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Ratings

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

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Ratings Detail

Reference Rating Level	**bbb**
Resolution Regime Uplift	+2
Systemic Importance	Very Strong
Adjusted Issuer Credit Rating	bb
GRE And Sovereign Support	-3
Issuer Credit Rating	**BBB**

+

Jurisdictional-Supported Rating Level	**a**
Assigned Jurisdictional Support Uplift	+3
Jurisdictional Support Assessment	Very Strong
Legal Framework	Very Strong
Systemic Importance	Very Strong
Sovereign Credit Capacity	Very strong

+

Maximum Achievable Covered Bond Rating	**a**
Collateral Support Uplift	0
Overcollateralization Adjustment	-1
Liquidity Adjustment	0
Potential Collateral-Based Uplift	0

=

Covered Bond Rating	**A/Stable**
Rating Constraints	a
Counterparty Risk	aaa
Country Risk	a

*Dexia Kommunalbank Deutschland GmbH (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.
- 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 GmbH'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 are publishing this transaction update following our June 15, 2018 affirmation of our 'A' ratings on DKD's public sector covered bond program and related issuances (see "Ratings Affirmed On Dexia Kommunalbank Deutschland's German Public Sector Covered Bonds Following Review; Outlook Stable").

Our covered bond rating process follows the methodology and assumptions outlined in our "Covered Bonds Criteria," published on Dec. 9, 2014, "Covered Bond Ratings Framework: Methodology And Assumptions," published on June 30, 2015. and "Methodology And Assumptions For Assessing Portfolios Of International Public Sector And Other Debt Obligations Backing Covered Bonds And Structured Finance Securities," published on Dec. 9, 2014.

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.

We do not assign any notches of collateral-based uplift above the JRL, because the available credit enhancement of 4.30% 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. €)	15.30
Redemption profile	Hard bullet
Underlying assets	Public sector
Jurisdictional support uplift	3
Unused notches for jurisdictional support	0

Table 1

Program Overview* (cont.)	
Target credit enhancement (%)	18.54
Available credit enhancement (%)	4.30
Collateral support uplift	0
Unused notches for collateral support	0
Total unused notches	0

*Based on data as of March 31, 2018.

Table 2

Program Participants

Role	Name	Rating	Rating dependency
Issuer	Dexia Kommunalbank Deutschland GmbH	NR*	Yes
Bank account provider	Deutsche Bundesbank	NR§	Yes
Bank account provider	Clearstream Banking Frankfurt (CBF)	NR	No
Bank account provider	Skandinaviska Enskilda Banken AB (publ)	A+/Stable/A-1	No

*Dexia Kommunalbank Deutschland GmbH (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. §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 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. The Federal Financial Supervisory Authority (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.

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 "Structured Finance: Asset Isolation And Special-Purpose Entity Methodology," published on March 29, 2017, 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.

As part of the Dexia Group winddown strategy, in the first-quarter of 2018, DKD completed a sale of a portfolio of 108 securities of approximately €3.6 billion to Dexia Credit Local (Dublin Branch). About €1.9 billion of such assets pertained to the cover pool. The portfolio sold included mainly Italian sovereign bonds and public sector bonds from Portugal, Italy, and the U.S. As a result of the sale of Italian and Portuguese assets, the cover pool's credit quality has improved while the available overcollateralization has reduced but remains sufficient to support the current 'A' rating on the covered bonds based on jurisdictional support.

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 potential back-up servicers would be available if the issuer became unable to manage the program considering that Germany is an established covered bond market and that the cover pool does not comprise product features that would materially limit the range of available servicers.

