FitchRatings

Structured Finance and Covered Bonds Country Risk Rating Criteria

Cross-Sector

Scope

This report outlines Fitch Ratings' approach to assigning and maintaining structured finance (SF) and covered bond (CVB) ratings, when the relevant sovereign's Local-Currency Issuer Default Rating (LC IDR) is below 'AAA'. The country risk is reflected by limiting the highest achievable rating of the notes or CVB, either through the Country Ceiling (CC) or by a maximum notch uplift from the sovereign's LC IDR, and by applying more punitive rating case assumptions.

The criteria relate to international-scale ratings globally, but not to credit linked notes (unless subject to currency conversion), future flow transactions and national-scale ratings. However, the principles described in these criteria will be used, together with the correspondence tables described in the National Scale Rating Criteria, to derive the National Scale rating approach for each specific asset class. This criteria report covers ratings related to multi-jurisdictional SF notes or CVB.

The criteria set out in this report are applied in conjunction with the applicable master and cross-sector criteria, and are supplemented by sector-specific criteria.

Key Rating Drivers

Each of the key rating drivers is of equal importance for the analysis.

Exceeding Sovereign LC IDR: Fitch's SF and CVB ratings are capped at zero to six notches above the sovereign LC IDR, depending on the country. To achieve a rating above the sovereign LC IDR, Fitch expects SF notes and CVB to be sufficiently strong to withstand the stresses resulting from a sovereign default and to demonstrate lower default risk than that of the sovereign.

Country Ceiling Limits: The ratings of SF notes and the timely payment rating level of CVB issued in a foreign currency cannot exceed the CC of the country of the assets or the issuer, unless transfer and convertibility (T&C) risk is mitigated. If it is, ratings cannot be higher than four notches above the CC. Fitch will limit the rating of foreign-currency issuances at the lower cap resulting from the analysis of macroeconomic and event risk (i.e. based on the LC IDR of the sovereign), or from the analysis of T&C risk (i.e. based on the CC).

Currency Unions: SF and CVB ratings in countries that are part of currency unions cannot exceed the country's CC; this captures the risk of the imposition of capital controls or an exit from the union. Upon such an exit from the union, T&C risk may not be mitigated and event risks could be acute.

Multi-Jurisdictional Structures: T&C, macroeconomic and event risks can become a secondary rating driver for multi-jurisdictional structures due to their diversified country risk exposure. Fitch applies a specific approach in determining a cap for SF and CVB exposed to several countries, based on the individual countries' caps and their exposure to these countries. Analytical assumptions will be adjusted if necessary to reflect increased country-related risks.

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This report replaces the *Structured Finance and Covered Bonds Country Risk Rating Criteria*, published 15 May 2023.

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Country Risk

Fitch addresses country risk by limiting the achievable SF or CVB ratings, depending on the LC IDR and the CC, and by applying more punitive rating case assumptions.

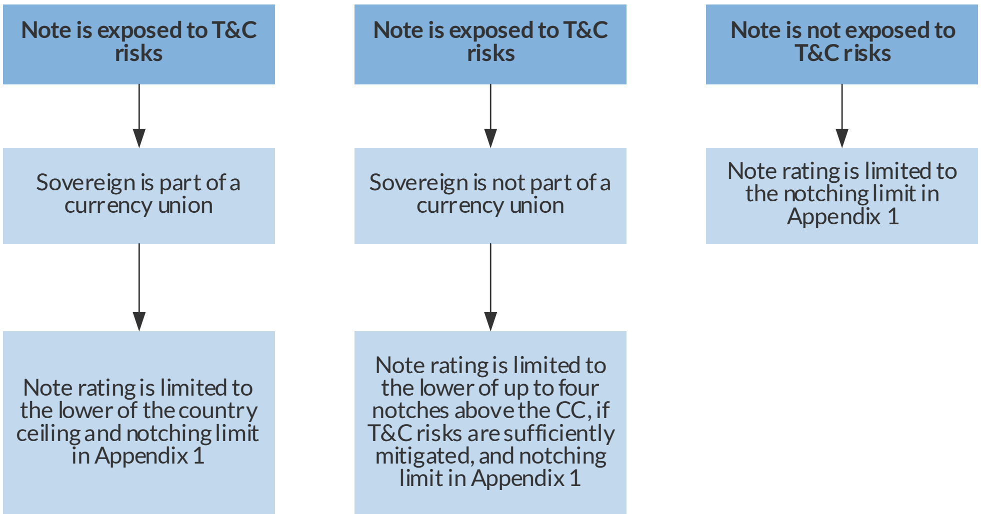
Summary of Assumptions

Limitations from Sovereign LC IDR:

- The maximum number of notches of a SF or CVB rating above the sovereign LC IDR differs by country and can be between zero and six notches. The limit can be found in *Appendix 1*; and
- To embed the agency's expectation of the impact of a sovereign default on the SF and CVB asset performance, Fitch applies at the cap level rating-case assumptions comparable to those we would otherwise apply two rating categories above the cap level. In developing markets (for example in Latin America) stresses up to three rating categories above the cap level can be applied.

