

Transaction Update: DZ HYP AG (Public Sector Covered Bond Program)

Öffentliche Pfandbriefe

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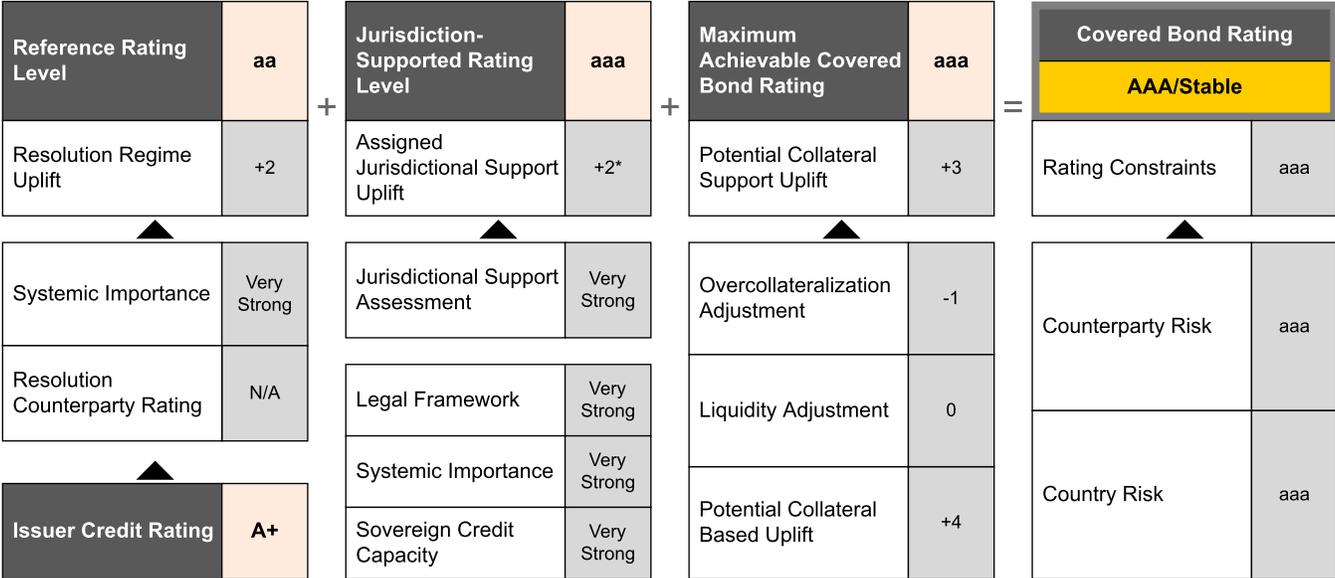
Related Criteria

Related Research

Transaction Update: DZ HYP AG (Public Sector Covered Bond Program)

Öffentliche Pfandbriefe

Ratings Detail



*The maximum jurisdictional support uplift is three notches above the RRL. However, only one notch is required to achieve a 'AAA' rating on the covered bonds. N/A--Not applicable.

Major Rating Factors

Strengths

- The program benefits from four unused notches of collateral uplift, which would protect the rating if we downgraded the issuer.
- Strong credit quality of the highly granular public sector cover pool.

Weaknesses

- Commingling and bank account risk prior to the issuer's insolvency that is not addressed structurally or by the German legal framework, but is mitigated by the available collateralization.
- The issuer is not committed to maintaining the level of overcollateralization that is commensurate with the current rating; therefore, we deduct one notch of collateral-based uplift.

Outlook: Stable

S&P Global Ratings' stable outlook on DZ HYP AG's (DZ HYP) public sector covered bonds ("Öffentliche Pfandbriefe") reflects the cushion of four unused notches--comprising one notch of jurisdictional support and three notches of collateral-based support--that would protect the ratings on the covered bonds if we were to lower the long-term issuer credit rating (ICR) on DZ HYP.

We would lower our ratings on the covered bonds if we lowered the ICR by more than four notches or if the available credit enhancement became insufficient to cover credit risk as defined in our covered bonds criteria.

