Credit Rating Announcement

22 November 2023

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

The rating reflects a combination of cover pool and governance support. Credit risks stemming from the mixed cover pool in combination with interest rate mismatches between assets and liabilitites drive the level of rating-supporting overcollateralisation

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).

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 70.5% of overcollateralisation as of 30 September 2023, 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 (excluding housing associations), results in moderate credit risk. Cover assets continue to be fully domestic and of good credit quality, reflected in their low average loan to value ratios.

4. **Asset-liability mismatches (moderate).** Interest rate mismatches are elevated, with around 65% of floating rate assets compared to 93.4% of fixed rate covered bonds. While under the current high

interest rates, this benefits the programme, it is likewise exposed to declining rates – especially if more bonds are refinanced under the current marketrates. Maturity mismatches are relatively low. The weighted average life of the covered bonds of 10.5 years compares to 7.4 years of the cover assets. The bonds do benefit from call rights (which we assume to be exercised) bringing down the WAL to 6 years only. Such exercise however is discretionary and may, if not exercised, increase the programmes risk profile.

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. This effectively provides a floor against deterioration in the cover pool's credit quality (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 resized the commercial and residential portfolio by allocating larger housing associations into the commercial subportfolio. With this, the residential portfolio accounted to around 40% instead of 70%.

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 11.0% and a coefficient of variation of 60%, based on internal loan-by-loan risk assessments provided by the bank and benchmarking.

For the commercial mortgage portfolio Scope used a market-standard portfolio analysis to estimate default statistics, taking the exposure's credit quality, its amortisation profile and asset correlation assumptions into account. A default distribution was derived for the cover pool taking the banks risk scoring into account. 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 10.4% and an implied coefficient of variation of 78.3%.

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 48%-76%, depending on the property's type and location. This results in portfolio recovery rates of 99.0% in the base case. In the most stressed scenario Scope assumes a recovery rate of 68.3%.

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. Reflecting the widely stable credit metrics.

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 low prepayments increasing the costs of asset sales should available cash becomes insufficient to pay maturing bond.

Market risk accounts for the remaining 3 pp of the 10% supporting overcollateralisation. This mainly reflects the high interest rate environment, which creates additional excess spread from the floating rate cover assets, especially under base case stresses.

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 and taken into account to reinforce the programme's supporting overcollateralisation, specifically against a drop in interest rates immediately after a potential recourse to the cover pool as well as a scenario under which no call rights are executed.

Rating driver references

1. Bank Burgenland –issuer rating
2. Confidential quarterly cover pool reportings (Confidential)
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 1.1). 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 methodology used for this Credit Rating and Outlook, (Covered Bond Rating Methodology, 24 May 2023), is available on https://scoperatings.com/governance-and-policies/rating-governance/methodologies.
The models used for this Credit Rating and Outlook are (Covered Bonds Expected Loss Model Version 1.1 and Portfolio Model Version 1.1), 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 and Scope Ratings' 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 the Credit Rating 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 Rating and Outlook and the principal grounds on which the Credit Rating and Outlook are based. Following that review, the Credit Rating was not amended before being issued.

Regulatory disclosures

The Credit Rating and Outlook is issued by Scope Ratings GmbH, Lennéstraße 5, D-10785 Berlin, Tel +49 30 27891-0. The Credit Rating and Outlook is UK-endorsed.

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Person responsible for approval of the Credit Rating: Antonio Casado, Managing Director

The Credit Rating/Outlook was first released by Scope Ratings on 15 November 2017. The Credit Ratings/Outlook were last updated on 28 November 2022.

Potential conflicts

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

Conditions of use / exclusion of liability

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