

ECBC Response

S&P Request for Comment – Methodology and Assumptions: Analyzing European Commercial Real Estate Collateral in European Covered Bonds

Brussels, 30 January 2015

The European Covered Bond Council (ECBC)¹ represents the covered bond industry, bringing together covered bond issuers, analysts, investment bankers, rating agencies and a wide range of interested stakeholders. The ECBC was launched by the European Mortgage Federation (EMF) to promote the interests of covered bond market participants at international level. As of January 2015, the ECBC brings together over 100 members from more than 25 active covered bond jurisdictions representing over 95% of the EUR 2.6 trillion outstanding covered bonds.

The ECBC welcomes the opportunity to comment on S&P's Request for Comment (RFC) on the "Methodology and Assumptions: Analyzing European Commercial Real Estate Collateral in European Covered Bonds" published on 11 December 2014. We would like to thank you for your ongoing commitment to a constructive dialogue.

The proposed criteria have been discussed within the ECBC Rating Agency Approaches Working Group and we would like to share some observations with you below.

1. Introduction

Firstly, the proposed criteria changes reflect a determination to harmonise across commercial mortgage-backed securities (CMBS) and covered bond transactions on one side, and across European jurisdictions on the other. The main motivation for this is the absence of available performance data for certain aspects of commercial real estate (CRE) assets in cover pools.

In some jurisdictions, non-performing loans are kept on the balance sheet. Hence, historic cover pool data is available. Compiling this data would pave the way for tying the criteria to actual market based covered bond data as opposed to data based on CMBS transactions.

In general terms, rating criteria governing covered bonds should reflect actual market conditions prevailing in the covered bond market, if such information is available. Therefore, and with the view to secure a criteria based on actual cover pool data, it would be beneficial if S&P engages the European covered bond community, where applicable, in order to explore the availability of covered bond data.

While it is true that a data exercise of this magnitude and complexity could be time consuming, it is also true that there seems to be a significant departure from current criteria without any specific market event warranting the proposed methodology changes, therefore granting the industry an extended timeframe to provide data would be in the best interest of all covered bond market participants (issuers, investors and S&P).

¹ The European Mortgage Federation - European Covered Bond Council (EMF-ECBC) is registered in the European Institutions' Transparency Register under ID Number 24967486965-09.

Key observations:

- The base default frequency (BDF) and the market-value decline (MVD) parameters should be market specific as markets across Europe are heterogeneous in terms of probability of default, market value fluctuations and foreclosure costs;
- The proposed BDF for CRE assets should further be adjusted to account for lower probabilities of default for certain CRE categories such as Multi-family housing (in particular, subsidised housing and cooperative housing);
- The proposed MVD for CRE assets combine market value declines general to the market with market value decline and costs specific to the event of a foreclosure. In regard to the former the MVD should reflect the current position of the market on the market value cycle. In regard to the latter the MVD should be calibrated to historical data.

2. Specific Comments

1) What is your view in the proposed BDF for CRE assets?

Overall, while the BDF should be high in an AAA-stress, in a historical perspective a BDF of 25 % could be considered very high.

2) What is your view on the proposed adjustment factors to default frequencies by jurisdiction, property type, and whole loan LTV? What other adjustment factors would you suggest?

With regard to the whole loan LTV, for CRE assets, it could be seen as an indicator that is not credible relating to the degree of indebtedness, as cost concerns typically mean that properties are mortgaged ahead of other assets.

In particular, the scale in Table 3 of the proposed criteria could cause “cliff effects”. By way of example, if the WLTV on a property were to marginally exceed 80%, if for instance financing costs are themselves included in the financing, the BDF would leap from a factor 1.3 to a factor 1.7, which would not correctly represent the risk to the property. In principle, the scale should be continuous, or at least much more granular. In general, the factoring should also adjust for property type. For instance, an adjustment factor of 0.9 giving rise to a 10% reduction of the BDF on multi family housing would not reflect the actual risk in the asset class as also expressed in the current criteria. All in all, we understand the inclusion of a reduction factor for multifamily housing expressing the risk diversification inherent in the asset class; however, we would invite you to consider a significantly lower adjustment factor or assess these loans separately.

Additionally, and relating to the residential nature of housing cooperatives, which is characterized by the same attributes across borders, this asset class should be treated the same way across borders

Some characteristics that highlight the residential nature of housing cooperatives as the following:

- A housing cooperative is a non-profit organization, which only purpose is to provide its shareholders/members with an exclusive right of use to their own dwelling;
- A housing cooperative is owned by its shareholders/members and only natural persons are allowed to hold shares or be registered as members;
- The shareholders/members do not pay rent to the housing cooperative, but they are responsible to cover their proportionate share of the joint costs, including interest and instalments on the joint debt.

With regard to non-performing loans, a 75 percent default rate seems excessive. As to the geographic concentration, in general, adjusting the BDF to reflect geographic diversification could be beneficial. Nevertheless, in the case of agricultural properties, for example, adjusting for geographic diversification does not seem to be a feasible approach. Related to other CRE assets, it should be carefully assessed, whether population distribution is necessarily the correct proxy to assess geographic diversification.

Finally, another possible suggestion is that the BDF could reflect debtor seasoning – the length of time a customer relationship has lasted without going into arrears – with some adjustment factor.

3) What is your view on basing the default frequency adjustment by jurisdiction on the country's economic risk according to our BICRA methodology and assumptions?

Overall, rating parameters should reflect market conditions and therefore the adjustment of BDF according to the BICRA economic risk score could be seen as a positive step. However, such an adjustment enhances the importance of the BICRA to be aligned to the underlying fundamentals.

4) What is your view on the proposed MVD assumptions to our loss severity calculation?

Paragraph 56 of the RFC states that the availability of empirical data on loss severity for CRE assets securing covered bonds is limited, because issuers typically remove assets from the cover pool as soon as they start exhibiting characteristics of a non-performing loan. This is not the case in all jurisdictions. Here, it would be possible to obtain loss severity data with the aim to calibrate against observed market data.. Consequently, it is desirable when applying the MVD that the stress scenarios take into consideration, in which phase of the market value cycle the relevant properties are located.

Furthermore, paragraph 57 classifies agricultural and land properties as operating properties, which according to the description, are properties where the business carried out leads to a degree of property specialization, which would translate into lower liquidity than for investment properties. In regards to the tradability and valuation of agricultural properties, specialisation is solely connected to the specialisation in the production of livestock. The valuation of agricultural properties is mainly based on the land possessions, which on a portfolio level make up approximately 70% of the property value and indeed have general use. Land is a scarce resource, which historically has enjoyed a significant turn over. Additionally, the value of land will likely increase with the development of housing communities Hence, the classification of agricultural properties as operating properties with an MVD of 85% does not seem to match market evidence regarding tradability.

5) What is your view on the proposed recovery timing assumptions for CRE assets in each jurisdiction group?

A recovery period of 12 months is in line with market experiences. The criterion proposes a recovery period of at least 12 months for Group 1. A possible proposal would be to fix the recovery period at 12 months or at least introduce a cap on recovery period assumptions.

3. Conclusion

The BDF and the MVD parameters should be market specific as markets across Europe are heterogeneous in terms of probability of default, market value fluctuations and foreclosure costs.

Also, the proposed BDF for CRE assets need further adjustment in order to take account of lower probabilities of default for certain CRE categories such as multifamily housing in general, and subsidised housing and housing cooperatives, in particular.

Moreover, the proposed MVD for CRE assets combine market value declines general to the market with market value decline and costs specific to the event of a foreclosure. In regard to the former, the MVD should reflect the current position of the market on the market value cycle.