Rationale

We are publishing this transaction update as part of our periodic review of DZ HYP's public sector covered bond program.

Our rating process follows the methodology and assumptions outlined in our covered bonds criteria (see "Covered Bonds Criteria," published on Dec. 9, 2014) and the criteria articles referenced in the "Related Criteria" section.

In our analysis, we assume the issuer's insolvency and look to the resolution regime, the jurisdictional support, and the cover assets to repay the covered bonds. The ratings reflect the likelihood of the covered bonds being fully repaid in a timely manner at their legal final maturity.

From our analysis of the legal and regulatory framework for covered bonds in Germany, we have concluded that the assets in DZ HYP's cover pool are isolated from the risk of the issuer's bankruptcy or insolvency. This asset isolation allows us to potentially assign a higher rating to the covered bonds than our long-term ICR on DZ HYP.

DZ HYP is domiciled in Germany (unsolicited; AAA/Stable/A-1+), which is subject to the EU's Bank Recovery and Resolution Directive (BRRD). We consider that public sector covered bonds have a very strong systemic importance to Germany. These factors increase the likelihood that DZ HYP (A+/Stable/A-1) would continue servicing its covered bonds without accessing the cover pool or receiving jurisdictional support, even following a bail-in of its senior unsecured obligations. Under our covered bonds criteria, a very strong systemic importance means the reference rating level (RRL) is the maximum of (i) two notches above the long-term ICR and (ii) the resolution counterparty rating (RCR). Given that we have not assigned an RCR to DZ HYP, the RRL is 'aa', which reflects the two-notch uplift from the ICR.

We consider the likelihood for the provision of jurisdictional support, which we assess as very strong for public sector covered bonds in Germany. As a result, the covered bonds are eligible for up to three notches of uplift from the RRL, leading to a jurisdiction-supported rating level (JRL) of 'aaa'. Given the RRL of 'aa', the covered bonds only need two notches of jurisdictional support uplift to achieve a JRL of 'aaa' leaving a rating cushion of one unused notch of jurisdictional support.

Under our covered bonds criteria, to achieve a 'AAA' rating solely based on jurisdictional support, overcollateralization

must at least cover the credit risk that is commensurate with a 'AAA' level of stress. Based on our credit and cash flow analysis as of Dec. 31, 2021, the available overcollateralization of 14.79% exceeds the overcollateralization required to cover 'AAA' credit risk of 9.62%.

Furthermore, the covered bonds have sufficient credit enhancement to qualify for four notches of potential collateral-based uplift under our covered bonds criteria. However, because overcollateralization is uncommitted, we reduce this potential collateral-based uplift by one notch resulting in three available notches of collateral-based uplift. This, together with the one notch of unused jurisdictional support, results in a total rating cushion of four unused notches.

There are currently no rating constraints for the covered bonds related to legal, operational, counterparty, and sovereign risks.