Limitations from CC:

- The SF or CVB rating can be up to four notches above the CC if T&C risks are sufficiently mitigated. The liquidity coverage period determines the number of notches above the CC (see table *Sizing of Liquidity Reserves to Breach Country Ceilings*); and
- For currency unions, ratings above the CC cannot be achieved.



Source: Fitch Ratings

If There Is Exposure to Several Countries:

- We must determine whether a cap applies using the matrix *Indicative Rating Cap Category for SF or CVB;*
- Assets from jurisdictions with extreme T&C are excluded; and
- When rating above the sovereign LC IDR, quantitative assumptions will be typically adjusted (e.g. devaluation stress and liquidity stress).

Related Criteria

Global Structured Finance Rating Criteria (March 2023)
Covered Bonds Rating Criteria (June 2023)
Country Ceilings Criteria (July 2020)
Exposure Draft: Country Ceiling Criteria (June 2023)
Sovereign Rating Criteria (April 2023)

Sovereign LC IDR Linked Cap

SF and CVB ratings will be a maximum of six notches above the sovereign's LC IDR[1], irrespective of credit enhancement or overcollateralisation. This is because Fitch assumes that the rating case assumptions exceeding the sovereign LC IDR by more than six notches would be affected by a volatile macroeconomic environment and unpredictable economic stress; in such a scenario, event risk could substantially undermine SF transactions and CVB programmes, rendering asset performance simulations ineffective.

A sovereign default could trigger a chain of events that would severely affect the ability of individuals and corporates to remain current on their obligations. These events may not always be equally disruptive, but the macroeconomic and systemic instability that is generally associated with a sovereign default event may result in a sudden and material deterioration in the creditworthiness of securitised or cover assets.

A high level of sovereign default risk, relative to the rating of SF transactions or CVB, therefore increases the likelihood of extreme macroeconomic events occurring in a country and reduces the certainty of performance projections for the related assets.

In addition, a higher level of sovereign default risk increases the likelihood of significant adverse events occurring, such as heavy political interference with the economy or major disruption to the legal or financial system and severe instability of financial institutions. Examples for macroeconomic and event risks are summarised below.

Sovereign Rating Influence

Macroeconomic risks	As the country approaches default, macroeconomic conditions deteriorate and risks, including the following, will impact the asset performance:
	• increase in inflation/deflation;
	• increase in interest rates;
	• collapse in asset prices/deflation;
	• devaluation/de-pegging of currency;
	• decreasing GDP; • increasing unemployment levels and insolvencies.
Event risks	When a country defaults on its debt, this can cause certain events that cannot be simply covered by overcollateralisation, including the following:
	• dysfunctional legal environment;
	• systemic banking crisis;
	• political interference, e.g. borrower relief programmes or expropriation/nationalisation.

Source: Fitch Ratings

For example, Fitch applies limits lower than six notches in jurisdictions with a weak or weakening financial sector; with a materially worsening asset performance resulting in volatility that makes performance predictions increasingly unreliable; when the legal system is showing dysfunctional aspects; or when political interference has or is expected to affect the performance of securitised or cover pool assets.

If a sovereign default scenario is assumed to be associated with excessively volatile and unpredictable asset performance, or with event risks that could substantially undermine SF transactions and CVB programmes, no rating above the LC IDR of the sovereign is assigned.

The maximum number of notches above the LC IDR that can be achieved under these criteria can be found in *Appendix 1* for relevant countries. The limits are determined based on the below described approach and changes to the factors will be reviewed at least annually; new countries can be added to the list if necessary. A rating committee can decide to lower the limit (see next section for examples). In rare circumstances Fitch may opt for higher than the published limit

[1] Fitch applies the uplift above a distressed sovereign LC IDR (CCC+ and below) such that the first notch moves the cap to 'B-sf', the second to 'Bsf', and so forth.

(but never more than six notches); such an approach will be treated as a criteria variation (see section *Variations from Criteria*).

The factors listed below are used to rank order countries by their degree of country risk. The rank order builds a basis for assigned limits and may be supplemented by other considerations of macroeconomic and event risks. The rank order does not automatically lead to a specific notch limit being applied, but indicates peer groups and changes within the rank.

