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S&P's proposed criteria for residential loans

FINANCE DENMARK

December 20, 2019
Doc: FIDA-568862079-686976-v1

To S&P Global Ratings,

Finance Denmark is pleased to provide feedback on S&P's Request for Comment on residential loans and appreciates the dialogue with S&P concerning the RFC. Finance Denmark is a business association for banks, mortgage institutions, asset management, securities trading and investment funds in Denmark. All Danish covered bond issuers are members of Finance Denmark. Danmark has the world's largest covered bond market and almost 70 percent of all lending in Denmark is financed through issuance of covered bonds. Hence, the new criteria proposed by S&P can potentially have a big impact on the Danish financial system and the impact can be much larger than in other countries covered by the new criteria. Therefore, to assess the criteria it is very important to have clear and transparent information about the criteria and the dynamics in different scenarios.

We appreciate that the new criteria are aiming to increase transparency with respect to how S&P determines the credit risk of residential loans in covered bond cover pools, but more transparency is needed in some areas. For instance, we need to have a better understanding of the use of BICRA as input to the residential criteria and the interactions between the two in different scenarios. In addition, results of stress testing and the impact of the proposed criteria in different scenarios should be available as it is an important prerequisite for assessment of the criteria. Without stress testing results and added transparency, it is not possible to access if the proposed model leads to more pro-cyclicality in ratings, which would be a major concern to Finance Denmark. We note that the revised model is quite complex with a multitude of variables. It would be helpful if table 49 in the RFC is populated for all Mortgage Market Assessment levels. Such transparency should be provided to all markets where S&P assign ratings to covered bonds under the proposed criteria.

Please find below Finance Denmark's general initial comments on S&P's proposed criteria "Global Methodology And Assumptions: Assessing Pools Of Residential Loans (Sweden, Norway, Finland, And Denmark)", published and amended on 6 November 2019.

General comments on the proposal

Transparency

We understand that the motivation for the new criteria is to increase transparency with respect to how S&P determines the credit risk of residential loans in covered bond cover pools. Transparency is very much welcomed and appreciated by the market, however, there are areas where more transparency is needed if the proposed criteria are to be truly transparent and thereby helpful to the market. For example:

- The component scores for Economic Risk and Mortgage Industry Risk should be included, i.e. the individual scores for Economic resilience, Economic imbalances, Credit risks, Institutional framework, Competitive dynamics, and Market sensitivity.
- Table 49 should be expanded to include archetypal foreclosure frequencies for all MMA categories, i.e. Very low risk, Low risk, Intermediate risk, High risk, Very high risk and Extremely high risk.

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Linkage of archetypal foreclosure frequencies to S&P's BICRA

A significant change as a consequence of the proposed criteria is the linking of archetypal foreclosure frequencies to S&P's BICRA via S&P's Mortgage Market Assessment (MMA). The proposal to use the outputs of the application of the BICRA criteria as a starting point for the MMA raises primarily two issues. Firstly, how will the Economic Risk and Mortgage Industry Risk of the MMA differ from the BICRA, and why? Secondly, and very importantly, if BICRA scores move with the cycle, and not through the cycle, this will add volatility to S&P's OC requirements. In order for us to gain a better understanding of any inherent volatility in BICRA scores and any resulting OC volatility, stress tests are in our view a key factor for assessing the revised criteria. At the meeting with S&P on December 12 2019 Andrew Bowyer and Casper Andersen from S&P asserted that the MMA will not be moving in tandem with the BICRA and that there will be considerable leeway not to change the basic assumptions as laid out in the draft criteria and specifically in table 49. However, this is not clear from the criteria.

Stress testing

It would be helpful if S&P could include in the criteria results of stress testing done in connection with S&P's evaluation of the impact of the proposed criteria, not only based on today's scenario, but also in worse and worst case scenarios as well as better case scenarios. Understanding the sensitivity of archetypal foreclosure frequencies and AAA credit risk to the underlying assumptions for the market as a whole is key to being able to provide comments to S&P and we are not able to replicate S&P's model ourselves. In addition, it would be helpful if S&P could provide a decomposition of stress test results in order for us to understand, how the proposed components contribute. As an example, it would be valuable for us to know, how the proposed new LTV curve, including CLTV, contributes to changes in OC.

LTV adjustment factor for WAFF for Danish residential loans

There is a correlation between the LTV and the foreclosure frequency. However, compared to historical observations the LTV adjustment factor (chart 9 in the RFC) is too high when the adjustment factor is above 1. Based on the historical observations the LTV curve in chart 9 in the RFC is in line with the historical observations when the adjustment factor is below 1.