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 Nov. 3, 2017). 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 March 31, 2018. On that date, there were €15.30 billion of covered bonds outstanding backed by a cover pool of €15.05 billion of public sector assets and a cash reserve of €1.43 billion held with Deutsche Bundesbank (see table 3). Compared with our previous review, the cover pool has reduced by about 25% as a result of the above mentioned asset transfer, and outstanding covered bonds reduced by about 15% (see "Dexia Kommunalbank Deutschland AG (Public Sector Covered Bonds)," published on March 9, 2017). Available credit enhancement as of March 31, 2018 is 4.30%, down from 7.65% at our previous review. At the same time, the portfolio's credit quality has improved as is shown in the higher weighted-average portfolio rating of 'A-', up from 'BBB+' at our previous review (see table 4). The pool comprises mainly public sector assets.

Compared to our previous analysis, which was based on data from Sept. 30, 2016, the scenario default rate (SDR) has improved (28.6%) due to the sale of Italian and Portuguese cover pool assets. However, the cover pool is now more concentrated. The top 20 obligors account for nearly 71% of the cover pool compared to 65% as of Sept. 30, 2016. Exposure to the largest obligor increased to 11.5% of the cover pool (see table 4).

During the same period the recovery assumptions 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.

We have not assigned any notches of collateral-based uplift above the JRL. This is because the available credit enhancement of 4.30% 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 10.37%) and the result of our supplemental tests (17.52%; see table 8).

In particular, the 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 overcollateralization requirements for any notches of collateral-based uplift. 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 €5.60 billion. 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 €2.24 billion. This represents 17.52% 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 slightly to 18.54% from 18.14%.

The overcollateralization needed for the 'A' rating is 3.93%, 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

Cover Pool Composition

	March 31, 2018		Sept. 30, 2016	
Asset type	**Value (€)**	**Percentage of cover pool (%)**	**Value (€)**	**Percentage of cover pool (%)**
Public-sector assets	15,050,789,240	91.32	20,061,061,074	100
Cash Reserve	1,430,000,000	8.68	0	0
Total	16,480,789,240	100.00	20,061,061,074	100

Table 4

Key Credit Metrics

	As of March. 31, 2018	As of Sept. 30, 2016
Weighted-average cover pool asset rating	A-	BBB+
Weighted-average loan asset maturity (years)	8.58	8.75
Largest obligor (% of the cover pool)	11.53	9.72
20 largest obligors (% of cover pool)	70.88	64.94
Credit analysis results:		
Scenario default rate (%)	28.55	29.36
Weighted-average recovery rate (%)	82.15	79.90
Weighted-average time to recovery (years)	3.65	3.44
Largest obligor test result (% of covered bonds)	12.11	13.08
Largest industry test result (% of covered bonds)	17.52	14.90

Table 5

Asset Distribution By Geography

	As of March 31, 2018	As of Sept. 30, 2016
	Percentage of cover pool	
Germany	74.26	66.04
Italy	6.75	10.72
Austria	9.11	7.58
Belgium	6.91	6.06
Portugal	1.05	2.32
Other	1.93	9.14

Table 6

Recovery Assumptions For Cover Pool Assets*

As of March 31, 2018

Borrower type	Recovery classification*	'AAA' recovery rate (%)	Time to recovery (years)	Percentage of cover pool as of March 31, 2018
German states	Public sector category A	90	4	48.6
German municipalities outside Nordrhein-Westfalen (NRW)	Public sector category A	90	4	15.05
Austrian state	Public sector category A	90	4	8.67
Sovereigns and sovereign-related	Sovereign	37	0	4.83

Table 6

Recovery Assumptions For Cover Pool Assets* (cont.)

As of March 31, 2018

Borrower type	Recovery classification*	'AAA' recovery rate (%)	Time to recovery (years)	Percentage of cover pool as of March 31, 2018
German municipalities in NRW	Public sector category B	75	4	7.41
Belgium communities	Public sector category A	90	4	6.91
Municipal enterprises	Public sector category C	18	0	1.61
Other public sector assets	Various	Various	Various	6.92
Total cover pool assets				100

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

Table 7

Asset Distribution By Rating

	As of March 31, 2018	As of Sept. 30, 2016
	--Percentage of cover pool--	
AAA	5.24	4
AA	58.61	52
A	23.49	23
BBB	10.08	14
BB or lower	2.57	7
Total	100	100

