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Western Europe

Covered Bond Strategy

Upgrades in Portugal and Ireland?

- **Sovereign upgrade expected:** As outlined in our latest Global Economic Outlook and Strategy - April 2014, we expect Portuguese sovereign debt to be upgraded by one notch by Moody's. Additionally, Ireland's current positive outlook given by Moody's should also translate into a sovereign upgrade.

- **Positive for covered bonds?** Given the covered bond rating methodology of Moody's, an upgrade for some of the Portuguese and Irish covered bonds might seem to be logical. However, the reality is less clear, and making strong predictions of covered bond ratings has become increasingly challenging.

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Covered Bond Strategy

As outlined in our latest Global Economic Outlook and Strategy - April 2014, we expect Portugal to be upgraded one notch by Moody's. Given the covered bond rating methodology of Moody's, an upgrade of some Portuguese and Irish covered bonds might be on the cards. However, predictability becomes increasingly challenging.

Upgrades in Portugal and Ireland?

Since last year, rating actions on sovereigns have usually followed a rating calendar. Fortuitously, Portugal features on S&P's and Moody's rating calendar on the same day: 9th May. Fundamentals are improving, with risks to Portugal's growth outlook now to the upside albeit both rating agencies note Portugal's relatively high debt as a key credit challenge. In their last analysis, Moody's indicated that *"upward pressure on Portugal's Ba3 government bond rating will develop if (1) the authorities successfully bring the current external support program to an end while continuing to reduce the budget deficit; and (2) the economic recovery gathers speed so that government debt metrics are placed on a clear downward path."* Moody's rates Portugal Ba3 stable and we think it likely that it upgrades the sovereign by one notch to Ba2 on 9th May. For S&P, its BB rating carries a negative outlook, meaning an upgrade is more unlikely. However, we do see a good chance S&P's outlook will be revised to stable or moved to positive, with an upgrade perhaps later in the year.

Figure 1. Upcoming sovereign rating calendar

Date	Sovereign	Rating Agency	Current Rating	Current Outlook
09-May	Malta	Moody's	A3	Stable
09-May	Portugal	Moody's	Ba3	Stable
09-May	Portugal	S&P	BB	Neg
16-May	Ireland	Moody's	Baa3	Pos
23-May	Netherlands	S&P	AA+	Stable
23-May	Spain	S&P	BBB-	Stable
23-May	France	Moody's	Aa1	Neg
23-May	Slovenia	Moody's	Ba1	Neg
30-May	Latvia	S&P	BBB+	Pos

Source: Citi Research, Moody's, S&P

In the case of Ireland, where the rating update is expected to take place on May 16th, we also expect Moody's to upgrade the sovereign rating. Ireland has sold debt both via syndications and auctions in 2014, having successfully exited its Troika programme. Given its Baa3 rating, being on positive outlook and ongoing economic improvements, an upgrade from Baa3 to Baa2 is on the cards, in our opinion. A more detailed overview on the sovereign rating calendar can be found here.

Figure 2. Sovereign ratings and country ceilings

Country	Moody's sovereign rating	Moody's country risk ceiling	Current gap
Ireland	Baa3	A2	4 notches
Italy	Baa2	A2	3 notches
Portugal	Ba3	Baa3	3 notches
Spain	Baa2	A1	4 notchers

Source: Moody's, Citi Research

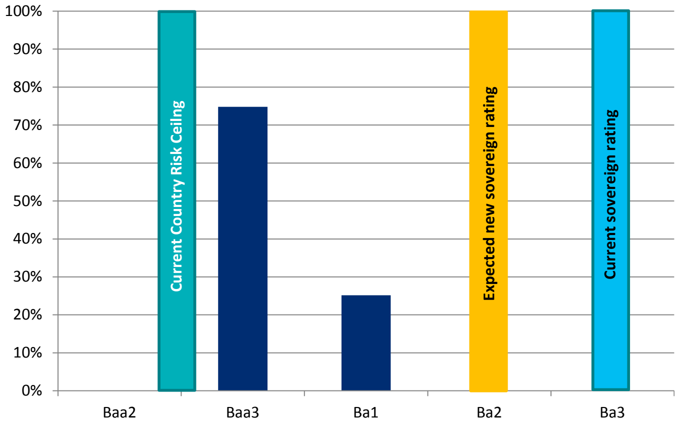
It cannot be said for sure how the country ceiling will be changed after a potential sovereign upgrade