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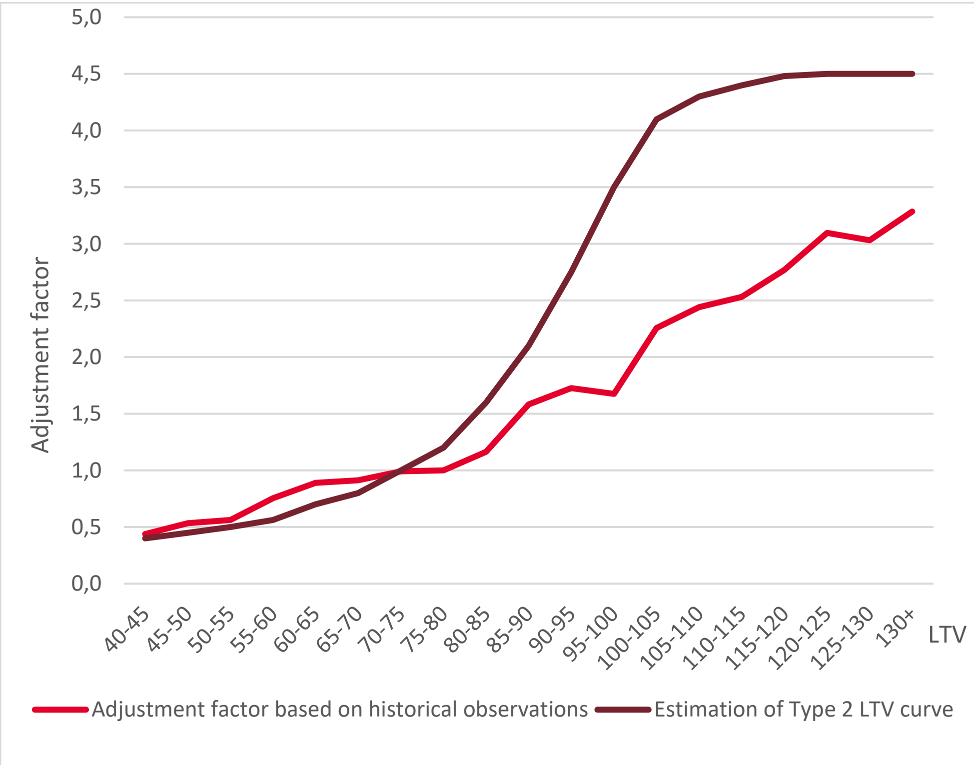
Figure 1 shows historical average 90–days arrears (proxy for the foreclosure frequency) for the period 2009 – 2011 for residential mortgage loans divided into LTV-buckets. In figure 1 the adjustment factor is calculated relatively to the quarterly arrears for the LTV-bucket 75-80 percent.

Figure 1: Historical adjustment factor based on 90-day arrears (2009 – 2011)[1] and adjustment factor based on residential RFC

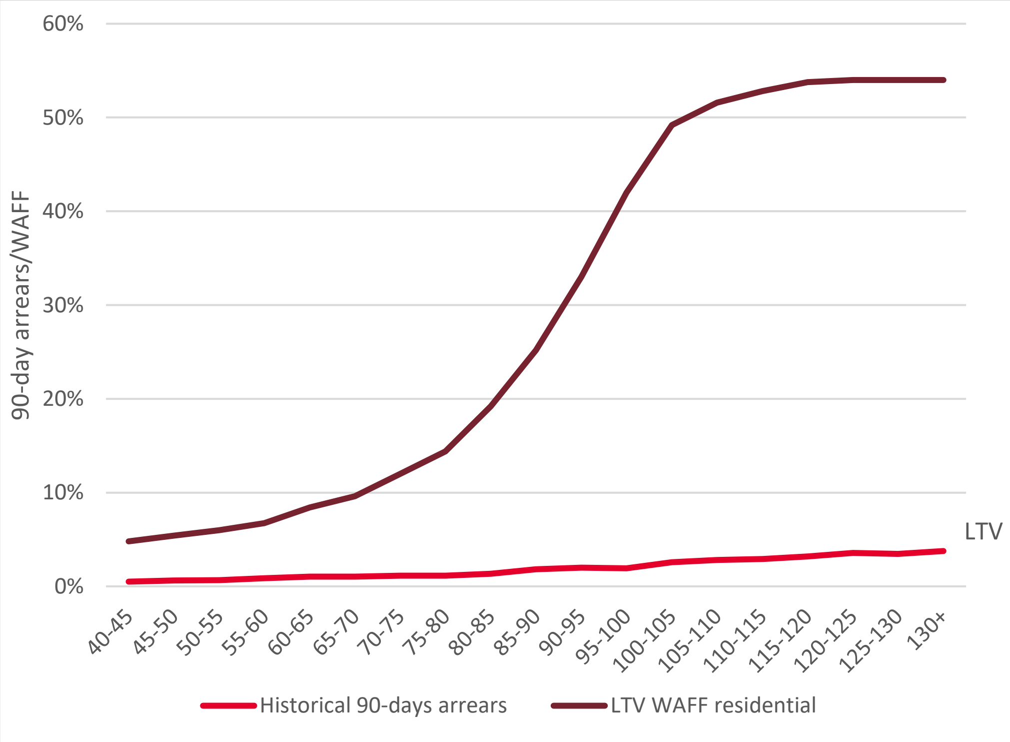


[1] There are very few arrears when the LTV is below 40 percent and it is therefore difficult to get a significant estimate for the period.