Table 8

Collateral Uplift Metrics

	As of March 31, 2018	As of Sept. 30, 2016
Asset WAM (years)	8.66	8.84
Liability WAM (years)	6.60	6.98
Available credit enhancement (%)	4.30	7.65
'AAA' credit risk (%)	10.37	7.55
'AAA' credit risk plus 25% refinancing costs (%)	12.41	10.20
'AAA' credit risk plus 50% refinancing costs (%)	14.46	12.85
'AAA' credit risk plus 75% refinancing costs (%)	16.50	15.49
Target credit enhancement for maximum uplift (%)	18.54	18.14
Largest industry test (% covered bonds)	17.52	14.90
Potential collateral-based uplift (notches)	0	0
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.

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.

Potential Effects Of Proposed Criteria Changes

Our ratings are based on our applicable criteria, including our "Covered Bonds Criteria," published on Dec. 9, 2014. However, the resolution regime analysis section of these criteria is under review (see "Methodology For Assigning Financial Institution Resolution Counterparty Ratings," published on April 19, 2018 and "Request For Comment: Methodology For Incorporating The Effect Of Resolution Regimes Into Covered Bond Ratings," published on Jan. 31, 2017). As a result of this review, we may amend certain paragraphs of our covered bonds criteria. This change may affect the ratings on the outstanding covered bonds issued under this covered bond program. Until this time, we will continue to rate and surveil these covered bonds using our existing criteria (see "Related Criteria").

Related Criteria And Research

Related Criteria

- Structured Finance: Asset Isolation And Special-Purpose Entity Methodology - March 29, 2017
- Ratings Above The Sovereign - Structured Finance: Methodology And Assumptions - August 08, 2016
- Counterparty Risk In Covered Bonds - December 21, 2015
- Covered Bond Ratings Framework: Methodology And Assumptions - June 30, 2015
- Methodology And Assumptions For Assessing Portfolios Of International Public Sector And Other Debt Obligations Backing Covered Bonds And Structured Finance Securities- December 09, 2014
- Covered Bonds Criteria - December 09, 2014
- Counterparty Risk Framework Methodology And Assumptions - June 25, 2013
- Criteria - Structured Finance - CDOs: CDOs And Pooled TOBs Backed By U.S. Municipal Debt; Methodology And Assumptions - 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 Affirmed On Dexia Kommunalbank Deutschland's German Public Sector Covered Bonds Following Review; Outlook Stable, June 15, 2018
- Global Covered Bond Characteristics And Rating Summary Q2 2018, June 13, 2018
- Criteria Guidance: Covered Bonds Criteria, May 2, 2018
- Glossary Of Covered Bond Terms, April 27, 2018
- European Economic Snapshots For 2Q Published, April 9, 2018
- EMEA March 2018 – Trade And market Volatility Threaten To Overshadow Brexit, March 28, 2018
- Credit FAQ: Are Ratings On German States Moving Up?, March 20, 2018
- Considerable Tax Inflows Will Curtail German, Swiss, And Austrian Local And Regional Government Borrowing In 2018, Feb. 22, 2018
- Assessments for Target Asset Spreads according To Our Covered Bonds Criteria, Nov. 3, 2017
- Assessments For Jurisdictional Support According To Our Covered Bonds Criteria, Nov. 3, 2017
- Germany 'AAA/A-1+' Ratings Affirmed; Outlook Stable, Oct. 27, 2017
- Dexia Credit Local, June 29, 2017
- Dexia Kommunalbank Deutschland AG (Public Sector Covered Bonds), March 9, 2017
- Request For Comment: Methodology For Incorporating The Effect Of Resolution Regimes Into Covered Bond Ratings, Jan. 31, 2017
- Why We Don't Rate Every German State And Municipality 'AAA', Feb. 23, 2016
- Covered Bond Monitor: Technical Note, Aug. 12, 2015