

## Rating Methodology - Comment

July 14, 2006

### FITCH'S RATING METHODOLOGY ON COVERED BONDS

New Fitch approach names crucial bonds of covered bond credit quality

**Fitch published a rating methodology on covered bonds and opened a one-month consultation period. Crucial in the Fitch approach is the question of interruption or non-interruption of payments of covered bonds in the event of a default of the issuing bank. According to Fitch, complete independence can hardly be justified as financial institutions remain in charge of their cover pool and can issue further covered bonds right up until their insolvency. In our view, the Fitch approach is a practical one and refrains from analyzing the crucial points of covered bond credit quality by fleeing into complex mathematical formulas only. As Fitch ratings have been consistent in the past and the approach is, in our view, mainly a formulation of what has been done, at least implicitly, in the past anyway, we do not expect rating changes as a result of the implementation of the "new" rating approach.**

Fitch opens a one-month consultation period

The new methodology will be applied to newly rated covered bonds at the end of the consultation period. In contrast to Moody's methodology, Fitch does not rely on an analysis of the joint probability of default (PD) of the issuer and the cover pool. This is due to the lack of historical data on the defaults of both financial institutions and covered bonds, which makes the assessment of the correlations between the two variables difficult. This seems sensible to us.

Fitch will assess how smoothly covered bonds will be paid in case of issuer insolvency...

Fitch introduced a so-called "discontinuity factor" to assess how smoothly the cash-flows from the cover pool can replace the issuer's payments in the aftermath of an insolvency of the issuing bank. This factor will be measured on a scale of 0% to 100%. 0% stands for a perfect continuity of the payments of covered bonds in case of insolvency of the issuer, whereas 100% stands for an automatic default of the covered bonds upon issuer default.

....four key areas to take into account in assessing this

According to Fitch, four key areas must be taken into account in determining the discontinuity factor.

- Segregation of the cover assets backing the issues of covered bonds from the bankruptcy estate of the issuing bank
- alternative management of the cover assets and the covered bonds
- liquidity gaps between the respective amortization profiles of the cover pool and the covered bonds
- dedicated covered bonds oversight

Willingness to pay on residential mortgages driven by amount of equity invested

In its approach, Fitch mentions further practical topics, e.g. that the propensity of default of residential mortgages is a combination of the ability and willingness to pay, where the ability to pay is measured by the debt to income ratio, which is the most commonly used affordability measure. Willingness to pay is driven by the amount of equity invested by the borrower in the property. Furthermore, recoveries on defaulted commercial mortgage loans are mainly driven by current LTV ratios.

Spanish issuers are worse off

According to Fitch, most legislation-based Western European covered bonds obtain discontinuity factors in the rating of 5%-20%, with the exception of Spanish issuers which would fall in the 40%-50% range. In general, public sector bonds rank safer than their mortgage counterparty in terms of continuity factor.

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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)

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