Rating Report

Bank Burgenland

Austrian Mortgage-Covered Bonds

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RATINGS

Cut-off date	Eligible cover pool	Main cover asset type	Covered bonds*	Rating/ Outlook
1 August 2017	EUR 761m	Mortgage loans	EUR 186.0m	AA+/Stable

* Hypothekenpfandbriefe (HyPF) – Austrian mortgage-covered bonds

Scope's covered bond ratings constitute an opinion about relative credit risks and reflect the expected loss associated with the payments contractually promised by an instrument on a particular payment date or by its legal maturity. See Scope's website for the covered bond rating definitions.

Covered bond rating:

Covered bond rating (long-term):	AA+
Outlook:	Stable
Rating action:	New

Covered bond rating-uplift above issuer rating (notches):

Bank Burgenland Mortgage-covered bond	
Legal framework	**2**
Resolution regime	**2**
Fundamental factors	**4**
Cover pool analysis	**7***
Used credit differentiation	**7**

*Maximum issuer specific uplift seven notches i.e. four notches (fundamental support) + three notches (cover pool support)

Issuer rating:

Long-term:	N/D*
Outlook:	N/D
Last rating action date	New
Issuer rating and covered bond rating:	Monitored

*N/D – not disclosed

The issuer has solicited the assigned rating and participated in the rating process.

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RATING RATIONALE

Scope Ratings (Scope) has assigned a AA+ with Stable Outlook to the Austrian mortgage-covered bonds issued by HYPO-BANK BURGENLAND Aktiengesellschaft (Bank Burgenland). The rating is driven by Scope's private rating on the issuer, further enhanced by i) a four notch fundamental support driven credit differentiation that reflects Scope's analysis of legal and resolution regime, which also provides a current floor for the covered bond rating and ii) a seven-notch credit differentiation reflecting the cover pool ability to mitigate identified credit and market risks under stressed assumptions.

Bank credit quality

Scope's credit view on Bank Burgenland reflects a well-established and profitable banking franchise. The bank has been a fully owned subsidiary of Grazer Wechselseitige Versicherung AG (Grawe) since 2006 and is the controlling financial institution of the 'Grawe banking group', which consolidates several banks and financial subsidiaries under a multi-brand strategy. Bank Burgenland is a regionally focused bank, mainly active in state of Burgenland and bordering areas, including Vienna and Styria. The bank offers comprehensive retail and corporate banking services. Other entities within the group provide asset management services to Grawe as well as to external customers, allowing the group to reduce dependence on interest income and to diversify its revenue and customer base.

Bank Burgenland's asset quality is adequate, and its financial results have been improving gradually since its takeover by Grawe. The bank exhibits a conservative funding and liquidity profile as well as prudent capitalisation – also reflecting the parent's acceptance to retain earnings within the bank rather than upstream them to the parent. Scope's credit view on the bank also reflects the concentration risk and limited growth potential in its home market. Parental support was not directly factored into the rating due to the lack of a formalised and enforceable guarantee commitment by Grawe.

Fundamental credit support

Scope's assessment of fundamental credit support factors provides a four notch uplift above our credit view on the bank. Two notches of uplift are driven by the agency's analysis of the Austrian covered bond legal framework, which meets all provisions relevant to establishing and maintaining a high-quality cover pool that remains available after the issuer's potential insolvency. Scope notes that under its methodology the covered bond framework just meets the minimum standards, as the framework remains relatively vague on best practice regarding liquidity or risk management.

The issuer- and country-specific assessment of the benefits of the resolution regime and the systemic importance of covered bonds provide the covered bonds with an additional credit differentiation of two notches. It reflects the covered bonds' exclusion from bail-in in a hypothetical scenario of the bank experiencing regulatory intervention. We also have provided one additional notch to reflect the combination of i) a moderate likelihood that regulators are, in a resolution scenario, more likely to restructure the issuer as a going concern using available tools; and ii) the increasing systemic importance of covered bonds in Austria; but offset in part by iii) the bank's limited visibility as covered bond issuer. The latter is currently unlikely to fully sustain a covered bond issuer-driven support.

Cover pool support

The covered bond ratings reflect the strong cover pool support provided by a generous overcollateralisation of 389% (based on whole loan balances). This fully mitigates the moderate credit risk of the cover pool, as well as market risks.

The strong protection against final losses is evidenced by an average eligible cover pool LTV of 47.4%, which is low and well seasoned. The fully domestic and wider Vienna area focussed cover pool is geared towards SMEs, followed by private individuals and residential housing-focused corporates. High overcollateralisation and relatively fast amortisation are sufficient to pay outstanding covered bonds on time and in full in a run-down scenario. Overcollateralisation also mitigates the moderate market risk driven by negative carry and residual foreign exchange risk. Based on whole loan balances (whole loan cover pool balances of EUR 910.4m) an overcollateralisation of about 40% supports the current rating uplift.

Stable Outlook

The Stable Outlook on the covered bonds reflects the expected stable credit performance of both the bank and its mortgage assets. Scope's Outlook reflects its expectation that the issuer will maintain its prudent risk management and that further diversification of its funding structure will not adversely impact the covered bonds' maturity profile. The agency expects that Bank Burgenland will remain willing and able to continuously provide the overcollateralisation needed to support the very strong credit quality of the covered bonds.

The covered bond rating incorporates the maximum uplift provided by cover pool support. The covered bond rating could therefore directly be impacted by changes to Scope's credit view and Outlook on the issuer.

Rating change drivers

The covered bond rating could be affected positively by a further improvement in the bank's financial results and by more stable profitability. A positive review of fundamental support factors could also be prompted by improvements in: the bank's prominence as covered bond issuer; the funding product's importance to the Austrian market; and increasing cohesiveness and cooperation between all relevant stakeholders.

Deterioration in the bank's credit quality will directly affect the covered bond rating or Outlook. Such rating changes could be driven by a deterioration in the bank's risk profile, profitability and prudential metrics. Excessive increases in the cover pool's risk could reduce cover pool support; but Scope does not currently expect such an outcome. At present, these risks are also mitigated by available overcollateralisation.

Fundamental support factors effectively provide a floor for the covered bond rating. Credit-negative changes to the cover pool's risk profile would at most result in a three-notch downgrade.

RATING DRIVERS AND MITIGANTS

Positive	Negative
The issuer. Regional bank with a track record of adequate asset quality and profitability since its 2006 integration into the Grawe group, the latter of which provides an underlying, mutually defined business strategy; conservative funding and liquidity profile as well as prudent capitalisation; lean business structures, which provide a competitive advantage through a faster and more tailored response to client needs, but may represent challenges regarding risk management	**The issuer.** Business model challenged by the lower-for-longer interest environment
Covered bond legal framework (+2 notches). Austrian covered bond laws which address rating-relevant aspects, allowing Scope's full legal framework uplift	**Covered bond legal framework.** Austrian covered bond framework just at the minimum standards under Scope's methodology
Resolution regime assessment (+2 notches). Covered bonds excluded from bail-in; Scope's view on the issuer's resolvability and systemic importance as a covered bond issuer (one additional notch)	**Resolution regime assessment.** Additional rating uplift prevented by the low importance of covered bonds in Austria, Scope's view on the result of a potential resolution, and the issuer's low prominence in the covered bond market
Cover pool support (+3 notches). Moderate credit risk (whole loan) but adequate asset quality of the eligible cover pool; risk of asset sales in a run-down scenario mitigated by extremely high overcollateralisation as well as a balanced maturity structure of the covered bond liability structure	**Cover pool support.** Negative spread between the cover pool and outstanding covered bonds; negative maturity mismatch; unhedged interest rate and foreign exchange exposures

Positive rating-change drivers	Negative rating-change drivers
Issuer/group. Successful implementation of a cost-saving programme with increased improvement in profitability and flexibility; strategic partnership that helps to stabilise prudential metrics	**Issuer/group.** Higher risk profile with weakened credit quality, greater reputational risk from subsidiaries, decreasing market shares and reduced capital market access
Resolution regime assessment. Increased covered bond visibility for the issuer and Austrian covered bonds in general; more cohesive stakeholders in the Austrian covered bond market	**Resolution-regime assessment.** Significantly reduced capitalisation and/or market share that could discourage the regulator from maintaining the issuer as going concern
	Cover pool support. Significant deterioration in the cover pool's asset quality and/or unbalanced new issuance activity resulting in an excessive increase of the asset-liability mismatch, all of which are not mitigated

THE ISSUER

A regionally focused bank with adequate asset quality and profitability

Scope regularly monitors the credit quality of Bank Burgenland, the issuer of the rated covered bonds.

Our credit view on Bank Burgenland reflects the adequate asset quality and improved profitability of its regional retail and small business focussed banking franchise. The bank also continues to benefit from its status as the 'house bank' for the regional state of Burgenland.

Grawe group established Bank Burgenland as the financial institution which oversees the group's various financial subsidiaries. Other members of the so called 'Grawe banking group' mainly provide complementary services that focus on asset management and private banking. Within the wider Grawe banking group, the bank provides the expertise for real estate financing, including commercial, mostly housing related, real estate lending.

Bank Burgenland benefits from strong contributors to profit on a consolidated basis. This is particularly the case with Capital Bank – including its subsidiaries Brüll Kallmus Bank AG, Security KAG and BK Immo Vorsorge GmbH – and the recent addition, Bankhaus Schelhammer & Schattera AG. Within the Grawe group, the banking arm has around EUR 18bn assets under management, with the majority being overseen by Capital Bank and its subsidiary Security KAG.

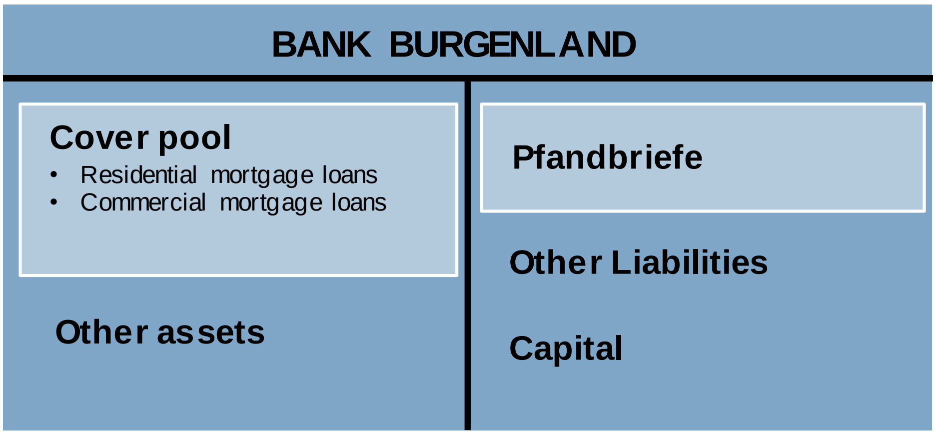
Despite the 100% ownership by Grawe, Bank Burgenland is managed at arm's length and does not benefit from any formal guarantees. Nevertheless, the bank is integrated into the group's risk controlling and, in line with Grawe management's conservative attitude, profits are not distributed but retained to strengthen capital. Grawe also distributes its insurance products via Bank Burgenland's network, while Bank Burgenland facilitates the wider group's treasury and asset management services.

For further details on the credit quality of Bank Burgenland see Appendix II.

COVERED BOND STRUCTURE

Bank Burgenland's covered bonds are on-balance sheet

Figure 1. On-balance sheet issuance structure



Source: Scope Ratings AG

Bank Burgenland issues covered bonds using an on-balance sheet structure, which is typical for most Austrian issuers of covered bonds. As a former Landeshypothekenbank, its issuances of mortgage-covered bonds are not only governed by the 'Gesetz über die Schuldverschreibungen und verwandte Schuldverschreibungen öffentlich-rechtlicher Kreditanstanalten' (21 December 1927 dRGBL – PfandbriefG; see 'Legal Framework' for further details) but also supervised by Austria's Financial Market Authority (FMA) and a dedicated trustee (Treuhänder).

COVERED BOND RATING

Covered bond ratings are supported by the cover pool

The cover pool analysis supports Bank Burgenland's covered bond ratings by the maximum three additional notches above the fundamental credit support. The fundamental support factors also provide the rating with a floor of four notches above the bank's issuer rating.

COVER POOL

Bank Burgenland's cover pool substantially enhances the covered bonds' credit quality. While currently overcollateralization of 389% is provided, in Scope's view, overcollateralisation of 40% (both including non-eligible loan portions) supports the uplift. The supporting overcollateralization reflects the cover pool's current credit quality as well as the planned issuance structure. Based on discussions with the issuer Scope expects sufficient overcollateralisation to remain available to allow the maintenance of the maximum cover pool support.

We limit the credit benefit provided by the cover pool to three notches above our fundamental support assessment, even though the whole loan cover pool balance is almost five times that of the outstanding covered bonds. This reflects the cover pool's dynamic nature and the general ability of the issuer to significantly and swiftly reduce overcollateralisation.