We agree with S&P that there is a relationship between foreclosure frequency and LTV. However, the absolute levels of the foreclosure frequency in the RFC are very high compared to historical observations from a stressed period for the residential segment in Denmark (2009-2011). At the meeting with S&P on December 12 2019 Andrew Bowyer from S&P stressed that the foreclosure frequencies were estimated using historical data on foreclosures. Hence, it would be helpful if S&P could explain the discrepancies between the data provided in figure 1 and chart 9 in the RFC. Idiosyncratic features can be included, when assessing the default risk, as mentioned in paragraph 38 in the RFC. The low foreclosure frequency on Danish mortgages is an idiosyncratic feature S&P should take into account when making the foreclosure frequency assumption.

The graph below shows the historical observed average quarterly 90-day arrears from 2009 to 2011. The majority of the residential borrowers that was in 90-day arrears never went into foreclosure, so the historical foreclosure frequency is even lower.

Figure 2: Average historical 90-day arrears (2009 – 2011) and WAFF from RFC



All Danish mortgage institutes provide each quarter, on a loan-by-loan basis original property value and original loan balance to S&P. Hence, it is possible for S&P to calculate accurate OLTV estimates for Danish mortgage loans. The use of CLTV in the WAFF calculation instead of the OLTV will increase the volatility in the estimates of WAFF over an economic cycle.

Stability of MAA

If as indicated it is S&P's opinion that Denmark's 'Low risk' MMA is likely to remain unchanged going forward, and in practice the MMA categorisation is not sensitive to changes in Denmark's BICRA, it would be helpful and reassuring if S&P could state this in the criteria. However, if there is a correlation, more transparency and details of the consequences of a change in MMA is needed.

Comment to the Seasoning adjustment factor for WAFF for Danish residential loans

We agree with S&P that there is a correlation between the seasoning and the foreclosure frequency. However, for Danish residential mortgage loans the seasoning factor should be based on the seasoning of the customer relationship and not the seasoning of the loan.

For Danish residential borrowers it is very common to remortgage existing debt into a new loan - both with and without equity release. The foundation for the high remortgaging activity is the Danish market based prepayment model, which allows borrowers to prepay their mortgages at market prices or par. Borrowers remortgage existing loans into new loans without equity release to get a lower interest rate or a lower nominal debt (mainly for loans financed in callable bonds). In both situations, the risk on the borrower will be lower. If a loan is remortgaged into a new loan with equity release, a credit assessment is also performed, so the credit institute gets updated information on the customer and the risk associated with the customer.

Based on historical observations for Danish residential mortgage loans (figure 3 and 4) it is clear, that the correlation is higher between seasoning of the borrower and the foreclosure frequency, than the correlation between the seasoning of the loan and the foreclosure frequency. Figure 3 below shows the historical level of residential mortgage debt in 90-day arrears (proxy for foreclosure frequency) against seasoning of the loan. There is not a clear relationship between the level of 90-day arrears and the seasoning of the loan.

Figure 3: Historical 90-day arrears based on seasoning of loan

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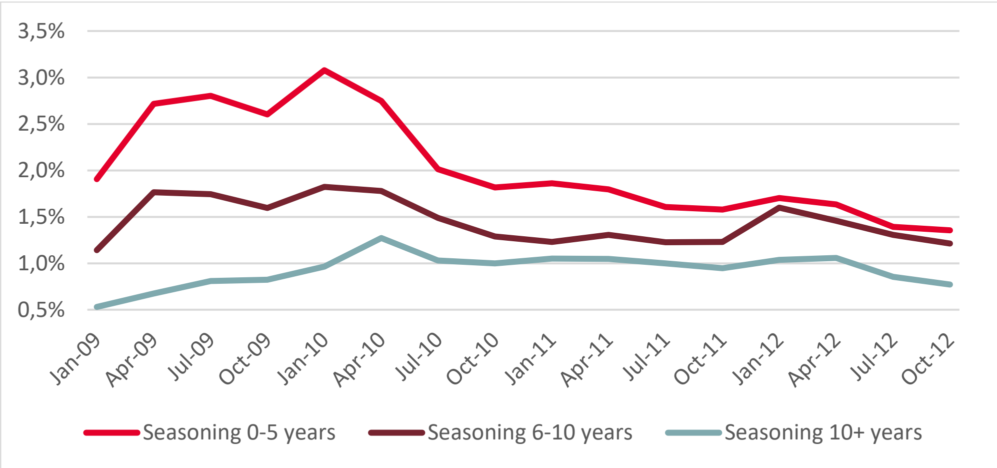
Figure 4 below shows the historical level of residential mortgage debt in 90-day arrears (proxy for foreclosure frequency) against seasoning of the borrower. Here there is a clear relationship between the level of 90-day arrears and the seasoning of the borrower.

Figure 4: Historical 90-day arrears based on seasoning of borrower



Better understanding is needed to provide an answer

The inclusion of residential loans in the Nordics in the global criteria is a complex exercise and it is necessary for us to have additional information and clarity so that we understand the changes fully before we can give you our final comments to the RFC.

Once we have a better understanding of the above we will be able to give you our views on the proposed expansion of the scope of the global criteria to include Sweden, Norway, Finland, and Denmark, and if there are any additional factors that we believe S&P should consider.

Kind regards

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