Credit Rating Announcement

28 November 2022

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

The rating reflects strong support from the cover pool. Credit risks stemming from the mixed cover pool in combination with asset-liability mismatches drive the level of rating-supporting OC. High stakeholder cohesiveness increases the rating floor.

Rating action

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

Rating rationale

Sound issuer rating (positive). Bank Burgenland's issuer rating of A-/Stable[1] reflects its well-established, profitable and regionally focused banking operations in the Austrian regions of Burgenland, Vienna and Styria. Despite a traditional focus on real estate financing, Bank Burgenland's business model is very well-diversified thanks to good market positions in retail and private banking as well as in the institutional business areas of asset management and custodian banking.

Cover pool support (positive). Cover pool support[2] is the primary rating driver and adds as much as six notches of credit uplift, one notch on top of governance support factors. The cover pool uplift reflects:

1. **Cover pool complexity category (positive).** Scope assigns the interplay between complexity and transparency a cover pool complexity category of 'low', allowing for a maximum additional uplift of three notches on top of the governance uplift. (ESG factor).

2. **Overcollateralisation (positive).** The 89.9% of overcollateralisation as of 30 September 2022, on an eligible-loan basis, shields the covered bonds from market and credit risks and is well above the minimum 10.0% of overcollateralisation that supports the additional one-notch cover pool-based uplift.

3. **Mixed mortgage pool (moderate).** The mixed nature of the cover pool, comprising around 30% of commercial mortgage loans, results in moderate credit risk. Cover assets continue to be fully domestic and of high credit quality, reflected in their low average loan/value ratios.

4. **Asset-liability mismatches (moderate).** Interest rate mismatches are elevated, with around 70% of

floating rate assets compared to fully fixed rate covered bonds. Further, the gap between the weighted average life of the assets (7.5 years) and the bonds (7 years, when accounting for potential call rights) is small. However, the gap increases when accounting for potential asset prepayments.

Governance support (positive). The strength of the Austrian legal covered bond and resolution framework[3] supports up to five notches of uplift above the issuer rating, up from four notches previously. This provides (i) a higher floor against a deterioration in the credit quality of the cover pool, (ii) an increase in the rating buffer and (iii) a less severe application of credit and market stresses.

Stronger visibility and higher domestic stakeholder cohesiveness drive the increase in governance support. This reflects the consolidation of the previous three covered bond legislations into one, ongoing industry efforts to create a common Austrian covered bond brand and the regular use of public placements, also among midsize banks. (ESG factor)

One or more key drivers of the credit rating action are considered an ESG factor.

Rating-change drivers

Scope's Stable Outlook on the mortgage-covered bonds reflects a rating buffer of two notches from cover pool support. The rating may be downgraded upon: i) a deterioration in Scope's view on the credit quality of the issuer by more than two notches; ii) a deterioration in Scope's view on governance support factors (ESG factor) relevant to the issuer and Austrian mortgage-covered bonds in general as well as on the interplay between complexity and transparency (ESG factor); and/or iii) an inability of the cover pool to provide additional rating uplift.

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 9.5% 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 11.5% and a coefficient of variation of 60.1%.

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 50.0%-70.0%, depending on the property's location. This results in portfolio recovery rates of 95.0% in the base case. In the most stressed scenario Scope assumes a recovery rate of 65.2%, around 8 pp below last year's assumption, reflecting increased risks in the Austrian housing market.

Scope assumed a recovery lag of 30 months for mortgage loans originated by Bank Burgenland, and 48 months for the substitute assets.

In total, credit risk accounts for an unchanged 7 pp of the 10.0% supporting overcollateralisation. This reflects

Bank Burgenland's benefits from the increase in maximum cover pool uplift, which offsets the lower stressed recovery expectations. This is because Scope applies its credit and market stresses proportionally based on the uplift needed (six notches) and the maximum cover pool uplift possible (eight notches, up from seven notches previously).

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.

Scope tested for low (1%) and high prepayments (15%) to assess sensitivity to unscheduled repayments. The programme is most sensitive to high prepayments increasing the negative costs of carry.

Market risk accounts for the remaining 3 pp of the 10% supporting overcollateralisation, 4 pp below the previous year. This reflects: i) the increasing interest rate environment, which creates additional excess spread from the floating rate cover assets, especially under base case stresses; and ii) the application of less severe market stresses reflecting the increased maximum cover pool uplift.

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

To calculate a net present value for the cover pool in the event of an asset sale, liquidity premiums were added to the rating-distance- and scenario-dependent discount curve, of 200 bps for the residential mortgage loans and 400 bps for the commercial loans.