40% overcollateralisation supports the rating uplift

Figure 2. Characteristics of the cover pool and covered bond structure

Reporting date	1 August 2017
Total cover pool/eligible assets (EUR m)	910.4 / 761.4
Covered bonds outstanding (EUR m)	186
Current overcollateralisation (OC, of total cover pool/eligible cover assets)	389.5%/ 309.3%
Legal minimum OC	2.0%
Duration/WAM (cover pool – assets)	5.64 / 5.94
Duration/WAM (covered bond – liabilities)	9.69 / 11.01
Duration/WAM mismatch	-4.05 / -5.07
OC to cover credit risk at current uplift	18.4%
OC to support current rating/OC to support a AA upon a one-notch issuer-rating downgrade (based on whole loan balances)	40% / 38%
Main cover asset type	Commercial and residential mortgages
Number of loans	4,166
Average loan size [EUR '000s]	218.5
Average whole loan LTV/eligible LTV	123.4% / 47.4%
Top-10 exposures	15.1%
Top-20 exposures	21.5%
Geographic split (top 3)	Vienna (38.9%)
	Burgenland (35.7%)
	Lower Austria (12.1%)

Source: Bank Burgenland and Scope Ratings AG

Cover pool composition

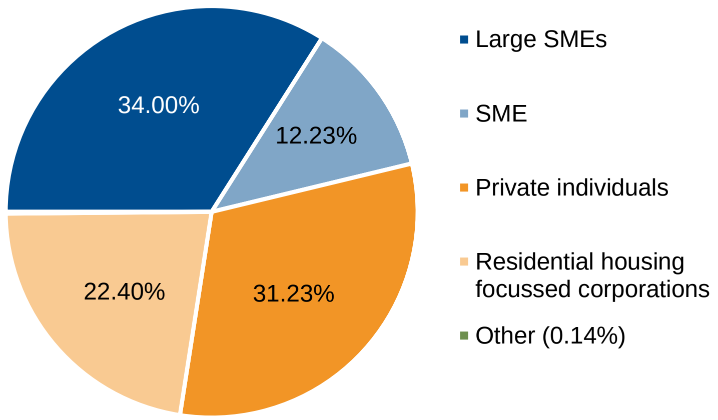
Cover pool is of moderate credit quality and is geared towards commercial real estate financing of corporates

The granular cover pool is of moderate credit quality and comprises solely domestic exposures. It comprises residential and commercial mortgage loans, averaging a balance of EUR 218,536.

Bank Burgenland applies the same prudent underwriting criteria for the cover pool's mortgage loans as it does for those granted in its ordinary course of business. The cover pool is well seasoned with a weighted average seasoning of 5.1 years.

The cover pool consists of 4,166 loans granted to 2,860 obligors, comprising SME's (46.2%), residential borrowers (31.2%). residential housing focussed corporations (22.4%), We observe a higher concentration than for a typical mortgage cover pool, with top 20 obligors making up 21.5%. However, these obligors have a relatively better credit quality and lower whole loan LTVs.

Figure 3. Cover pool by borrower type

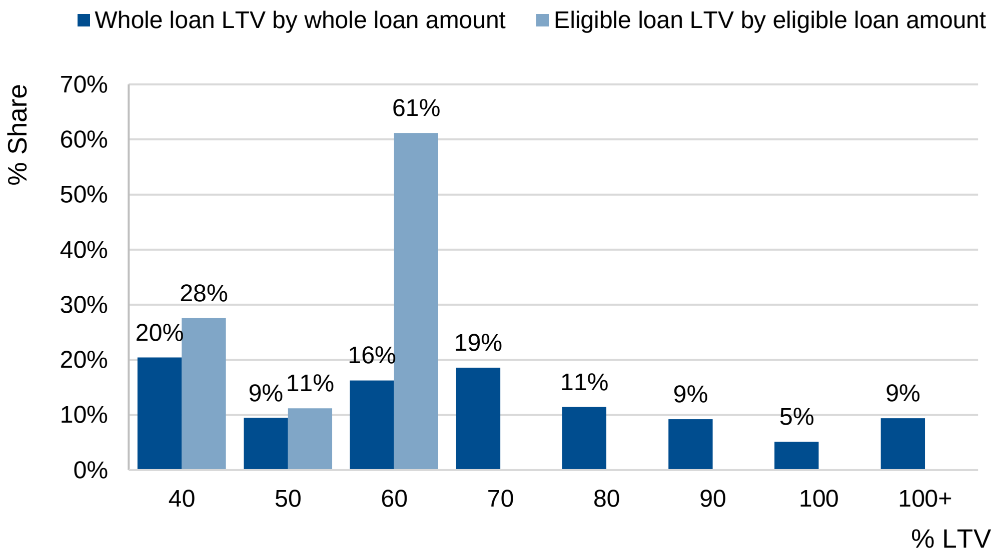


Source: Bank Burgenland

The Austrian covered bond act stipulates a maximum loan-to-value (LTV) of 60% for cover pool assets – if a borrower takes out a mortgage loan with a higher LTV, the whole loan[1] becomes part of the cover pool and effectively establishes the issuance limit.

The cover pool's weighted average indexed whole loan LTV is 123.4% which implies a relatively high default risk and is relatively high also compared to other cover pools. However, this high average LTV is driven by a few borrowers. Often those loans benefit from additional, non-mortgage related security packages and only a very small fraction of their loan is mortgage secured and registered in the cover pool. Excluding the largest 10 commercial borrowers, this ratio drops to a moderate 78%. Taking into account the corresponding 'eligible' average LTV of only 47.4%, any borrower default is not very likely to result in a loss given default.

Figure 4. Cover pool by LTV

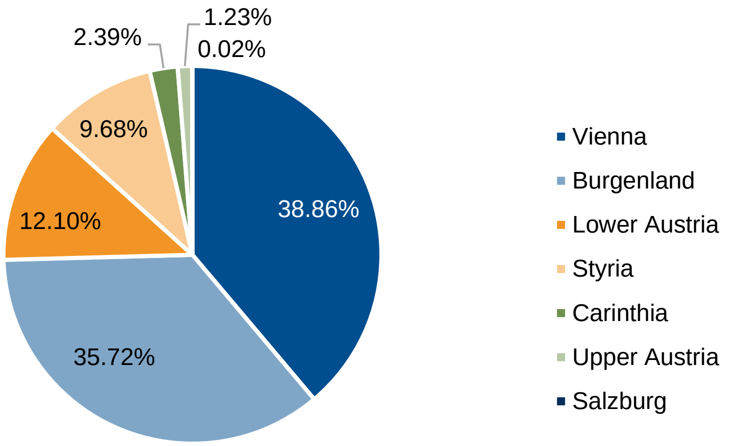


Source: Bank Burgenland

Bank Burgenland has a regional focus, which is evident in the cover pool. Most properties securing the loans are located in Vienna (38.9%), Burgenland (35.7%), with the remainder in bordering areas.

[1] The whole loan LTV considers the whole loan balance (eligible and ineligible parts) as well as prior ranks over the available collateral.

Figure 5. Geographic split by Austrian state

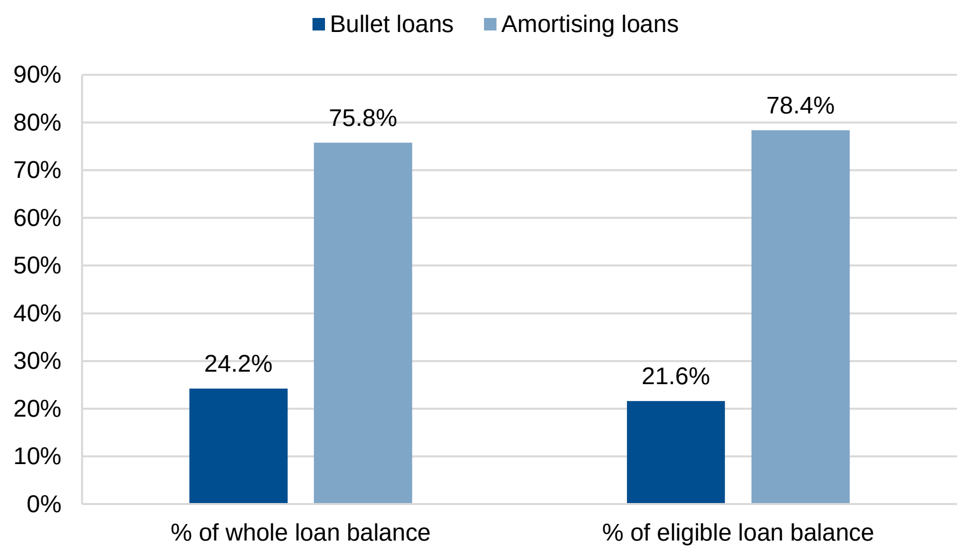


Source: Bank Burgenland

While most loans are amortising (75.8%), there is a high share of bullet exposures (24.2%), increasing refinancing risk

Most of the cover pool consists of amortising loans (75.8%); the rest is granted as bullet loans. We assumed bullet loans as higher risk because, in our view, a driver of loan default is the ability to refinance such loans at the scheduled maturity date, especially among corporates and SMEs. Bullet loans do not deleverage over time, which could severely impair the ability to refinance when borrowers are faced with stressed market value declines.

Figure 6. Repayment type



Source: Bank Burgenland

Our assumption for LTV at maturity considers the expected contractual amortisation during the life of the loan, calculated as our expectation of the outstanding loan amount divided by our assumption of the sustainable property value.

Cover asset origination and servicing

Bank Burgenland's underwriting standards for its mortgage loans are prudent. However, the bank has not applied a positive selection, resulting in a cover pool composition that appears in LTV terms slightly weaker than for national peers. However, the comparatively higher whole loan LTV is driven by a small number of borrowers that contribute an insignificant share to the eligible asset balance. When viewed in terms of whole loan LTV, those borrowers drive the observed shift. The issuer's cover pool management has become more active recently, which in the short term will likely align the whole loan LTV to peers' levels. We view the bank's monitoring and early-delinquency management to be efficient in dealing with weak obligors – evidenced by low provisioning ratios and low final losses.

The cover pool has no delinquent or defaulted loans because the issuer voluntarily removes overdue loans.

Credit risk assessment

Scope derived the cover pool's default assumptions using the bank´s internal risk assessments.

Scope determined that 18.4% of the cover pool is sufficient to mitigate the impact of losses arising from the application of stresses supporting the maximum achievable uplift, i.e. seven notches above the credit quality of the issuer.

Scope's cover pool default projections are based on an inverse Gaussian distribution. To establish a mean default assumption, we have analysed the bank's loan-by-loan risk assessments, relevant back testing information as well as migration matrices.

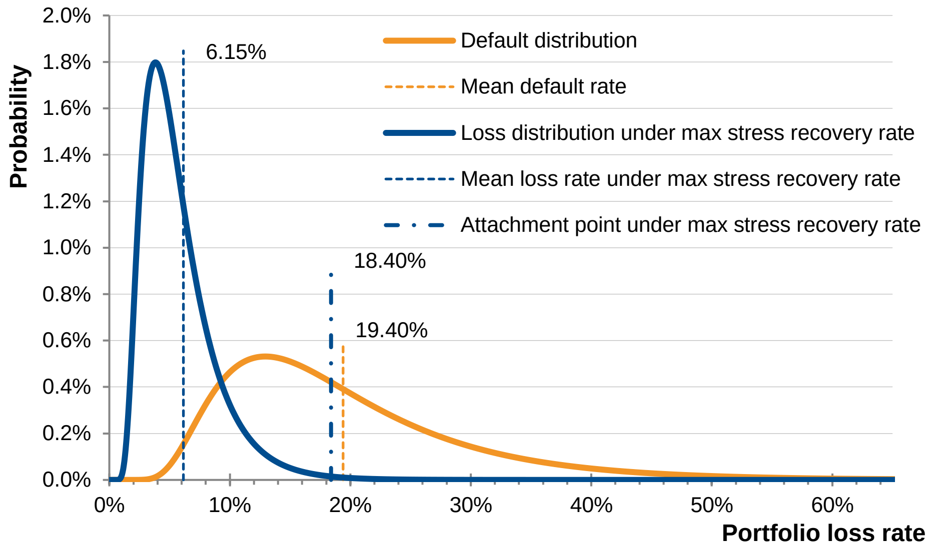
Scope has established a mean default assumption of 19.4%, with a coefficient of variation of 52.6% to analyse the impact of default risk. To determine a corresponding loss distribution, we have applied a weighted average stressed recovery rate of 68.3%, which is commensurate to support the maximum cover pool uplift.

This translates into a mean loss rate of 6.15% under stressed recoveries and compares to a 2% mean loss rate under our base case recovery assumptions. See Appendix I for further details on recovery estimation.