- Fitch's Macro Prudential Indicator, which measures jurisdictions' vulnerability to financial stress over the medium term based on trends in credit expansion, equity and property prices and real exchange rates[2].
- Membership of international organisations like the OECD, G20 or EU.
- Status as a developed economy, economy in transition, developing economy or least developed country by the UN World Economic Situation and Prospects report based on basic economic country conditions (see https://www.un-ilibrary.org/economic-and-social-development/world-economic-situation-and-prospects-wesp_720b4d75-en).
- Status as a developed, emerging and frontier market by MSCI Country Classification Standard based on economic development, size and liquidity requirements and market accessibility criteria (see https://www.msci.com/market-classification).
- Governance-related indicators published by the World Bank relating to rule of law, control of corruption and regulatory quality (see http://info.worldbank.org/governance/wgi/index.aspx#home).
- Securitisation and CVB activity in a country and the existence of securitization and CVB law.
- Fitch Banking System Indicator, measuring the strength of the banking system in a country.

Countries with lower country risk allow for a higher rating above the LC IDR than in cases when country risk is considered high. Fitch considers further factors, if deemed appropriate, to assess macroeconomic and event risks in a particular country. For example, if political interference (e.g. forbearance programmes or nationalisation) are concrete risks, a limit may be more restrictive.

In contrast to the CC, the limit applies to CVB and SF notes irrespective of the denomination currency.

Special considerations are necessary for countries rated in the 'CCC' category or below, because country risks may vary substantially. For instance, countries may be in default or in restricted default (RD); if it is obvious that transactions will not be interfered with, uncertainty around the impact of a sovereign default is reduced. If a sovereign falls below 'B-', a committee may determine a notching limit different to the published one as a criteria variation to address the specifics of the case at hand. To avoid unnecessary rating volatility in SF notes and covered bonds that could result from a short-lived sovereign default, Fitch may wait up to 30 days from the date of the sovereign D or RD before applying a revised SF country cap to the extent it believes it is highly likely that such a default will be cured within the 30 day period.

Additional Limitations from the Sovereign LC IDR

Fitch will apply further transaction-specific rating limitations when sovereign weakness is also a significant driver of performance. Ratings of SF notes or CVB involving public or private sector assets, when their performance relies on, or is linked to, sovereign performance, are unlikely to achieve the highest notch uplift above the sovereign LC IDR, even if this would be possible for other transactions in this jurisdiction.

For example, for CVB programmes secured by public-sector debt concentrated in a single country, Fitch will generally cap the CVB timely payment rating level at the rating of the

[2] Details on the Macro-Prudential Indicator can be found in the report *Sovereign Rating Criteria*, available at www.fitchratings.com.

sovereign itself. For more details on this topic, see Covered Bonds and CDOs Public Entities' Asset Analysis Rating Criteria.

Another example can be seen in SF structures involving financial sector debtors from a single country. These are not likely to achieve a rating six notches above the sovereign LC IDR. The stricter cap applicable in these instances reflects two main concerns:

- Sovereign crises typically correlate strongly with banking crises, as illustrated by for instance the eurozone crisis; and
- The ratings of financial sector entities could generally be more dependent upon the sovereign rating: Although bail-in and other moral hazard-tempering rules were introduced in developed markets after the global financial crisis, a tendency of governments to support their major financial institutions in times of stress is still prevalent in many emerging markets.

As a result, there will in some cases be a lower cap for a specific transaction or asset class than published in *Appendix 1* (see *Transaction-Specific Disclosure)*.

Rating Above the Sovereign LC IDR

The assumptions Fitch applies when assigning ratings above the sovereign LC IDR embed the agency's expectation of the impact of a potential sovereign default on the SF and CVB asset performance. Therefore, the guiding principle is that ratings above the LC IDR in a country with an SF country cap will result in higher rating-case assumptions than in a country without an SF rating cap. In most cases, these more punitive rating case assumptions could be addressed by applying assumptions comparable to those Fitch would otherwise, all else being equal, apply two rating categories above the cap level, up to the maximum stress of 'AAA'.

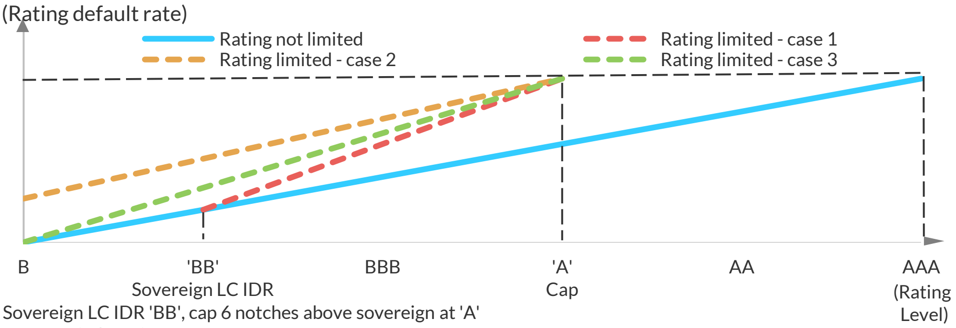
For rating caps at 'A' flat or above, 'AAA' rating case assumptions would be used for the rating test at the cap level. In developing markets (for example in Latin America) stresses up to three rating categories above the cap level can be applied to capture significant event risk or macroeconomic volatility. If the pool assets are domiciled in a country rated below 'B-', then 'CCC' represents the base case with respect to which stresses are scaled.

