Polish covered bonds: a lot of green lights but challenges remain

Issuance of Polish covered bonds could be set for further growth. Favourable macro conditions and a stable housing market are supportive of the credit quality of prime covered bond collateral: mortgage loans. The covered bond framework is solid and Polish covered bonds have the potential to achieve highest ratings. But a number of outstanding issues need to be resolved.

Increased use of covered bonds could help moderate the sovereign bank-nexus and provide stable and long-term funding for banks. However, the way that risks related to foreign currency-linked mortgages are addressed will determine whether covered bonds become a systemically important funding tool or fall into oblivion.

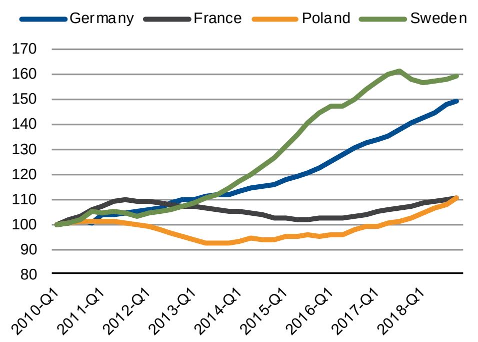
Poland (A+/ Stable) was the only country in the EU which avoided recession during the Global Financial Crisis and remains one of the bright economic spots in Europe. The economy benefits from a low level of private debt, robust domestic demand, a large internal market and a flexible exchange-rate regime.

Even though growth is expected to moderate, average annual real GDP growth rates of 3.6% between 2007 and 2018 distinguish Poland from most other European countries. For the EU 28, GDP growth hovered around the 1% mark for the same period. On the back of strong economic growth, Polish unemployment continues to reduce[1], while per capita GDP is increasing and consumer sentiment is positive.

Combining the favourable macroeconomic conditions and the low interest-rate environment in a country with a high home ownership rate of 83.4% (as of 2016) it is not surprising that demand for mortgage loans is growing, thereby fueling the pool of available collateral for covered bonds.

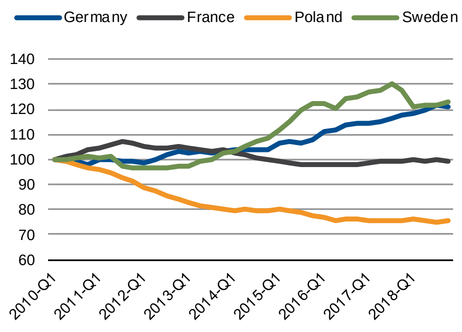
New mortgage loans have grown at a double-digit pace over the last few years and, not surprisingly, ongoing high demand for housing has pushed up house prices by about 20% since a trough in Q3 2013 (see Figure 1). In contrast to some other European countries, Polish house prices are in general not over-valued, however.

Figure 1: Nominal growth of HPI



Source: BIS, Scope

Figure 2: Price to income



Source: BIS, Scope

Nominal growth rates are more than neutralised when put into perspective (see Figure 2). Poland is one of the few countries where price-to-income ratio has constantly dropped in past years, for example, and as such housing has become more affordable.

[1] From above 10% in 2012/13 it has come down to less than 5% in August 2019

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Poland maintains strong economic growth, though proposed EU funding changes present major challenges
July 2018

Scope Covered Bond Rating Methodology, July 2019

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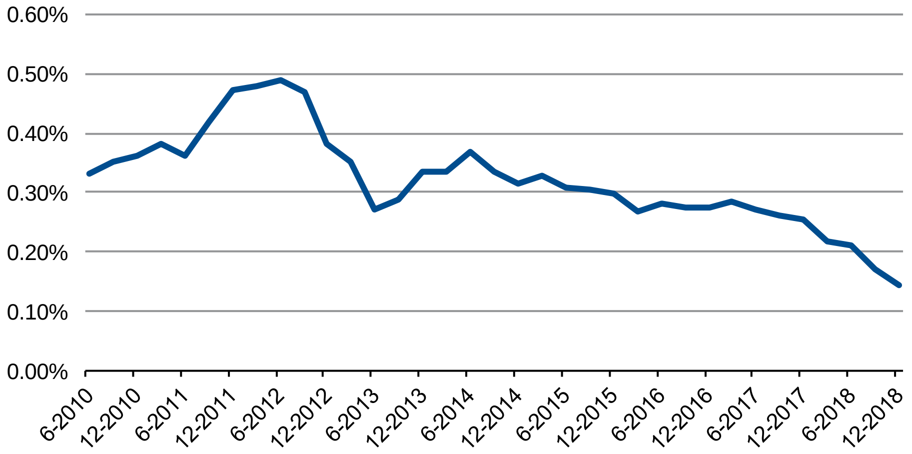
Polish NPLs on housing loans are at low levels – also when compared internationally

Low unemployment and strong wage growth have increased disposable income, which support low levels of delinquencies and suppresses non-performing housing loans. With about 14bp of the corresponding stock, it compares favourably to other European mortgage markets.