Program Description

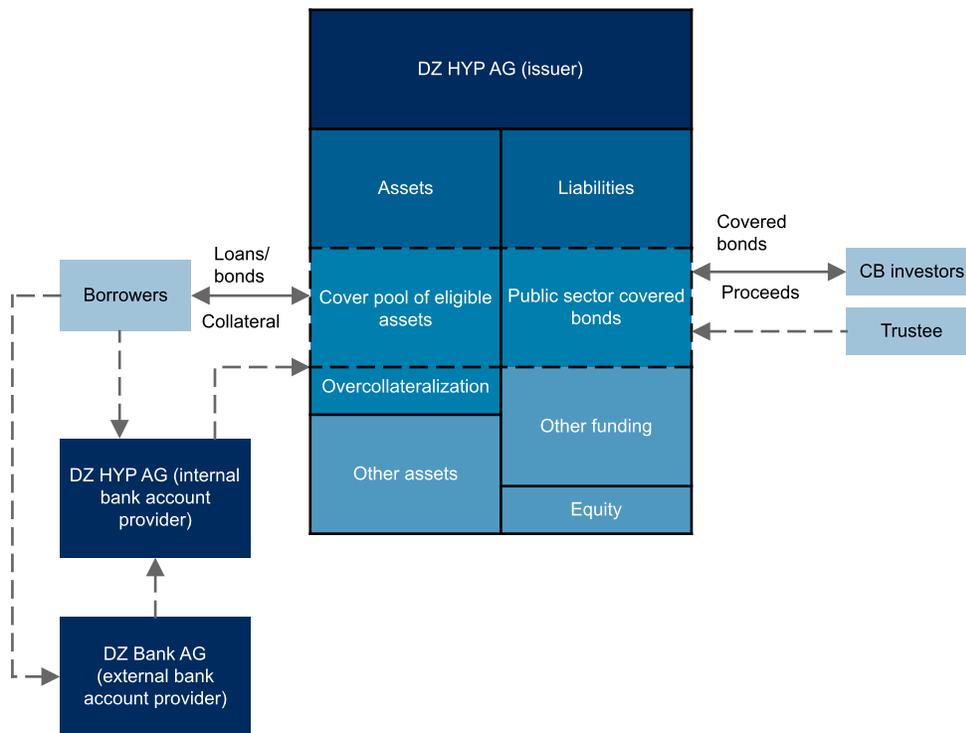
Table 1

Program Overview	
As of Dec. 31, 2021	
Jurisdiction	Germany
Covered bond type	Legislation-enabled
Outstanding covered bonds (bil. €)	12.22
Redemption profile	Soft-bullet
Underlying assets	Predominantly local and regional governments, sovereigns, and municipal enterprises
Assigned jurisdictional support uplift	2
Unused notches for jurisdictional support	1
Target credit enhancement (%)	13.02
Credit enhancement commensurate with current rating (%)	9.62
Available credit enhancement (%)	14.79
Assigned collateral support uplift	0
Unused notches for collateral support	3
Total unused notches	4

DZ HYP is a majority owned subsidiary of DZ BANK AG Deutsche Zentral-Genossenschaftsbank (DZ BANK) and a core member of the German cooperative banking sector. It is a major covered bond issuer in Germany, issuing public sector and mortgage covered bonds.

DZ HYP issues public sector covered bonds under Germany's covered bond legislation. The covered bonds are issued directly by the bank, and the cover pool assets are segregated from the issuer's remaining assets through entry in a cover pool register. Investors in covered bonds have recourse to DZ HYP and to a portfolio of public sector cover assets assigned to the cover pool as collateral.

Program Structure



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Table 2

Program Participants			
Role	Name	Rating	Rating dependency
Issuer	DZ HYP AG	A+/Stable/A-1	Yes
Account provider	DZ HYP AG	A+/Stable/A-1	No
Account provider	DZ Bank AG Deutsche Zentral-Genossenschaftsbank	A+/Stable/A-1	No

Legal and regulatory risks

The German Covered Bond Act (Pfandbriefgesetz; "PfandBG") and the relevant secondary legislation provide the legal framework for the issuance of German covered bonds ("Pfandbriefe").

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.

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 the U.K., Canada, the U.S., Japan, and Switzerland. Additionally, the cover pool can also comprise other, 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 are covered by liquid assets 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, the German supervisory authority for financial institutions, appoints and supervises the cover pool monitor and cover pool administrator. BaFin also regularly conducts a covered bond audit.

We have also 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. In our view, the German Covered Bond Act segregates cash received after the issuing bank's insolvency, but cash received shortly before insolvency and not reinvested in cover pool assets could be exposed to commingling risk. We address this risk in our counterparty risk analysis (see "Counterparty risk").

We base our analysis of legal risk on our criteria "Structured Finance: Asset Isolation And Special-Purpose Entity Methodology," published on March 29, 2017, as well as our "Covered Bond Ratings Framework: Methodology And Assumptions," published on June 30, 2015.

On April 15, 2021, the German Bundestag passed the Covered Bonds Directive Implementation Act ("CBDUmsetzungsgesetz" [CBDUmsG]), and on July 8, 2021, it transposed the EU's Covered Bonds Directive into the covered bond law (PfandBG).

