

## Transaction Update: Dexia Kommunalbank Deutschland AG (Public Sector Covered Bonds)

### Oeffentliche Pfandbriefe

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## Oeffentliche Pfandbriefe

### Ratings Detail

Reference Rating Level	bbb		Jurisdictional-Supported Rating Level	a		Maximum Achievable Covered Bond Rating	a		Covered Bond Rating	
Resolution Regime Uplift	+2	+	Assigned Jurisdictional Support Uplift	+3	+	Collateral Support Uplift	0	=	A/Stable	
Systemic Importance	Very Strong		Jurisdictional Support Assessment	Very Strong		Overcollateralization Adjustment	-1		Rating Constraints	a
Adjusted Issuer Credit Rating	bb		Legal Framework	Very Strong		Liquidity Adjustment	0		Counterparty Risk	aaa
GRE And Sovereign Support	-3		Systemic Importance	Very Strong		Potential Collateral-Based Uplift	0		Country Risk	a
Issuer Credit Rating	BBB		Sovereign Credit Capacity	aaa						

\*Dexia Kommunalbank Deutschland AG (DKD) is a core entity to its parent Dexia Credit Local (DCL; BBB/Stable/A-2). Therefore, we derive the ratings on the covered bonds by applying notches of uplift to the long-term issuer credit rating (ICR) on DCL.

### Major Rating Factors

#### Strengths

- Strong credit quality of the public sector assets in the cover pool.
- Relatively well-matched asset and liability maturity profiles.
- Very strong jurisdictional support and 180 days liquidity coverage required by law.

#### Weaknesses

- Obligor-level concentration risks in the cover pool, which we reflect in our credit enhancement results.
- Commingling and bank account risk that is not addressed structurally or by the German legal framework.

## Outlook

S&P Global Ratings' stable outlook on its ratings on Dexia Kommunalbank Deutschland AG's (DKD) public sector covered bond program and related issuances reflects the outlook on the long-term issuer credit rating (ICR). As there are no unused notches of uplift, a lowering of the ICR would have a direct impact on the ratings on the covered bonds.

## Rationale

We have today affirmed our 'A' ratings on DKD's public sector covered bond program and related issuances (see "Ratings On Dexia Kommunalbank Deutschland's Public Sector Covered Bonds Affirmed At 'A' Following Review; Outlook Stable").

Our rating analysis for the covered bonds follows the framework set out in our criteria article "Covered Bond Ratings Framework: Methodology And Assumptions," published on June 30, 2015.

The 'A' ratings on DKD's covered bonds reflect our rating reference level (RRL) of 'bbb' and jurisdiction-supported reference level (JRL) of 'a' for the program under our covered bonds criteria (see "Covered Bonds Criteria," published on Dec. 9, 2014).

We do not assign any notches of collateral-based uplift above the JRL, because the available credit enhancement of 7.65% is below the level that we would consider commensurate with the first notch of collateral-based uplift.

Finally, we also consider legal, regulatory, and operational risks, which do not constrain our ratings on the covered bonds.

## Program Description

**Table 1**

Program Overview*	
Jurisdiction	Germany
Year of first issuance	1997
Covered bond type	Legislation-enabled
Outstanding covered bonds (bil. €)	
Redemption profile	Hard bullet
Underlying assets	Public sector
Jurisdictional support uplift	3
Unused notches for jurisdictional support	0
Target credit enhancement (%)	18.14
Available credit enhancement (%)	7.65
Collateral support uplift	0
Unused notches for collateral support	0
Total unused notches	0

\*Based on data as of Sept. 30, 2016.

**Table 2**

Program Participants			
Role	Name	Rating	Rating dependency
Issuer	Dexia Kommunalbank Deutschland AG	NR*	Yes
Account bank	Deutsche Bundesbank	AAA/Stable/A-1+ (ECB branch§)	Yes
Account bank	Clearstream Banking Frankfurt (CBF)	NR	No
Account bank	Banque Internationale a Luxembourg	A-/Stable/A-2	No
Account bank	Skandinaviska Enskilda Banken AB (publ)	A+/Stable/A-1	No
Account bank	Citibank Japan Ltd.	A+/Stable/A-1	No

\*Dexia Kommunalbank Deutschland AG (DKD) is a core entity to its parent Dexia Credit Local (DCL; BBB/Stable/A-2). Therefore, we derive the ratings on the covered bonds by applying notches of uplift to the long-term ICR on DCL. §As long as we believe Germany is unlikely to exit the eurozone (European Economic And Monetary Union), we consider Bundesbank's credit standing to be indistinguishable from that of the European Central Bank (unsolicited AAA/Stable/A-1+). NR--Not rated.