Figure 3: Development of non-performing Polish housing loans



Source: Polish FSA, Scope

Polish CRE loans are also eligible for CB refinancing

Commercial real estate-backed mortgage loans are also an eligible asset class for Polish covered bonds. The CRE market has benefited from the progressive transformation of the economy and associated dynamic economic developments. This is also driven by the re-allocation of labour from nearby foreign countries, such as Germany, not only benefiting from lower labour costs, but also taking advantage of the lasting upswing and growing economy in Poland.

Heightened CRE activity, still solid credit quality….

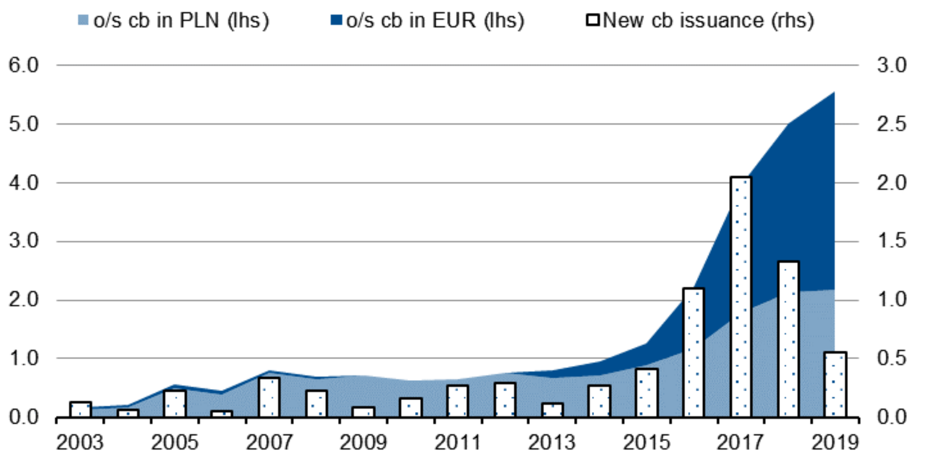
This development has been accompanied by strongly rising commercial property prices, expressed in prime yields that fell to less than 5% in 2018 from around 8% in 2004, for both, office and retail. Still, vacancy rates are moderate, at around 9% for office (in Warsaw); lower for retail and warehouse. Demand remains healthy as reflected in stable rents and declining vacancy rates.

… but potential higher volatility when credit cycle turns

The overall CRE market remains bullish with strong construction activity in the pipeline, but this could suffer proportionally more from a global or European economic downturn due to its dependency on international demand.

Generally, however, refinancing of commercial mortgage and residential loans with covered bonds is becoming more attractive and the stock of Polish covered bonds has started to rise. This has been aided by changes to the Polish covered bond framework in 2015.

Figure 4: Polish covered bonds (all in EUR bn)



Source: ECBC, Scope

Supportive macro environment and 2015 framework update fuels new issuances

From a purely domestic-focused market that barely existed, Polish covered bond issuance has started to increase. There has been benchmark-sized issuance in euros and the first green Polish covered bond (in zloty) appeared in 2019.

Long history but limited covered bond issuance to-date

The foundations of covered bonds were laid in Silesia 250 years ago, so it comes as no surprise that some of the underlying concepts resonated in Poland as far back as 1825. Poland is also one of the countries with the oldest covered bond histories.

Unlike Germany, however, usage of covered bonds in Poland has been low and their importance has only recently started to pick up. There has been strong growth since the last update of the covered bond framework, in effect since 2016. On the back of a pool of approximately EUR 90bn of residential mortgage loans in Poland[2] plus commercial real estate and public-sector loans, it is valuable to look at themes that could impact supply of Polish covered bonds.

Polish covered bonds could help to soften a potential doom loop

Polish debt capital markets less developed than peers…

The Polish debt capital market is not as developed as those of its European peers. This partially reflects the fact that Polish bank funding is significantly deposit-based. With interest rates not yet in negative territory, deposits also remain stable. Further, the need for a developed debt market only increased recently. At a peak in 2008, about three quarters of the Polish banking sector was foreign-owned[3]. Stand-alone domestic and in particular foreign-currency funding was not needed as it was mostly provided by parent companies, if it was needed at all.