At the current stage, most peripheral covered bond ratings are limited by specific country ceilings. For Moody's this stands at A2 in the case of Ireland and Baa3 in the case of Portugal. As Moody's has a qualitative approach on setting country risk ceilings it is possible that the gap between sovereign rating and country ceiling differs between equally rated sovereigns (as can be seen in Italy and Spain, Figure 2). Hence, it cannot be stated that a one-notch sovereign upgrade translates into a one-notch upgrade of the risk ceiling. When Spain was upgraded recently the country ceiling was increased by two notches. Equally, no action on the country ceiling could be on the cards, although we see this as being less likely. Moreover, Moody's doesn't have to apply this ceiling on a consistent basis. An example is the Irish market. Given the fact that the outstanding Irish public sector covered bonds have a strong link to the sovereign of Germany, a higher rating than the ceiling for Irish covered bonds is possible.

However, we expect the ceiling to be upped by at least one notch

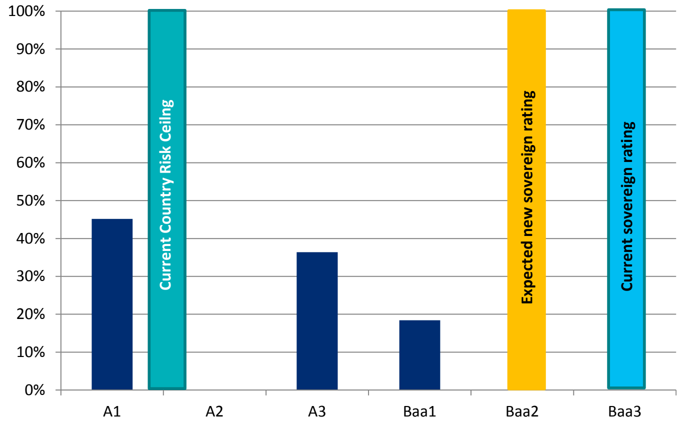
If the country risk ceiling was levelled by one notch following a sovereign upgrade, the ceiling would stand at A1 and Baa2 in Ireland and Portugal, respectively. Obviously the potential uplift of covered bond ratings to these ceilings would not be a market moving step as neither rating is characterized as an important investment cliff. Nevertheless, especially in the case of Portugal, a considerable share of the market is currently rated in line with the country risk ceiling.

Figure 3. Moody's covered bond rating distribution by market volume: Portugal



Source: Bloomberg, Citi Research

Figure 4. Moody's covered bond rating distribution by market volume: Ireland



Source: Bloomberg, Citi Research

Effects on mortgage ACS should be limited

"The TPI framework limits the rating uplift that covered bonds may achieve over the CB anchor and may constrain the final covered bond rating to a lower level than the maximum potential rating under the EL Model."

"The TPI reflects the probability that the issuer will make timely payments on the covered bond following a CB anchor event and follows a scale that ranges from "Very High" to "Very Improbable"."[1]

As can be seen in Figure 4, Irish covered bonds are less affected by the current country ceiling of A2. As mentioned above, public sector ACS are rated above the ceiling given the strong link to Germany. Mortgage ACS have been upgraded recently as the new anchor point for covered bonds is the banks' deposit rating, superseding the senior unsecured rating. However, the mortgage covered bonds issued by Bank of Ireland and AIB are currently still one and two notches away from the ceiling, respectively. In this case, a covered bond upgrade could only be expected if the agency upgraded the anchor point for covered bonds – in the case of Irish mortgage ACS it's the deposit rating – and/or if the Timely Payment Indicator (TPI) was changed. This stands at "Probable" in the case of Irish covered bonds and relatively high compared to its European peers. Hence, we don't expect any change in the TPI.

Moreover, we don't think that a sovereign upgrade would translate into banks being upgraded. As noted in their last note "*Moody's has a positive outlook on the Irish sovereign reflecting the expectations of a sustained recovery in the Irish economy; however Moody's believes that the severity of the crisis on the credit fundamentals of the banks means that their recovery will lag that of the economy as a whole."*[2] Hence, we would not expect that a sovereign upgrade would positively affect the mortgage covered bond ratings of Bank of Ireland and AIB Mortgage Bank, as an upgrade of the deposit ratings is not on the cards, in our opinion.

