Covered Bonds Attachment Point – Request for Comments
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The Bank Recovery and Resolution Directive (BRRD) was enacted on 15 May 2014 and has been effective in the European Union (EU) countries since January 2015, with the bail-in option to be available in January 2016. To date, Germany, the United Kingdom, Austria and Denmark have enacted BRRD into national legislation. Other countries are expected to complete the process within the next few months.

The BRRD acknowledges the fact that general corporate insolvency procedures are often not the most appropriate way to deal with a bank facing financial difficulties because of the negative repercussions that these may have on the economy that the bank serves and the financial system as a whole. The BRRD equips authorities with alternative tools of intervention in a failing bank so as to ensure continuity of functions critical to the banks customers and minimise any possible contagion risk while, at the same time, shielding taxpayers from any potential cost.

Under the BRRD, there are four resolution tools: the sale of business, the bridge institution, asset separation and the bail-in tool. Any or a number of these tools can be used in lieu of insolvency proceedings at the discretion of the authorities. DBRS Ratings Limited (DBRS) reviewed the BRRD provisions as they relate to Covered Bonds (CB) and explored some possible scenarios of the resolution of the Reference Entity (RE) with respect to their impact on the repayment of CBs.

This analysis led DBRS to conclude that (i) the introduction of the BRRD, particularly the bail-in tool, creates a differentiation between the role of the financial institution as the first debtor of recourse in a CB programme and its role as debtor of general senior unsecured obligations; and (ii) in certain circumstances, the CB programme may survive the resolution of the RE without a switch from the RE to the CB Cover Pool (CP).

Under the current Rating European Covered Bonds methodology, the Covered Bonds Attachment Point (CBAP) designates the credit strength of the RE as the source of payment for the CB programme or, in other words, the probability that the source of payment will switch from the RE to the CP. The CBAP is composed of a reference rating and a notching uplift schedule (when applicable) from the reference rating. Currently, the CBAP is set at the senior unsecured rating of the RE; however, taking into consideration the conclusions above, DBRS proposes that under certain circumstances, the CBAP may be set at a higher level than the RE's senior unsecured rating.

DBRS proposes to use the senior unsecured rating of the RE as the reference rating for the CBAP. This is in line with (i) above.

DBRS proposes that the uplift from the reference rating be between zero and two notches as explained further in the document. The level of notching will depend on the analysis performed under (ii) above.

DBRS’S VIEW OF KEY BRRD PROVISIONS' IMPACT ON THE CBAP

While it is important that the different EU jurisdictions must enact the BRRD into their respective legislation and that the actual application of the BRRD will only become clearer at the point when case studies are available, DBRS considers the following to be the main tenets of the BRRD in so far as they concern CBs:

- The resolution authorities have the discretion to decide on the application of resolution and the type of resolution tool to be applied to an RE, which is failing or is likely to fail at the time of resolution.

- Under its bail-in tool, the BRRD provides an order of seniority for bailing in liabilities and Article 44(2) explicitly excludes the CBs from bail-in, provided that the value of the liabilities in the CB programme does not exceed the value of the assets in the CP.

- Under Article 44(2), the BRRD provides that, should the bail-in tool be the instrument of choice, the CPs will remain unaffected, segregated and adequately funded to the extent that they are collateralized.

- Should the asset separation tool be the instrument of choice, under Article 42(3), the asset management vehicle will manage the CB programme with a view to maximizing its value through eventual sale or orderly wind-down.

- Should a different resolution tool be the instrument of choice, Article 79 supports the safeguarding of the CB programmes' integrity, except when it is necessary for the resolution authorities to ensure the availability of the covered deposits.

1. The notching schedule proposed in the document is a general guideline from which DBRS may deviate if the special circumstances for a CB programme merit such deviation.
Taking these into consideration, DBRS is of the opinion that, should the RE be subject to the resolution tools, it is highly likely that one of the following cases may materialise:

- The CB programme in its entirety is acquired by another private-sector party which then becomes the new RE;
- The CB programme in its entirety remains with the going-concern part of the RE in resolution;
- The CB programme in its entirety is transferred to the wind-down part of the RE in resolution; and
- The CB programme in its entirety is transferred to an asset management vehicle.

DBRS considers that, should one of the first two scenarios materialize, the source of payment for the CBs would not switch from the RE to the CP but that the CB programme would survive the resolution effort intact.

Should the last two scenarios materialize, the CB programme would most likely receive some temporary operational support while the programme is orderly wound down or liquidated because such support would help preserve value. The source of payment for the CBs would, however, switch from the RE to the CP.

**PROPOSED CHANGES TO THE DBRS METHODOLOGY:**

**Scope of application**

DBRS proposes to apply the following method to derive the CBAP for all European CB programmes that have an RE that is subject to the BRRD or an equivalent regime.

**Determination of CBAP:**

DBRS considers the two following main factors, which may affect the authorities' decision to place the RE into resolution (rather than placing it in insolvency) and the continuation of the CB programme:

- The importance of the RE for the economic and financial system of the relevant country. For this factor, DBRS considers whether the RE performs essential financial activities in the jurisdiction, is sufficiently complex and is interconnected with the real economy to be systemically important. It also considers the potential risk of contagion from the RE's abrupt liquidation.
- The importance of the CB as an instrument for the economic and financial system of the relevant country and for the core business of the RE. For this factor, DBRS considers how likely the authorities are to avoid putting the CB instrument to the test (as such action is likely to destroy value by leading to an abrupt and disorderly liquidation of the programme) as well as how inclined the authorities will be to leave the CB programme with the going-concern part of the RE as opposed to leaving it to an orderly wind-down.

For banks deemed systemically important:

1. Should DBRS either (a) regard the CB, as an instrument, as important for the host jurisdiction or (b) regard the CB programme as strategic for the funding of the primary activity of the RE, then the CBAP would be set up to two notches above the senior unsecured rating of the RE (RE-SUR).
2. If the conditions under (1) above do not hold, the CBAP would be set up to one notch above the RE-SUR.

For banks not deemed systemically important:

1. Should DBRS regard the CB, as an instrument, as important for the host jurisdiction, then the CBAP would be set up to one notch above the RE-SUR.
2. If the conditions under (1) above do not hold, the CBAP would be set at the RE-SUR.

The CBAP would be further limited by the rating level of the sovereign.

In assessing whether the CB, as an instrument, is important for the host jurisdiction, DBRS will take account of the presence of dedicated legislation and supervision of the CB, the history and track record of the instrument in the jurisdiction, the total size of CB issuance in the jurisdiction compared with the gross domestic product of the sovereign and total banking sector funding as well as the interconnectedness of the CB instrument with the real economy.

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2. Refer to the DBRS Criteria: Support Assessments for Banks and Banking Organisations (March 2015) for more information about DBRS's view on systemically important banks.

3. In rare instances where the RE-SUR is above the sovereign rating, DBRS would use the RE-SUR.