Credit Rating Announcement 22 November 2018

Scope affirms AAA ratings of mortgage-covered bonds issued by Bank Burgenland, Outlook Stable

Covered bonds credit quality benefit from the issuer's active risk management, reducing forex and credit risk; ample available overcollateralisation mitigates risks supporting AAA ratings.

For the detailed performance update report, click here.

Rating action

Scope Ratings has today affirmed its AAA ratings for the Austrian mortgage-covered bonds (Hypothekenpfandbriefe) issued by Hypo Bank Burgenland AG (Bank Burgenland). The Outlook remains Stable. The covered bond ratings reflect the private issuer rating assigned to Bank Burgenland, further enhanced by support provided by the cover pool analysis. A seven-notch credit uplift to Bank Burgenland's private issuer rating based on cover pool support allows the covered bonds to be rated AAA. Fundamental credit support factors provide four notches of uplift above the bank's rating effectively providing a rating floor at AA-.

Key rating drivers for the covered bond ratings

- Sound issuer credit rating (positive)

- Cover pool support of seven notches reflecting:

1. Overcollateralisation (positive): available overcollateralisation of 254% shields the covered bonds from market and interest-rate risks and is well above the 28% that supports the AAA ratings

2. Sound credit quality: moderate credit risk even under the highest rating stresses (positive)

3. Maturity mismatches (negative): high asset-liability mismatch risk resulting in negative carry from the bonds' high duration

4. Substantial interest rate mismatches (negative): most cover assets are floating rate while the bonds generally pay a fixed coupon

- Fundamental credit support resulting from the strength of the Austrian legal and BRRD framework, which supports a four-notch uplift to the private issuer rating (positive)

Cover pool supports highest rating achievable

As of 30 September 2018, Bank Burgenland's EUR 828.9m (eligible) cover pool supports a rating uplift of seven notches on top of the private issuer rating for the EUR 234.2m of covered bonds outstanding. The supporting overcollateralisation is 28%, down from 35%, and compares to an available overcollateralisation of 254%.

The issuer has actively managed the asset portfolio, positively influencing credit risk. Since Scope's 2017 analysis, all foreign currency loans and loans with very high loan/value (LTV) ratios have been removed from the cover pool. This has effectively reduced re-denomination risk and improved Scope's recovery analysis. Scope also notes that the share of fixed rate loans has increased to 23.9%, up from 12.6% in 2017. This reduces interest rate mismatch as most of the covered bonds are issued with a fixed coupon.

The rating-supporting overcollateralisation is predominantly driven by a low prepayment together with a decreasing interest rate scenario. In this environment, the assets' floating interest would not be sufficient to cover fixed interest on the liabilities. Accordingly, overcollateralisation is needed to cover the negative carry over the life of the transaction. In a low prepayment scenario overcollateralisation is also driven by the higher allocation of defaults during the assets' remaining term to maturity.

Cover pool composition

The cover pool is granular and purely domestic. It comprises residential and commercial mortgage loans as well as registered substitute assets. The 3,855 mortgage loans were granted to 2,839 obligors, comprising SMEs (36%), private individuals (29%) and corporates focused on residential housing (35%).

Despite the removal of foreign currency loans and loans with high whole LTVs, the pool's composition has remained fairly stable. By property type, 66% of total (eligible) loan exposure is secured by residential properties. Most properties securing the loans are located in Vienna and Burgenland (together 77%). The cover pool has a weighted average whole LTV of 61.5% and a corresponding eligible LTV (against which bonds can be issued) of 49.4%.

The substitute assets amount to EUR 5.2m and are exposed to highly rated bonds.

Fundamental credit support: the Austrian legal framework and resolution regime provide a four-notch uplift

Two notches of uplift are driven by the agency's view of the Austrian legal covered bond framework. Another two notches are based on Scope's assessment of the support the resolution regime affords the issuer.

Analysis of the Austrian covered bond legal framework

Scope's analysis of the 'Pfandbriefgesetz' act confirms that the framework just meets the criteria to assign the maximum credit differentiation under the rating agency's methodology. The provisions ensure that the cover pool is segregated from the issuer's insolvency estate; bond payments continue after insolvency; and identified risks can be mitigated by overcollateralisation, which generally remains available after insolvency. Austrian covered bonds also benefit from specific regulatory oversight. However, Scope recognises the framework's lack of clarity on liquidity or risk management for covered bonds.

