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

Öffentliche Pfandbriefe

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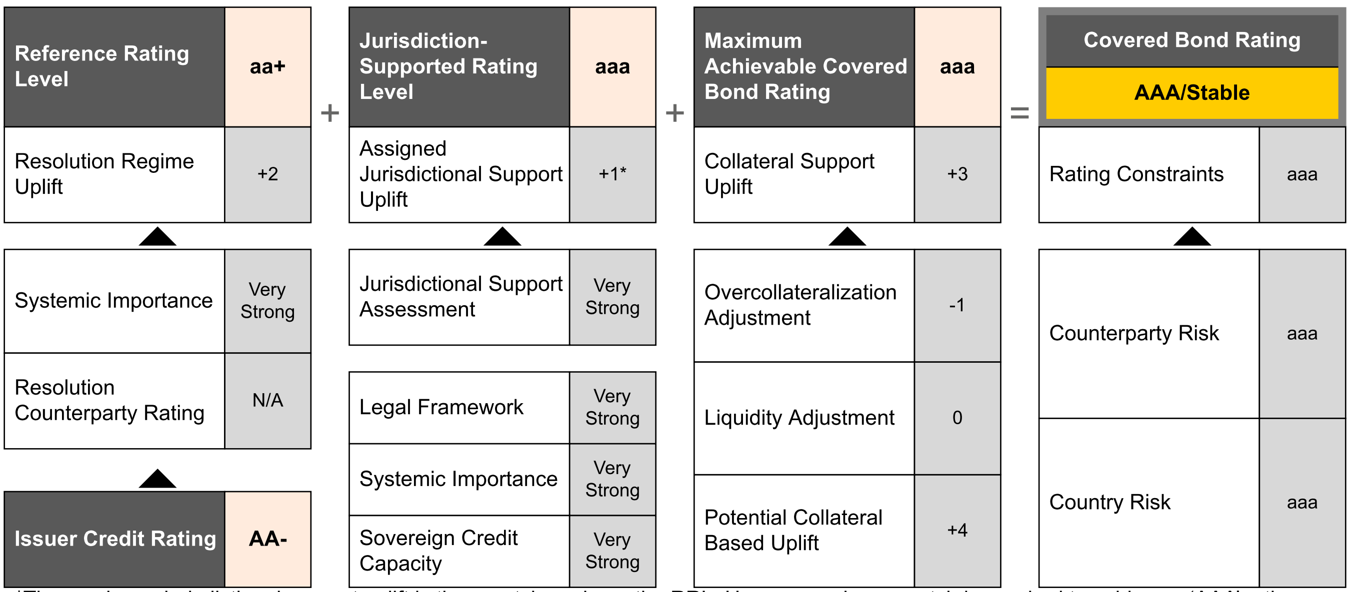
Ratings Detail



*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

- Strong credit quality of the highly granular public sector cover pool.
- Five unused notches of uplift provide cushion to the 'AAA' rating on the bonds.

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 five unused notches--comprising two notches 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 five 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 (AA-/Negative/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 (see "Assessments For Jurisdictional Support According To Our Covered Bonds Criteria," published on Nov. 27, 2020). 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 one notch of jurisdictional support uplift to achieve a JRL of 'aaa' leaving a rating cushion of two unused notches 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, 2020, the available overcollateralization of 19.03% exceeds the overcollateralization required to cover 'AAA' credit risk of 9.88%.

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 two notches of unused jurisdictional support, results in a total rating cushion of five 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, 2020	
Jurisdiction	Germany
Covered bond type	Legislation-enabled
Outstanding covered bonds (bil. €)	13.03
Redemption profile	Hard bullet
Underlying assets	Predominantly local and regional governments, sovereigns, and municipal enterprises
Assigned jurisdictional support uplift	1
Unused notches for jurisdictional support	2
Target credit enhancement (%)	13.78
Credit enhancement commensurate with current rating (%)	9.88
Available credit enhancement (%)	19.03
Assigned collateral support uplift	0
Unused notches for collateral support	3
Total unused notches	5

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. DZ HYP was formed on July 27, 2018, following the merger of WL Bank and DG HYP, which combined a large share of the German cooperative banking sector's real estate competence into one legal entity. Prior to their merger, we used to rate the covered bond programs of both issuers. DZ HYP combines the three major business lines of the merged real estate banks: corporate clients, retail customers, and public-sector clients. 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

