

ISSUER COMMENT

07 OCTOBER 2014

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SCBC's first soft bullet covered bond reduces fire-sale risk

Executive Summary

The Swedish Covered Bond Corporation (SCBC¹) is set to issue, for the first time, a soft bullet covered bond in benchmark size on 7 October. This is a credit positive step as it reduces fire-sale risk associated with covered bonds in the event of issuer default. Fire-sale risk is currently the major driver of cover pool losses in most covered bonds.

Soft bullet structures are new for Swedish benchmark issuances

Traditionally, SCBC and the other Swedish issuers have issued hard bullet bonds. Soft bullet covered bond structures have not, to this point, been a standard in Sweden. However, soft bullet structures have become prevalent in other covered bond markets, notably in neighbouring Norway where it is an accepted market norm. We understand that SCBC is also likely to pursue future Euro benchmark issuances as soft bullet structures.

Soft bullet structures reduce fire-sale risk

SCBC's soft bullet structure implies an automatic extension of the bonds' maturity dates by maximum twelve months in case the bonds are not repaid in full on the initial maturity date. We expect that the soft bullet bonds will – while the issuer is not insolvent – be repaid by the issuer at the initial maturity date. However, in periods of severe stress the maturity extension helps to reduce fire-sale risk as it allows additional time to raise alternative financing or to liquidate the cover pool assets in a more orderly manner, thereby avoiding a high discount. This gives the issuer additional flexibility also in a pre-insolvency situation. Fire-sale risk exists when cash collected from the cover pool assets is insufficient to make timely payments on the covered bonds after the issuer has become insolvent.

Fire-sale risk is the major driver of SCBC's cover pool losses

Similar to most covered bond programmes, fire-sale risk is currently the major driver of cover pool losses at SCBC's programme. The Maximum Mismatch², which is our measure of the portion of the cover pool subject to fire-sale risk, is 64% for SCBC's programme, compared to circa 43% as the European average and circa 60% on average for Swedish programmes. Fire-sale risk is currently significant as the weighted average (WA) life of SCBC's cover pool assets is 22.8 years compared to the WA life of the covered bonds of 2.8 years³.

Impact of soft bullet structures under our rating approach

This first soft bullet issuance of one billion euros accounts for just about 6.2% of SCBC's total outstanding covered bonds, affecting our current fire-sale risk assessment of the programme only marginally. If SCBC were to issue only soft bullets in future, the share of hard bullet covered bonds would decrease over time. However, a significant risk of a fire sale remains in structures in which not all series are soft bullet.

In programmes which only issue soft bullet covered bonds, we reflect the lower risk of a fire sale according to the two steps of our published methodology for rating covered bonds:

- (1) Expected loss analysis: the soft bullet structure results in a reduction in the over-collateralisation (OC) consistent with the current Aaa rating, and;
- (2) Timely payment indicator (TPI) framework: the structure also entails a higher probability of timely payments in the event the issuer is unable to make payments on the covered bonds, which in turn could result in an improved TPI for that programme.

Moody's Related Research

[Moody's Approach to Rating Covered Bonds, March 2014 \(SF345822\)](#)

[Moody's Global Covered Bonds Monitoring Overview: Q1-2014 \(SF376198\)](#)

[SBAB's Performance Overview report per Q1-2014](#)

[German Pfandbriefe: More of Cover Pool is Protected Against Fire-Sale Risk \(SF345328\)](#)

This publication does not announce a credit rating action. For any credit ratings referenced in this publication, please see the ratings tab on the issuer/entity page on www.moody's.com for the most updated credit rating action information and rating history.

Endnotes

- 1 SCBC, the wholly owned covered bond issuer of SBAB Bank AB publ (A2 Negative, n/a).
- 2 For further detail, see SCBC's latest Performance Overview report and our Special Comment "German Pfandbriefe: More of Cover Pool is Protected Against Fire-Sale Risk", 29 April 2014.
- 3 Numbers as per SCBC's latest Performance Overview report based on reporting as per 30 June 2014.

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