## Rating Analysis

### Legal and regulatory risks

We consider that the German covered bond legal framework satisfies the relevant legal aspects of our covered bonds criteria. This enables us to assign ratings to the covered bonds that exceed the long-term ICR on the issuer.

The German Covered Bond Act (Pfandbriefgesetz; "PfandBG") and the relevant secondary legislation provide the legal framework for the issuance of German covered bonds (Pfandbriefe). The current Covered Bond Act was introduced in 2005 and last amended in January 2015. Under the framework, banks can issue public sector, mortgage, ship, and aircraft covered bonds.

Covered bond investors have a preferential claim to a cover pool of assets which, for public sector covered bonds, may comprise exposures to state, regional, and local public sector authorities of EU/European Economic Area countries, as well as exposures to public sector entities in Canada, the U.S., Japan, and Switzerland. Additionally, the cover pool can also comprise eligible substitute assets.

According to the legal framework, the issuer must maintain overcollateralization of at least 2% on a net present value basis for the outstanding covered bonds (a risk-based add-on might be requested by BaFin, the German supervisory authority for financial institutions) and ensure 180 days of liquidity needs at all times.

An independent trustee is responsible for monitoring the cover pool (cover pool monitor) until an independent cover pool administrator is appointed in case of the issuer's insolvency. BaFin appoints and supervises the cover pool monitor and cover pool administrator. BaFin also regularly conducts a special covered bond audit, usually every two years (see paragraph 3 of the PfandBG).

We have analyzed the risk that, if the issuing bank becomes insolvent, cash received from the cover pool assets could be commingled with the cash belonging to the bank, resulting in a loss to the cover pool. We have determined that the German Covered Bond Act effectively segregates cash received after the issuing bank's insolvency, but that cash received shortly before insolvency and not reinvested in the cover pool assets could be exposed to commingling risk. We address this risk in our cash flow analysis (see "Collateral support analysis").

In our analysis of legal risk we considered the guidelines in "Europe Asset Isolation And Special-Purpose Entity Criteria--Structured Finance," published on Sept. 13, 2013, as well as our covered bonds rating framework criteria.

### **Operational and administrative risks**

We review operational risk according to our covered bonds rating framework criteria. We consider the procedures used by the issuing bank in the origination and monitoring of the cover pool assets.

Since the European Commission's approval of the revised orderly resolution plan of the Dexia Group in December 2012, DKD is in run-off management without new lending business.

There are no operational risks that would require a particular adjustment to our standard credit or cash flow assumptions. The issuer has a track record of cautiously managing risks and overcollateralization within the covered bond program. We also believe that there is a high likelihood that the issuer could appoint a replacement cover pool manager if it became unable to manage the program following its default.

### **Resolution regime analysis**

The RRL on the issuer, which is the starting point for any further uplift in our analysis, is 'bbb'. We consider the following factors:

- DKD is domiciled in Germany, which is subject to the EU's BRRD.
- In line with our covered bonds criteria, because the adjusted ICR is below our 'BBB' long-term ICR on the bank, the long-term ICR on the issuing bank caps our ratings on the covered bonds.

### **Jurisdictional support analysis**

The JRL on the issuer's public sector covered bonds is 'a'. Based on the application of our covered bonds criteria, ratings on public sector covered bonds in Germany would be eligible for three notches of uplift from the RRL given our very strong jurisdictional support assessment of German public sector covered bonds (see "Assessments For Jurisdictional Support According To Our Covered Bonds Criteria," published on July 20, 2016). We also consider that the issuer's cover pool continues to comply with legal and regulatory minimum standards in Germany and that there are no limitations from the foreign currency rating on the German sovereign.

### **Collateral support analysis**

We base our analysis on the data provided by the issuer as of Sept. 30, 2016. The pool comprises mainly public sector assets.