..but changes ahead reflecting different Polish banks ownership structures …

This has changed significantly. Foreign ownership in the Polish banking sector has significantly reduced and regulatory changes also stipulate a more balanced funding profile. Today, the two largest Polish banks are directly or indirectly State-owned. In total, the controlling stake of the State in particular in the systemically-important banks has increased to 42% as per the end of 2018. Ownership might have changed but banks still remain largely deposit-funded.

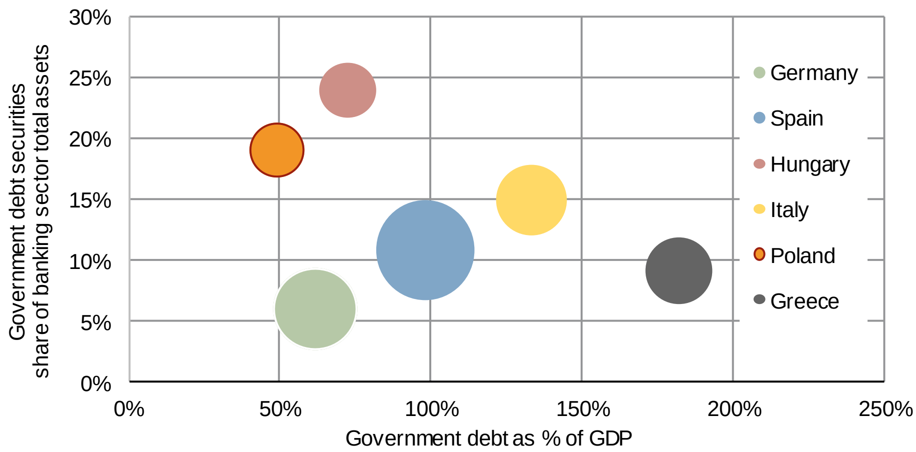
[2] Eurostat: Real GDP growth rate [TEC00115], EMF Hypostat 2018, p. 89
[3] Feb 2019 IMF Article IV Staff report on the Republic of Poland

Changes in bank funding structures ahead?

and regulations which require a changed funding mix for banks

Since the adoption of Basel II, Polish banks have had to comply with the Liquidity Coverage Ratio (LCR) and the Net Stable Funding Ratio (NSFR). To ensure sufficient short-term liquidity and meet LCR requirements, banks are required to hold highly-liquid and high-credit-quality bonds to comply. With limited high-grade and PLN-denominated supply, further aided by tax incentives for domestic sovereign debt, Polish banks are significantly exposed to Polish sovereign debt, resulting in a strong sovereign-bank nexus.

Figure 5: Domestic banks sovereign debt exposure across Europe



Source: Polish central bank, Scope

Holdings of Treasury notes are even more widespread than for Italian banks, and at 19.1% at the end of 2018, the exposure of the Polish banking sector to sovereign debt ranked at the upper end of European peers (see figure 5[4]).

Prices and spreads of Polish sovereign debt have not experienced great volatility in recent years. The Polish sovereign rating remains firmly in the high Single A category and foreign exchange developments have been stable, reflecting Poland’s regional safe-haven status.

Covered bonds could moderate the sovereign-bank nexus…

The potential for a doom loop for Polish banks is on the cards, reflecting the strong domestic sovereign-bank nexus. Regulators and supervisors should be conscious of the challenges experienced by the Italian banking sector – which at 15% has a similarly high exposure to sovereign debt. If the sovereign becomes stressed, banks are burdened with additional provisioning needs for such holdings. This can pressure bank capitalisation at the same time as sensitive capital-market funding becomes more expensive – or at worst, dries up. In a pessimistic scenario, sensitivities could be exacerbated as a high share of banks is government-controlled.

