Credit Rating Announcement 17 July 2018

Scope upgrades Austrian mortgage covered bonds issued by Bank Burgenland and Wüstenrot to AAA

Enhanced clarity on insolvency ranking of Austrian unsecured debt prompts upgrade of the covered bond ratings. Strong credit quality of the cover pools coupled with ongoing high levels of overcollateralisation supports rating uplift.

Rating action

Scope Ratings has today upgraded to AAA from AA+ the Austrian mortgage covered bonds (Hypothekenpfandbriefe) issued by Hypo Bank Burgenland AG (Bank Burgenland) and Bausparkasse Wüstenrot AG (Wüstenrot). The Outlook for both covered bonds remains Stable.

Rating rationale

Scope's upgrade to AAA/Stable of the Hypothekenpfandbriefe issued by Bank Burgenland and Wüstenrot is primarily driven by the one notch upgrade of the banks' issuer ratings. (both bank ratings are private). The improved bank ratings translate into a one-notch higher starting point for the determination of covered bond ratings. Rating actions on the issuers follow the recently adopted amendment to Section 131 of the Austrian Bank Recovery and Resolution Act (BASAG) which leads Scope to fully apply its bank rating methodology when rating Austrian banks.

Both covered bond programmes' credit characteristics, in combination with the available overcollateralisation, fully support the higher ratings. Scope's covered bond ratings reflect a seven-notch rating uplift, , which incorporates an unchanged view on the fundamental support factors (+4 notches) for both programmes, anchoring the rating floor at AA-. The additional cover pool uplift of three notches on top of the fundamental uplift allow the programmes' to achieve AAA ratings.

The higher rating floor for the covered bond ratings reflects the ability of the Austrian banks to issue contractually defined senior debt replicating the characteristics of non-preferred senior debt issued elsewhere in the European Union. In a liquidation scenario (or, by extension, a resolution scenario) such debt would rank below covered bonds, senior unsecured liabilities such as deposits and outstanding senior unsecured debt, but above subordinated debt and/or capital securities. Scope's bank rating methodology specifies that when there is sufficient clarity regarding the positioning of MREL debt in an EU bank's capital structure, the agency's rating will be at least one notch below the respective bank's issuer rating or the rating of its preferred senior debt. Based on the amended legislation referenced above, Scope will rate currently outstanding senior unsecured debt of Austrian banks at the same level as the issuer rating, while future MREL-eligible senior non-preferred debt will be rated at least one notch below.

Scope has introduced the notching via a one-off uplift of the respective banks' ratings. This approach reflects the agency's opinion that while the credit fundamentals of the groups have not changed, their bank rating (which is the starting point for the covered bond rating) can now benefit from the protection of a materially more ample capital structure in a default-like situation going forward.

Sound and broadly unchanged risk profiles of the covered bond programmes continue to support the maximum three-notch cover pool uplift, now supporting AAA covered bond ratings.

Credit quality of Bank Burgenland's cover pool stable, removal of forex risk lowers supporting overcollateralisation

At 31 March 2018, Bank Burgenland's covered bonds benefitted from an overcollateralisation of 280% based on the eligible cover assets and 321.1% on a whole loan basis. Since Scope's rating of the bonds, the credit quality of the cover pool has improved slightly, reflecting a reduced share of commercial properties (down to around 63% from 68% as of end-July 2017). The cover pool is concentrated in the wider Vienna region and only contains performing loans.

From a cash flow risk perspective, the cover pool remains primarily exposed to mismatch risk. It exhibits a negative weighted average maturity gap of approx. 6.3 years, up from a negative gap of 5.1 years as of last year's review. The cover assets have a low weighted average maturity of 5.1 years (down from 5.9 years) whereas the outstanding covered bonds exceed the life of the assets with a weighted average maturity of 11.4 years (up from 11 years). This exposes the programme to negative carry.

Interest rate mismatches are high but remained relatively stable with cover assets mostly floating (88% up from 87%) and maturing before the covered bonds, of which 89% (up from 87%) are issued with fixed interest rates and therefore are exposed to interest rate risk.

The covered bond programme is most sensitive to a decreasing and lower-for-longer interest rate environment. There is no remaining forex risk as Swiss franc-denominated mortgage loans, still present at 31 March 2018, have been fully removed from the cover pool by 30 June 2018. According to Scope's cover pool analysis, an overcollateralisation of 35% on a whole loan basis is able to fully mitigates identified credit and market risks and supports the AAA ratings.

Fundamental credit factors have not changed since the last review, maintaining the four-notch rating uplift and anchoring the additional cover pool-based uplift at AA-.

Credit profile of Wüstenrot's covered bond programme stable, cover pool increased, long-term issuances raise asset-liability mismatch – ratings remain well supported by available overcollateralisation

At 31 March 2018, Wüstenrot's cover pool had increased to about EUR 410m (up from EUR 263m as of December 2017) and provides the outstanding mortgage covered bonds with an overcollateralisation of 211% based on the eligible cover assets and 271% on a whole loan basis. The cover pool only comprises Austrian residential mortgage loans granted throughout Austria. Despite the cover pool balance nearly doubling, its characteristics remained relatively stable. Because of the newly added mortgage loans, the average whole loan LTV of 70.3% (up from 68.9%) has increased slightly whereas the weighted average eligible LTV has remained stable at about 53%. The mortgage loans remain granular with a low average loan size of EUR 98,000. The cover pool only comprises performing loans.