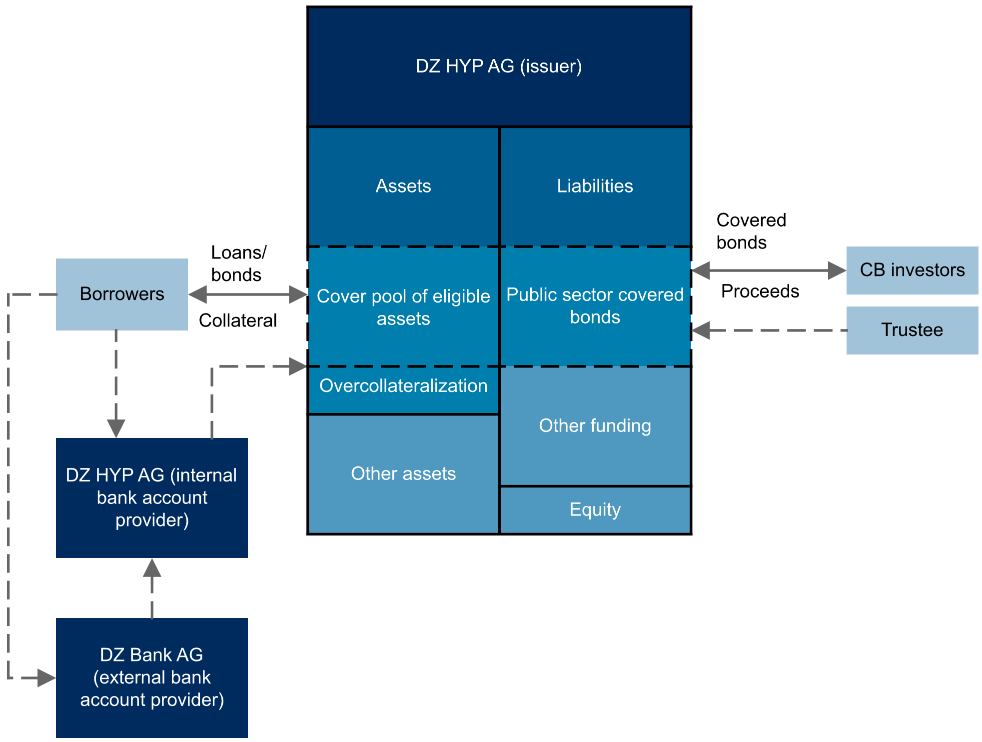


Table 2

Program Participants

Role	Name	Rating	Rating dependency
Issuer	DZ HYP AG	AA-/Negative/A-1+	Yes
Account provider	DZ HYP AG	AA-/Negative/A-1+	No
Account provider	DZ Bank AG Deutsche Zentral-Genossenschaftsbank	AA-/Negative/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.

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 Bank Recovery And Resolution Directive (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 taking into account 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 only make use of one notch to achieve a 'aaa' JRL, leaving two unused notches 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.

As of Dec. 31, 2020, the dominant share of the portfolio (88%) comprised LRGs, most of them (78%) located in Germany. Exposures to various European sovereigns made up about 10% of the cover pool, and the remaining small share are loans backed by non-LRG international public finance (IPF) entities. We view the credit quality of about 81% 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. Therefore, we adjusted our correlation assumption between German LRG assets to 20% from 15% when modeling default probability. This assumption is unchanged compared to our previous analyses.

Since our last review, the cover pool has reduced in size, but its composition and credit quality have remained stable. The share of LRG and sovereign exposures has slightly increased, while the share of loans to non-LRG IPF entities have declined (see table 6). Both within the LRG and sovereign sectors, we see a small increase toward German exposures. These changes have contributed to a small reduction in the 'AAA' scenario default rate (SDR; see table 3).

Obligor concentration increased somewhat since our previous analysis. The top five obligors account for 13% of the cover pool, about one percentage point more 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, 2020, we determined a 'AAA' SDR of 23.6%. In addition, 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 77.4% and a weighted-average time to recovery of 3.5 years (see table 3). 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 "Assessments For Target Asset Spreads According To Our Covered Bonds Criteria," published on Nov. 27, 2020, we have determined a stressed refinancing spread of 229 basis points (bps).

Table 3

Key Credit Metrics

	As of Dec. 31, 2020	As of Dec. 31, 2019
Weighted-average cover pool asset rating	A-	A-
Weighted-average loan asset maturity (years)	8.48	8.78
Largest obligor (% of the cover pool)	3.13	2.93
Five largest obligors (% of the cover pool)	13.0	11.75
20 largest obligors (% of cover pool)	27.70	27.20
Credit analysis results		
Scenario default rate (%)	23.60	24.09
Weighted-average recovery rate (%)	77.38	77.55
Weighted-average time to recovery (years)	3.46	3.48
Largest obligor test result (% of covered bonds)	5.29	5.03
Largest industry test result (% of covered bonds)	2.50	3.09
Stressed refinancing spread (bps)	229.04	229.20

Table 4

Asset Distribution By Geography

	Percentage of cover pool	
	As of Dec. 31, 2020	As of Dec. 31, 2019
Germany	80.43	79.40
Spain	6.32	6.28
Portugal	3.13	2.93
Austria	2.88	2.70
Canada	2.40	2.52
Italy	2.37	2.33
Switzerland	1.12	1.43
Other	1.35	2.41
Total	100.00	100.00

Table 5

Asset Distribution By Rating

	Percentage of cover pool	
	As of Dec. 31, 2020	As of Dec. 31, 2019
AAA	5.26	4.32
AA	33.89	34.86
A	42.19	42.80
BBB	13.80	14.08
BB	4.11	2.83

Table 5

Asset Distribution By Rating (cont.)