…and provide Polish banks with stable and less expensive funding

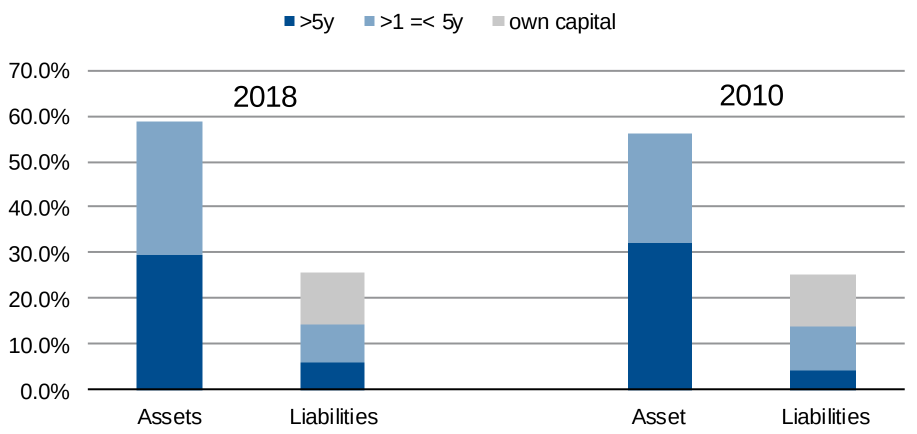
Covered bond funding is typically less sensitive than unsecured bank funding. As some Southern European covered bond markets have shown, they can even provide banks with more favourable international capital market funding than the sovereign. Italian covered bonds for example have been trading below corresponding sovereign spreads since 2012. Further supporting covered bond funding could therefore reduce the banks’ direct exposure to Polish Treasuries – while still providing LCR-eligible investment opportunities for domestic banks.

[4] Narodowy Bank Polski: June 2019 Financial Stability report

Can covered bonds help to increase the duration of Polish bank funding?

Banks' NSFR could benefit from more intense use of covered bonds as a long-term refinancing instrument. At a time where long-term funding needs (partially driven by housing finance) are increasing, the ability of banks to refinance long term are limited. The structure of banks' long-term funding (>1 year contractual maturity, excl. equity) broadly remained at 14% while corresponding long-term assets increased to 59% in 2018 from 56% in 2010.

Figure 6: Long- and Medium-term lending and funding structure of Polish banks



Source: Polish central bank, Scope

Long term CB funding can reduce deposit dependence

Covered bonds could help Polish banks better match their funding profiles. Investors will be more likely to provide long-term funding when they can benefit from the additional security package covered bonds can provide. With enough available collateral and economic rationales supporting covered bond funding, though, certain factors are holding back Polish banks from making further use of covered bonds.

Past risks: FX mortgage loans

FX-linked mortgages were common throughout CEE…

In Poland, similar to other CEE countries such as Hungary, mortgages were often granted in or linked to foreign currencies. Borrowers were attracted by the lower interest rates in foreign currencies than those available domestically. But they often neglected the risk of appreciation in the foreign-currency loan. When the Swiss franc rose significantly after 'Black Friday' in January 2015, the appreciation of the CHF brought serious problems to many borrowers. Instalments made over the years reversed and they suddenly had negative equity.

… but borrowers were not cognisant on currency appreciation risk

Borrowers had diligently amortised over years but because of foreign-currency appreciation, amortised loan amounts, due in Zloty, were higher than when taken out. Affordability can suffer swiftly and significantly as a result. When the Swiss National Bank abandoned the currency cap against the euro in 2015, exchange rates skyrocketed by approximately 20%, putting significant pressure on the debt-servicing capabilities of borrowers throughout CEE.

FX loan conversion needs to balance the interests of both sides

For Poland, the jury is still out as to whether there will be a forced currency conversion as there was in Hungary with potentially dire consequences for bank capitalisation and profitability and the covered bond market.

Polish FX exposures not as severe as in Hungary

Back in 2012, similar to the situation in Hungary, Polish banks had ceased to underwrite new FX-linked mortgage loans. Since 2018, the Polish FSA has introduced macroprudential measures raising the risk weights of such loans to 150% – incentivising banks to seek a reduction or conversion of such mortgages.

The 2010 stock of PLN 200bn of FX-denominated or FX-referenced mortgage loans – equivalent to about 10% of GDP – remains sticky and has only decreased to PLN 130bn or roughly 6.5% of GDP this year. Similar to Hungary, the stock of Polish FX loans is mainly denominated in Swiss francs (82%). The strong appreciation of the Swiss franc has put significant pressure on Polish borrowers. A CHF-linked loan taken out at the trough of the CHF/PLN rate in 2010 would by now have appreciated by about 50%, significantly eating into borrowers' amortisations.

Solutions are politically sensitive..

FX loans are a politically-sensitive topic. Campaigns for the October 2019 parliamentary elections are likely to see promises for a forced conversion from politicians to gain popularity. Given its sensitivity, the Polish courts have escalated cases to European courts, shifting responsibilities to Luxembourg.

The final ruling of the European Court of Justice on Polish FX loans is expected in late 2019. In an extreme scenario, it could render the mortgage loans invalid and demand that the banks unwind them. This would likely have to be at the rate prevailing at origination, pushing the appreciation factor and the costs of unwinding the hedges on the banks. Banks might also have to compensate borrowers.