The main changes to the PfandBG include:

- The introduction of an option for the cover pool administrator to extend the maturities of an insolvent issuer's covered bonds by up to one year;
- An additional nominal statutory overcollateralization requirement of 2% for mortgage and public sector covered bonds and 5% for ship and aircraft covered bonds;
- Derivative eligibility amendments;
- Amendments to provisions for the liquidity buffer and the cover pool monitor's reporting duty; and
- The expansion of transparency provisions.

Article 1 of the CBDUmsG, which includes the option to extend the maturities of covered bonds, entered into force on July 1, 2021. Article 2, including provisions on implementing the EU's Covered Bonds Directive, will enter into force on July 8, 2022.

The covered bonds maturity extension is subject to the conditions set out in the CBDUmsG, which include avoiding imminent insolvency of the ringfenced Pfandbriefe, confirming it is not overindebted, and having no reason to believe it will not be solvent when the extension period ends.

The CBDUmsG introduces the extension option to both new and existing covered bonds. Our rating analysis considers the coverage of refinancing costs, which is the additional credit enhancement expected to be required to be able to

refinance the cover pool in a stressed environment (see "Related Criteria"). Our analysis of German covered bonds therefore considers the covered bonds' extended maturity date when estimating the refinancing cost of a program. In a stressed environment, we assume that an administrator will initiate an extension of all outstanding covered bonds (see "Approach To Analyzing German Covered Bonds Clarified Following Changes To The German Covered Bond Law," published on Oct. 6, 2021).

Operational and administrative risks

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

In our opinion, there are no operational risks from the cover pool's management and loan origination that would constrain the covered bond ratings to the same level as the long-term ICR. DZ HYP voluntarily maintains overcollateralization levels that exceed the legal minimum requirement, in order to support the current ratings on the covered bonds.

In our view, potential backup servicers would be available, if DZ HYP 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

As part of our covered bonds criteria, our analysis considers the resolution regime in place in Germany to determine the RRL. The RRL on DZ HYP, which is the starting point for any further ratings uplift in our analysis, is 'aa'. We consider the following factors:

- DZ HYP is domiciled in Germany, which is subject to the EU's BRRD.
- Absent an assigned RCR for DZ HYP, we add two notches of uplift to the ICR because we assess the systemic importance for German public sector covered bonds as very strong.

Jurisdictional support analysis

Under our covered bonds criteria, we conduct a jurisdictional support analysis to assess the likelihood that a covered bond program facing stress would receive support from a government-sponsored initiative. This is reflected in our JRL, which is our assessment of the creditworthiness of a covered bond program considering jurisdictional support, but before giving benefit to a covered bond program's ability to access other refinancing sources.

Our assessment of the expected jurisdictional support for German public sector covered bonds is very strong. Therefore, under our covered bonds criteria, the program can receive up to three notches of jurisdictional support uplift from the RRL. The covered bonds make use of two notches to achieve a 'aaa' JRL, leaving an unused notch for jurisdictional support.

We also consider that the cover pool continues to comply with legal and regulatory minimum standards in Germany and that sovereign risk does not constrain the ratings on the covered bonds.

Collateral support analysis

Our analysis of the cover pool is based on our "Methodology And Assumptions For Assessing Portfolios Of International Public Sector And Other Debt Obligations Backing Covered Bonds And Structured Finance Securities," criteria, published on Dec. 9, 2014.

Since our previous review, the cover pool has reduced in size, but its composition and credit quality have remained stable. The share of local and regional government (LRG) and sovereign exposures has slightly decreased, while the share of loans to non-LRG international public finance (IPF) entities has increased somewhat (see table 6).

Obligor concentration decreased somewhat since our previous analysis. The top five obligors account for 12% of the cover pool, about one percentage point less than in the previous pool cut. The available credit enhancement covers the result of our largest obligor and industry concentration test results (see table 3).