From a cash flow risk perspective, the cover pool has become exposed to mismatch risk. The bank has predominantly issued long-term covered bonds resulting in a negative weighted average maturity gap of approx. 1.8 years. The weighted average maturity of the cover assets remained almost unchanged at around 14 years, whereas the weighted average maturity of the EUR 132m in outstanding covered bonds increased to a very long 16.4 years. The long maturities of the bonds expose the programme to negative carry that substantially drives overcollateralisation in a high prepayment scenario. There is limited interest rate risk as around 73% of the loans in the cover pool have a fixed interest rate and most of the floating loans have caps and floors while all covered bonds are currently issued at fixed rates.

The programme remains most sensitive to a decreasing and lower-for-longer interest rate environment. According to Scope's cover pool analysis, an overcollateralisation of 21% on a whole loan basis is able to fully mitigate identified credit and market risks and supports the AAA ratings.

Fundamental credit factors have not changed since the last review, maintaining the four-notch rating uplift and anchoring the additional cover pool-based uplift at AA-.

Quantitative analysis and key assumptions

Bank Burgenland: Scope analysed the cover pool loan defaults using a normal inverse distribution. Scope assumes stressed lifetime default rates of 10.6% for residential loans and 20% for commercial loans, with coefficients of variation at 60% and 50%, respectively. Scope calculated a weighted average recovery rate of 79% for residential loans and 64.5% for commercial loans in the stressed scenario. The blended servicing fee used in the analysis is 33 bps and the blended refinancing spread 150 bps. In the stressed analysis, Scope used a high prepayment rate (15%) together with non-converting low interest rates that decrease to 1% after the second year.

Wüstenrot: Scope analysed the cover pool loan defaults using a normal inverse distribution. Scope assumes a stressed lifetime default rate of 10.7% with a coefficient of variation at 60%. Scope calculated a weighted average recovery rate of 58.5% in the stressed scenario. The servicing fee used in the cash flow analysis is 20 bps and the refinancing spread 150 bps. In the stressed analysis, Scope used a high prepayment rate (15%) together with non-converting low interest rates that decrease to 1% after the second year.

Rating-change drivers

Scope's Stable Outlook on both covered bonds reflects: i) the continuous availability of high overcollateralisation which provides a significant buffer against a rise in credit and market risks, thereby maintaining the three notches of cover pool-based support; ii) Scope's view that European covered bond harmonisation will not negatively impact the fundamental support factors relevant for the issuers and Austrian mortgage covered bonds in general; and iii) Scope's Stable Outlook on the issuer credit rating of both banks.

The covered bond ratings may be downgraded if: i) the issuer's credit rating is adjusted by one notch or more; ii) risk in the covered bond programme increases and provided overcollateralisation no longer supports a seven-notch rating uplift; or iii) Scope revises downward the fundamental support factors relevant to the issuers and Austrian mortgage covered bonds in general.

Stress testing

No stress testing was performed.

Cash flow analysis

In order to determine the cover pool-supported rating uplift, Scope performed a cash flow analysis to establish an expected loss for the covered bonds. The cash flow analysis uses the scheduled cash flows of the cover assets and covered bonds as a starting point. Scope applies rating-distance-dependent stresses to simulate the impact to cash flows arising from increasing credit and market risks. The cash flow analysis also includes the impact of stressed asset sales or other variables such as changing prepayment speeds or servicing costs.

Methodology

The methodologies used for this rating and outlook were Scope's Covered Bond Rating Methodology and Scope's General Structured Finance Rating Methodology (for the translation of the expected loss into ratings). Scope's Bank Rating Methodology was used for the private rating on the issuer.
The methodologies are available on www.scoperatings.com.
Historical default rates of Scope Ratings can be viewed in the rating performance report on https://www.scoperatings.com/#governance-and-policies/regulatory-ESMA. Please also refer to the central platform (CEREP) of the European Securities and Markets Authority (ESMA): http://cerep.esma.europa.eu/cerep-web/statistics/defaults.xhtml. A comprehensive clarification of Scope's definition of default as well as definitions of rating notations can be found in Scope's public credit rating methodologies on www.scoperatings.com.

Solicitation, key sources and quality of information

The rated entities participated in the rating process.
The following substantially material sources of information were used to prepare the credit rating: public domain, the rated entity, third parties and Scope internal sources.
Scope considers the quality of information available to Scope on the rated entity or instrument to be satisfactory. The information and data supporting Scope's ratings originate from sources Scope considers to be reliable and accurate. Scope does not, however, independently verify the reliability and accuracy of the information and data.
Prior to publication, the rated entity was given the opportunity to review the rating and/or outlook and the principal grounds on which the credit rating and/or outlook is based. Following that review, the rating was not amended before being issued.

Regulatory disclosures

The credit ratings and rating outlooks are issued by Scope Ratings GmbH.
Lead analyst (Bank Burgenland and Wüstenrot): Karlo Fuchs, Executive Director
Person responsible for approval of the ratings: Guillaume Jolivet, Managing Director
The ratings/outlooks on Bank Burgenland were first released by Scope on 15.11.2017 and on Wüstenrot on 06.04.2017.

Potential conflicts

Please see www.scoperatings.com. for a list of potential conflicts of interest related to the issuance of credit ratings.

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