Figure 7, below illustrates the default distribution and loss distribution of the cover pool under maximum uplift.

Cover pool: Credit risk of the cover pool to support maximum uplift established at 18.4%

Figure 7. Default and loss distribution for the cover pool



Source: Scope Ratings AG

Market risk assessment

Overcollateralisation of 40% is sufficient to support the full rating uplift provided by the cover pool

Ample overcollateralisation shields the covered bonds against market, interest-rate and foreign-exchange risks. The highest rating uplift is supported by a 40% overcollateralisation level, and the current level is well above this. We have incorporated the bank's issuance projections to determine the uplift-supporting overcollateralisation.

Bank Burgenland currently issues most covered bonds as private placements, with relatively long-dated maturities. The covered bond maturity structure does not exhibit high concentrations, and the maximum issuance size to date is EUR 30m.

The overcollateralisation provides sufficient inflows in a stand-alone and run-down scenario of the cover pool, allowing the full and timely payment of maturing covered bonds and interest due. As a result, the issuer has not registered substitute assets in the cover pool to mitigate potential shortfalls.

Issuance plans will not lead to overcollateralisation falling below 40% in the medium term nor below the minimum regulatory level of 2%.

Figure 8. Main cash flow characteristics as of August 2017

Currency	Total assets EUR	Net present value EUR	WAM (principal) (years)	Duration (years)	Fixed-interest-paying assets	Floating-interest-paying assets
EUR	**835,275,161**	**936,808,350**	5.74	5.47	13.72%	86.28%
CHF	**75,146,104**	**85,447,287**	8.15	7.59	0.73%	99.27%
Total (EUR)	**910,421,264**	**1,022,255,637**	5.94	5.64	12.70%	87.30%

Currency	Total liabilities EUR	Net present value EUR	WAM (principal) (years)	Duration (years)	Fixed-interest-paying bonds	Floating-interest-paying bonds
EUR	**186,000,000**	**220,520,813**	11.01	9.69	86.60%	13.40%

The whole loan based, rating supporting overcollateralisation is relatively high because of:

- The credit risk of the cover pool reflects a relatively high whole loan LTV (high stressed default risk due to the 24.2% share of bullet exposures, which have a whole loan LTV of 143.6%; at the same time, an eligible loan LTV of 52.4% protects the covered bonds against a loss given a default of such loans);
- Asset-liability maturity mismatch risk, with a negative maturity gap of 5.1 years, and negative duration gap of four years;
- A negative asset-liability spread of about 39bps (weighted average interest is 1.87% for the cover assets versus 2.26% for the covered bonds);
- 8.25% of unhedged Swiss-franc-denominated loans; and
- A mismatch between floating-rate cover assets (87.3%) and fixed-rate liabilities (86.6%).

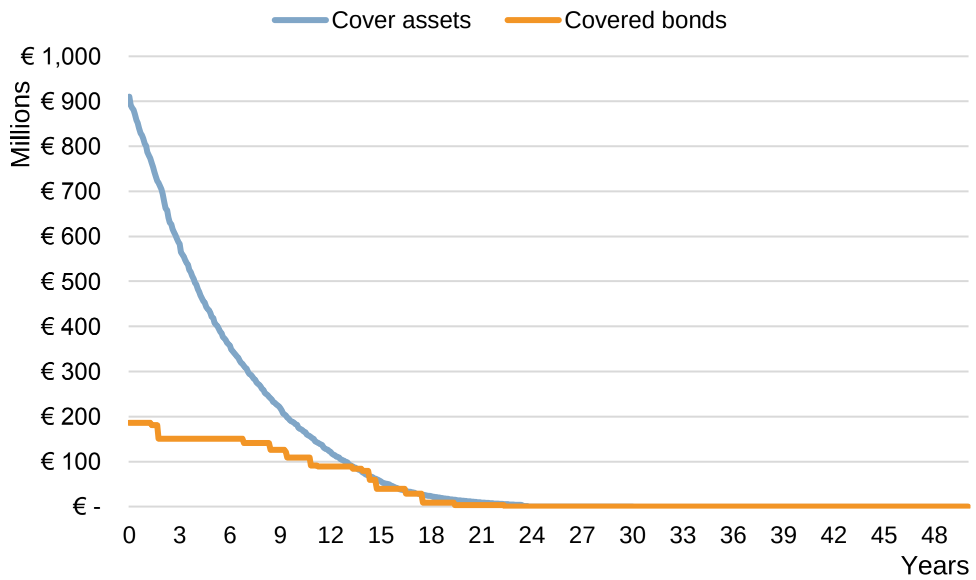
Moderate interest and foreign exchange risks

Current liability profile with ample overcollateralisation does not result in material asset-liability mismatch risk

Asset-liability maturity mismatch risk

The asset-liability mismatch is high in our view. There is a negative maturity gap of 5.1 years between the weighted average life of the assets (5.9 years) and of outstanding covered bonds (11 years). Based on duration, the gap is a negative four years. As there are always more cover pool redemptions than maturing covered bonds, this gap exposes the covered bond programme to negative carry risk.

Figure 9. Asset and liability redemption profile



Source: Bank Burgenland and Scope Ratings AG

Interest rate risk

A high interest rate mismatch exists between the cover pool and the covered bonds. As typical for Austria most mortgage loans are granted at floating rates (87%), while covered bonds are issued at fixed rates (86.6%). We have tested the resilience of the covered bond structure against a deterministic set of adverse interest rate scenarios with rising and falling interest rates (starting at different times) and complemented the stresses with high and low prepayment scenarios[2].

Our analysis shows that under a high prepayment scenario the most stressful scenario for the cover pool involves 'higher for longer' interest rates where current market rates persist for next four years, rise, and then stay at that level. Among others this reflects the impact of negative carry and the long maturity of the covered bonds.

Under a low prepayment scenario, the most stressful scenario involves 'lower for longer' interest rates where current market rates persist for four years, decrease to negative 1%, and stay at that level.

Incorporating the banks issuance projections, the high average covered bond coupon and the negative excess spread will reduce as and no longer remain a risk driver.

Foreign exchange risk

The cover pool has an unhedged exposure to about 8.2% of Swiss-franc-denominated mortgage loans, which introduces the susceptibility to a falling foreign exchange rate. (see Appendix II for further details). The bank is no longer originating such foreign exchange related mortgage loans and their relative risk contribution is expected reduce in line with their amortisation.

Asset-sale risk

No asset sale would be needed in a run-down scenario of the cover pool, assuming the current overcollateralisation and planned issuance structure. The only time we identified the need for asset sales was when we simulated defaults and scaled down overcollateralisation to determine the overcollateralisation needed to support the cover pool-based uplift.

To establish stressed disposal proceeds we discounted the remaining cash flows of the cover pool and added an additional discount factor, a liquidity premium. We have assumed a liquidity premium of 150bps for residential financings, and 300bps for corporate or SME financings, based on the change in Austrian secondary-market covered-bond trading spreads.

Overcollateralisation (OC)

Current credit quality of Bank Burgenland beneficial to available overcollateralisation

Bank Burgenland's covered bond ratings are supported by the cover pool and therefore hinge on the issuer's ability and willingness to provide overcollateralisation above the legal minimum.

Our credit view of Bank Burgenland allows us to fully consider available overcollateralisation for the analysis. Applying all credit and market risk stresses we established that an overcollateralisation of 40% (based on the whole loan balance) will mitigate the identified stresses and support the full uplift under our methodology.

If our credit view on the issuer deteriorated, we would need to identify whether the issuer's capital market communication on intended overcollateralisation sufficiently reports on provided levels. In the absence of this, we would establish a sustainable level against which we would compare rating-supporting overcollateralisation to determine whether we can maintain the rating.

If the issuer rating reduced by one notch, the covered bond rating would also be downgraded by one notch, provided that the covered bond programme's credit and cash flow profiles remain the same. The bond ratings are supported by the highest cover pool-based uplift under our methodology. Therefore additional overcollateralisation would not change our credit view. To support a lower rating of AA, however, the rating-supporting overcollateralisation for a seven-notch uplift would decrease to 38%.

We are not aware of plans that would significantly change the risk profile or reduce available overcollateralisation to levels that would no longer support the current rating uplift.

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[2] For the high CPR scenario we have applied 15% on residential mortgages and 20% on commercial mortgages; the low CPR takes into account scheduled amortisations only.

Counterparty risk

The covered bonds are exposed to Bank Burgenland's roles as originator, servicer, bank account provider and paying agent. There are no documented replacement mechanisms that would shield the covered bonds from the credit deterioration of a counterparty. However, if such a scenario were to occur, we believe the strong alignment of interests between the bank and covered bond holders would mitigate negative impacts in the time before the regulator intervenes in the counterparty. As part of the risk management process, the bank regularly monitors its external bank accounts to ensure it can enter remedial actions early on. We also take a positive view that most collections are done via direct debit, allowing for a relatively swift redirection of payments if needed.

In addition, we expect that if the regulator intervenes in Bank Burgenland, available resolution tools would be used to maintain the issuer. Scope does not expect the active management and servicing of the cover pool to be severely impacted in such a scenario.

FUNDAMENTAL CREDIT SUPPORT

The Austrian covered bond framework (in particular the PfandbriefG relevant for Bank Burgenland's mortgage-covered bonds), combined with our credit-positive view on the resolution regime, allows us to assign the covered bonds a positive, fundamental-analysis-based credit differentiation of four notches above the bank's rating. This fundamental credit support also provides the ratings with a current floor of A+, unless the issuer significantly increases risks and decreases the overcollateralisation to the regulatory minimum.

LEGAL FRAMEWORK

Maximum two-notch rating uplift reflects the sound legal framework

The Austrian legal covered bond framework drives the two-notch credit differentiation: our analysis confirms that the three frameworks in Austria meet the minimum criteria to assign the maximum credit differentiation under our methodology. The framework's provisions are robust, ensuring the cover pool is segregated from the issuer's insolvency estate. In addition, the frameworks allow bond payments to continue after insolvency, and ensure identified risks can be mitigated by overcollateralisation, which generally will remain available after insolvency. Covered bonds also benefit from specific regulatory oversight. On the other hand, we recognise that these frameworks are still relatively vague on best practice regarding the liquidity or risk management of covered bonds.

Austrian covered bond framework just meets the minimum standards – though likely to improve in 2018

Currently, the Austrian covered bond frameworks just meet the minimum standards under our methodology. We believe the European Commission's analysis on the Austrian covered bond frameworks, labelling them among the least prescriptive, along with industry efforts to improve and consolidate the three frameworks in 2018, will eventually reduce complexity and introduce more covered bond-specific management guidelines. This will lead to better credit protection for covered bond investors.

For a more comprehensive assessment of the fundamental support factors relevant for Austrian covered bonds, see the related research.[3]

RESOLUTION REGIME

Resolution-regime analysis supports additional credit differentiation of two notches

We have assigned an additional credit differentiation of two notches to reflect the exclusion of the rated covered bonds from bail-in in the hypothetical scenario of regulatory intervention in the issuer. We also have provided one additional notch to reflect the combination of i) a moderate likelihood that regulators are, in a resolution scenario, more likely to restructure the issuer as a going concern using available tools; and ii) the increasing systemic importance of covered bonds in Austria; but offset in part by iii) the issuer's limited prominence in the covered bond market. At this point, the latter is unlikely to fully sustain issuer-driven support.

In the resolution framework assessment, we analyse how likely a regulatory intervention in the issuer will preserve the covered bond's credit quality and assess whether:

- Austrian covered bonds comply with regulatory definitions to benefit from the preferential status;

[3] Covered Bond Framework Analysis – Analytical Considerations: Austria.

- The issuer is bail-inable and regulators would use available tools to preserve the covered bond issuer;
- Mortgage-covered bonds in general and the issuers' covered bonds are systemically important in the domestic context; and
- An active domestic stakeholder group (issuers, regulators and investors) is maintaining confidence in and a high credit quality of the covered bonds.

The rated covered bonds are excluded from bail-in in a hypothetical scenario of regulatory intervention in the bank, and we expect regulators would restructure the issuer using available resolution tools. This reflects the bank's high capitalisation, which, as a first defence, would encourage its restructuring (excluding potential additional parental support). In the extremely adverse scenario in which available capital and potential bail-inable debt were fully used up and regulators could not establish the bank as a going concern, we would instead expect an orderly wind-down. This is because the bank does not provide critical services, and its core activity, retail banking, can be easily substituted by other banks in the already overbanked Austrian market.

Bank Burgenland's limited prominence as a covered bond issuer is, in our view, unlikely to result in product-driven support by market stakeholders. The bank, while a longstanding issuer of covered bonds, has only recently restarted to issue covered bonds under its own name. It has not issued larger, internationally placed covered bonds and is expected to remain active in private placements, primarily to better manage asset-liability mismatches and regulatory ratios (NSFR). With only EUR 186m of outstanding covered bonds to date, the bank captures a mere 60bps of the Austrian mortgage-covered bond market (end-2016) and 45bps of total outstanding covered bonds (including than bank's EUR 30m public sector-covered bonds). Most of the issues are placed with domestic investors and are not represented in relevant indices.