Moreover, assumptions applied will not automatically become more conservative upon a sovereign downgrade (or less conservative upon a sovereign upgrade). Base-case and rating-case assumptions will only change when the downgrade or upgrade is associated with a relevant change in the macroeconomic environment that Fitch does not deem to be adequately reflected in its current assumptions. Fitch will review the assumptions once a revised rating cap is implemented for SF transaction or CVB programme ratings.

Following this overarching principle, Fitch will define its rating case assumptions, or the approach taken to define them, for each country and asset class individually considering the specific circumstances, and disclosing them in the respective sector-specific rating criteria and/or transaction-specific publication. In its analysis, Fitch will consider the impact of a sovereign default on obligor default behaviour, the recovery prospects of defaulted assets and other variables, depending on the asset class.

An example of how to derive default rating-case assumptions for an asset portfolio can be found below. Given the increased default risk of a sovereign rated 'BB', the default rate at the 'A' cap level could be comparable to a 'AAA' default rate, if the same factors, such as historical asset performance and market expectations, occurred in a country with a sovereign rated 'AAA' (Case 1). When the sovereign downgrade/upgrade is not coinciding with increased/decreased asset performance risk, Fitch could amend its rating case assumptions to cover the increased/decreased risk from a potential default of the sovereign.

Illustrative Example for Setting Default Assumptions



Sovereign LC IDR 'BB', cap 6 notches above sovereign at 'A'
Source: Fitch Ratings

However, in many cases a reduction in the sovereign rating is caused by or accompanied by a macroeconomic deterioration, which will itself have an impact on Fitch's asset assumptions. In such a scenario, Fitch's base case becomes more 'conservative' and closer to a rating case (Case 2) and more conservative rating case assumptions at the cap level may be partially or fully driven by a higher base case, rather than an additional stress. This approach may also be applied in countries with a long history of economic stress.

The chart above shows two of many potential situations. In reality, actual observations and Fitch's analytical treatment will often be a combination of that described as Case 1 and Case 2, as shown in Case 3.

Country Ceiling as Limit

The ratings of SF notes and the timely payment rating level of CVB denominated in a foreign currency are capped at the lower of the CC of the country of the assets or of the issuer, unless Fitch believes T&C risk is effectively mitigated or not relevant (e.g. when no money needs to be converted or transferred across borders). When T&C risk is mitigated, SF and CVB ratings cannot be higher than four notches above the CC.

Transfer and Convertibility Risk

T&C risk can impact debt service when authorities of the relevant sovereign impose restrictions or controls on the ability of private-sector entities to convert local currency into the required foreign currency of the SF notes or CVB and to transfer the proceeds to non-resident creditors. A transaction or a programme may be performing strongly, with adequate or even excess generation of local or foreign currency, but the cash flow may be unavailable to meet debt service because of T&C restrictions.

Country Ceiling Approach

A CC indicates Fitch's assessment of T&C risk with respect to public- and private-sector obligations within a jurisdiction that are denominated in a foreign currency.

Fitch assumes that in stress scenarios associated with rating levels up to four notches above the CC, T&C risk would be temporary and could therefore be mitigated by specific structural provisions. The period for which liquidity coverage is expected, increases with the distance between SF or CVB ratings and the CC, as outlined in the table below. Fitch will typically not assign SF and CVB ratings above the CC when T&C restrictions are expected to continue for at least 18-24 months.

Both the period for which Fitch assumes exchange controls are in place and the rating level above the CC up to which this assumption is deemed appropriate may differ from those below, depending on jurisdictional circumstances (variation from criteria).

Sizing of Liquidity Reserves to Breach Country Ceilings

Liquidity coverage period	Notches
From 6 to less than 12 months	One notch
From 12 to less than 18 months	Two notches
From 18 to less than 24 months	Three to four notches

Source: Fitch Ratings

Fitch has assessed different forms of structural mitigants to T&C risk, mostly in the context of SF ratings assigned in emerging market economies. These mitigants normally consist of offshore liquidity sources in the relevant foreign currency, which can be accessed regardless of any exchange controls that might be imposed by the local sovereign. The most common mitigants include[3]:

- Offshore reserve accounts funded at closing;
- Offshore foreign-exchange swaps with T&C protection;
- Offshore liquidity lines provided by an entity whose rating is commensurate with the ratings of the SF notes;
- Offshore guarantees (e.g. 'partial credit guarantees' by multilaterals); and
- T&C risk insurance policies.