As of Dec. 31, 2021, the dominant share of the portfolio (87%) comprised LRGs, most of them (77%) located in Germany. Exposures to various European sovereigns made up about 9% of the cover pool, and the remaining small share are loans backed by non-LRG IPF entities. We view the credit quality of about 83% of the cover pool as 'A-' or higher.

While the German LRG assets are well-diversified across the federal states, we observe a relative concentration--when compared with the respective shares of the federal states within German GDP--of LRG assets located in Rheinland-Palatine and Saarland. In the previous analyses, we adjusted our correlation assumption between German LRG assets to 20% from 15% when modeling default probability. In the current analysis, we have revised this assumption and modelled our standard 15% correlation assumption between German LRG assets because while in the above cases the share of assets in the cover pool materially exceeds the GDP share of the respective German federal state where the asset is located, the share of these exposures does not dominate the cover pool. Therefore, this overrepresentation in the cover pool of the two federal states compared to their respective share in the German GDP does not result in a concentration risk that could affect overall pool performance, in our view.

As of Dec. 31, 2021, we determined a 'AAA' scenario default rate (SDR) of 19.71% compared to 23.60% one year earlier. There are two main reasons for our lower default assumption: (i) our credit assessment of certain German LRGs has improved since our previous analysis, and (ii) the updated correlation assumption described in the above paragraph had a positive effect on the final result of our credit analysis.

Based on our classification of the portfolio under our criteria for assessing public sector cover pools, we have determined a weighted-average recovery rate at a 'AAA' level of stress of 78.24% and a weighted-average time to recovery of 3.5 years (see table 3). Both indicators remained fairly stable compared to the previous analysis mainly because the cover pool composition has not materially changed. Under our covered bonds criteria, LRGs attract a recovery rate of 75% or 90%--depending on their associated institutional framework score--and a time to recovery of four years. We assume 37% immediate recovery inflows on sovereign assets. We model corporate recovery rates on non-LRG public sector assets, which depend on the type and jurisdiction of the asset and are assumed to be immediate as well (see table 6).

Based on our covered bonds criteria, we have determined a stressed refinancing spread of 219 basis points (bps).

Table 3

Key Credit Metrics		
	As of Dec. 31, 2021	As of Dec. 31, 2020
Weighted-average cover pool asset rating	A-	A-
Weighted-average loan asset maturity (years)	8.34	8.48
Five largest obligors (% of the cover pool)	11.96	13.00
20 largest obligors (% of cover pool)	26.85	27.70
Credit analysis results		
Scenario default rate (%)	19.71	23.60
Weighted-average recovery rate (%)	78.24	77.38
Weighted-average time to recovery (years)	3.52	3.46
Largest obligor test result (% of cover pool)	4.80	5.29
Largest industry test result (% of cover pool)	2.65	2.50
Stressed refinancing spread (bps)	218.53	229.04

Table 4

Asset Distribution By Geography		
	Percentage of cover pool	
	As of Dec. 31, 2021	As of Dec. 31, 2020
Germany	81.23	80.43
Spain	5.73	6.32
Austria	3.15	2.88
Canada	2.80	2.40
Italy	2.50	2.37
Portugal	2.00	3.13
Switzerland	1.28	1.12
Other	1.32	1.35
Total	100.00	100.00

Table 5

Asset Distribution By Rating		
	Percentage of cover pool	
	As of Dec. 31, 2021	As of Dec. 31, 2020
AAA	4.77	5.26
AA	34.44	33.89
A	43.51	42.19
BBB	14.51	13.80
BB	1.96	4.11
B or lower	0.81	0.75
Total	100.00	100.00

Table 6

Borrower type	'AAA' recovery rate (%)	Time to recovery (years)	Percentage of cover pool	
			As of Dec. 31, 2021	As of Dec. 31, 2020
Category A German LRGs	90	4	52.39	50.32
Category B German LRGs	75	4	24.42	25.12
Category A LRGs outside Germany	90	4	4.42	3.87
Category B LRGs outside Germany	75	4	6.66	7.26
German sovereign	37	0	1.45	2.13
Sovereigns and sovereign-related outside Germany	37	0	7.28	8.07
Non-LRG IPF assets	18	0	3.39	3.24
Total			100.00	100.00

*According to our criteria for pools of public sector assets. LRG--Local and regional governments. IPF--International public finance.