At the same time we expect the support for Austrian covered bonds to gradually increase and eventually allow for an additional notch of support, also for smaller issuers. The number of Austrian covered bond issuers has remained relatively stable, and 26 banks actively use the product. At the same time, the number of covered bond programmes increased in four years, to 48 in 2016 from 39 in 2012; and the volume of outstanding covered bonds increased to EUR 48bn from EUR 42bn in the same period. The 'covered bond intensity' in Austria has already started to exceed 10%, making it one of the more covered bond-intensive countries. In our view, it is therefore more likely that even smaller covered bond issuers would receive product-driven support to avoid a contagion to the funding channels of other smaller financial institutions.

For Austria we have constrained the fundamental-resolution-based uplift to three notches given the lower predictability of stakeholder and regulatory support.

The absence of strong, proactive communication by regulators and support by industry stakeholders was evidenced during the prolonged uncertainty on the credit quality of covered bonds of two banks in workout, HETA and Kommunalkredit. These banks were placed under close regulatory supervision and moratorium, or split into a 'good' and 'bad' bank. Nevertheless, investors were not regularly informed on how this affected their outstanding covered bonds. Such uncertainty on credit quality is, in our view, not commensurate with an additional fundamental support.

RATING STABILITY

Changes to the issuer assessment

Changes in our assessment of the bank will directly translate into cover pool rating changes

The covered bond ratings would move in line with an issuer downgrade or negative change on its Outlook. This reflects that the maximum cover-pool-driven uplift under our methodology can only be three notches above our assessment of fundamental support factors; while credit differentiation based on additional collateral is limited to three notches above fundamental support factors. Similarly, a positive credit development would result in an upgrade of the covered bonds.

Changes to overcollateralisation

Minimum overcollateralisation to support a AA upon an Issuer downgrade reduces to 38%

If the issuer were downgraded by one notch, the covered bond rating would also be downgraded by one notch. The minimum rating-supporting overcollateralisation under a seven-notch uplift would also reduce to 38% from 40%.

Assuming no change in our credit assessement of the issuer but assuming that overcollateralisation fell below 40%, the rating would be downgraded by one notch to AA and the minimum rating-supporting overcollateralisation for this rating would be 33%.

The issuer has started to address some of the credit and market risks relevant for the rating-supporting overcollateralisation. Provided no additional risks are introduced into the covered bond programme, Scope will likely reduce the rating-supporting overcollateralization once implemented.

SOVEREIGN RISK

Immaterial risk of institutional meltdown, legal insecurity or currency problems

Sovereign risks (particularly macroeconomic) do not limit Bank Burgenland's mortgage-covered bond ratings. We believe the risks of an institutional framework meltdown, legal insecurity or currency-convertibility problems are currently very remote. Scope has rated the Republic of Austria at AAA, Stable Outlook,[4].

DATA ADEQUACY

Detailed cover pool data provided by the bank

We consider the data quality as adequate considering the cover pool's granularity.

Scope analysts visited Bank Burgenland and interviewed key personnel to understand the banks' origination, monitoring and workout processes. We also discussed key trends relevant for the development of the cash flow profile, including issuance plans.

MONITORING

Ratings regularly monitored

Scope will monitor this transaction using information regularly provided by the issuer. The ratings will be monitored and reviewed at least once a year, or earlier if warranted by events.

APPLIED METHODOLOGY

To analyse the mortgage-covered bonds, Scope applied the 'Covered Bond Rating Methodology', published 31 July 2017, and the 'Methodology for Counterparty Risk in Structured Finance', dated 11 August 2017. We also applied the principles in our 'General Structured Finance Rating Methodology', dated 28 August 2017, for the asset and cash flow analysis. For establishing our credit view on the issuer we also applied the principles of the Bank Rating Methodology. Our rating methodologies are available on our website www.scoperatings.com.

[4] Sovereign report on Austria can be found here.

APPENDIX I. QUANTITATIVE COVERED BOND ANALYSIS

Credit risk analysis

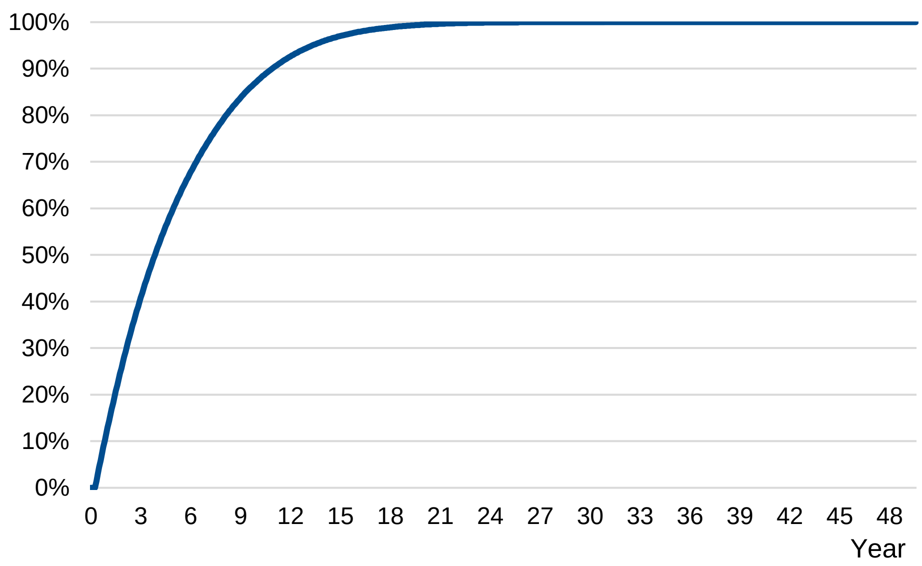
Bank Burgenland's cover pool is granular enough to apply an inverse Gaussian distribution in order to assess the likelihood of defaults in the cover pool. We use the default distribution together with different market scenarios to analyse the cash flows for the covered bonds to derive an expected loss.

We applied an inverse Gaussian distribution to apply defaults in our cash flow analysis to calculate the expected loss on the covered bonds. The analysis applies rating-conditional recovery rates as a function of the distance (D0 to D7) between the covered bonds' and the issuer's ratings. D0 is our base case while D7 is the most stressful scenario allowing the highest rating uplift.

To establish lifetime default rate assumptions, we have adjusted available data with Scope's view on the borrowers' refinancing risk. In the absence of more detailed issuer-specific vintage data we used a default-rate coefficient of variation[5] that we observed for granular pools of mortgage loans in Germany and Austria.

Scope used a front-loaded default timing structure. Back-loaded default scenarios are not as severe for the covered bonds because of excess cash build-up and the effect of seasoning on the portfolio. The cumulative default-timing assumptions are shown in Figure 10 below and represent the assumed default timings for the cover pool. The defaults are classified as an 'after 90+ days past due' delinquency.

Figure 10. Cumulative default timing assumptions



Source: Scope Ratings AG

Rating-distance-conditional market value declines

Scope calculated the recovery rate on a mortgage by applying fundamental analysis estimating the stressed value of the underlying property. Scope's framework involves:

i) estimating the current value of the property (typically by indexation);

ii) estimating the distance from current price to long-term sustainable values;

iii) applying a rating-distant haircut on the sustainable value of the property;

iv) applying a fire sale discount; and

v) deducting foreclosure costs (e.g. stamp duty land tax, legal fees) from the security value.

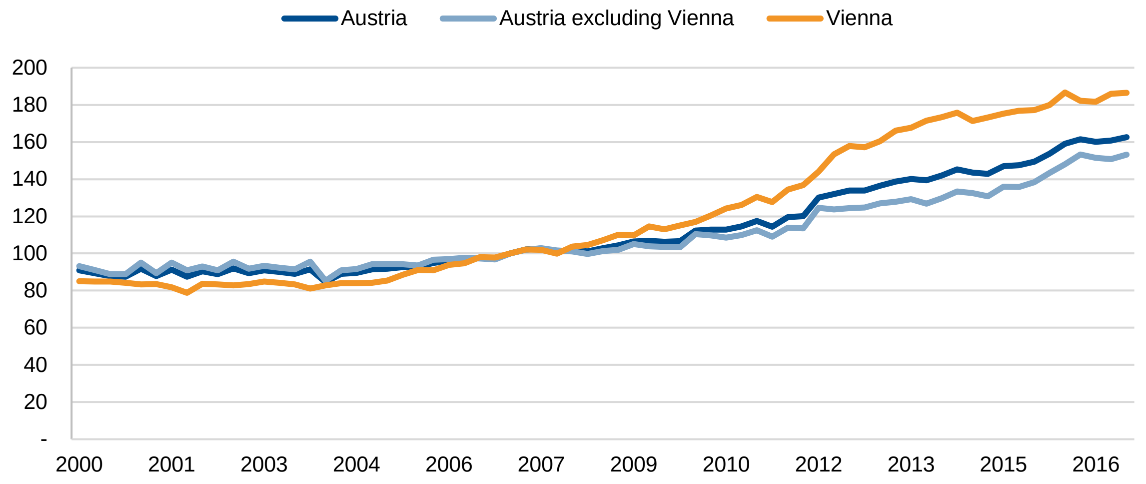
Steps ii) and iii) constitute the market-value-decline assumptions as calculated in the below section 'Market-value-decline analysis'.

The recovery rates considered in the analysis reflect the outstanding notional of the loan as of closing. This implies that recovery rates are conservative because deleveraging reduces LTV and increases the expected recovery rates over time.

5 The coefficient of variation is defined as the standard deviation divided by the mean.

Market-value-decline assumptions

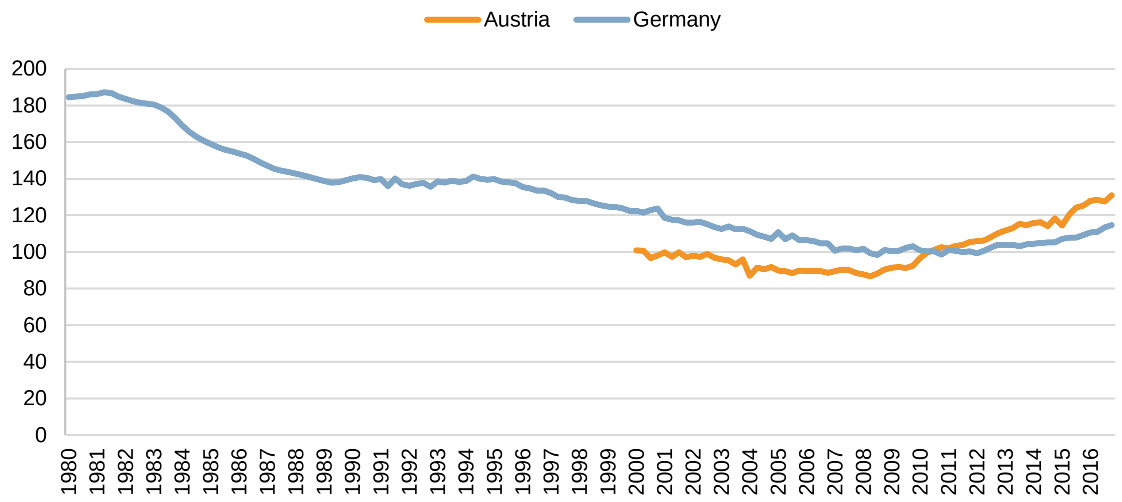
Figure 11. House price development in Austria (index 2007Q1 = 100)



Source: OeNB

We derived market-value-decline assumptions based on our view of sustainable prices and the observed volatility of the OECD's and OeNB's (Oesterreichische Nationalbank) affordability indices for Germany, Austria and Vienna. Our affordability analysis used the longer historical series for Germany because the timeframe of the comparable index for Austria was limited. This also reflects our view that fundamental risk factors for both countries are highly comparable.

Figure 12. Affordability index (price-to-income index)



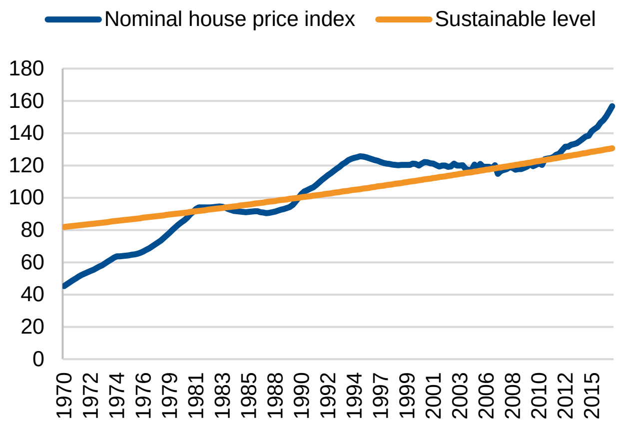
Source: OECD

Scope used the affordability index as a proxy for the volatility of commercial and residential real estate.