Resolution regime and systemic importance considerations for Bank

Burgenland's covered bond programme

Bank Burgenland's covered bonds benefit from an additional two-notch uplift reflecting the benefit of a bail-in exemption and Scope's view on the resolvability and likely maintenance of Bank Burgenland in a resolution scenario. Scope has not provided additional, resolution framework-based support to Bank Burgenland's covered bonds because of the bank's limited prominence as a covered bond issuer, a lack of support from stakeholders and Austrian regulators' track record of weak proactivity.

Quantitative analysis and key assumptions

Scope's projections of default for the cover pool employ a non-parametric distribution using a Monte Carlo analysis with a mean default rate of 11.3% and a coefficient of variation of 73.2% for the mortgage loans and 0.0% for the substitute assets. The agency also assumed an asset recovery rate for the mortgage loans ranging between 97.1% in the base scenario and 77.8% in the most stressed scenario and 100% to 40% for the substitute assets accordingly.

For the mortgage loans, Scope assumed a general correlation of 7% also considering that all of the assets are exposed to Austria. For residential loans, a regional correlation of 20% was assumed for collateral in Burgenland and Vienna and 15% for the remaining regions. For the commercial sub-portfolio, the agency applied 10% and 8% respectively. An industry-specific correlation of 20% within the commercial segments was assumed. A large obligor stress was applied to 30 (exceeding 50 bps of the total cover pool) out of 2,841 obligors with an additional correlation of 20%. Scope assumed a 100% correlation for the substitute assets, as they are exposed to the Austrian sovereign.

Scope established a default assumption for each borrower using the issuer's internal rating system, migration matrixes, the issuer's back-testing and third party information. In the absence of detailed performance data on the corporate and the medium sized enterprise ('MU') segments, their probabilities of default were conservatively aligned with the issuer's small enterprise ('Retail') segment.

Scope applied rating distance-dependent market value declines to establish recovery rates. Assumptions were based on an analysis of Austrian mortgage market developments and their unique characteristics. Scope established security value haircuts for the properties securing the mortgage loans ranging between 53.5% for commercial and 50.7% for residential collateral assuming the highest stresses, and 35.7% and 33.6% respectively in a base scenario.

To calculate a net present value for the cover pool in the event of an asset sale, a liquidity premium for Austrian residential mortgage loans of 150 bps, 300 bps for commercial mortgage loans and 200 bps for the substitute assets was added to the discount curve in the most stressful scenario. Scope derived this liquidity premium by analysing the long-term development of trading spreads for Austrian covered bonds.

Scope tested for low (0%) and high prepayments (15%) to stress the programme's sensitivity to unscheduled repayments. The programme is most sensitive to low prepayments.

The covered bonds were tested against several scenarios with rising and falling interest rates. The programme is most vulnerable to a non-reverting negative interest rate scenario (down to -1%) as the covered bonds are fixed rate with relatively long maturities.

Scope assumed a recovery lag of 24 months for residential loans originated by Bank Burgenland, 36 months for commercial loans and 48 months for the substitute assets.

The rating agency applied asset type-specific servicing fees to be paid by the cover pool annually. Scope assumed a servicing fee of 25 bps for the residential mortgage loans, 50 bps for commercial loans and 10 bps for the substitute assets.

Scope was not provided with the split of prior liens within a borrower group (internal) or external prior liens. As Scope calculated recoveries on a borrower level, internal (registered) prior liens are neutral. To calculate the external prior liens the agency used the whole LTV calculated by the issuer on a borrower level.

Scope considered different default timings, from mid-loaded to front-loaded. Back-loaded default scenarios are not as severe for the covered bonds, mainly as a result of amortisation.

Rating-change drivers

Scope's Stable Outlook 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) the agency's view that European covered bond harmonisation will not negatively impact the fundamental support factors relevant for the issuer and Austrian mortgage covered bonds in general; and iii) Scope's Stable Outlook on the issuer credit rating of the bank.

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 on 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 the entities rated by 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.
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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): 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. The ratings/outlooks were last updated on 17.07.2018.

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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