

Fitch rating methodology - more in depth

July 19, 2006

LOWER RATED COVERED BOND ISSUER MIGHT BENEFIT FROM FITCH'S NEW RATING METHODOLOGY

Fitch presented its new rating methodology

On 17 July, Fitch held a presentation in Frankfurt regarding its new rating methodology for covered bonds. The new approach is applicable to plain vanilla covered bonds only. Multi-Cédulas will continue to be analyzed via Fitch's structured finance approach. As a result of the new rating methodology, there will not be many covered bond rating changes. Nevertheless, for example, some Spanish issuers like Caixa Catalunya, whose Cédulas are currently rated AA- (rated Aa2 at Moody's) only, might benefit from the new rating methodology. Also, Cédulas of Santander and Banesto whose AA+ rating is already on watch positive at Fitch (rated Aa1 at Moody's), might benefit. Business prospects for Fitch in the Spanish market might also improve through the new rating methodology as well.

Positive rating effects for AA+ rated German Pfandbriefe like mortgage Pfandbriefe of Hypo Real Estate Bank Germany also seem possible, even though Fitch is negative regarding the insolvency remoteness of the voluntary overcollateralization of German Pfandbriefe. In contrast to Fitch, we are convinced that voluntary overcollateralization of German Pfandbriefe is insolvency remote.

Calculation of the covered bond rating via default probability of the issuer, continuity factor, cash flow stress test and recovery value

Fitch calculates the covered bond rating on the basis of the issuer (default) rating in four further steps:

- Calculation of the continuity score
- The maximum achievable covered bond rating based on the default probability of the covered bond (default probability of the issuer multiplied with the continuity factor)
- Stress test of the resulting covered bond default rating via a cash-flow model
- Possible further "uplift" of the covered bond rating via giving credit to the recovery value of the covered bond

EXHIBIT 1: COVERED BOND PROBABILITY OF DEFAULT DEPENDING ON ISSUER PROBABILITY OF DEFAULT AND DISCONTINUITY FACTOR (BETWEEN 0% AND 100%)

	5 Year issuer PD	100.00%	50.00%	40.00%	15.00%	10.00%	5.00%	0.00%
AAA	0.03%	AAA	AAA	AAA	AAA	AAA	AAA	AAA
AA+	0.09%	AA+	AAA	AAA	AAA	AAA	AAA	AAA
AA	0.20%	AA	AA+	AA+	AAA	AAA	AAA	AAA
AA-	0.26%	AA-	AA+	AA+	AAA	AAA	AAA	AAA
A+	0.50%	A+	AA-	AA	AA+	AAA	AAA	AAA
A	0.56%	A	AA-	AA	AA+	AAA	AAA	AAA
A-	0.79%	A-	A+	AA-	AA+	AA+	AAA	AAA
BBB+	1.02%	BBB+	A+	A+	AA	AA+	AAA	AAA
BBB	1.58%	BBB	A-	A	AA-	AA	AA+	AAA
BBB-	3.36%	BBB-	BBB	BBB	A+	AA-	AA	AAA
BB+	5.36%	BB+	BBB-	BBB	A-	A	AA-	AAA
BB	7.48%	BB	BBB-	BBB-	BBB+	A-	AA-	AAA
BB-	11.01%	BB-	BB+	BB+	BBB	BBB+	A	AAA
B+	15.37%	B+	BB	BB+	BBB	BBB	A-	AAA

Source: Fitch

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Probability of default of covered bond: probability of default of the issuer x discontinuity factor

According to Fitch, the probability of default of a covered bond is the result of the probability of default of the individual issuer and the discontinuity factor. Hence, the lower the discontinuity factor, the greater the "uplift effect" on the probability of default of the covered bond and hence of the rating of the covered bond compared to the issuer rating. A low discontinuity factor generally shows a high probability of continuity of payments after insolvency of the issuer.

Discontinuity factor of 100% would indicate complete segregation of covered bonds versus the issuer credit quality

The discontinuity factor takes into account asset segregation (50%), liquidity gaps (30%), alternative management (15%) and covered bonds' oversight (5%). The discontinuity factor will be mainly driven by the specific legal framework of each country. As asset segregation depends on the legal framework for covered bonds of the respective country, this part will be the same for all issuers of a specific legal framework. Fitch will not publish the individual components, but will publish the resulting discontinuity factor for each issuer.