If T&C risk is considered in the analysis of a transaction or programme, then the effective rating cap is the lower of the cap arising from the analysis of macroeconomic and event risk (i.e. based on the LC IDR of the sovereign) and from the analysis of T&C risk (i.e. based on the CC).

Recovery Uplift above the Country Ceiling for CVB

For foreign currency-denominated CVB, the timely payment rating level (as defined in the *Covered Bonds Rating Criteria*) is capped at the CC unless there is specific T&C risk mitigation to breach the CC as described above. In the absence of dedicated T&C risk mitigation, Fitch may still grant a one-notch recovery uplift above the CC if the following protections are all in place:

- Currency risk on the bonds is hedged with eligible swaps, commensurate with the bond's timely payment rating level under the Structured Finance and Covered Bonds Counterparty Rating Criteria;
- The overcollateralisation that Fitch relies on for the CVB rating is sufficient to additionally cover credit loss at the rating case corresponding with one notch above the CC and 12 months coverage for payment disruption that could result from the imposition of capital controls;
- The local currency of the cover assets is not prone to a track record of high currency volatility without consistent recovery against the foreign currency of the CVB. Among other things, this excludes domestic assets in Turkey and Argentina, due to these countries' historical currency behaviour versus major foreign currencies.
- The CVB are not issued from a country that is part of a currency union, or from a country with a Long-Term LC IDR of less than 'B-'; and
- The cover assets securing the bonds are standard and homogenous assets and their performance is not linked to or reliant on the performance of the sovereign.

Nevertheless, the one-notch recovery uplift granted as part of this provision is bound by the prescribed maximum rating uplift above the LC IDR and other rating limitations as outlined in this criteria.

[3] These examples are illustrative and Fitch does not prefer or recommend any specific structural feature to reduce T&C risk.

SF Notes and CVB Denominated in Local Currency

Although a sovereign could impose restrictions on local currency (as, for example, during the Malaysian crisis in 1997), Fitch believes this is unlikely.

Therefore, ratings assigned to cross-border SF notes and CVB denominated in the local currency are not capped by the CC, unless Fitch has a specific concern that local-currency restrictions could be undertaken by the relevant sovereign, due to the cross-border nature of the SF transaction or CVB programme.

However, in case a programme or transaction has obligations in both the foreign and local currency, and cross-default provisions trigger a default on the local-currency obligations in case of non-payment on the foreign-currency obligations, the local-currency obligations will not be rated higher than the foreign-currency obligations.

Currency Unions

For SF and CVB ratings in relation to countries in currency unions, Fitch follows the approaches described above, with the exception of the considerations concerning the mitigation of T&C risk. SF and CVB ratings in these countries cannot exceed the CC of the country of the assets. The most prominent examples involve countries that are within the eurozone.

Fitch's CC captures the risk of the imposition of capital controls or an exit from the union (the two are correlated, but do not always coincide, as in the case of Cyprus in 2013) and associates an exit from the union with scenarios when T&C risk may not be mitigated and event risks would be dramatic.

Appendix 3 illustrates the implications of a currency redenomination in the eurozone, which would leave SF transactions or CVB programmes exposed to unhedged foreign-currency positions.

Currency Pegs

Fitch applies similar analytical considerations as those applicable to a currency union in case of currency pegs. Additional restrictions apply for SF transactions or CVB denominated in a foreign currency while portfolios include assets denominated in a local currency that is pegged to the currency of the notes or bonds, and when the foreign-currency risk resulting from a break in the peg is not covered by a hedge.

As the CC does not necessarily encompass the risk of a break of the currency peg, in these instances the rating cap will be determined on a case-by-case basis, based on Fitch's assessment of the strength of the currency peg. Since currency pegs are, by their nature, easier to break than currency unions, rating caps are expected to be stricter than those applicable to currency unions, i.e. below the CC.

Rating Assumption Sensitivity

A rating cap based on a fixed number of notches above the sovereign LC IDR will typically mean that the maximum achievable rating for SF and CVB will change with the sovereign rating. However, Fitch may reassess the limit in this context and could, based on the situation, conclude that it should be increased (but not above six notches) or reduced, to reflect the changed situation.

When capped in relation to the sovereign LC IDR, SF and CVB ratings will have the same Outlook as the sovereign LC IDR. Consequently, SF and CVB rating Outlooks will move with the Outlooks of the sovereign LC IDR. When caps are solely related to T&C risk and determined in reference to the CC of the country of the assets, a rating committee has to determine an appropriate rating Outlook, considering the factors that resulted in the Outlook for the sovereign rating and the specifics of the SF transaction or CVB programme.