As consequences could significantly hurt credit supply and the banking system

The combined impact on the capitalisation of the Polish banking system could be massive. Some banks might even breach their solvency thresholds, and the system could be cut off from external funding. Politicians are conscious of these consequences and might soften the impact.

For example, a draft bill for a special fund has been submitted that would spread the impact over several years. Under this draft bill, banks would only have to provide for a certain percentage of their FX-related mortgage portfolios on a quarterly basis. While this would soften the impact on capital it would impair the banks' profitability. If a mutual consensus between all stakeholders is found, it still might dampen credit and thus the supply of covered bond collateral.

On a positive note, if raising unsecured debt in the international capital markets is blocked or becomes extremely expensive following a forced conversion, Polish covered bonds could be the ice-breaker needed to tap back into the pool of international investors.

Risk from FX-denominated CRE loans in covered bonds might not be obvious

The focus on FX mortgages often focuses solely on residential mortgage loans. But FX risks will remain a weak spot for Polish covered bonds, in particular if the cover pool comprises larger shares of commercial real estate financings. In Poland and most of CEE, the CRE market is predominantly a euro market. Properties are traded in euros and rental is generally euro denominated as well.

Euro-denominated CRE mortgage loans secured by euro-denominated properties mitigates any currency mismatch. If used to collateralise Polish covered bonds issued in euros, currency risk appears naturally hedged. However, in a recovery scenario it is most likely that recovery proceeds will be denominated in zloty, which may significantly increase the loss-given default of the covered bonds assuming the zloty depreciates against the euro in a recessionary environment. Such risks can hardly be hedged and are likely to persist if Poland firmly remains outside the Euro Area.

Current risk: 100% floating-rate mortgage loans expose borrowers to interest-rate shocks

Existing Polish cover pools have become infected with the poison of cheap funding. Low rates mean higher affordability prompting higher borrower leverage. This could create higher sensitivity against interest-rate rises, impacting borrowers' credit quality in the long run.

Unique feature of Polish mortgage market: 100% floating rates

The Polish mortgage market is one of the few markets globally that remains fully floating-rate. Borrowers in other mortgage markets – including those that have traditionally been focused on floating-rate mortgages such as Spain or Denmark – have started to secure very low interest rates and high affordability for longer. Borrowers are switching to longer-dated fixed-rate mortgage funding. This is not yet observed in Poland.

At the same time, leverage of Polish borrowers is not excessive, the proportion of mortgage loan-funded homeowners is limited (only one out of eight has a mortgage) and the general health of Polish mortgage loan stock is good. The level of non-performing loans has constantly decreased in the last years and is currently contained. At about 20bp, it is also low in an international context (see Figure 3 above).

Sensitivity to rising rates needs to be monitored

Available macroprudential measures to contain risk do add a level of comfort. As per above, regulators and supervisors have already increased the hurdle for foreign currency-denominated mortgages. In addition, maximum LTV limits for mortgage lending (max LTV residential/ commercial: 80%/75%; higher only with additional collateral or insurance) are in place. Debt service-to-income measures were put in place in 2014 but these are relatively weak. A 50% DSTI measure without a clear definition on the available (residual) income as well as an additional stress to the applied interest rate are not really containing the sensitivity of debt affordability to rising interest rates.

Summing up

Polish covered bond market likely to grow further

Polish residential mortgages amount to 20% of GDP in Poland but a mere one percentage point of that is refinanced with covered bonds. Unless negatively impacted by the way foreign exchange-denominated mortgage loans are addressed, we expect Polish covered bonds to show strong growth in coming years. Issuers will be able to enhance stability of their funding and investors to benefit from a spread premium – typical for nascent markets – but not necessarily heightened risk.

Highest ratings achievable and no constraint from sovereign ratings

For fundamental credit support, this will mean that the combined credit differentiation for Polish covered bonds will likely increase. From today's fundamental credit differentiation of between three to four notches, we likely will see additional uplift factored in over time. Adding up to three additional notches for cover pool support, this means that sound investment-grade Polish banks could see their covered bonds become highly rated – eventually reaching the highest ratings.

Appendix

How Scope determines the credit strength of a Polish covered bond

The ability of covered bonds to be rated above the issuer as well as its sovereign is predominantly dependent on its fundamental credit support. The fundamental support analysis focuses on the strength of the legal framework and the ability of a covered bond to remain a going-concern funding instrument. Only after that does the strength of the cover pool and its expected loss becomes relevant. Cover-pool analysis identifies how prevailing risks are mitigated and whether additional uplift – ultimately up to the highest ratings[5] can be factored into the rating.

