FitchRatings

FITCH AFFIRMS PEKAO BANK HIPOTECZNY'S COVERED BONDS AT 'A'; OUTLOOK NEGATIVE

Fitch Ratings-Frankfurt/London-06 July 2016: Fitch Ratings has affirmed Pekao Bank Hipoteczny's (PBH, A-/Stable/F2) PLN1.3bn mortgage covered bonds (listy zastawne, LZ) at 'A' and removed them from Rating Watch Positive (RWP). The Outlook is Negative.

KEY RATING DRIVERS
First, Fitch has resolved the RWP without upgrade, as the lack of full historical performance data means Fitch will continue to rate the programme on a limited uplift basis. Fitch placed the programme on RWP in January 2016 reflecting amendments to the Polish Covered Bond legislation and expectations of additional data.

Second, Fitch has assigned a Negative Outlook to the programme, reflecting the developing implementation of the resolution framework in Poland for specialised covered bond issuers, and the prospect of an increased likelihood that covered bond holders could be exposed to losses in a scenario where recourse against the cover pool were enforced.

Fitch currently assigns an Issuer Default Rating (IDR) uplift of one notch to PBH's LZ reflecting the favourable treatment of covered bonds and Fitch's view that resolution by methods other than liquidation would be likely.

The recent national implementation of the Bank Recovery and Resolution Directive (BRRD) in Poland, as with the directive, allows the possibility that mortgage credit institutions financed by covered bonds that are not allowed to take deposits may be exempt from the obligation to fulfil minimum requirement for eligible liabilities (MREL). This could mean that covered bondholders would be more likely to experience losses if recourse against the cover pool were enforced eg in a liquidation scenario. Should this path be chosen, Fitch would expect to remove the IDR uplift currently assigned. Together with significant unhedged foreign currency (FX) positions, this means that the programme's rating could eventually be equalised with that of PBH's IDR of 'A-'.

The programme's rating is based on PBH's Long-Term IDR of 'A-' and an unchanged IDR uplift of one notch. The IDR and the IDR uplift result in a rating floor of 'A' irrespective of the level of protection provided through overcollateralisation (OC). Fitch continues not to grant recovery uplift due to significant unhedged FX positions which could undermine recoveries from the cover pool.

More than 60% of PBH`s cover pool consist of euro (31.9%), Swiss franc (31.5%) or US dollar (0.3%) denominated assets. In accordance with the treatment of FX risk in its criteria, Fitch does not give credit to 59.7% of the cover assets as they exceed the 10% limit for unhedged open FX positions. When conservative credit loss assumptions are applied to the remaining cover pool, calculated recoveries on the defaulted covered bonds do not exceed the 51% level with sufficient certainty to assign a recovery uplift in rating scenarios above the current rating level ('A').

Fitch acknowledges that the share of FX denominated assets has decreased and that euro-denominated covered bonds (28.6%) have been issued to improve the natural hedging of the programme. However, as the difference between the weighted average life of the euro assets and the liabilities (assuming the covered bonds maturity is equal to that of the cover assets following the switch to pass-through) exceeds the maximum as per Fitch's criteria, the euro positions were not netted. A further increase of assets denominated in zloty would reduce the open FX position and increase the amount of assets given credit to in its analysis.

Fitch applied a variation from its Covered Bonds Master Criteria, dated 11 March 2016. This variation relates to the calculation of the open FX positions, which are netted depending on the difference in the weighted average life (WAL) between assets and liabilities in the same currency. As PBH's mortgage covered bonds are pass-through, the maturity of the liabilities was aligned with that of the assets. Hence, Fitch compares the WAL of the assets of each foreign currency bucket with the WAL of all assets rather than using the WAL of the liabilities in each individual currency. The variation has no impact on the rating of PBH's mortgage covered bonds and is reflected in the level of OC relied upon for unhedged FX positions exceeding a 10% limit.

RATING SENSITIVITIES
Pekao Hipoteczny's (PBH) mortgage covered bonds could be downgraded by one notch if the regulator approves the exemption from minimum requirement for eligible liabilities, which would mean that covered bondholders could bear losses in a manner that meets resolution objectives. If this were to be the case, no IDR uplift would be assigned.

PBH's mortgage covered bonds' 'A' rating would be vulnerable to a downgrade if: (i) PBH's IDR was downgraded to 'BBB+' or below; or (ii) an IDR uplift was not assigned.

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Applicable Criteria
Covered Bonds Rating Criteria (pub. 11 Mar 2016)
https://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=878761
Fitch's Foreign Currency Stress Assumptions for Residual Foreign Exchange Exposures in Covered Bonds - Excel file (pub. 11 Mar 2016)
https://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=878760