Multi-Jurisdictional SF Transactions and CVB

Fitch believes that sovereign risk may, in certain instances, become a secondary rating driver in the analysis of multi-jurisdictional SF transactions or CVB programmes, in light of their diversified exposure to several countries. For example, while ratings cannot exceed the CC of a country in a currency union in a single-country case, a higher rating can be possible if the portfolio share of this country is limited in a multi-jurisdictional portfolio and the distance between the SF or CVB rating and the CC is four notches or less.

This section of the report outlines principles that will be applied to address country risk in multi-country cases, but the framework can be adjusted and supplemented to address specific situations. Any cap applicable to SF notes or CVB, or any additional credit protection deemed adequate to achieve or maintain a certain rating, is based on a qualitative judgment.

The analysis of multi-jurisdictional transactions follows three steps: (Step 1) assess whether a rating cap is warranted; (Step 2) assess whether asset and transaction characteristics generate specific country risk; and (Step 3) assess whether loss and cash flow assumptions are appropriate in case the SF or CVB rating is above an individual countries' cap.

For CVB, the described stresses need to be applied to the then relevant rating case, which will be different depending on whether the analysis is run for timely payment or for recovery given default.

Step 1 – Rating Caps in Multi-Jurisdictional SF and CVB

This step focuses on the jurisdictions of the assets. An SF or CVB cap is determined based on the matrix below. Given the diversity of multi-country cases, Fitch may apply a different approach or matrix as a variation from criteria, e.g. for portfolios with exposures spread among lower correlated countries or regions.

Indicative Rating Cap Category for SF or CVB

Portfolio share[b] in the capped jurisdiction	Rating cap applicable[a] in a jurisdiction					
	AA	A	BBB	BB	B	Below B
0%-4%	AAA	AAA	AAA	AAA	AAA/AA	Decided case-by-case
5%-10%	AAA	AAA	AAA	AA	A	
11%-20%	AAA	AAA	AA	A	BBB	
21%-30%	AAA	AA	A	BBB	BB	
Above 30%	AA	A	BBB	BB	B	

[a] For each country, this is the lower of a limitation coming from the sovereign LC IDR or the CC, as determined following the principles outlined for a single country above. For the avoidance of doubt, in case T&C risk is mitigated, a limit can be up to four notches above the CC, as detailed in the section Country Ceiling as a Cap. Different to the principles for a single country case, a four-notch limit relating to the CC can be assumed for countries in currency unions (unless capped at a lower level relating to the LC IDR) but additional stresses apply, detailed under Step 3.
[b] The share refers to assets that are not excluded from the analysis to account for extreme T&C, macroeconomic and event risk as outlined below, or because the transaction/programme has sufficient credit protection without such assets. Fitch may take into account potential changes in the exposures over time, similar to assumptions made for other portfolio characteristics that may change for revolving or managed portfolios.
Source: Fitch Ratings

The matrix works by rating category and shows the maximum SF or CVB category rating Fitch would expect to assign. For example, a portfolio including 10% exposure to a sovereign, where the rating would be capped at 'BBB', while the rest of the pool is in countries where no cap applies, could still achieve a 'AAA' rating. However, if the exposure is 15%, a rating cap at the 'AA' category would be indicated. *Appendix 2* shows how Fitch applies the reference matrix in the case of portfolios exposed to several jurisdictions with different caps.

As an option, assets from certain jurisdictions can be disregarded in the analysis, which is equivalent to a 100% loss rate. Such assets would not be considered in the application of the matrix and would not result in a rating cap.

Fitch will exclude assets from jurisdictions in its analysis if T&C risk, macroeconomic risk or event risk are considered extreme relative to the rating of the SF transaction or CVB. For example, this would be the case when the SF or CVB rating is more than four notches above the CC and Fitch would therefore assume a 100% loss rate.

Step 2 – Asset Characteristics and Transaction Structure

This step focuses on the asset characteristics and the structure of the SF transaction or CVB programme, which may have an impact on country risk and hence require consideration.

For example, this would be the case for a CMBS comprising hotels in countries with a CC below the SF notes' rating, whose cash flows are primarily generated in a foreign currency (e.g. the US dollar) and are structurally isolated. A cap may not apply in such cases. Further examples could be bonds of multinational companies or export trade finance-related assets, when the specific circumstances need to be reflected.

Similarly, the ratings of SF notes or CVB issued out of countries with a low sovereign LC IDR could be capped, even if the underlying assets are from 'AAA' countries. This would be the case when Fitch believes that sovereign-related disruption to the legal or financial systems in the country of issuance could have implications for the SF transaction or the CVB's operational and/or legal viability. Similar to the considerations above, a distance larger than six notches between the LC IDR of the sovereign and SF/CVB rating would often be unachievable.