The first step, the legal framework analysis, identifies whether:

i) the covered bond structure can transit smoothly away from the insolvent issuer,

ii) the bond continues to pay principle and interest thereafter,

iii) how credit, market and liquidity risks are contained

iv) how the level of independent oversight can limit adverse cover-pool management by the issuer in times of stress.

The legal framework for Polish covered bonds

Comprehensive legal framework...

The legal framework for covered bonds (Listy Zastawne, also LZ) is comprehensive and based on a dedicated Covered Bond Act as well as specific sections in the Bankruptcy Act[6]. Secondary legislation is also available governing the valuation of collateral and the maintenance of the cover pool[7].

… provides solid investor protection…

…supports maximum legal framework uplift …

Since its most recent update in 2015, the Polish covered bond framework meets all the provisions relevant to assigning the maximum two-notch legal framework uplift as defined in the covered bond rating methodology. Investor protection is solid, regulatory oversight is stronger than in most other European jurisdictions and changes required to comply with the upcoming European covered bond harmonisation are limited.

… but details matter

At the same time, the framework has some peculiarities that can negatively impact an investor's expected loss. If mitigated with over-collateralisation, however, we do not expect this to impact the ability of Polish covered bonds to achieve highest ratings.

Harmonisation will likely label Polish covered bonds as "Premium"

In April 2017, the European Commission's covered bond harmonisation survey report[8] compared the previous EBA's best practices for covered bond frameworks against the current status across Europe. The Polish covered bond framework was already fully aligned with most of these best practices and at least partially aligned with others. Any shortcomings can be amended easily and without disruption allowing Polish covered bonds to fit into the proposed covered bond harmonisation framework. Polish covered bonds will likely become "Premium" covered bonds as per the European covered bond definition further supporting investor appetite.

Existing partial alignments with regards to the EBA's best practice were related to:

i) the composition of cover pools – Polish covered bonds can and do comprise both residential and commercial mortgage collateral and the respective shares are not fixed;

[5] For further details see Scope's Covered Bond Methodology available here
[6] The mortgage bank and covered bond act: Ustawa o listach zastawnych i bankach hipotecznych of August 29, 1997 and the dedicated bankruptcy section for mortgage banks, Prawo upadłościowe as of February 28, 2003, Chapter II Article 442–450
[7] "Recommendation F" and "Recommendation K"
[8] http://publications.europa.eu/resource/cellar/8df6d9cd-8c65-11e7-b5c6-01aa75ed71a1.0001.01/DOC_1

ii) the relative wide (OECD) definition of eligible countries for public sector collateral;

iii) the fact that the use of derivatives is not obligatory and that termination of derivatives upon issuer insolvency is not dis-applied,

iv) the relatively vague definition of stress testing

v) the scope and of covered bond disclosure

vi) the frequency of covered bond disclosure.

For the first four partial alignments, Poland is in good company as these were equally relevant for Germany and some other countries; the latter two points are not required by law but provided to investors on a voluntary basis.

But update of the framework needed

Similar to the above, any shortcomings against the final text of the harmonisation can easily and swiftly be included in a legislative update. Most features of the Polish framework are standard and do not materially differ against the European blueprint. As such, we refer to the ECBC's summary of key features of the Polish covered bond framework[9]. Even though details of the Polish framework might look similar to most other frameworks some are worth highlighting:

Framework results in harmonised and prudent valuation standards

Credit risk (positive): There are no credit-negative aspects that differentiate Polish asset eligibility definitions. We view positively the fact that like the German or Irish framework, valuations are not based on market values but a conservatively-established mortgage-lending value. This provides an additional buffer against potential market value declines. Principles for determining lending value are defined by the regulators ensuring a harmonised approach across issuers. There are limited deviations from those practices when put in practice by individual banks[10].

In addition, investors are protected as the LTV only establishes a "leverage limit" i.e. how many covered bonds issuers can issue. But they have recourse to all registered collateral potentially providing additional recoveries[11]. Further, the cover pool benefits from a clear registration into a dedicated cover pool which is monitored by an independent cover pool monitor – also tasked with monitoring adherence to coverage tests prescribed in the Act.