In the scenario needed to support the maximum achievable uplift we calculated a weighted average recovery rate of 68.3%, which compares to our base case recovery assumption of 89.6%.

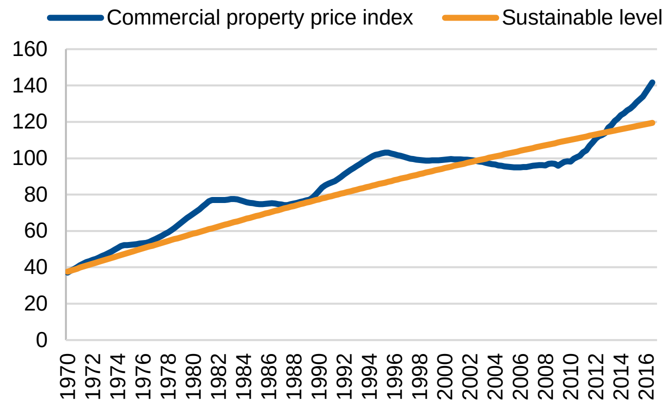
Figure 13. Market-value-decline (MVD) assumptions for Bank Burgenland's cover assets

House price index and MVD



Source: OECD and Scope Ratings AG

Commercial price index and MVD



Source: BIS and Scope Ratings AG

Market risk analysis

The main inputs for the cash flow analysis are the credit-related parameters of the pool (e.g. amortisation profile, default distributions, default timings, recoveries) and market-scenario parameters (e.g. stressed interest rate and foreign exchange term structures, and stressed refinancing assumptions). Scope assumes asset sales can cover liquidity shortfalls. Disposal proceeds are determined by calculating the present value, i.e. discounting all future expected cash flows and adding a liquidity premium for the cover pool.

The covered bond rating is anchored at our rating of the issuer. Our methodology reflects this by considering stress scenarios which depend on the rating distance. The base case scenario is anchored at the issuer rating, i.e. we allow the issuer to cover rating scenarios up to the issuer rating. The cover pool therefore only needs to support scenarios above this threshold. We translate the stresses commensurate with the potential uplift into a quantitative covered bond rating.

For more information please refer Appendix II of the methodology.

Key modelling parameters

The highest stress assumptions only apply in the scenario which, if passed, allows the maximum credit differentiation between the issuer and its covered bonds.[6]

Liquidity premium: We base the relevant average liquidity premium on the cover pool's composition. We applied on average 150bps as additional liquidity premium for the discounting of the Austrian residential mortgage assets and 300bps on commercial mortgage assets. We determined the liquidity premium by analysing the historical trading spreads of other Austrian covered bonds.

Market risk stresses: We assumed deterministic interest rate and foreign exchange stresses in our cash flow modelling, and applied a common framework to establish the stresses. The analysis allows us to establish stresses that equate to the maximum achievable rating uplift.

Interest rate sensitivity analysis: We tested Bank Burgenland's covered bonds against several scenarios of rising and falling interest rates. In the rising interest rate scenarios, the current level increases to a stressed rate of 10%, and after two years it starts to revert to a long-term mean. The falling interest rate stresses drop after the first two years to a low of minus 1%; we model interest rate developments that revert to the mean after two years as well as scenarios in which interest rates remain at those negative rates. For both rising and falling interest rate scenarios, we simulate interest rate patterns when rates start to deviate from current expectations; this is done at different starting points. The tested interest rate scenarios start to deviate between years 2 and 10. Further, the tested patterns include a scenario that reflects current interest rate expectations. For further details see Appendix II, section 4.1 of the covered bond methodology.

Foreign-exchange risk sensitivity analysis: Bank Burgenland's covered bonds are exposed to Swiss-franc-denominated mortgage loans (8.25% of the cover pool). These assets are unhedged and introduce a risk of the Swiss-franc rate falling against the euro rate. We have assumed for the maximum uplift that the foreign exchange rate falls from 10% in the short term to 75% in the long term.

[6] The maximum credit differentiation between the rating of the issuer and of its covered bond is typically determined by our fundamental assessment of the legal and resolution framework. Our methodology sets out that the maximum credit differentiation can only be three notches higher than this fundamental uplift. For Bank Burgenland, we have determined a fundamental support of four notches. According to our methodology, the maximum achievable uplift is seven notches (4+3).

Prepayment rate assumption: We tested all cover assets at a high constant prepayment rate (15% on residential mortgages and 20% on commercial mortgages) and at a low constant prepayment rate (0%). A high constant prepayment rate is the most stressful for the programme due to the higher coupon on the notes.

Servicing fee: We applied 34 bps of country- and asset-type-specific servicing fees paid annually by the cover pool.

APPENDIX II. BANK BURGENLAND CREDIT CONSIDERATIONS

Highlights

Bank Burgenland's ratings reflect a well-established, profitable, regionally-focused banking franchise in the Austrian state of Burgenland and bordering areas in eastern Austria, with access to real estate markets in the greater Vienna area and Styria. The bank is owned by Grazer Wechselseitige Versicherung AG (Graz Mutual Insurance Company, Grawe) since 2006.

In 2008, Bank Burgenland was established as the controlling financial institution within the Grawe group to oversee its various financial subsidiaries (Charts 1 & 2). This group of financial institutions comprises banks and financial service companies within Austria and Hungary. Although the group pursues a multi-brand strategy with the aim to have access to a wider diversified customer base, the entities are managed as part of an integrated business model, allowing various specialised financial services to complement each other as well as providing access points to funds.

Despite its 100% ownership by Grawe, Bank Burgenland is managed at arm's length and does not benefit from any formalised guarantee commitments. Nevertheless, group members are integrated into the Grawe group's risk control strategy. It is our impression that Grawe management is highly focused on a conservative, mutual business ethos with client services and customer satisfaction at the core of the company's evaluation of its success. In accordance with its overall strategy, the group's management is also strongly focused on capital preservation and intrinsic strength build-up via precocious provisioning, which is not only reflected in its own prudential metrics, but also in the wider management of other group entities.

Bank businesses take up about half of the Grawe group's balance sheet size, contributing nearly 40% of profits from ordinary business. The shareholder cooperates closely with Bank Burgenland and its subsidiaries on various levels, e.g. with regard to group-internal asset management agreements, commercial real estate business, as well as the utilisation of the bank network as an alternative distribution platform for insurance products. Given this, combined with the insurance company's strong financial position, we would assume that the group has a great interest, and also the ability, to support any group member in need. Nevertheless, the lack of any formalised support and guarantee structures does not permit an explicit rating uplift in the case of Bank Burgenland. The group structure and set up are rather reflected in the intrinsic strength of Bank Burgenland.

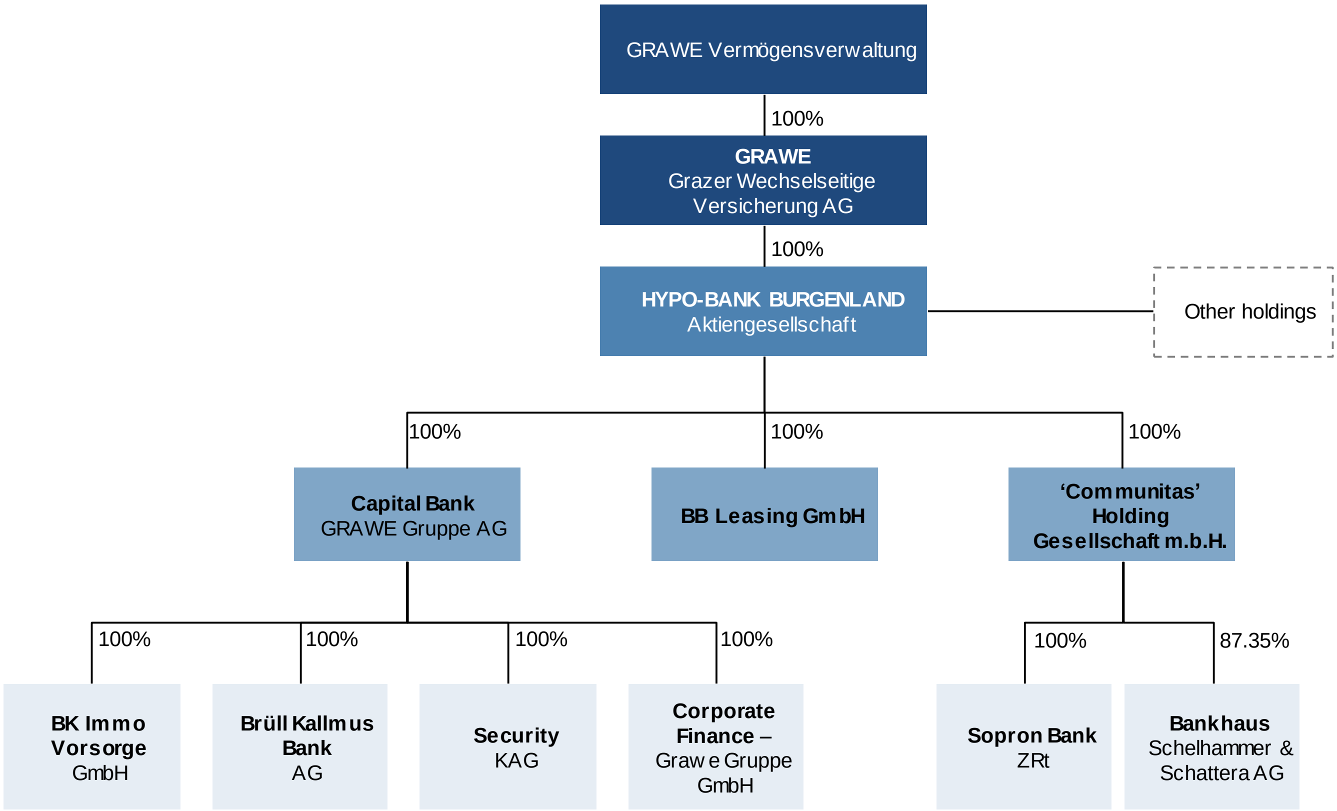
Bank Burgenland has had an adequate asset-quality and showed improved profitability over the past years. In accordance with Grawe group's conservative management, bank profits are not distributed, but rather are used to strengthen the bank's capital basis.

Bank Burgenland's financials have been improving due to certain intrinsic factors such as a restructured, more integrated business profile with its subsidiaries, as well as an aligned, conservative risk control strategy within the larger Grawe group. In this respect Scope especially highlights the positive profit contribution of the asset management business related to Bank Burgenland's fully consolidated subsidiary Capital Bank. In addition, the more benign macro-economic environment in Austria and the neighbouring CEE countries has provided positive momentum to the establishment of some profitable business.

Bank Burgenland's ratings also reflect the concentration risk in mortgage lending within a regional market, as well as the bank's limited growth potential without larger risk-taking.

Bank Burgenland is supervised by the Austrian Financial Market Authority.