Discontinuity factor of Spanish issuers between 40% and 50%

According to Fitch, the discontinuity factor of most issuers in the Western European legal frameworks will be between 5% and 20%. Due to a weaker legal framework, that of Spanish issuers might be between 40% and 50%.

A rated issuer in countries with strong legal framework can easily achieve an AAA rating

Taking into account that the probability of default of covered bonds in the Fitch methodology is the product of probability of default of the issuer and the discontinuity factor, an A rated issuer with a discontinuity factor of 10% - indicating continuation of covered bonds in case of insolvency of the issuer - could easily achieve a probability of default of its covered bonds in line with an AAA rating without a further uplift (see table above).

Best discontinuity factors for UK and Dutch covered bonds

According to Fitch, structured UK and Dutch covered bonds will be able to achieve the best discontinuity factors. However, Fitch emphasized that these covered bonds do not achieve absolute continuity. The reason is that in these countries the respective regulators are less involved. As we assume that German Pfandbriefe will not achieve absolute continuity under the Fitch approach either, this is not a problem on a relative basis. Due to higher liquidity of the cover pool assets, generally speaking, discontinuity factors for public sector covered bonds will be below discontinuity factors of mortgage covered bonds.

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MAXIMUM ACHIEVABLE RATING BASED ON PROBABILITY OF DEFAULT WILL BE STRESS TESTED AND GIVEN CREDIT TO RECOVERIES

Fitch gives credit to recovery values

The maximum achievable rating based on the probability of default of the covered bond calculated in the described way is then stress tested via a cash-flow model. Fitch would lower the rating following the cash flow stress test if the agency is not satisfied with the stress test results. An uplift of the rating as a result of the cash flow test is not possible in the Fitch approach. However, on top of all this, Fitch gives credit for the recovery prospects of the covered bonds.

Higher recovery values lead to higher covered bond ratings

Fitch predicts the majority of covered bonds will have recovery values of between 50% and 100%. Depending on the recovery prospects for covered bond holders, the rating can receive a further "uplift": hence, the greater the recovery range, the greater the notching on top of the above mentioned uplift.

EXHIBIT 2: FURTHER NOTCHING DEPENDING ON RECOVERY VALUES

Recover Rating	Recovery prospects	Recovery Range (%)	Notching Investment grade issuer	Notching non-Investment grade issuer
RR1	Outstanding	91 -100	2	3
RR2	Superior	71 -90	1	2
RR3	Good	51 -70	1	1
RR4	Average	31 -50		
RR5	Below Average	11 -30	-1	-1

Source: Fitch

Upgrade potential for Santander and Banesto

For example, a Spanish Cédulas issuer with an A rating can achieve a covered bond default probability in line with an AA rating assuming a 40% discontinuity factor ($0.56\% \times 0.4 = 0.22\%$) (see Exhibit 1 above). As the recovery prospects of the highly overcollateralized Spanish Cédulas are quite good, a further "uplift" is likely. Hence, an AAA rating, meaning an uplift by 2 notches (see Exhibit 2 above), for issuers who are committed to holding enough overcollateralization, is achievable. This leads to upgrade potential for Cédulas of Santander and Banesto, which are still rated AA+ by Fitch (Moody's rates Cédulas of Santander and Banesto Aa1 currently, but there seems to be rating upside potential as well).

Upgrade potential for A- rated German issuer

Moreover, German lower rated issuers might have upgrade potential according to the new Fitch approach. A3 s/BBB+ p/A- rated Hypo Real Estate Bank Germany (HYPORE) is one example. HYPORE's mortgage Pfandbriefe are currently rated Aa3 wp at Moody's and AA+ at Fitch. Given the A- issuer rating at Fitch and an assumed low discontinuity factor (between 5% and 20%) for the German legal framework of covered bonds, the probability of default of HYPORE's mortgage Pfandbriefe could easily be in line with an AA to AAA rating (see above).

