

FITCH DOWNGRADES 2 GERMAN PUBLIC SECTOR PFANDBRIEF PROGRAMMES, AFFIRMS OTHERS, WITHDRAWS 3 RATINGS

Link to Fitch Ratings' Report: Germany Covered Bond Programmes - Rating Action Report
<https://www.fitchratings.com/site/re/891592>

Fitch Ratings-Frankfurt/London-05 December 2016: Fitch Ratings has downgraded the ratings of two German public sector Pfandbrief (Covered Bond) programmes and affirmed six others following the implementation of the agency's revised Covered Bonds Rating Criteria published on 26 October 2016.

The following public sector covered bond programmes have been downgraded:

- Berlin Hyp's (BHB, A+/Stable/F1+) public sector Pfandbriefe rating downgraded to 'AA' from 'AA+'. The Outlook is Stable
- Commerzbank AG's (CBK, BBB+/Stable/F2) public sector Pfandbriefe downgraded to 'A+' from 'AA'; off Rating Watch Negative (RWN). Outlook Stable

The following six public sector covered bond programmes have been affirmed at 'AAA' /Stable:

- Aareal Bank AG's (ARB, BBB+/Stable/F2) public sector Pfandbriefe
- Bayerische Landesbank AG's (BLB, A-/Stable/F2) public sector Pfandbriefe
- Landesbank Baden-Wuerttemberg's (LBBW, A-/Stable/F1+) public sector Pfandbriefe
- Landesbank Hessen-Thueringen Girozentrale's (LBH, A+/Stable/F1+) public sector Pfandbriefe
- Unicredit Bank AG's (HVB, A-/Negative/F2) public sector Pfandbriefe
- Norddeutsche Landesbank Girozentrale's (NLB, A-/Stable/F1) public sector Pfandbriefe.

The public sector covered bond ratings of BHB, CBK and NLB have been withdrawn for commercial reasons.

The downgrade of CBK's public sector Pfandbriefe follows an updated full analysis of CBK's public sector cover pool after the integration of Hypothekbank Frankfurt's (HF) cover assets and outstanding public sector Pfandbriefe into CBK's public sector programme in May 2016. This led to a sharp increase in the cover pool to EUR15.9bn at end-June 2016 from EUR2.4bn at end-June 2015. The RWN was placed on the rating in June 2016 to reflect uncertainties on the outcome of a full analysis given limited information at the time.

CBK's programme's updated analysis resulted in a greater rating loss rate for the combined cover pool of 14.7% in a 'AA' rating scenario, versus 0% for the pre-transfer CBK pool, reflecting increased international exposure that included sub-investment grade rated assets (9% of the cover pool) and further peripheral Europe exposure (5.5% of the cover pool). The portfolio's weighted average rating fell to 'A-'/BBB+' from 'AAA'/'AA+' during the same period.

Furthermore, net present value differences in scenarios where Fitch tested for timely payment increased significantly, resulting from the high coupons of HF's outstanding public sector Pfandbriefe, significantly compressing the spread of the programme. Additionally the open FX position on the asset side now exceeds Fitch's 10% threshold. For ratings above 'A+' the combination of the above mentioned risks resulted in breakeven overcollateralisation (OC) levels being significantly above the current relied-upon OC of 14.2%.

Issuer Default Rating (IDR) Uplift

German Pfandbriefe are eligible for a maximum IDR uplift of two notches given their exemption from bail-in in a resolution scenario, Fitch's assessment that resolution of the issuer will not result in the direct enforcement of recourse against the cover pool and the low risk of undercollateralisation at the point of resolution (see Fitch's Jurisdictional Analysis of the Risk of Undercollateralisation of Covered Bonds - Excel file).

Fitch has assigned BHB's, BLB's, LBBW's and NLB's public sector programmes one-notch IDR uplift as their Long-Term IDR's are based on institutional support. Their IDRs benefit from significant uplift from support, above their Viability Ratings (VR), which range from 'bb+' to bbb+'. For BHB's public sector programme, the reduction of the IDR uplift to one notch led to today's downgrade of the covered bond rating.

We have assigned the other four programmes a two-notch IDR uplift, as the banks' Long-Term IDRs are either driven by their Viability Ratings (VR), which is the case for ARB, CBK and HVB or, in the case of LBH, by its Long-Term IDR being based on its participation in a mutual support scheme.