Compared to our previous analysis based on the data from Dec. 31, 2014, the scenario default rate (SDR) has deteriorated mainly due to the cover pool being more concentrated in the current period. The recovery assumptions marginally improved due to a higher share of local and regional governments with recovery category 'A' in the cover pool--for which we assign our highest recovery rates--during the same period.

We have not assigned any notches of collateral-based uplift above the JRL. This is because the available credit enhancement of 7.65% is below the level that we would consider to be commensurate with the first notch of collateral-based uplift.

Under our criteria, to achieve the first notch of collateral-based uplift, the available credit enhancement must exceed

the higher of 'AAA' credit risk plus 25% refinancing costs (which we calculate as 10.52%) and the result of our supplemental tests (14.90%, explained below).

In particular, these supplemental tests capture concentration risks in the cover pool. In the case of DKD, the largest industry test, and more specifically, the alternative largest industry test applied to German local and regional governments (LRGs), has driven our OC requirements for any collateral-based uplift notches. The largest industry test involves calculating the total net loss, assuming the default of a certain number of the largest individual obligor exposures of a similar nature (in this case, German LRGs) depending on their rating, and applying a stressed recovery rate. In this cover pool, the exposure to the six largest obligors rated 'AA+' or below is €6.503 million. These exposures are to German Bundesländer. Under our criteria for analyzing pools of public sector assets, we have applied a recovery rate of 60% in this supplemental test, resulting in a net loss of €2.601 million. This represents 14.90% of overcollateralization. In order to cover a 'AAA' credit stress scenario, the available credit enhancement must exceed this net loss result.

Finally, the target credit enhancement level has increased to 18.14% from 16.9% since our previous review, due to our more severe credit assumptions and higher commingling risks.

The overcollateralization needed for the 'A' rating is 3.44%, which is the required credit enhancement to achieve the current 'A' rating, on the sole basis of its jurisdictional support and represents the amount of overcollateralization needed to cover commingling risk, as this risk is not covered by the legislation.

**Table 3**

Key Credit Metrics		
	As of Sept. 30, 2016	As of Nov. 30, 2015
Weighted-average cover pool asset rating	BBB+	BBB+
Weighted-average loan asset maturity (years)	8.75	8.97
Largest obligor (% of the cover pool)	9.72	8.49
20 largest obligors (% of cover pool)	64.94	61.52
Credit analysis results:		
Scenario default rate (SDR) (%)	29.36	26.94
Weighted-average recovery rate (%)	79.90	78.29
Weighted-average time to recovery (years)	3.44	3.33
Largest obligor test result (% of covered bonds)	13.08	10.72
Largest industry test result (% of covered bonds)	14.90	13.77

**Table 4**

Asset Distribution By Geography		
	As of Sept. 30, 2016	As of Nov. 30, 2015
	Percentage of cover pool	
Germany	66.04	65.79
Italy	10.72	8.96
Austria	7.58	7.37
Belgium	6.06	5.84
Portugal	2.32	2.90

**Table 4****Asset Distribution By Geography (cont.)**

	As of Sept. 30, 2016	As of Nov. 30, 2015
Other	7.28	9.14

**Table 5****Recovery Assumptions For Cover Pool Assets\***

As of Sept. 30, 2016					
Borrower type	Recovery classification*	'AAA' recovery rate (%)	Time to recovery (years)	Percentage of cover pool as of Sept. 30, 2016	
German states	Public sector category A	90	4	42.4	
German municipalities outside Nordrhein-Westfalen (NRW)	Public sector category A	90	4	14.09	
Austrian state	Public sector category A	90	4	7.2	
Sovereigns and sovereign-related	Sovereign	37	0	9.9	
German municipalities in NRW	Public sector category B	75	4	6.68	
Belgium communities	Public sector category A	90	4	6.06	
Municipal enterprises	Public sector category C	18	0	2.25	
Other public sector assets	Various	Various	Various	11.42	
Total cover pool assets				100	

\*According to our criteria for pools of public sector assets.