Further uplift as a result of the recovery prospects

Assuming that the achieved rating passes the cash-flow test, again, the notching based on the recovery value applies. As a result of the 60% maximum LTV required by the German Pfandbrief law, a superior or even outstanding recovery value should be achievable, leading to a uplift of HYPORE's mortgage Pfandbriefe.

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Fitch questions insolvency remoteness of voluntary overcollateralization of German Pfandbriefe

A negative point according to Fitch's rating methodology for German Pfandbriefe is the consideration regarding the insolvency remoteness of voluntary overcollateralization. Fitch is not confident regarding the insolvency remoteness of overcollateralization regarding German Pfandbriefe. This might have negative effects on the discontinuity factor, the cash flow test and maybe also the recovery prospects in the Fitch rating process. Even if we are generally very pleased with Fitch's rating approach, we disagree regarding its view on insolvency remoteness of voluntary overcollateralization in Germany.

Overcollateralization in Germany is insolvency remote

Admittedly, voluntary overcollateralization can be reduced any time. But from a legal perspective, every overcollateralization that is available at the time of insolvency is safeguarded against claims of unsecured creditors. Unsecured creditors only have a claim on overcollateralization which is obviously not needed to satisfy claims of covered bond holders.

Unsecured creditors have to prove that collateral is "obviously" not needed to satisfy Pfandbrief holders

Even more, the insolvency administrator representing the unsecured creditors and not the cover pool administrator (Sachwalter) has to prove that some of the overcollateralization is obviously not needed. In case of insolvency of the issuer, this is hardly possible to prove, to say the least. Hence, voluntary overcollateralization of German Pfandbrief issues is insolvency remote and should be recognized as such by rating agencies.

Upgrade potential for most AA+ rated German Pfandbriefe

Taking into account this legal perspective and the fact that the discontinuity factor for German Pfandbriefe should be quite low, in the region between 5% and 15%, we see upside potential for AA+ rated German Pfandbriefe. This might not happen quickly. Fitch will start applying the new rating methodology to lower rated covered bonds and will generally discuss the topic with the respective issuer.

Negative rating actions unlikely

Fitch's rating approach has been quite consistent in the past. Hence, even in case of BBB+ rated issuers like Landesbank Berlin (A1 s/-/BBB+) we do not expect negative rating actions. In this special case, it has to be taken into account that the BBB+ rating of Landesbank Berlin is not considered as adequate by the issuer.

German Pfandbriefe are perceived as AAA quality anyway

Taking into account the improvements of credit quality and the implicit support by the Land Berlin, we agree with this view. At the end of the day, ratings and credit quality assessments will never be totally quantifiable. Also, Baa3 wn/BB+n/BBB- wn rated AHBR must not necessarily experience a downgrade on its AA+ rate mortgage Pfandbriefe. Moreover, as the market perceives most German Pfandbriefe of AAA quality anyway, market reactions are unlikely

Caixa Catalunya and Banesto trading with pick-up to peers

Spread impacts could be possible in case of Caixa Catalunya's CAIXAC 3.5% March 2016 currently trading at mid-swap + 8.5 bp and Banesto's BANEST 3.5% Jan 2016 trading at mid-swap - 8.7 bp. Nevertheless, due to the ongoing high supply of Spanish Cédulas burdening the secondary market, we refrain from giving buy recommendations on these papers.

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Company	Date	Product	Recomm.	Company	Date	Product	Recomm.
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Issuer level:

Marketweight: We recommend to have the same portfolio exposure in the name as the respective reference index (the iBoxx index universe for high-grade names and the ML EUR HY index for sub-investment grade names)

Overweight: We recommend to have a higher portfolio exposure in the name as the respective reference index (the iBoxx index universe for high-grade names and the ML EUR HY index for sub-investment grade names)

Underweight: We recommend to have a lower portfolio exposure in the name as the respective reference index (the iBoxx index universe for high-grade names and the ML EUR HY index for sub-investment grade names)

Instrument level:

Core hold: We recommend to hold the respective instrument for investors who already have exposure.

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Buy: We recommend to buy the respective instrument for investors who already have exposure.

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