The results of our credit analysis represent the inputs to our cash flow analysis. Most of the cover pool assets are denominated in euros (95%) with the remainder being mainly in U.S. dollar and Swiss franc. The currency composition of the assets broadly matches that of the outstanding covered bonds. There are no derivatives registered in the cover pool, and we have modeled foreign exchange as well as interest rate risk in our cash flow model. In addition, we have assumed a stressed servicing fee of 10 bps.

We also considered the risk that cash collections received from the cover pool assets shortly before the issuer's insolvency, and not reinvested in cover pool assets, could be lost through commingling with the issuer's cash (see "Counterparty risk").

The aim of the cash flow analysis is to assess whether the stressed cash flows from the cover pool assets suffice, at the 'AAA' rating level, to make timely payments of interest and ultimate payment of principal on the covered bonds.

Our cash flow analysis determines the target credit enhancement needed to achieve the maximum potential collateral-based uplift, inclusive of 100% refinancing costs, and the credit enhancement required to cover 'AAA' credit risk assuming no asset-liability maturity mismatch. We determined the credit enhancement required to cover 'AAA' credit risk of 9.16% and a target credit enhancement of 13.02%.

The reduction in 'AAA' credit risk mainly reflects the improvement in the credit results. In addition to the positive effect from the credit inputs, lower asset-liability maturity mismatch risk also contributed to the decrease in the target credit enhancement. We model the covered bond cashflows with a one-year maturity extension.

With available overcollateralization of 14.79%, the covered bonds' maximum potential collateral-based uplift above the JRL is four notches. According to our covered bonds criteria, we reduce the potential collateral-based uplift by one notch if the covered bonds do not benefit from at least six months of liquidity, and by a further notch if overcollateralization is uncommitted. DZ HYP maintains 180 days of liquid assets at all times, as is required by the German covered bond legal framework. However, because overcollateralization is uncommitted, we have reduced the potential collateral-based uplift by one notch, resulting in a final collateral-based uplift of three notches.

The covered bonds do not use these notches of uplift as their 'AAA' rating is based on their JRL assessment. As a result, the program currently has four unused notches comprising three unused notches of collateral-based support and one unused notch of jurisdictional support.

Table 7

Collateral Uplift Metrics		
	As of Dec. 31, 2021	As of Dec. 31, 2020
Asset WAM (years)	8.42	8.65
Liability WAM (years)	8.08	7.86
Maturity gap (years)	0.34	0.79
Available credit enhancement (%)	14.79	19.03
'AAA' credit risk (required credit enhancement for 'AAA' rating based on JRL) (%)	9.16	9.88
Required credit enhancement for first notch of collateral uplift (credit risk at 'AAA') (%)	10.13	9.88
Required credit enhancement for second notch of collateral uplift (credit risk at 'AAA' and 50% of refinancing costs) (%)	11.09	11.83
Required credit enhancement for third notch collateral uplift (credit risk at 'AAA' and 75% of refinancing costs) (%)	12.06	12.81
Target credit enhancement (credit risk at 'AAA' and 100% of refinancing costs) (%)	13.02	13.78
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)	3	3

WAM--Weighted-average maturity. JRL--Jurisdiction-supported rating level.

Counterparty risk

We analyze counterparty risk by applying our counterparty criteria (see "Counterparty Risk Framework: Methodology And Assumptions," published on March 8, 2019).

DZ HYP's public sector covered bonds rely on bank accounts, which DZ HYP and DZ BANK provide. This potentially exposes investors to bank account and commingling risks.

Bank account risk. Accounts held at DZ BANK are swept intraday so that there is no overnight exposure. We therefore consider that bank account risk arising from exposures to DZ BANK is mitigated.

Commingling risk. Commingling risk in the covered bond program arises where cash collections received from the cover pool assets shortly before the issuer's insolvency are not reinvested in cover pool assets, and therefore could be lost through commingling with the bank's other cash.