Step 3 – Adjustment of Quantitative Assumptions

Adjustments to quantitative assumptions may be applied to assets in countries where the individual rating cap (resulting from the sovereign's LC IDR or the CC) is below the SF or CVB rating. Such stresses will be defined on a case-by-case basis to reflect heightened T&C, macroeconomic and event risk, considering other stresses already applied to the multi-country case, e.g. foreign-currency stresses implemented to address currency mismatches. Adjustments can be determined for various parameters of the asset analysis, like default multiples or recovery rate haircuts. Further adjustments may be made to the cash flow analysis, such as liquidity stresses to account for T&C risk. Such transaction-specific stresses will be explained in rating communications.

For example, additional stresses are regularly applied for countries belonging to the eurozone, which are rated one to four notches above their CC. In rating cases above the CC, redenomination of assets is a real possibility. The resulting devaluation could be severe. Previous experience from sovereign defaults, although not associated with an exit from a currency union, indicates currency depreciation of 50% to 70%, resulting in a respective par value loss of assets. When Fitch believes the obligors would likely default in such scenario, which is reflected by elevated rating-case default assumptions for such assets, a devaluation stress of 50% is usually applied to recovery proceeds.

Reduced Asset Liquidity for CVB

If Fitch sees limitations in the liquidity of the assets in a country, it may tighten the link between the rating of the issuer and the achievable CVB rating that is explained in the CVB criteria. This would be done to address risks related to the timely payment of the CVB upon an enforcement of the recourse against the cover pool.

This may especially be the case in immature markets, or markets of limited size with limited domestic demand and high external debt. Fitch's assessment will also reflect the number of lenders, the securitisation and CVB activity in a country, and information on the time needed for portfolio transfers. The risk of reduced liquidity will be elevated when rating above the LC IDR of the sovereign.

Data Sources

Fitch analysed previous sovereign crises to derive the key rating assumptions detailed in this report. Important factors considered to determine the maximum limit for a SF or CVB rating above the LC IDR of the sovereign are outlined in the section *Sovereign LC IDR as Limit*.

Limitations

Ratings, including Rating Watches and Outlooks, assigned by Fitch are subject to the limitations specified in Fitch's ratings definitions (see *Related Research*, page 2).

Transaction-Specific Disclosure

In our initial rating report or RAC, Fitch expects to disclose the following items related to this criteria report:

- If we apply a limit above the sovereign LC IDR that is:
  - Lower than that published in *Appendix 1*;
  - This is because of the application of the section *Additional Limitations from the Sovereign LC IDR*; and
  - But if the use of the lower limit for a sector is separately disclosed in a sectorspecific criteria (for example, in the *Covered Bonds and CDOs Public Entities' Asset Analysis Rating Criteria)*, then we would not publish this as a transaction-specific disclosure.
- Any variation to criteria as per the next section.

In our subsequent rating action reports related to surveillance actions, Fitch expects to disclose the following items related to this criteria report:

- For cases in which we apply a lower limit above the sovereign LC than in Appendix 1 (due to application of the section Additional Limitations from the Sovereign LC IDR and when this treatment is not disclosed in sector-specific criteria) and the limit we apply changes or there is a change in the rationale for the use of a lower limit; and
- Any variations to criteria.

Variations from Criteria

Fitch's criteria are designed to be used in conjunction with experienced analytical judgment, exercised through a committee process. The combination of transparent criteria, analytical judgment applied on a transaction-by-transaction or issuer-by-issuer basis, and full disclosure via rating commentary, strengthens Fitch's rating process while assisting market participants in understanding the analysis behind our ratings.

A rating committee may adjust the application of these criteria to reflect the risks of a specific transaction or entity. Such adjustments are called variations. All variations will be disclosed in the respective rating action commentaries, including their impact on the rating where appropriate.

A variation can be approved by a ratings committee when the risk, feature, or other factor relevant to the assignment of a rating and the methodology applied to it are both included within the scope of the criteria, but when the analysis described in the criteria requires modification to address factors specific to the particular transaction or entity.

Appendix 1 – Limit Above Sovereign LC IDR per Country

Limit Above Sovereign LC IDR[a]

Country	Notches	Country	Notches
Andorra[b]	4	Kazakhstan	2
Argentina	2	Korea (South)	6
Australia	6	Latvia	6
Austria	6	Lithuania	6
Belgium	6	Luxembourg	6
Brazil	3	Macao	2
Bulgaria	4	Malaysia	4
Canada	6	Mexico	3
Chile	6	Morocco	3
China	4	Netherlands	6
Colombia	3	New Zealand	6
Costa Rica	3	Norway	6
Croatia	3	Panama[b]	4
Cyprus	5	Peru	3
Czech Republic	5	Philippines	3
Denmark	6	Poland	6
Dominican Republic	2	Portugal	6
Ecuador[b]	2	Romania	3
El Salvador[b]	3	Singapore	6
Estonia	4	Slovakia	5
Finland	6	Slovenia	6
France	6	South Africa	3
Germany	6	Spain	6
Greece	5	Sweden	6
Guatemala	2	Switzerland	6
Hong Kong	5	Taiwan	5
Hungary	4	Thailand	3
India	4	Turkey	3
Indonesia	2	Ukraine	2
Ireland	6	United Kingdom	6
Israel	5	United States	6
Italy	6	Uruguay	4
Jamaica	1	Vietnam	1
Japan	6		