Chart 1: Bank Burgenland ownership and group structure overview



Source: Company data, Scope Ratings

Rating drivers (summary)

The rating drivers, in decreasing order of importance to the rating, are:

1. Regionally focused bank with a recent track record of adequate asset quality and profitability since integration into the wider Grawe group, with the group providing an underlying conservative and mutually defined business strategy
2. Conservative funding and liquidity profile, as well as prudent capitalisation
3. Lean business structures equip the banking group with the competitive advantage of a faster and more individualised response to client needs; but the multi-brand strategy combined with the lack of a unified, integrated IT platform may pose some risk management challenges
4. Austrian state of Burgenland currently provides a benign and prosperous economic environment, supportive of growth

Rating-change drivers

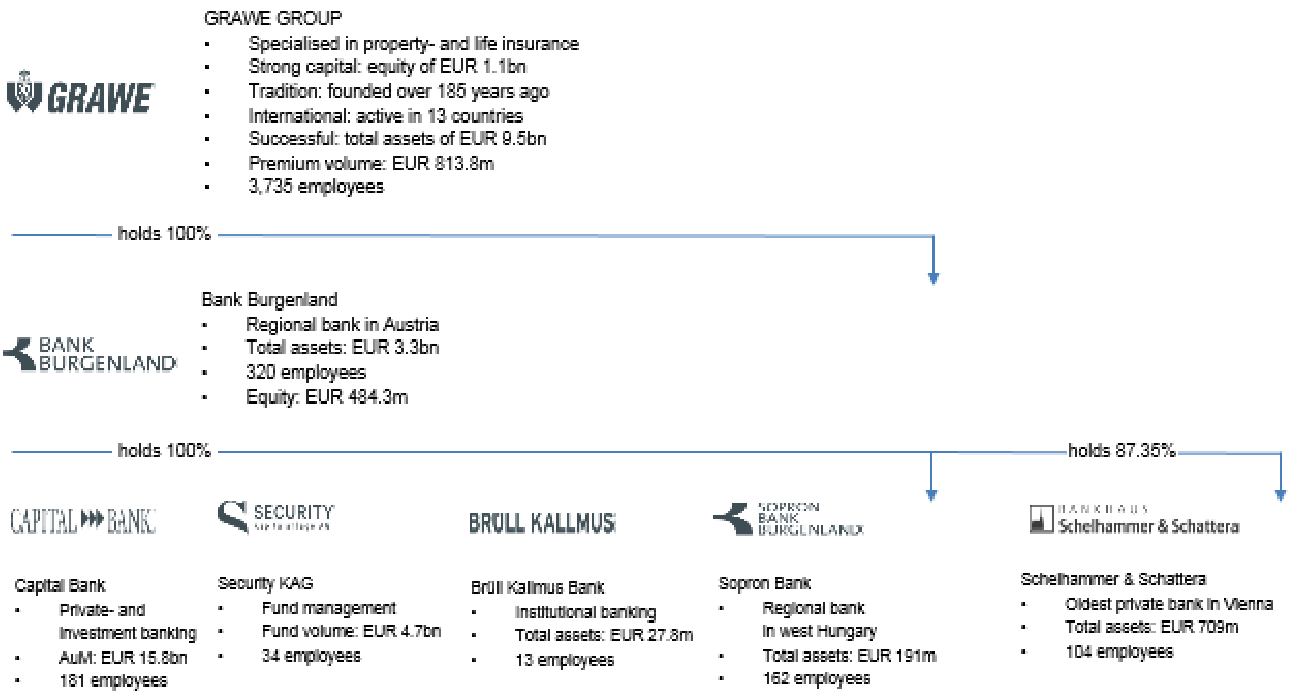
↑↓	Any changes in the shareholder structure could affect the issuer's ratings.
↑	Any further improvement in the financials and stabilising profitability of Bank Burgenland and its main shareholder – particularly during a period of weaker macro-economic fundamentals – could provide an uplift to the bank's ratings.
↑	Any formalisation of support commitments/guarantees by the current shareholder would positively influence the bank's ratings.
↓	Any adverse risk exposure or risk-taking on the part of the bank, its majority shareholder or financial subsidiaries could put pressure on the issuer's rating.
↓	Any decreased commitment by the current shareholder or capital depletion would lead to a downgrade of Bank Burgenland's ratings.

Rating drivers (details)

Regionally focused bank with a recent track record of adequate asset quality and profitability since integration into the wider Grawe group, with the group providing an underlying conservative and mutually defined business strategy

Bank Burgenland's business profile has been substantially re-shaped over the past ten years or so, since the takeover of the bank by Grawe. Bank Burgenland, as a banking institution itself, is focusing on the retail and small business segment, as well as continuing to benefit from its status as the 'house bank' for the regional state of Burgenland. Furthermore, in 2008 the Grawe group established Bank Burgenland as the financial institution which oversees the group's various financial subsidiaries. Within the so called 'Grawe banking group', Bank Burgenland provides also the expertise for real estate business, including commercial real estate lending. Other members of the Grawe banking group mainly provide complementary services that focus on asset management and private banking (Chart 2). Capital Bank and Schelhammer & Schattera, the private banking institutions within the group, count as part of the largest, independent private banks in Austria. Fund manager Security KAG has shown a strong growth in fund volumes over the past years.

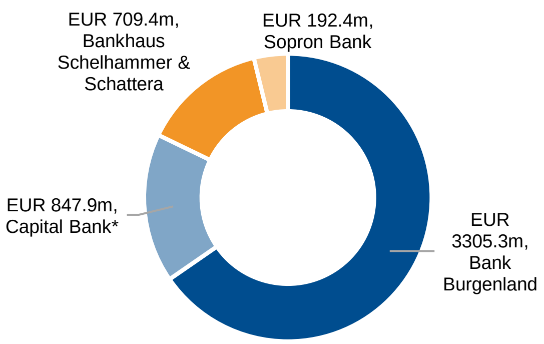
Chart 2: Overview Bank Burgenland group: main financial institutions and selected key information

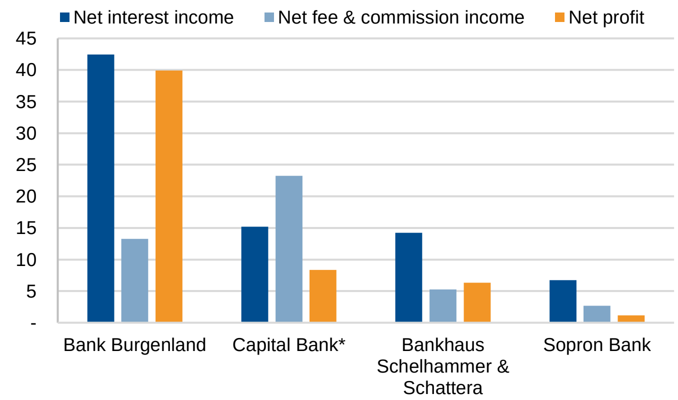


Source: Company data, Scope Ratings

As the group's controlling financial institution, Bank Burgenland benefits from strong contributors to profit on a consolidated basis. This is particularly the case with Capital Bank – including its subsidiaries Brüll Kallmus Bank AG, Security KAG and BK Immo Vorsorge GmbH – and the recent addition, Bankhaus Schelhammer & Schattera AG (Charts 3 & 4). Within the Grawe group, the banking arm has around EUR 18bn assets under management, with the majority being overseen by Capital Bank and its subsidiary Security KAG.

Charts 3 & 4: Overview Bank Burgenland group – Total assets & selected key figures of member institutions (EUR m, as of year-end 2016)



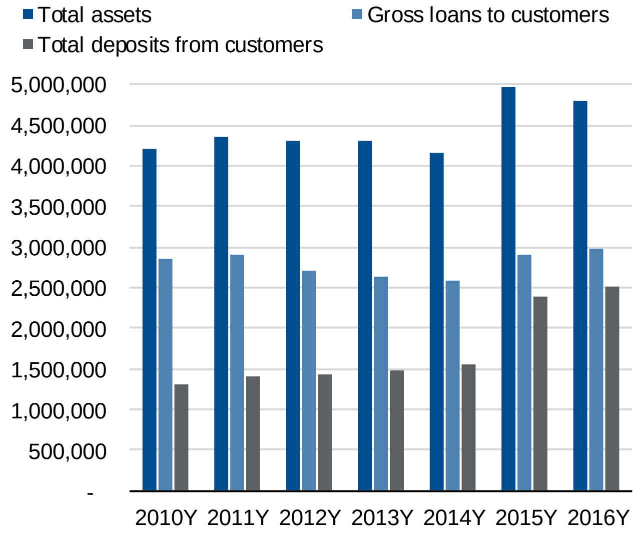


*Note: Including key subsidiaries Brüll Kallmus Bank AG and Security Kapitalanlage Aktiengesellschaft; Source: Company data, Scope Ratings

Bank Burgenland maintained relatively moderate balance sheet growth until 2014; however, due to additions to the banking group, a general improvement in the economic environment, as well as enhanced access to funding via primary funds (Chart 5), the bank is currently pursuing a more focused growth strategy.

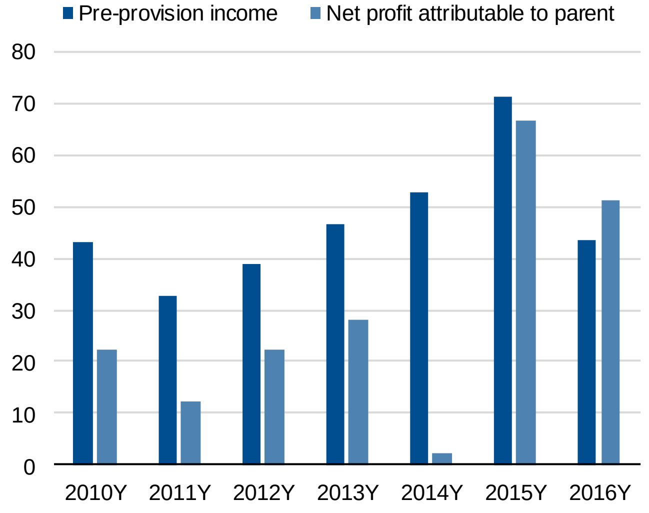
The bank's performance has improved somewhat over the past years, although various one-off effects, related to the bank's Heta exposures for example, somewhat distort the picture of the underlying business trend (Figure 6).

Chart 5: Bank Burgenland (consolidated) - Historic balance sheet trends



Source: SNL financial, Scope Ratings

Chart 6: Bank Burgenland (consolidated) - Historic business performance

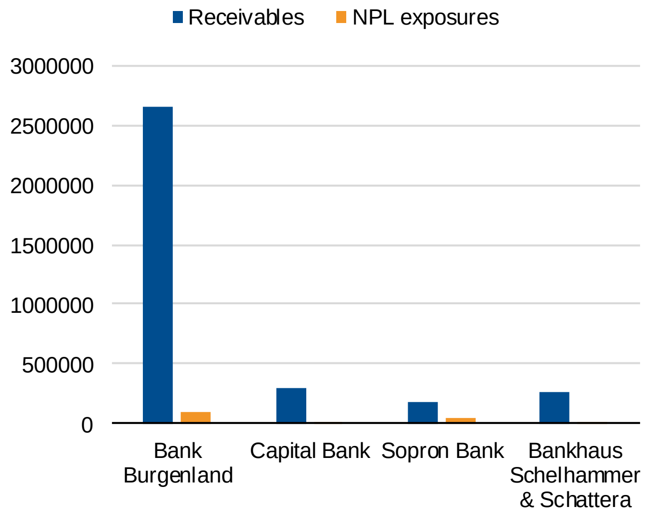


*Note: Provisions / NPL; Source: SNL financial, Scope Ratings

With regard to the wider Grawe group level, where business ethos is strongly influenced by mutual principals, the success of group members is partly measured by customer satisfaction rather than in terms of monetary results only. Nevertheless, all group members are expected to have profitable and sustainable business profiles and to achieve leading market shares in their respective business segments. We therefore believe that the bank's growth and profitability profile corresponds to the wider strategy of the Grawe group.

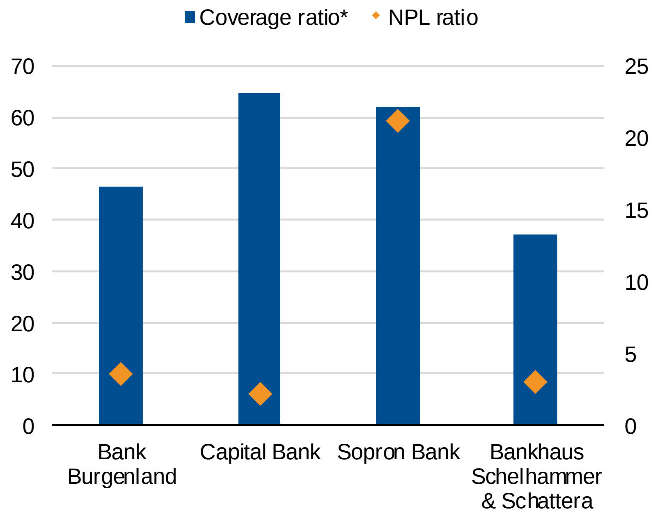
The asset quality of the bank is adequate. NPL ratios of members of the banking group are typically below 3% of total loans (Figures 7 & 8); however, in this context it is important to note that Bank Burgenland is the main risk taker in the group due to the bank's relatively larger lending businesses. In Hungary, larger risks and non-performing loan exposures are based on loans which were granted before the financial crisis and which also carried forex risk due to their CHF and EUR denominations. It is our understanding that a larger part of these loans has been converted in the meantime.

Chart 7: Receivables and NPLs held by group banks



Source: Company data, Scope Ratings

Chart 8: NPLs and coverage ratios with group banks



Source: Company data, Scope Ratings

2. Conservative funding and liquidity profile, as well as prudent capitalisation

The prudent metrics of Bank Burgenland have demonstrated strong stability over the past years, with owner Grawe supporting intrinsic capital build up and conservation at the banking level.

Risk-weighted asset levels have remained stable over the past years and growth in capital is based on retained profits. All financial entities within the group have prudent capitalisation levels (Chart 9). Although Bank Burgenland does not benefit from an explicit guarantee from its owner, our view is that the integration of the bank within the group, as the leading institution for its financial arm, as well as the strategy of intrinsic capital build up, reflect a strong strategic commitment on the part of Grawe.