In the absence of legal assurance or structural mitigants, we considered commingling risk when determining the required credit enhancement assuming that the highest one-day net cash inflow over the life of the covered bonds is lost, using information provided by the issuer. As of Dec. 31, 2021, the amount assumed lost is about €291.7 million--unchanged since the previous analysis. The commingling risk is reflected in the 'AAA' credit risk and target credit enhancement figures.

There are no derivatives registered in the cover pool. We model any interest and foreign exchange risks in our cash flow model.

Sovereign risk

We analyze sovereign risk under our structured finance sovereign risk criteria (see "Incorporating Sovereign Risk In Rating Structured Finance Securities: Methodology And Assumption," published on Jan. 30, 2019).

This is a multi-jurisdictional pool of loans to public sector entities in Germany (over 81%) and other developed countries. The issuer is located in Germany, which is part of a monetary union, and liquidity risk is covered for 12 months via the potential maturity extensions of the covered bonds. This results in a low sensitivity to refinancing risk, which implies a maximum rating differential of five notches between the covered bonds and the issuer's host sovereign.

The multi-jurisdictional treatment for covered bonds under the sovereign risk criteria, including the supplemental test--largest sovereign default test (6.07%)--results in the rating on the program not being constrained by sovereign default risk.

As a result of the above, and based on our unsolicited long-term rating on Germany, our structured finance sovereign risk criteria do not constrain our ratings on the covered bonds.

Environmental, Social, And Governance

ESG Credit Indicators

E-1	E-2	E-3	E-4	E-5	S-1	S-2	S-3	S-4	S-5	G-1	G-2	G-3	G-4	G-5
- N/A					- Social capital					- Risk management, culture, and oversight				

N/A--Not applicable. ESG credit indicators provide additional disclosure and transparency at the entity level and reflect S&P Global Ratings' opinion of the influence that environmental, social, and governance factors have on our credit rating analysis. They are not a sustainability rating or an S&P Global Ratings ESG Evaluation. The extent of the influence of these factors is reflected on an alphanumeric 1-5 scale where 1 = positive, 2 = neutral, 3 = moderately negative, 4 = negative, and 5 = very negative. For more information, see our commentary "ESG Credit Indicator Definitions And Applications," published Oct. 13, 2021.

Environmental credit factors have a neutral influence on our analysis of this program. Social factors are a positive consideration in our credit rating analysis of DZ HYP's public sector covered bonds. DZ HYP funds public infrastructure with social goals, which benefit from guarantees from German municipalities. Governance factors are a moderately negative consideration in our credit analysis of this program because the issuer does not commit to maintain a level of overcollateralization above the legal minimum level, which reduces the unused notches of uplift by one.

Related Criteria

- Environmental, Social, And Governance Principles In Credit Ratings, Oct. 10, 2021
- Counterparty Risk Framework: Methodology And Assumptions, March 8, 2019
- Incorporating Sovereign Risk In Rating Structured Finance Securities: Methodology And Assumption, Jan. 30, 2019

- Asset Isolation And Special-Purpose Entity Methodology, March 29, 2017
- Covered Bond Ratings Framework: Methodology And Assumptions, June 30, 2015
- 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. 9, 2014
- Covered Bonds Criteria, Dec. 9, 2014
- Principles Of Credit Ratings, Feb. 16, 2011

Related Research

- ESG Credit Indicator Report Card: Covered Bonds, April 7, 2022
- Global Covered Bond Insights Q1 2022, March 17, 2022
- DZ HYP AG, April 28, 2021
- S&P Global Ratings Definitions, Nov. 10, 2021
- Approach To Analyzing German Covered Bonds Clarified Following Changes To The German Covered Bond Law, Oct. 6, 2021
- ESG Industry Report Card: Covered Bonds, Nov. 9, 2020
- Covered Bond Monitor: Technical Note, Sept. 6, 2019
- Glossary Of Covered Bond Terms, April 27, 2018

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