	Percentage of cover pool	
	As of Dec. 31, 2020	**As of Dec. 31, 2019**
B or lower	0.75	1.11
Total	100.00	100.00

Table 6

Recovery Assumptions For Cover Pool Assets*

			Percentage of cover pool	
Borrower type	**'AAA' recovery rate (%)**	**Time to recovery (years)**	**As of Dec. 31, 2020**	**As of Dec. 31, 2019**
Category A German LRGs	90	4	50.32	49.49
Category B German LRGs	75	4	25.12	25.98
Category A LRGs outside Germany	90	4	3.87	4.28
Category B LRGs outside Germany	75	4	7.26	7.27
German sovereign	37	0	2.13	1.23
Sovereigns and sovereign-related outside Germany	37	0	8.07	8.70
Non-LRG IPF assets	18	0	3.24	3.05
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 (96%) with the remainder being mainly Swiss franc and U.S. dollar with a nearly matching proportion of 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 took into account 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 9.88% and a target credit enhancement of 13.78%.

The reduction in 'AAA' credit risk mainly reflects the improvement in the credit results, while somewhat higher asset and liability mismatch risk resulted in a marginal increase in the target credit enhancement. .

With available overcollateralization of 19.03%, 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 five unused notches comprising three unused notches of collateral-based support and two unused notches of jurisdictional support.

Table 7

Collateral Uplift Metrics

	As of Dec. 31, 2020	As of Feb. 7, 2020
Asset WAM (years)	8.65	8.86
Liability WAM (years)	7.86	8.63
Maturity gap (years)	0.79	0.23
Available credit enhancement (%)	19.03	20.94
'AAA' credit risk (required credit enhancement for 'AAA' rating based on JRL) (%)	9.88	10.01
Required credit enhancement for first notch of collateral uplift (credit risk at 'AAA') (%)	9.88	10.01
Required credit enhancement for second notch of collateral uplift (credit risk at 'AAA' and 50% of refinancing costs) (%)	11.83	11.82
Required credit enhancement for third notch collateral uplift (credit risk at 'AAA' and 75% of refinancing costs) (%)	12.81	12.73
Target credit enhancement (credit risk at 'AAA' and 100% of refinancing costs) (%)	13.78	13.63
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, 2020, 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 80%) and other developed countries. The issuer is located in Germany, which is part of a monetary union, and liquidity risk is not covered for 12 months. This results in a moderate sensitivity to refinancing risk, which implies a maximum rating differential of four 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 (6.32%)--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 factors

Environmental factors are credit neutral in our analysis of DZ Hyp AG's public sector cover pool, while we consider social factors to be a credit positive in the assessments of the public sector entities included in the cover pool. DZ HYP provides financing to smaller German municipalities to invest in public infrastructure and thereby support the provision of public services. The German covered bond legal framework has a requirement to cover 180 days liquidity. DZ Hyp is not committed to maintain a minimum level of OC in the program, which introduces the risk that the bonds' credit enhancement could decrease in the future to levels that are not commensurate with the current rating. While it does not currently affect our ratings on DZ Hyp's public sector covered bonds, it reduces the number of unused notches available to the program in the event of an issuer downgrade.

Potential effects of COVID-19

S&P Global Ratings believes there remains high, albeit moderating, uncertainty about the evolution of the coronavirus pandemic and its economic effects. Vaccine production is ramping up and rollouts are gathering pace around the world. Widespread immunization, which will help pave the way for a return to more normal levels of social and economic activity, looks to be achievable by most developed economies by the end of the third quarter. However, some emerging markets may only be able to achieve widespread immunization by year-end or later. We use these assumptions about vaccine timing in assessing the economic and credit implications associated with the pandemic (see our research here: www.spglobal.com/ratings). As the situation evolves, we will update our assumptions and estimates accordingly.

Related Criteria

- 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

- Global Covered Bond Characteristics And Rating Summary Q1 2021, April 8, 2021
- Global Covered Bond Insights Q1 2021, April 8, 2021
- S&P Global Ratings Definitions, Jan. 5, 2021
- ESG Industry Report Card: Covered Bonds, Nov. 9, 2020
- Assessments For Jurisdictional Support According To Our Covered Bonds Criteria, Nov. 27, 2020
- Assessments for Target Asset Spreads according To Our Covered Bonds Criteria, Nov. 27, 2020
- Covered Bond Monitor: Technical Note, Sept. 6, 2019
- DZ HYP AG, April 3, 2020
- Glossary Of Covered Bond Terms, April 27, 2018