Depfa ACS could see a further upgrade but more clarity is needed

In the case of Depfa ACS, the situation is again completely different. Three months ago, when Moody's upped the country ceiling to A2, the public sector covered bonds were upgraded to A1. "[…] *[V]arious adverse elements expressed by the A2 country ceiling do not apply, or may apply only to a lesser extent, whilst the rating constraints from certain elements of the A2 country ceiling for Ireland, in particular the risk of currency redenomination, still apply. This allows the ratings of Depfa ACS Bank Covered Bonds to exceed the Irish country ceiling by one notch."* [3] Following the last sentence, we would expect the covered bonds to be upped by one notch if the country ceiling was increased to A1. However, again it is not clear if this will be the case as the overall risk needs to be modelled and be in line with a one notch rating upgrade. Moreover, increasing uncertainty over the attempt to sell the bank

[1] Moody's: "Moody's Approach to Rating Covered Bonds", 12.03.2014

[2] Moody's: "Ireland's banking system outlook remains negative", 21.03.2014

[3] Moody's: "Moody's upgrades Depfa's and EAA's covered bonds to A1", 24.01.2014

makes it difficult to predict where the covered bond rating might stand in the medium-term. In the case of a sale leading to a loss of systemic support for the covered bond entity, downgrade pressure would increase substantially, in our opinion.

Banco Santander Totta would qualify for a covered bond rating upgrade

Things might look different in the case of Portugal. 75% of the outstanding Portuguese benchmark covered bonds are rated at Baa3, the current country ceiling. These include Caixa Geral de Depositos as well as Banco Santander Totta (BST, Figure 3). In the case of Santander Totta things stand as following: the senior unsecured rating is at Ba1 which is used as the covered bond anchor. Given the Timely Payment Indicator of "very improbable" and the senior unsecured rating being used as a covered bond anchor, a theoretical covered bond rating of Baa1 to Baa3 would be possible. Hence, we would expect that moving the country risk ceiling to Baa2 would lead to an upgrade of the covered bonds by one notch. Moreover, *"[u]pward pressure on BST's BCA* [Ba3] *is unlikely over the short-to medium-term rating horizon, as the bank's standalone ratings are unlikely to be higher than those of the Portuguese sovereign, given the difficulty in disconnecting BST's credit profile from that of the Portuguese government - in view of the multiple interdependencies between the government and a purely domestically focused bank."* Hence, as we understand Moody's with respect to the underlying covered bond anchor, a BCA upgrade could go hand in hand with the expected sovereign rating upgrade. Therefore, theoretically, this means that without a country ceiling, a multi-notch upgrade of these covered bonds cannot be ruled out.

Figure 5. Portuguese covered bond ratings

Banco Santander Totta		Caixa Geral de Depositos / Banco BPI / Banco Espirito Santo	
Anchor Point	Timely Payment Indicator	Anchor Point	Timely Payment Indicator
Senior Unsecured Rating	Very Improbable	Senior Unsecured Rating	Very Improbable
Baa1	Aa3	Baa3	A3
Baa2	A1	Country Risk Ceiling Baa3	
Baa3	A3	Ba1	Baa1-Baa3
Country Risk Ceiling Baa3		Ba2	Baa2-Ba1
Ba1	**Baa1-Baa3**	**Ba3**	**Baa3-Ba2**
Ba2	Baa2-Ba1	B1	Ba1-Ba3
Ba3	Baa3-Ba2	B2	Ba2-B1

Source: Moody's, Citi Research; green framed area: potential covered bond ratings given the anchor point and the TPI

…while the senior unsecured rating is too low in many other cases

In the case of other Portuguese covered bond issuers things look different. Although the covered bonds are currently rated at the country ceiling, upping the latter would probably not lead to an upgrade of the covered bonds per se. The covered bond anchor currently used is the senior unsecured rating, which is at Ba3 for Caixa Geral, Banco BPI and Banco Epsirito Santo. Given the Timely Payment Indicator (TPI) of "Very Improbable" the covered bond rating can only be in a range of Baa3 and Ba2. Hence, the covered bonds are already rated on the upper side of the range. An upgrade could only be expected if Moody's decided to change the TPI to "Improbable" or an upgrade of the sovereign went in hand with an upgrade of the issuers. However, we don't expect the latter to happen since most issuer ratings have a negative outlook (Caixa Geral and Banco Espirito Santo) and Moody's doesn't mention a sovereign upgrade to be a potential trigger for lifting the issuer rating. For Banco BPI, an issuer rating upgrade seems more likely given the stable outlook for the entity. Hence, there would be a higher chance of seeing the covered bonds being upped.

