Credit Rating Announcement 19 November 2019

Scope affirms at AAA/Stable the mortgage-covered bonds issued by Bank Burgenland

The rating reflects strong support from the cover pool. Asset-liability mismatches drive the rating-supporting overcollateralisation. The high credit quality of the domestic residential and commcercial mortgage pool adds only incremental risk.

Rating action

Scope Ratings has today affirmed the AAA/Stable ratings on the Austrian mortgage-covered bonds (Hypothekenpfandbriefe) issued by Hypo-Bank Burgenland AG (Bank Burgenland). The Outlook remains Stable.

Additional information and research on the issuer and its covered bonds is available on scoperatings.com.

Key rating drivers

Sound issuer rating (positive). Bank Burgenland's sound credit quality reflects its conservative and integrated business model, improving profitability and adequate capitalisation.

Cover pool support (positive). Cover pool support is the primary rating driver and adds at least six notches of credit uplift, reflecting:

1. **Overcollateralisation (positive).** Overcollateralisation of 163.1% as of 30 September 2019, on an eligible-loan basis, shields the covered bonds from market and credit risks and is well above the minimum overcollateralisation of 22.0% needed for a cover pool-based uplift.

2. **Sound credit quality (positive).** The cover pool continues to be of high credit quality, reflecting the domestic, low loan/value cover assets. This results in low credit risk, even under the highest credit stresses.

3. **Asset-liability mismatches (negative).** A negative weighted average life gap of approximately three years exposes the program to cost of carry - in particular in a high prepayment scenario. Additional buffers are needed to mitigate the risk from interest rate mismatches.

Fundamental credit support (positive). The strength of the Austrian legal covered bond and resolution framework supports up to four notches of uplift above the issuer rating and effectively provides a floor against a deterioration in the credit quality of the cover pool.

Rating-change drivers

Scope's Stable Outlook on the covered bonds reflects: i) the continuous availability of high overcollateralisation, which provides a significant buffer against a rise in credit and market risks; ii) Scope'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.

The covered bond ratings may be downgraded if: i) the issuer's credit quality deteriorates by two notches or more; ii) risk in the covered bond programme increases and the overcollateralisation provided no longer supports a six-notch rating uplift; or iii) there is a deterioration in Scope's view on fundamental support factors relevant to the issuer and Austrian mortgage-covered bonds in general.

Quantitative analysis and assumptions

Scope's projections of defaults on Bank Burgenland's residential mortgage loans use an inverse Gaussian distribution. Scope derived an effective lifetime mean default rate of 12.5% and a coefficient of variation of 60%, based on internal loan-by-loan risk assessments provided by the bank and benchmarking.

Scope used a market-standard portfolio analysis to estimate default statistics for the commercial mortgage loans, taking the exposure's credit quality, its amortisation profile and asset correlation assumptions into account. A default distribution was derived for the cover pool using name-by-name credit assessments. Scope also applied a correlation framework which accounts for geographical, industry and issuer concentration. The resulting non-parametric default distribution has a mean default rate of 8.8% and a coefficient of variation of 74.9%.

Scope's recovery rate calculations reflect rating-distance-dependent market value declines as well as the agency's assumptions regarding the Austrian housing market and its unique characteristics. Scope's stressed security value haircuts range between 40.0%-70.0%, depending on the property's location. This results in recovery rates of 95.9% in the base-case and 73.7% in the most stressed scenario.

Scope used the resulting loss distribution and default timing to project the covered bond programme's losses and reflect its amortisation structure. The analysis also incorporated the impact of rating-distance-dependent interest rate stresses. The covered bond programme is most sensitive to a 'lower for longer' scenario, in which interest rates drop to negative 1% after two years and remain at that level until the last bond has been repaid. This reflects the fact that 75% of the cover assets are referenced to floating rates while 100% of the covered bonds are fixed rate.

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 200 bps, 400 bps for commercial mortgage loans and 200 bps for the substitute assets was added to the rating-distance- and scenario-dependent discount curve.

Scope tested for low (0%) and high prepayments (15%) to assess sensitivity to unscheduled repayments. The programme is most sensitive to high prepayments. As of 30 September 2019, the unstressed gap between the weighted average life of the assets and the covered bonds stands at 2.6 years (a weighted average life of 7.0 years for the assets and 9.6 years for the covered bonds, when accounting for potential call rights). However, this gap increases significantly to around six years when accounting for potential prepayments, thus increasing the negative costs of carry.

Scope assumed a recovery lag of 30 months for mortgage loans originated by Bank Burgenland, 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 the commercial loans and 10 bps for the substitute assets.

Stress testing

No stress testing was performed.

Cash flow analysis

The cover pool-supported rating uplift is based on a cash flow analysis using Scope's covered bond model (CobEL version 1.0.2). The model applies rating distance-dependent stresses to scheduled cash flows to simulate the impact of increasing credit and market risks. The model outcome is the expected loss for a given level of overcollateralisation as well as the impact of stressed asset sales or variables such as changing prepayment speeds or servicing costs.

Methodology

The primary methodology for the analysis of the covered bond ratings and outlooks is the Covered Bond Rating Methodology. The secondary methodology used is our General Structured Finance Rating Methodology for the application of Scope's idealised expected loss tables.

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 definitions of default and rating notations can be found at https://www.scoperatings.com/#governance-and-policies/rating-scale.

The rating outlook indicates the most likely direction of the rating if the rating were to change within the next 12 to 18 months.

Solicitation, key sources and quality of information

The rated entity and/or its agents 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 the issuance of the rating or outlook action, 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

This credit rating and/or rating outlook is issued by Scope Ratings GmbH.

Lead analyst: Reber Acar, Senior Analyst

Person responsible for approval of the rating: Karlo Fuchs, Managing Director

The ratings/outlooks were first released by Scope on 15 November 2017. The ratings/outlooks were last updated on 22 November 2018.

Potential conflicts

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

Conditions of use / exclusion of liability

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