The programme's sensitivity was also tested to reinforce the programme's supporting overcollateralisation, specifically against front-loaded defaults and a drop in interest rates immediately after a potential recourse to the cover pool.

Rating driver references

1. Bank Burgenland –issuer rating
2. Confidential quarterly cover pool reportings
3. Govenance support assessment Austria

Stress testing

No stress testing was performed.

Cash flow analysis

The Credit Rating uplift is based on a cash flow analysis using Scope Ratings' covered bond model (CobEL version 1.0). The model applies Credit 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.

Methodology

The methodologies used for this Credit Rating and Outlook, (Covered Bond Rating Methodology, 25 April 2022, General Structured Finance Rating Methodology,17 December 2021), are available on https://scoperatings.com/governance-and-policies/rating-governance/methodologies.

Scope Ratings tested the programme's sensitivity to additional interest-rate scenarios not prescribed in the Covered Bond Rating Methodology (methodology deviation). The additional sensitivity testing did not affect the instrument's Credit Rating, but led to a higher rating-supporting overcollateralisation.

The model used for this Credit Rating and Outlook (Covered Bonds Expected Loss Model version 1.0) is available in Scope Ratings' list of models, published under https://scoperatings.com/governance-and-policies/rating-governance/methodologies.

Information on the meaning of each Credit Rating category, including definitions of default, recoveries, Outlooks and Under Review, can be viewed in 'Rating Definitions – Credit Ratings, Ancillary and Other Services', published on https://www.scoperatings.com/governance-and-policies/rating-governance/definitions-and-scales. Historical default rates of the entities rated by Scope Ratings can be viewed in the Credit

Rating performance report at https://scoperatings.com/governance-and-policies/regulatory/eu-regulation. 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 Ratings' definitions of default and Credit Rating notations can be found at https://www.scoperatings.com/governance-and-policies/rating-governance/definitions-and-scales. Guidance and information on how environmental, social or governance factors (ESG factors) are incorporated into the Credit Rating can be found in the respective sections of the methodologies or guidance documents provided on https://scoperatings.com/governance-and-policies/rating-governance/methodologies.
The Outlook indicates the most likely direction of the Credit Rating if the Credit Rating were to change within the next 12 to 18 months.

Solicitation, key sources and quality of information

The Rated Entity and/or its Related Third Parties participated in the Credit 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 Ratings considers the quality of information available to Scope Ratings on the Rated Entity or instrument to be satisfactory. The information and data supporting these Credit Ratings originate from sources Scope Ratings considers to be reliable and accurate. Scope Ratings does not, however, independently verify the reliability and accuracy of the information and data.
Prior to the issuance of the Credit Rating action, the Rated Entity was given the opportunity to review the Credit Ratings and Outlook and the principal grounds on which the Credit Ratings and Outlook are based. Following that review, the Credit Ratings were not amended before being issued.

Regulatory disclosures

These Credit Ratings and Outlook are issued by Scope Ratings GmbH, Lennéstraße 5, D-10785 Berlin, Tel +49 30 27891-0. The Credit Ratings and Outlook are UK-endorsed.
Lead analyst: Reber Acar, Associate Director
Person responsible for approval of the rating: Benoit Vasseur, Executive Director
The Credit Rating/Outlook was first released by Scope Ratings on 15 November 2017. The Credit Ratings/Outlook were last updated on 30 November 2021.

Potential conflicts

See www.scoperatings.com under Governance & Policies/EU Regulation/Disclosures for a list of potential conflicts of interest related to the issuance of Credit Ratings.

Conditions of use / exclusion of liability

About Scope Group

With more than 250 employees operating from offices in Berlin, Frankfurt, Hamburg, London, Madrid, Milan, Oslo and Paris, Scope Group is the leading European provider of independent credit ratings, ESG and fund analysis. Based on forward-looking and innovative methodologies, Scope offers a European perspective that contributes to greater diversity of opinion for institutional investors worldwide. **Scope Ratings** is the largest European credit rating agency, registered in accordance with EU and UK rating agency regulation, offering opinion-driven and non-mechanistic credit risk analysis. **Scope ESG Analysis** provides tools for analysing and reporting on ESG impact and risk, as well as second-party opinions on green, social and sustainable bonds. **Scope Fund Analysis** rates more than 10,000 funds and asset managers across all major asset classes. The shareholders of Scope Group include CEO and founder Florian Schoeller and anchor shareholder Stefan Quandt, numerous senior personalities in European finance and industry as well as institutional investors from several European countries. More on www.scopegroup.com

Contact

Analyst	Reber Acar	r.acar@scoperatings.com
Team leader	Karlo Fuchs	k.fuchs@scoperatings.com