Is there a chance that the TPI for Portugal will be upped?

Changing the TPI would however lead to substantial upside pressure on all Portuguese covered bond ratings. It is hard to predict if/when Moody's increases the TPI for Portuguese covered bonds. In the case of Spain, this happened at the end

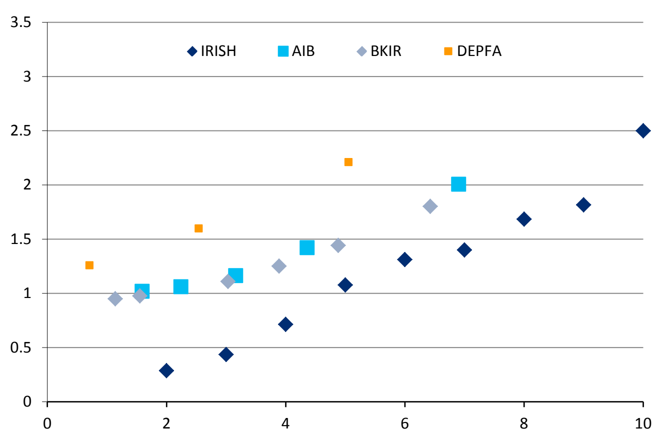
of last year (TPI raised from "Improbable to "Probable") due to *"(1) [t]he stabilization of the Spanish economy, reflected in the change of Spain's Baa3 government bond rating outlook to stable from negative, (2) [s]tronger market liquidity, reflected in an improvement of funding conditions for Spanish banks, (3) [t]he high level of over-collateralisation (OC) maintained by Spanish issuers […] [and] (4) [l]egal improvements that reflect the systemic importance of covered bonds […]".*[4] Apart from (4), all points would also meet the current situation of the Portuguese covered bond market. In hindsight, the TPI for Portuguese covered bonds came down to "very improbable" from "improbable" three years ago when the Portuguese sovereign was downgraded from Baa1 to Ba2. Hence, although the above mentioned points read supportively for a positively revised TPI assessment, a sovereign upgrade from Ba3 to Ba2 would still be four notches away from the initial point in July 2011. Hence, we expect the TPI to remain at "very improbable" for Portuguese covered bonds in the near-term.

Secondary markets and RV

Mortgage ACS outperformed public sector ACS in the last months

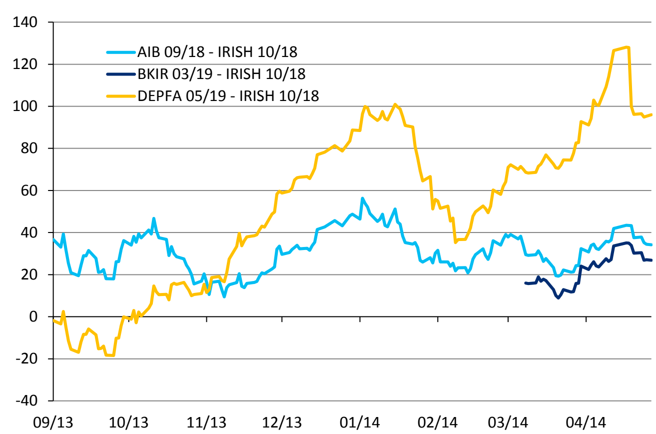
Irish mortgage covered bonds have been range trading versus the sovereign bond market during the last months. Within the small segment, BKIR is trading slightly tighter than AIB. Depfa has been underperforming peers and sovereign debt during the last months given the uncertainty around the sale of the entity. Although the spread looks attractive vs peers we think that investors should expect some further ongoing volatility, while a rating downgrade from S&P cannot be ruled out. Apart from that, it is seen quite clearly that Irish covered bonds are trading much more like (semi-)core covered bonds to the respective sovereign bond markets, i.e. in a specific range. In other peripheral markets covered bonds from Tier-1 issuers have been underperforming sovereign debt over the course of the last months (see below for Portugal as an example). At the current stage we don't expect Irish mortgage covered bonds to outperform Irish sovereign bonds, while near-term underperformance might be on the cards if a sovereign upgrade does not translate into covered bond upgrades.