Chart 9: Overview Bank Burgenland group: financial institutions, selected key figures

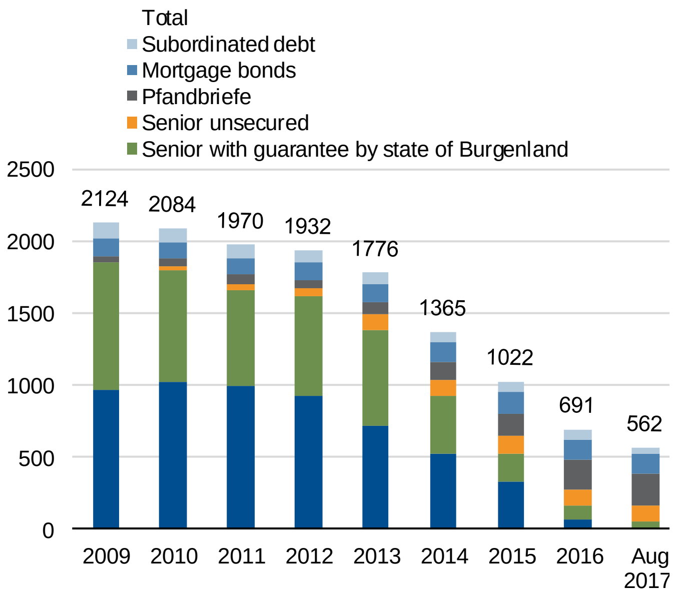
Data as of 2016/ in EUR m if not indicated otherwise	Total assets	RWAs	Core capital	Operational result	Pre-tax profits	Employees
Bank Burgenland	3,305,287	1,864,750	19.83%	25,818	41,819	306
Capital Bank	847,896	389,188	16.60%	15,559	11,110	166
Bruell Kallmus Bank	27,775	1,897	73.79%	4,477	4,541	12
Schelhammer & Schattera	709,379	425,228	19.79%	8,380	7,016	90
Sopron Bank	191,317	93,025	16.26%	1,695	1,031	144

Source: Company data, Scope Ratings

After the discontinuation of state guarantees for Landes-Hypothekenbank funding in 2003, Bank Burgenland had to gradually shift its funding profile in line with upcoming maturities. Increased primary funds enabled the bank to decrease market funding substantially (Charts 10 & 11). However, we believe that a changed market environment and regulatory requirements will move the bank's focus again, this time towards more regular access to capital markets via Pfandbrief (covered bond) issuance, as well as senior unsecured funding.

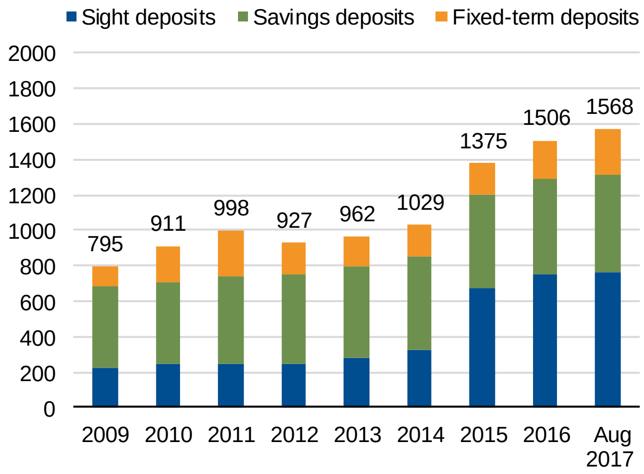
Liquidity is managed adequately. We note however that mutual financial dependence leads to some complexities within the group. In 2015, Bank Burgenland initiated the purchase of Bankhaus Schelhammer & Schattera AG, a private bank based in Vienna. Bank Burgenland's liabilities to Bankhaus Schelhammer & Schattera AG based on money market business represent one of the largest within the group. In Q1 2017, Bankhaus Schelhammer & Schattera also established a new online bank 'DADAT – Die ALLES Direktbank'. Both entities provide the group with access to funding via deposits.

Chart 10: Historic development of funding profile



Source: Company data, Scope Ratings

Chart 11: Development of deposit base



Source: Company data, Scope Ratings

3. Lean business structures equip the group with the competitive advantage of a faster and more individualised response to client needs; but the multi-brand strategy combined with the lack of a unified, integrated IT platform may pose some risk management challenges

Bank Burgenland benefits from relatively lean business and flat hierarchy structures which support fast, streamlined decision-making processes. The bank, and overall Grawe group, promote a sustainable business model by providing long-term commitments to its employees. This governance structure helps to preserve know-how in the bank which may help to maintain flatter, more flexible hierarchies.

The Grawe group established a multi-brand strategy to access various, diversified business segments. Bank Burgenland is the leading institute for the financial arm of the group, providing a centralized risk management function for the banking group.

Bank Burgenland services its subsidiaries via various administrative departments; back office, risk control, legal & compliance, treasury functions, accounting and other sections are centralised with Bank Burgenland.

Although the group benefits from lean, centralised administrative and risk management functions, it is our understanding that the individual group members still have ample room to develop their own market strategies and promote their business profiles to ultimately increase respective market shares.

We acknowledge the various advantages of multi-brand platforms; however, we nevertheless believe that diversified business entities provide a risk of silo functions which can develop their own risk cultures within the overall framework. To mitigate such risks, the bank has established cross supervisory positions of management in all member institutions. However, despite established reporting lines and for example due to the recent acquisition of Bankhaus Schellhammer & Schattera AG, we note that the banking group yet lacks a unified IT system. A uniform IT platform is in the process of being developed and is planned to become available to all entities in early 2019. Hence, from a risk management point of view, operational risk is the main concern within the group. Although the bank seems, in principle, to have adequate risk management structures and capabilities in place, we believe that a centralised IT platform would provide some additional comfort in this respect.

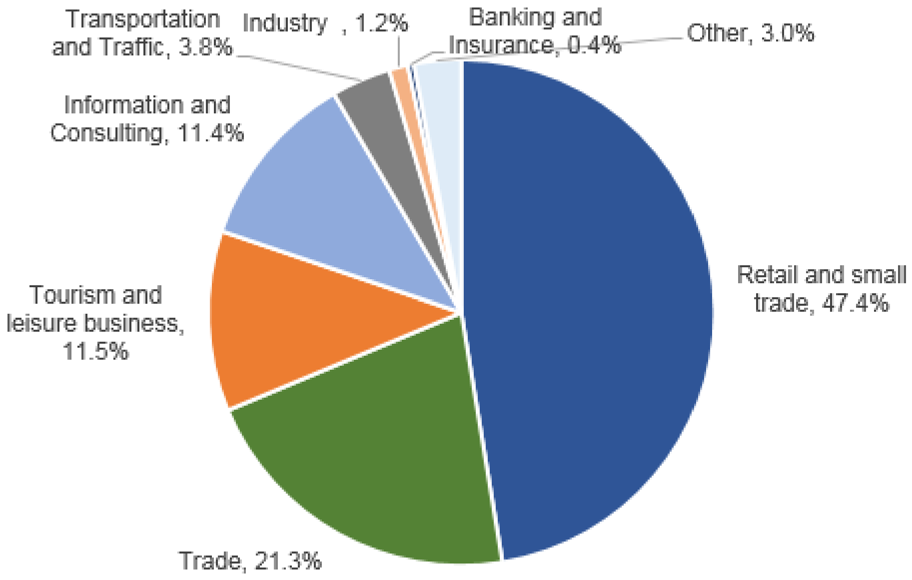
4. Austrian state of Burgenland currently provides a benign and prosperous economic environment, supportive of growth

As a regionally-focused bank, Bank Burgenland's growth and performance is also dependent on the development of the local economy. Although, access to the greater Vienna area and Styria somewhat helps to provide some risk diversification.

The state of Burgenland benefited from the enlargement of the European Union with the integration of eastern European countries during the 1990s. Over the past three years in particular, the economy of the state of Burgenland has revived in line with the recovery and stabilisation of the neighboring CEE economies. The region receives much of the transitional economic traffic from its eastern neighbours and many CEE citizens living near the border also work and have banking relationships in Austria.

Due to these dynamics, the economic growth of the state of Burgenland has been partly above the average growth achieved in other Austrian States. Business activities in retail, industry, and tourism have predominantly contributed to this growth.

Chart 12: Economy of the state of Burgenland by sector



Source: Company data, Scope Ratings

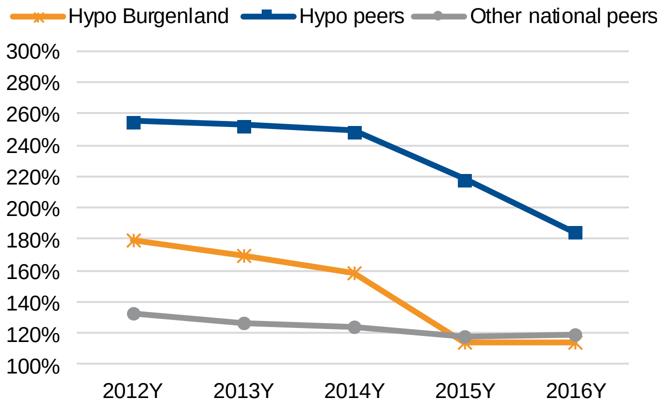
However, we note that the economy in the state of Burgenland tends to be based on small businesses with a strong focus on retail and trade (Chart 12). About 37% of the 133,200 people in paid work commute into other areas such as Vienna and Lower Austria. As a consequence, we would argue that the economic growth is partly imported and hence also heavily dependent on developments in the neighboring regions.

The economic growth in the region is particularly visible via the price rises in residential real estate, with house price changes over the past five years or so partly exceeding developments in neighboring areas. Although Austria recorded strong price changes related to real estate across various regions, we understand that the OeNB does not recognize any substantial real estate risks in Austria.

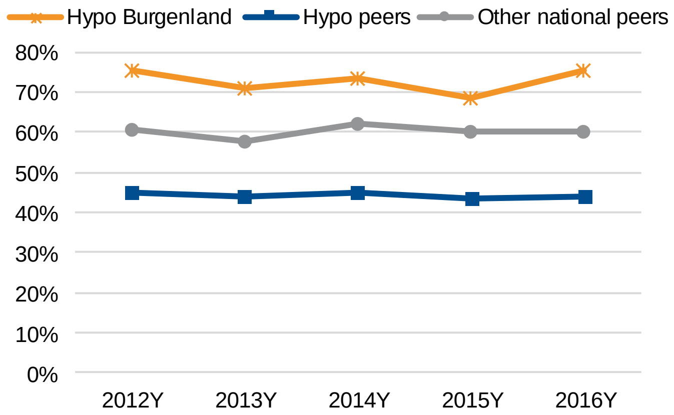
Despite the recent positive economic trends in the region, we would argue that, going forward, the potential for growth for Bank Burgenland may remain limited without any major risk-taking. As is the case for any regional business profile, concentration risks may provide more magnified liquidity as well as greater asset quality problems in times of economic downturn, compared to national/more diversified peers.

Appendix A: Peer comparison

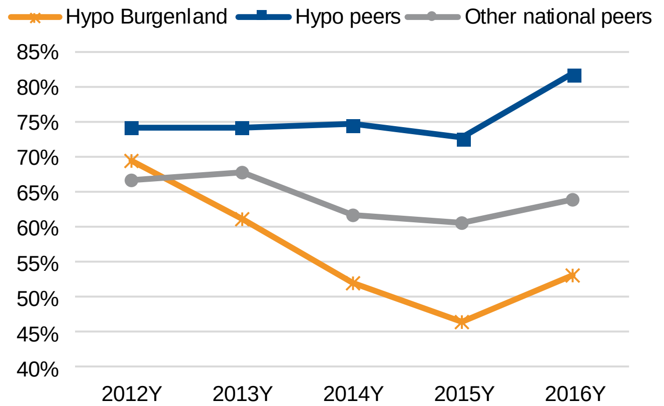
Amortised Loans % Deposits



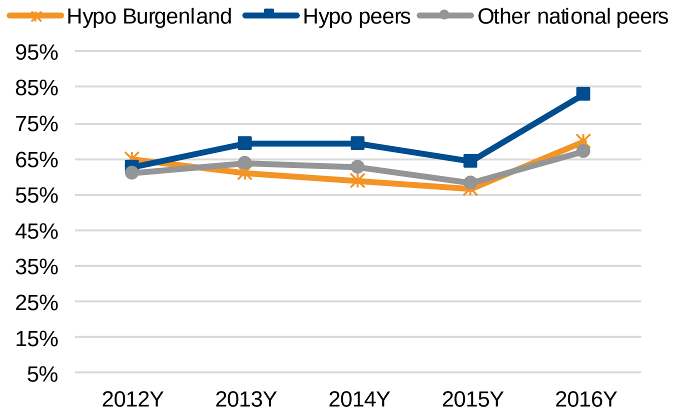
Asset risk intensity (RWAs % total assets)