Payment Continuity Uplift (PCU)

Fitch has assigned a PCU of five notches to all eight public sector programmes based on the mandatory inclusion of liquid assets in the cover pool matching the maximum negative cumulated balance of cash flows for the next 180 days. Fitch also gives credit to the larger range of refinancing options offered for such cover pools. In our view this provides effective protection for interest and principal payments for standard German public sector Pfandbriefe.

Recovery Uplift

BHB's and CBK's programmes could potentially achieve a two-notch recovery uplift but because the OC relied upon by Fitch in its analysis does not offset the stressed 'AA+' (BHB) and 'AA-' (CBK) credit losses for these programmes they have been assigned a one-notch recovery uplift.

All other public sector programmes benefit from a two-notch recovery uplift, as the OC Fitch takes into account compensates for credit losses modelled in a stress scenario corresponding to the level of their respective covered bond ratings, and no material downside risk to recovery expectations has been identified.

Breakeven OC for Ratings

Given that Fitch does not necessarily test OC for timely payment if the covered bond rating can be reached based on a combination of the IDR uplift and two-notch recovery uplift, the breakeven OC will correspond to the stressed credit loss for the target rating level provided this is below the relied-upon OC. This is the case for LBH's programme. As the 'AAA' credit loss exceeds the OC previously needed for a 'AAA' rating, the 'AAA' breakeven OC for this programme has increased to 7% from 3.5% previously.

As per criteria, Fitch floors the breakeven OC for the rating at the minimum regulatory OC of 0% (or 2% on a net present value basis) when the analysis results in a lower breakeven OC. This is the case for BHB's and CBK's public sector covered bond programmes.

Following the update of its refinancing spread levels and fire-sale discount assumptions NLB's breakeven OC has decreased to 18.5% from 19%.

HVB's 'AAA' breakeven OC has decreased to 12.5% from 15% as no commingling loss has been reflected in the breakeven OC. This is because HVB's IDR of 'A-' sufficiently mitigates commingling risk for the tested 'AA' rating on a tested Probability of Default (PD) basis. Fitch no longer accounts for commingling loss in the recovery uplift assessment.

A summary of rating steps for the programmes mentioned in this commentary can be found in the excel file "German Covered Bond Programmes - Rating Action Report" dated 5 December 2016 which can be accessed in the link above.

VARIATIONS FROM CRITERIA

CBK Public Sector Pfandbriefe

Fitch has applied a variation from its 'Asset Analysis Criteria for Covered Bonds and CDOs of European Public Entities'. Fitch applied a 'CCC' assumption to unrated single obligor concentrations below 2% of the cover pool and without individual credit opinions. The application of this variation has had no impact on CBK's covered bond rating.

Fitch has applied a variation from its 'Covered Bonds Rating Criteria'. Fitch took into account the sub-buckets for GBP and USD to calculate the open FX position instead of considering the FX buckets' weighted average life. The application of this variation has had no impact on CBK's covered bond rating.

LBBW Public Sector Pfandbriefe

Fitch has applied a variation from its 'Asset Analysis Criteria for Covered Bonds and CDOs of European Public Entities'. Fitch applied a 'CCC' assumption to unrated single obligor concentrations below 2% of the cover pool and without individual credit opinions. The application of this variation has had no impact on LBBW's covered bond rating.

KEY RATING DRIVERS

ARB Public Sector Pfandbriefe

ARB's public sector covered bonds are rated 'AAA', seven notches above the bank's Long-Term IDR of 'BBB+'. This is based on an IDR uplift of two notches, a newly assigned PCU of five notches and a recovery uplift of two notches. The OC of 15.9% which Fitch relies upon in its analysis provides more protection than the unchanged breakeven OC of 15% for a 'AAA' rating. The breakeven OC corresponds to a 'AA' tested rating on a PD basis and a two-notch recovery uplift. The Stable Outlook on the covered bonds' rating reflects that on ARB's Long-Term IDR and the two-notch buffer against a downgrade of the bank due to different uplift factors above the bank's IDR.

BHB Public Sector Pfandbriefe

Prior to its withdrawal BHB public sector covered bonds' 'AA' rating was based on the bank's Long-Term IDR of 'A+', an IDR uplift of one notch and a recovery uplift of one notch. Fitch deemed this programme to be dormant and, in the absence of a public OC statement, it relied on the legal minimum OC, which is the higher of 0% on a nominal basis and 2% on a stressed net present value basis. The Stable Outlook on the covered bonds' rating reflected that on BHB's Long-Term IDR.