Polish were first to introduce conditional pass-through triggers in the legal framework

Liquidity risks (positive): We also view positively the legal obligation to switch the covered bond repayment from a hard bullet to a pass-through structure. In combination with the mandatory liquidity tests, this legal obligation effectively mitigates asset-liability mismatch risk for all Polish covered bonds. Upon a consecutive breach of mandatory liquidity tests, the legal final maturity of all covered bonds is extended to the maturity of the last amortising asset plus three years[12]. Investors in Polish covered bonds therefore have clear guidance on when the extension takes place. They do not need to read and compare the fine print of each issuer's prospectus – as is still common for CPT programmes in other countries. Polish legislators therefore have already put in place what other jurisdictions need to standardise once the European harmonisation framework becomes binding.

FX risk not covered during the extension period

Market risks (negative): The Polish legal framework expects issuers to address interest and foreign exchange-rate exposures by entering into hedging agreements.

[9] http://www.ecbc.eu/framework/freeCompare/add_filter_framework/77
[10] We understand that the issuer-specific translation of the general rules has to be approved by the Polish FSA. Typically, the issuer specific differences between the market and lending value range from 5% to 25%.
[11] The law also prescribes a maximum lending limit of 100% of the mortgage lending value and the share of collateral above the residential 80%/60% commercial LTV limit has to be below 30% in total.
[12] To allow for a standard work-out of the security if the loan defaults just before its maturity

However, the Act is not explicit on the impact of a legally-triggered extension to those derivatives. This means that unlike the clear requirement in the Harmonisation Directive[13] derivatives currently could terminate when the CPT feature is activated.

It is our understanding that issuers have not sought to hedge potentially extended cash flows. This is because the long-term PLN/EUR FX swap market is very shallow – in particular for a potential 30-year swap and as such is not economically viable. This effectively means that the umbrella which should shield investors once it starts raining is no longer available once the covered bond programme has become extended and is in run-down.

Polish banks currently have sound credit profiles, but to achieve the highest ratings coverage during the extension period – a situation where the issuer is insolvent – is relevant. The same holds true for the credit quality of eligible covered bond collateral, currently boosted by a prolonged period of strong GDP growth and low unemployment.

Increasing share of euro-denominated issuance…

Most of the EUR 5.5bn of Polish covered bonds have been issued in the last three years. Investors have become comfortable with benchmark-sized euro issuance (now amounting to 58% of stock) – which has also made Polish covered bonds eligible for covered bond indices (Iboxx).

..provides issuers with competitive funding…

With ultra-low yields for eurozone issuers, Polish covered bonds appear to be a win-win. Investors are attracted by the pick-up against other eurozone issuers; spread differentials between Polish covered bonds and the German covered bond Iboxx only amount to about 35bp to 40bp) and Polish covered bond issuers are able to receive cheap euro funding. However, euro-denominated covered bonds have the potential to become a double-edged sword for investors.

As an example, we assume a fully domestic and zloty-denominated cover pool exclusively funded with euro-denominated Polish covered bonds. In a going-concern situation, issuers hedge the FX risk. Upon regulatory intervention on the issuer, its subsequent insolvency and the trigger of the extension, the covered bonds become fully exposed to foreign exchange risk.

..but mis-matches increase risk for a cover pool in wind-down

To elevate the covered bonds to highest ratings it needs to be able to withstand stressful macro environments. Lately, the zloty has been trading within a narrow band against the euro. Looking back, between June 2001 and February 2004 and again between June 2008 and March 2009, the zloty devalued by more than 40%. This highlights that if not hedged, high credit quality collateral in itself cannot compensate for the impact of market, in particular FX risk.[14].

If mitigated covered bonds could still achieve highest ratings

At the same time, though, the existence of current or potential FX risk will not hinder Polish covered bonds from achieving highest ratings. Depending on the risk composition of a covered bond programme, all-in funding benefits can still be achieved – even though some of it might be watered down because of higher over-collateralisation needed to compensate for FX risk. Further, the combination of strong regulatory oversight and the expectation that the harmonisation will introduce the requirement for covered bond derivatives to remain available even after the insolvency could become positive.

[13] Article 11(1) of the upcoming "Directive (EU) 2019/… of the European Parliament and of the Council on the issue of covered bonds and covered bond public supervision and amending Directive 2009/65/EC and Directive 2014/59/EU" which specifies that Member States shall ensure investor protection by allowing derivative contacts to be included in the cover pool"… if .." (d) the derivative contracts cannot be terminated upon the insolvency or resolution of the credit institution issuing covered bonds"

[14] Often Polish covered bonds also comprise FX-denominated commercial real estate-backed loans which at first glance provides a "natural hedge" against EUR covered bonds and as such are not hedged with derivatives. However, CRE collateral often has much shorter maturities than the covered bonds issued also exposing issuers to currency depreciation.

Polish covered bonds benefit from standing in resolution. Systemic importance is increasing.