Figure 6. Yield universe Irish sovereign and covered bond market, %



Source: Citi Research

Figure 7. CAS-spreads over Irish sovereign bonds, bp



Source: Citi Research

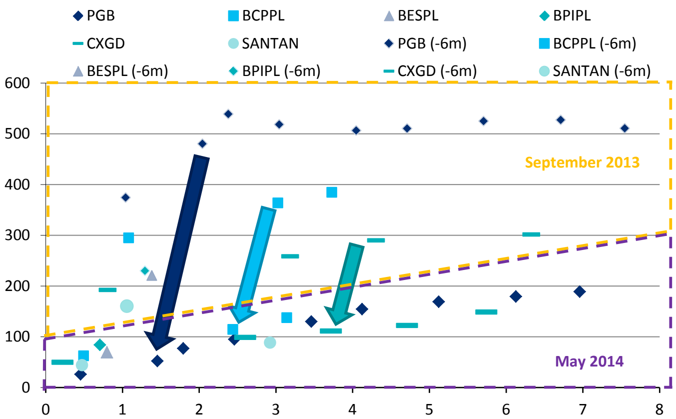
PGBs strongly outperformed Portuguese covered bonds

In Portugal, intra-segment spread convergence took place, while there is still a differentiation between the more expensive names like BST and CXGD compared to other covered bond issuers. On a cross-asset basis, PGBs strongly outperformed secured debt during the last eight months and have now reached levels flat to

[4] Moody's: "Moody's takes multiple actions on Spanish covered bonds; raises Spanish TPIs to Probable", 13.12.2013

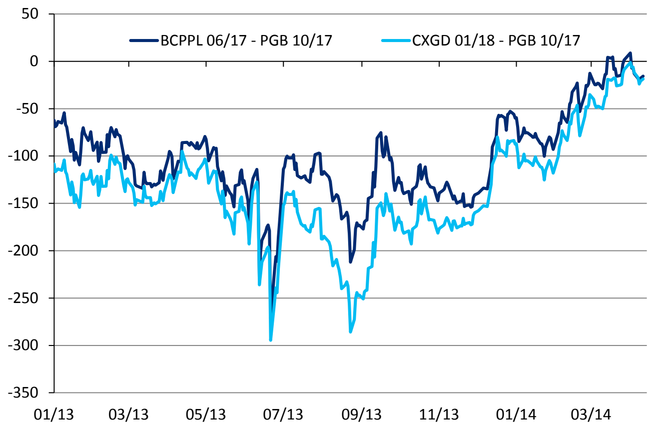
covered bonds. At this stage we continue to prefer sovereign bonds to covered bonds, although outperformance at a similar pace looks unlikely. It seems more probable that covered bonds will cheapen somewhat relative to sovereign debt before the segments trade more range bound to each other.

Figure 8. Spread convergence in Portugal, mid-cas, bp



Source: Citi Research

Figure 9. CAS-spreads over Portuguese sovereign bonds, bp



Source: Citi Research

Conclusion

In general, some positive rating actions on covered bonds to be expected

Citi's base case for rating actions on Portugal and Ireland is an upgrade by one notch in the next few weeks (for the general sovereign rating outlook, please see our latest Global Economic Outlook and Strategy). Although this has often been a positive push for peripheral covered bond ratings in the recent past (after some years of pushing covered bond ratings persistently lower) the picture now is less clear, and the predictability of covered bond rating actions is more difficult. We don't think that an overall wave of upgrades should be expected. Hence, the spread impact should be limited. We expect positive rating actions following a higher country risk ceiling to be limited to Banco Santander Totta and possibly Depfa ACS. This should not be a significant spread driver. We rather think that the underperformance of the covered bond segments compared to their sovereign debt markets will continue, albeit on a lower scale. In general, however, if Moody's acts the way we expect them to in the near-term, it would be another sign of the generally positive rating cycle in which European sovereign and covered bond markets are currently in.

Appendix A-1

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