BLB Public Sector Pfandbriefe

BLB's public sector covered bonds are rated 'AAA', six notches above the bank's Long-Term IDR of 'A-'. This is based on an IDR uplift of one notch, a newly assigned PCU of five notches and a recovery uplift of two notches. The OC of 33.2% which Fitch relies upon in its analysis provides more protection than the unchanged breakeven OC of 12% for a 'AAA' rating. The breakeven OC corresponds to a 'AA' tested rating on a PD basis and a two-notch recovery uplift. The Stable Outlook on the covered bonds' rating reflects that on BLB's Long-Term IDR and the two-notch buffer against a downgrade of the bank due to different uplift factors above the bank's IDR.

CBK Public Sector Pfandbriefe

Prior to its withdrawal CBK public sector covered bonds' 'A+' rating was based on the bank's Long-Term IDR of 'BBB+', an IDR uplift of two notches and a one-notch recovery uplift. The

one notch recovery uplift is supported by the legal minimum OC, which is the higher of 0% on a nominal basis and 2% on a stressed net present value basis. The Stable Outlook on the covered bonds' rating reflected that on CBK's Long-Term IDR.

LBBW Public Sector Pfandbriefe

LBBW's public sector covered bonds are rated 'AAA', six notches above the bank's Long-Term IDR of 'A-'. This is based on an IDR uplift of one notch, a newly assigned PCU of five notches and a recovery uplift of two notches. The OC of 32.5% which Fitch relies upon in its analysis provides more protection than the unchanged breakeven OC of 14% for a 'AAA' rating. The breakeven OC corresponds to a 'AA' tested rating on a PD basis and a two-notch recovery uplift. The Stable Outlook on the covered bonds' rating reflects that on LBBW's Long-Term IDR and the two-notch buffer against a downgrade of the bank due to different uplift factors above the bank's IDR.

LBH Public Sector Pfandbriefe

LBH's public sector covered bonds are rated 'AAA', four notches above the bank's Long-Term IDR of 'A+'. This is based on an IDR uplift of two notches and a two-notch recovery uplift. The covered bonds achieve the 'AAA' rating on a recovery basis as the relied-upon OC of 7.6% covers the rating level credit loss of 7%. The Stable Outlook on the covered bonds' rating reflects that on LBH's Long-Term IDR and the five-notch buffer against a downgrade of the bank due to different uplift factors above the bank's IDR.

NLB Public Sector Pfandbriefe

NLB's public sector covered bonds are rated 'AAA', six notches above the bank's Long-Term IDR of 'A-'. This is based on an IDR uplift of one notch, a newly assigned PCU of five notches and a recovery uplift of two notches. The OC of 20.5% which Fitch relies upon in its analysis provides more protection than the breakeven OC of 18.5% for a 'AAA' rating. The breakeven OC corresponds to a 'AA' tested rating on a PD basis and a two-notch recovery uplift. The Stable Outlook on the covered bonds' rating that on NLB's Long-Term IDR and the two-notch buffer against a downgrade of the bank due to different uplift factors above the bank's IDR.

HVB Public Sector Pfandbriefe

HVB's public sector covered bonds are rated 'AAA', six notches above the bank's Long-Term IDR of 'A-'. This is based on an IDR uplift of two notches, a newly assigned PCU of five notches and a recovery uplift of two notches. The OC of 36.9% that Fitch relies upon in its analysis provides more protection than the breakeven OC of 12.5% for a 'AAA' rating. The breakeven OC corresponds to a 'AA' tested rating on a PD basis and a two-notch recovery uplift. The Outlook on the covered bonds' rating is Stable despite the Negative Outlook on HVB's IDR given that a one notch downgrade to its parent's IDR would not result in a downgrade of the covered bonds. This is because of the three-notch buffer against a downgrade of the bank due to different uplift factors above the bank's IDR.

RATING SENSITIVITIES

Aareal Bank AG (ARB) Public Sector Covered Bonds

The 'AAA' rating would be vulnerable to downgrade if any of the following occurs: (i) ARB's Long-Term Issuer Default Rating (IDR) is downgraded by three or more notches to 'BB+' or below or (ii) the OC that Fitch considers in its analysis drops below Fitch's 'AAA' breakeven level of 15%. If the OC that Fitch considers in its analysis drops to the legal minimum requirement of 0%, the rating would likely be downgraded to 'A+'.