[a] For countries rated at a distressed level the starting point for notching is notionally 'CCC+'.
[b] In dollarised jurisdictions the FC IDR replaces the LC IDR for the purposes of this criteria if a separate LC IDR is not maintained. This is currently the case for Andorra, Ecuador, El Salvador and Panama.
Source: Fitch Ratings

For countries not listed in the table, Fitch may apply a limit of zero notches above the LC IDR or alternatively, as a variation from criteria, use a higher number of notches (but never more than six, except as it relates to countries rated below 'B-') and highlight this in the rating communication.

Appendix 2 – Application of the Reference Matrix

Portfolios Exposed to Multiple Capped Jurisdictions

In the case of portfolios exposed to more than one capped jurisdiction, the rating categories in the head row of the reference matrix Indicative Rating Cap Category for SF or CVB must be read as "rating category and below". The portfolio is assessed against each column of the matrix and the matrix' indicative rating cap feedback is the lowest achievable rating of each individual assessment, as shown in the examples below.

Portfolio Composition Examples

Rating cap applicable to SF and CVB in the jurisdiction (rating category)	Portfolio composition (%)		
	Example 1	Example 2	Example 3
AAA	65	80	85
AA	20	0	0
A	10	5	0
BBB	0	0	13
(of which BBB but excluded for extreme T&C risk)	-0	-0	-5
BB	5	15	2
B	0	0	0
Total	**100**	**100**	**100**

Source: Fitch Ratings

Example 1

"Rating category and below"	Aggregate exposure (%)	Reference matrix indicative rating cap (individual assessment)
AA	20+10+0+5+0 = 35	AA
A	10+0+5+0 = 15	AAA
BBB	0+5+0 = 5	AAA
BB	5+0 = 5	AA
B	0	AAA
Applicable cap (lowest individual assessment)		**AA**

Source: Fitch Ratings

Example 2

"Rating category and below"	Aggregate exposure (%)	Reference matrix indicative rating cap (individual assessment)
AA	0+5+0+15+0 = 20	AAA
A	5+0+15+0 = 20	AAA
BBB	0+15+0 = 15	AA
BB	15+0 = 15	A
B	0	AAA
Applicable cap (lowest individual assessment)		**A**

Source: Fitch Ratings

Example 3

"Rating category and below"	Aggregate exposure (%)	Reference matrix indicative rating cap (individual assessment)
AA	0+0+(13-5)+2+0 = 10	AAA
A	0+(13-5)+2+0 = 10	AAA
BBB	(13-5)+2+0 = 10	AAA
BB	2+0 = 2	AAA
B	0	AAA
Applicable cap (lowest individual assessment)		**AAA**

Source: Fitch Ratings

Appendix 3 – Exit from the Eurozone

Fitch's long-standing view is that the likelihood of the departure of any country from the eurozone is low and is significantly lower than a sovereign default within it; a full breakup of the eurozone is extremely unlikely. The agency also considers the risk of new capital controls being imposed in the eurozone to be very low. Nevertheless, in 2013 Fitch revised CCs in relation to the eurozone to be a maximum of six notches above a participating country's FC IDR (whereas all the eurozone countries – except Greece – previously had a CC of 'AAA'). More information on CCs can be found in *Country Ceilings* under *Related Criteria*.

The biggest hurdle for SF notes and CVB would be redenomination. If it were to leave the eurozone, a country would have to establish a new national currency that would almost certainly be weaker than the euro (assuming it was not a strong country as part of a wider break up). This would render outstanding euro-denominated SF notes and CVB more expensive to repay. These factors would likely result in a restructuring or even default on the SF notes or CVB.

With reference for example to a euro-denominated consumer ABS, the underlying consumer debt portfolio would be redenominated in the new currency. However, outstanding SF notes could remain denominated in euros. This would likely cause severe unhedged currency stress and expose the ABS to a significant downgrade, if not an inevitable default in Fitch's view. Depending on the legal regime under which the notes were issued, the notes themselves may be directly redenominated, which Fitch would likely view as an immediate default.

When an economically weak country leaves the eurozone, Fitch expects this would create huge problems for its banking sector. Major currency mismatches would be created, banks are likely to be faced with deposit and capital flight, and the ECB would no longer be available as lender of last resort. It is also possible that EU membership would be lost, which would affect the country's economy and institutional quality.

An exit from the euro may well also be associated with substantial political interference in the economy (e.g. nationalisations and expropriations), which could include disruption of SF and CVB legal principles.

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