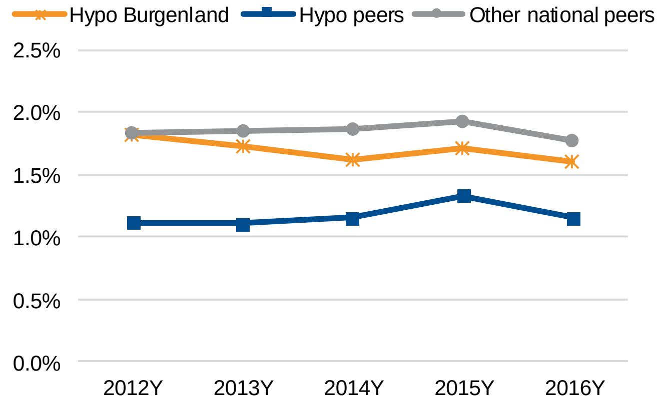
Net interest income % revenues



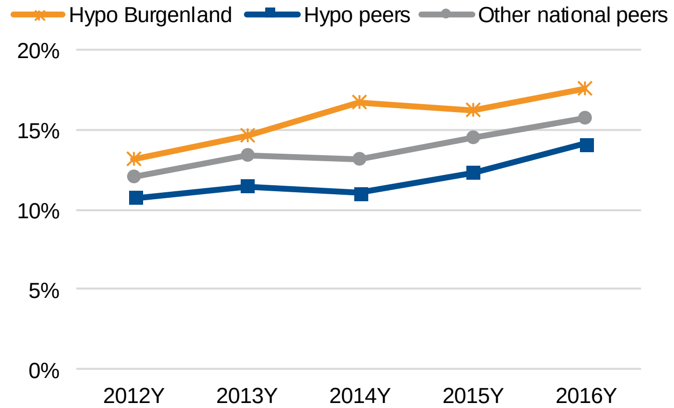
Cost income ratio (%)



Net interest margin (%)



Common equity tier 1 ratio (%, transitional)



Source: SNL, Scope Ratings

*Hypo peers: Salzburger Landes Hypo, Hypo NOE, Hypo Oberoesterreich, Hypo Steiermark, Hypo Tirol, Hypo Vorarlberg, Anadi Bank, Hypo Burgenland.
**Other national peers: Bankhaus Carl Spaengler, Bank Tirol, BAWAG, BKS Bank, Oberbank, Volkskreditbank, Steiermaerkische Bank und Sparkassen, RLB Steiermark, Hypo Burgenland.

Appendix B: Selected Financial Information – HYPO-BANK BURGENLAND Aktiengesellschaft

	2012Y	2013Y	2014Y	2015Y	2016Y	2017H1
Balance sheet summary (EUR m)						
Assets						
Cash and interbank assets	362	457	396	578	235	373
Total securities	1,294	1,244	1,225	1,492	1,527	1,462
of which, derivatives	117	91	99	80	63	65
Net loans to customers	2,580	2,501	2,461	2,768	2,903	3,068
Other assets	72	95	78	126	129	NA
Total assets	**4,308**	**4,297**	**4,160**	**4,965**	**4,794**	**5,038**
Liabilities						
Interbank liabilities	86	88	219	368	352	478
Senior debt	1,908	1,857	1,487	1,165	891	854
Derivatives	55	47	35	33	36	37
Deposits from customers	1,421	1,467	1,547	2,396	2,520	2,666
Subordinated debt	85	75	72	74	72	47
Other liabilities	226	217	238	264	219	NA
Total liabilities	**3,781**	**3,750**	**3,599**	**4,300**	**4,090**	**4,321**
Ordinary equity	527	547	561	636	703	716
Equity hybrids	0	0	0	0	0	0
Minority interests	0	0	0	29	1	1
Total liabilities and equity	**4,308**	**4,297**	**4,160**	**4,965**	**4,794**	**5,038**
Core tier 1/ common equity tier 1 capital	428	448	514	553	637	694
Income statement summary (EUR m)						
Net interest income	76	73	66	76	76	38
Net fee & commission income	43	52	54	60	67	37
Net trading income	-8	1	3	29	2	4
Other income	-4	-1	5	4	0	NA
Operating income	**107**	**125**	**129**	**168**	**146**	**81**
Operating expense	71	72	75	92	100	51
Pre-provision income	**35**	**53**	**54**	**76**	**46**	**30**
Credit and other financial impairments	11	28	47	34	-30	1
Other impairments	0	0	0	0	0	0
Non-recurring items	NA	NA	NA	31	NA	NA
Pre-tax profit	**24**	**25**	**7**	**72**	**76**	**30**
Discontinued operations	0	0	0	0	0	0
Other after-tax Items	0	0	0	0	0	0
Income tax expense	2	-3	5	5	24	4
Net profit attributable to minority interests	0	0	0	0	1	0
Net profit attributable to parent	**22**	**28**	**2**	**67**	**51**	**26**

Source: SNL

Appendix C: Ratios – HYPO-BANK BURGENLAND Aktiengesellschaft

	2012Y	2013Y	2014Y	2015Y	2016Y	2017H1
Funding and liquidity						
Loans/deposits (%)	179.0%	169.3%	158.0%	114.7%	114.5%	114.5%
Liquidity coverage ratio (%)	NA	NA	NA	NA	NA	NA
Asset mix, quality and growth						
Loans/assets (%)	59.9%	58.2%	59.2%	55.7%	60.6%	60.9%
Impaired & delinquent loans/loans (%)	NA	NA	NA	NA	NA	NA
Loan-loss reserves/impaired loans (%)	NA	NA	109.3%	113.9%	72.5%	NA
Net loan growth (%)	-6.8%	-3.1%	-1.6%	12.4%	4.9%	11.4%
Impaired loans/tangible equity & reserves (%)	NA	NA	17.2%	14.1%	13.8%	NA
Asset growth (%)	-1.1%	-0.2%	-3.2%	19.3%	-3.4%	10.2%
Earnings and profitability						
Net interest margin (%)	1.8%	1.7%	1.6%	1.7%	1.6%	1.6%
Net interest income/RWAs (%)	2.4%	2.3%	2.2%	2.3%	2.2%	2.0%
Net interest income/revenues (%)	71.7%	58.1%	51.6%	45.0%	52.3%	46.8%
Fees & commissions/revenues (%)	40.3%	41.6%	42.0%	35.5%	46.0%	45.0%
Cost/income ratio (%)	67.0%	57.8%	58.0%	54.7%	68.6%	62.8%
Operating expenses/RWAs (%)	2.2%	2.3%	2.4%	2.8%	2.8%	2.7%
Pre-provision income/RWAs (%)	1.1%	1.7%	1.8%	2.4%	1.3%	1.6%
Loan-loss provision charges/pre-provision income (%)	32.6%	52.2%	86.6%	45.3%	-66.4%	2.1%
Loan-loss provision charges/gross loans (%)	0.6%	0.8%	1.8%	1.1%	-1.2%	0.0%
Pre-tax profit/RWAs (%)	0.7%	0.8%	0.2%	2.2%	2.2%	1.6%
Return on average assets (%)	0.5%	0.7%	0.0%	1.5%	1.1%	1.1%
Return on average RWAs (%)	0.7%	0.9%	0.1%	2.1%	1.5%	1.4%
Return on average equity (%)	4.4%	5.2%	0.4%	10.9%	7.6%	7.3%
Capital and risk protection						
Common equity tier 1 ratio (%, fully loaded)	13.2%	14.7%	NA	NA	NA	NA
Common equity tier 1 ratio (%, transitional)	13.2%	14.7%	16.8%	16.2%	17.6%	17.8%
Tier 1 capital ratio (%, transitional)	13.2%	14.7%	16.8%	16.2%	17.6%	17.8%
Total capital ratio (%, transitional)	15.9%	17.2%	17.9%	17.0%	18.1%	18.2%
Tier 1 leverage ratio (%)	10.1%	10.5%	12.5%	11.2%	13.4%	13.9%
Asset risk intensity (RWAs/total assets, %)	75.4%	71.0%	73.6%	68.8%	75.3%	77.3%

Source: SNL

APPENDIX III. SUMMARY OF COVERED BOND CHARACTERISTICS

Reporting date	1 August 17
Issuer name	Bank Burgenland
Country	Austria
Covered bond name	Hypothekenpfandbrief (Hypf) Austrian mortgage-covered bonds issued under the PfandG
Covered bond legal framework	Austrian legal covered bond framework
Cover pool type	Residential and commercial mortgages
Issuer rating	ND
Current covered bond rating	AA+ / Stable
Covered bond maturity type	Hard bullets
Cover pool currency	EUR (91.75%) / CHF (8.25%)
Covered bond currency	EUR (100%)
Fundamental cover pool support (notches)	4
Max. achievable covered bond uplift (notches)	7
Potential covered bond rating buffer	0
Cover pool whole-loan/eligible assets [EUR m]	910.4 / 761.4
Covered bonds [EUR m]	186.0
Substitute assets [EUR m]	0
Current overcollateralisation/legal minimum OC	389.5% / 2.0%
OC to support current uplift (based on whole loan)	40.0%
OC to support rating upon a one-notch downgrade	38.0%
Weighted average seasoning	5.1 years
Duration / WA maturity of assets	5.64 / 5.94
Duration / WA maturity of liabilities	9.69 / 11.01
Duration gap / WA maturity gap	-4.05 / -5.07
Number of loan exposures	4,166
Average loan size (in EUR '000s)	218.5
Top-10 exposures	15.1%
Top-20 exposures	21.5%
Interest rate type – of total cover pool	12.6% (fixed) / 87.4% (floating)
Interest rate type – covered bonds	86.6% (fixed) / 13.4% (floating)
WA whole loan LTV/eligible LTV	123.4% / 47.4%
Geographic split (top 3)	Vienna (38.9%) Burgenland (35.7%) Lower Austria (12.1%)

Default measure	Inverse Gaussian
Weighted average default rate	19.4%
Coefficient of variation	52.6%
Weighted average recovery assumption (D0/D7)[1]	89.5% / 68.3%
Current share of loans > 6 months in arrears	0.0%
Interest rate stresses (min./max.; currency-dependent)	-1% to 10%
Forex stresses (min./max.; currency-dependent)	10% to 75% depreciation (CHF)
D7[1] Liquidity premium	150bps (residential mortgages) / 300bps (commercial mortgages)
Servicing fee (mortgage)	34bps

[1] D0 or D7 denote the stresses commensurate with the rating distanced between the issuer rating and the covered bond rating.

Source: Bank Burgenland and Scope Ratings AG

APPENDIX IV. REGULATORY AND LEGAL DISCLOSURES

Regulatory disclosures

This credit rating and/or rating outlook is issued by Scope Ratings AG.

The rating analysis has been prepared Karlo Fuchs, Executive Director. Responsible for approving the rating: Guillaume Jolivet, Managing Director

The rating was first assigned by Scope on 15 November 2017.

Methodology

The principle methodology applicable for the covered bond rating is the ‘Covered Bond Rating Methodology’, published July 2017. Scope also applied the principles listed in the ‘Rating Methodology for Counterparty Risk in Structured Finance Transactions’, published August 2017, and the ‘General Structured Finance Rating Methodology’, published August 2017.

For the credit assessment of the issuer Scope also applied the principles contained in the “Bank Rating Methodology” dated May 2017. All documents are available on www.scoperatings.com

Historical default rates of Scope Ratings can be viewed in the rating performance report on https://www.scoperatings.com/#governance-and-policies/regulatory-ESMA Please also refer to the central platform (CEREP) of the European Securities and Markets Authority (ESMA): http://cerep.esma.europa.eu/cerep-web/statistics/defaults.xhtml. A comprehensive clarification of Scope’s definition of default as well as definitions of rating notations can be found in Scope’s public credit rating methodologies on www.scoperatings.com.
The rating outlook indicates the most likely direction of the rating if the rating were to change within the next 12 to 18 months.

Stress testing & cash flow analysis

No stress testing was performed.

In the determination of the cover pool supported rating uplift Scope performed a cash flow analysis to determine an expected loss for the covered bonds. The cash flow analysis uses as starting point the scheduled cash flows of the cover assets and covered bonds. Scope has applied rating distance-dependant stresses to simulate the impact of increasing credit and market risks to these cash flows. The cash flow analysis also incorporates the impact of stressed asset sales or other variables such as changing prepayment speeds or servicing costs.

Solicitation, key sources and quality of information

The rated entity participated in the rating process.

The following substantially material sources of information were used to prepare the credit rating: public domain, the rated entity, third parties and Scope internal sources.

Scope considers the quality of information available to Scope on the rated entity or instrument to be satisfactory. The information and data supporting Scope’s ratings originate from sources Scope considers to be reliable and accurate. Scope does not, however, independently verify the reliability and accuracy of the information and data.

Prior to publication, the rated entity was given the opportunity to review the rating and/or outlook and the principal grounds on which the credit rating and/or outlook is based. Following that review, the rating was not amended before being issued.

Potential conflicts

Please see www.scoperatings.com. for a list of potential conflicts of interest related to the issuance of credit ratings.

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