Scope also incorporates into its fundamental credit support (the first pillar establishing the minimum credit differentiation between the issuer and covered bonds) the likelihood that an issuer can maintain its covered bonds as a going-concern funding instrument. This building block analyses the status of covered bonds upon regulatory intervention as well as aspects that could incentivise stakeholders to support covered bonds – among other things because of the systemic importance of the issuer and the relevance of covered bonds as a refinancing instrument.

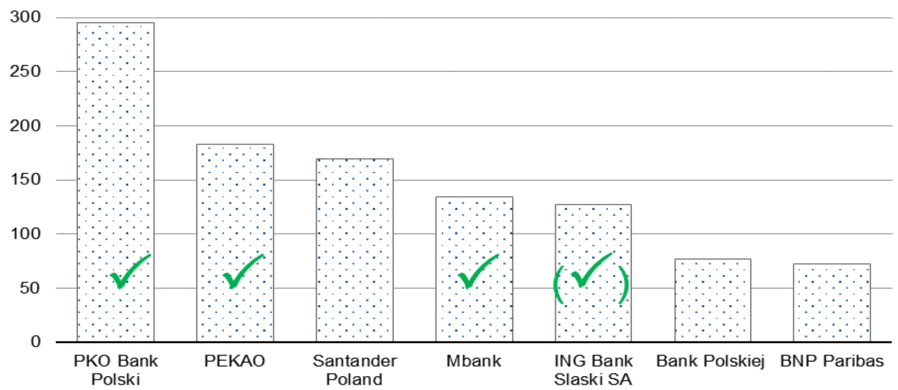
Polish covered bonds not impacted by a bail-in…

Generally, Polish covered bonds are not impacted by a potential bail-in scenario. They currently meet the pre-requisites and the covered bond harmonisation is not likely to change this, adding one additional notch of uplift for all Polish covered bonds. Scope also will also likely provide all Polish covered bonds with an additional uplift because of the cohesiveness of stakeholders.

…cohesive stakeholders have recurrently updated the covered bond framework and ..

Changes to the covered bond legislation, which improved the security package for investors, were the result of joint co-operation between issuers, regulators and supervisors. We also take comfort from the focus on the overall strength i.e. valuation or documentary provisions introduced when the LZ Act was originally passed in 1997 were too difficult to comply with or economically non-viable. Changes since have not materially weakened the product but ensured that the security package can be used as covered bond collateral.

Figure 7: Largest Polish Banks (PLN m, 2018) and ability to issue covered bonds



✓ Bank has a covered bond subsidiary and is actively issuing CBs; (✓) Bank has a CB licence but not yet issued

Source: Investor reports, Scope

…importance and usage of covered bond funding is increasing

Further, we observe that covered bonds have become more of a mainstream funding product for Polish banks. From only one bank irregularly using covered bonds, they now see more widespread and regular use. Three of Poland’s largest banks already use covered bonds, another one has received the licence in 2018 (ING Bank Slaski S.A) and we understand that additional banks are actively considering setting up covered bond issuers.

A higher importance of covered bond funding in Poland will over time allow the incorporation of additional support for the fundamental into our covered bond ratings.

Can highest covered bond ratings be achieved in Poland ?

No mechanistic cap because of the sovereign rating…

Scope does not mechanistically limit the maximum covered bond rating at the sovereign rating of the issuer's country. At the same time, credit ratings must adequately and consistently reflect the credit risks of a financial instrument, including risks arising from an issuer or collateral in a country with weak economic fundamentals. Where relevant, our ratings therefore also incorporate an assessment of transfer risk (e.g. risk of capital controls), convertibility risk, the risk of an institutional meltdown, and the impact on the covered bond rating.

…country risk is low and does not constrain, which means…

Generally we do not expect the above considerations to constrain the rating of Polish covered bonds. Poland is highly rated and demonstrates strong and stable economic conditions. It maintains a relatively independent monetary policy and the importance of the free flow of capital in an open economy such as Poland is high. The Polish banking system is well capitalised, and we deem the risk of an institutional meltdown sufficiently remote.

As such, covered bond ratings will solely reflect i) the credit fundamentals of the issuer, ii) the additional support provided by the fundamental credit analysis and last but not least iii) the additional credit support provided by the risk structure of the covered bond programmes.

…if credit risks are mitigated, highest ratings are achievable for Polish CBs

If identified risks in the covered bond structure are adequately mitigated and the expected loss is in line with highest ratings, Scope does not expect to artificially cap the rating for reasons other than directly related to the issuer and its cover pool.

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