithstanding, it is difficult to determine the likelihood of sovereign intervention risk a priori and we may revise our assessment when there is a high or imminent risk of a sovereign default or financial instability and we have a better idea of the likely policy response.

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