Bayerische Landesbank (BLB) Public Sector Covered Bonds

The 'AAA' rating would be vulnerable to downgrade if any of the following occurs: (i) BLB's Long-Term IDR is downgraded by three or more notches to 'BBB-' or below or (ii) the OC that Fitch considers in its analysis drops below Fitch's 'AAA' breakeven level of 12%. If the OC that

Fitch considers in its analysis drops to the legal minimum requirement of 0%, the rating would likely be downgraded to 'A+'.

Berlin Hyp (BHB) Public Sector Covered Bonds
Not applicable as the rating has been withdrawn.

Commerzbank AG (CBK) Public Sector Covered Bonds
Not applicable as the rating has been withdrawn.

Landesbank Hessen-Thuringen (LBH) Public Sector Covered Bonds
The 'AAA' rating would be vulnerable to downgrade if LBH's IDR is downgraded to 'BB+' or below or (ii) the OC that Fitch considers in its analysis drops below Fitch's 'AAA' breakeven level of 7%. If the OC that Fitch considers in its analysis drops to the legal minimum requirement of 0%, the rating would likely be downgraded to 'AA+'.

Landesbank Baden-Wuerttemberg (LBBW) Public Sector Covered Bonds
The 'AAA' rating would be vulnerable to downgrade if any of the following occurs: (i) LBBW's Long-Term Issuer IDR is downgraded by three or more notches to 'BBB-' or below or (ii) the OC that Fitch considers in its analysis drops below Fitch's 'AAA' breakeven level of 14%. If the OC that Fitch considers in its analysis drops to the legal minimum requirement, the rating would likely be downgraded to 'A+'.

Norddeutsche Landesbank Girozentrale (NLB) Public Sector Covered Bonds
Not applicable as rating has been withdrawn.

Unicredit Bank AG (HVB) Public Sector Covered Bonds
The 'AAA' rating would be vulnerable to downgrade if any of the following occurs: (i) HVB's Long-Term IDR is downgraded by four or more notches to 'BB+' or below or (ii) the OC that Fitch considers in its analysis drops below Fitch's 'AAA' breakeven level of 12.5%. If the OC that Fitch considers in its analysis drops to the legal minimum requirement of 0%, the rating would likely be downgraded to 'AA-'.

Fitch's breakeven OC for a given covered bond rating will be affected by, among other factors, the profile of the cover assets relative to outstanding covered bonds, which can change over time even in the absence of new issuance. Therefore, the breakeven OC for a covered bonds rating cannot be assumed to remain stable over time.

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Applicable Criteria

Asset Analysis Criteria for Covered Bonds and CDOs of European Public Entities (pub. 20 Jan 2016)

<https://www.fitchratings.com/site/re/876457>

Counterparty Criteria for Structured Finance and Covered Bonds (pub. 01 Sep 2016)

<https://www.fitchratings.com/site/re/886006>

Counterparty Criteria for Structured Finance and Covered Bonds: Derivative Addendum (pub. 18 Jul 2016)

<https://www.fitchratings.com/site/re/884964>

Covered Bonds Rating Criteria (pub. 26 Oct 2016)

<https://www.fitchratings.com/site/re/888874>

Criteria for Country Risk in Global Structured Finance and Covered Bonds (pub. 26 Sep 2016)

<https://www.fitchratings.com/site/re/881269>

Criteria for Interest Rate Stresses in Structured Finance Transactions and Covered Bonds (pub. 26 Oct 2016)

<https://www.fitchratings.com/site/re/888492>

Fitch's Cover Asset Refinancing Spread Level (RSL) Assumptions - Excel File (pub. 26 Oct 2016)

<https://www.fitchratings.com/site/re/888877>

Fitch's Interest Rate Stress Assumptions for Structured Finance and Covered Bonds - Excel File (pub. 17 May 2016)

<https://www.fitchratings.com/site/re/880522>

Fitch's Foreign-Currency Stress Assumptions for Residual Foreign-Exchange Exposures in Covered Bonds and Structured Finance – Excel File (pub. 26 Oct 2016)

<https://www.fitchratings.com/site/re/888865>

Global Bank Rating Criteria (pub. 25 Nov 2016)

<https://www.fitchratings.com/site/re/891051>

Related Research

Fitch's Jurisdictional Analysis of the Risk of Undercollateralisation of Covered Bonds - Excel file

<https://www.fitchratings.com/site/re/884084>

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