**Table 6****Asset Distribution By Rating**

	As of Sept. 30, 2016	As of Nov. 30, 2015
	--Percentage of cover pool--	
AAA	4	4
AA	52	49
A	23	28
BBB	14	12
BB or lower	7	7
Total	100	100

**Table 7****Collateral Uplift Metrics**

	As of Sept. 30, 2016	As of Dec. 31, 2015
Asset WAM (years)	8.84	9.59
Liability WAM (years)	6.98	7.12
Available credit enhancement	7.65	7.75
Required credit enhancement for first notch of collateral uplift (%)	10.20	9.81
Required credit enhancement for second notch of collateral uplift (%)	12.85	12.17
Required credit enhancement for third notch of collateral uplift (%)	15.49	14.54

**Table 7**

<b>Collateral Uplift Metrics (cont.)</b>		
	<b>As of Sept. 30, 2016</b>	<b>As of Dec. 31, 2015</b>
Target credit enhancement for maximum uplift (%)	18.14	16.9
Potential collateral-based uplift (notches)	4	4
Adjustment for liquidity (Y/N)	N	N
Adjustment for committed overcollateralization (Y/N)	Y	Y
Collateral support uplift (notches)	0	0

\*Results under previous criteria. WAM--Weighted-average maturity.

### Counterparty risk

We have identified bank account risk and commingling risk as relevant for the program. While these risks are not structurally mitigated, they do not constrain the ratings as we have taken them into account in our cash flow modeling, or by introducing a cap to the long-term ICR on the German central bank, Bundesbank, one of DKD's account banks (see "Assessing Credit Quality By The Weakest Link," published Feb. 13, 2012).

We analyzed the counterparty risks according to our criteria "Counterparty Risk Framework Methodology And Assumptions," published on June 25, 2013 and "Counterparty Risk In Covered Bonds," published on Dec. 21, 2015).

### Country risk

The covered bond cover pool includes loans to obligors in multiple jurisdictions. When assigning covered bond ratings for multijurisdictional pools that exceed the ratings on sovereigns we apply our structured finance ratings above the sovereign criteria (see "Ratings Above The Sovereign - Structured Finance: Methodology And Assumptions," published on Aug. 8, 2016). Although the cover pool comprises assets from different jurisdictions, we do not assign any ratings uplift based on the collateral, therefore country risk does not constrain the ratings on the covered bonds.

## Related Criteria And Research

### Related Criteria

- Criteria - Structured Finance - General: Ratings Above The Sovereign - Structured Finance: Methodology And Assumptions, Aug. 08, 2016
- Criteria - Structured Finance - Covered Bonds: Counterparty Risk Analysis In Covered Bonds, Dec. 21, 2015
- Criteria - Structured Finance - Covered Bonds: Covered Bond Ratings Framework: Methodology And Assumptions, June 30, 2015
- Criteria - Structured Finance - Covered Bonds: Covered Bonds Criteria, Dec. 09, 2014
- Criteria - Structured Finance - Covered Bonds: Methodology And Assumptions For Assessing Portfolios Of International Public Sector And Other Debt Obligations Backing Covered Bonds And Structured Finance Securities, Dec. 09, 2014
- Legal Criteria: Europe Asset Isolation And Special-Purpose Entity Criteria--Structured Finance, Sept. 13, 2013
- Criteria - Structured Finance - General: Counterparty Risk Framework Methodology And Assumptions, June 25, 2013
- Criteria - Structured Finance - CDOs: CDOs And Pooled TOBs Backed By U.S. Municipal Debt, April 03, 2012
- General Criteria: Methodology: Credit Stability Criteria, May 03, 2010
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

## **Related Research**

- Ratings On Dexia Kommunalbank Deutschland's Public Sector Covered Bonds Affirmed At 'A' Following Review; Outlook Stable, March 9, 2017
- Request For Comment: Methodology For Incorporating The Effect Of Resolution Regimes Into Covered Bond Ratings, Jan. 31, 2017
- Request for Comment: Methodology For Assigning Financial Institution Resolution Counterparty Ratings, Jan. 31, 2017
- Global Covered Bond Characteristics And Rating Summary Q4 2016, Jan. 13, 2017
- Assessments For Jurisdictional Support According To Our Covered Bonds Criteria, July 20, 2016
- Assessing Credit Quality By The Weakest Link, Feb. 13, 2012

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