Rating Report

Dexia Kommunalkreditbank AG

German Public Sector Covered Bonds

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RATINGS

Cut off date	Cover pool notional	Main cover asset type	Covered bonds*	Rating
31 Dec. 2015	EUR 20.96bn	Public sector loans and bonds	EUR 19.3bn	**AA-/Stable**

* Öffentliche Pfandbriefe (OePf) – German public sector 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
Last rating action date:	New

Covered bond rating-uplift determination (notches):

DKD Public-sector covered bonds	
Legal framework	**2**
Resolution regime	**3**
Fundamental factors	**5**
Cover pool analysis	**6***
Covered bond credit differentiation	**6**

* Max. possible uplift for 8 notches; N/D: not disclosed

Issuer Credit-Strength Rating:

Long-term:	N/D
Short-term:	N/D
Outlook:	N/D
Last rating action date	N/D
ICSR and covered bond rating:	Monitored

The issuer solicited the assigned rating and has taken part in the rating process.

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Ratings rationale

Scope's ratings of AA-/Stable for the EUR 19.3 bn Öffentliche Pfandbriefe (German public-sector covered bonds or OePf) issued by Dexia Kommunalbank Deutschland AG (DKD or the bank) reflect our credit assessment of the issuer, further enhanced by:

- credit benefit from the cover pool. The sound asset quality of the cover pool resulting in low expected credit losses, combined with the available overcollateralisation (OC) allows to mitigate the limited market risk and moderate maturity mismatches of the covered bonds. When stressing the risks, the cover pool can support a credit differentiation of six notches above the rating of the issuer.
- the fundamental credit positive impact of the German legal covered bond framework and the benefits of the resolution regime. Our assessment however also reflects that Dexia Group is in an orderly wind down after having received state support and being bailed out. Therefore, we expect it is less likely for DKD than for other issuers of German public sector covered bonds that regulators will use all available resolution tools to ensure the further maintenance with a view to preserve critical functions. In our view this translates into a fundamental credit differentiation of five notches to the issuer rating.

The covered bond analysis allows for a higher rating uplift than the sole reflection of the fundamental legal and resolution regime analysis.

Scope assigned and monitors a private rating on DKD. Our credit assessment of the issuer, DKD reflects the limitations the public sector business faces in Dexia Group's orderly resolution and unwinding, but helped by a letter of support from DKD's parent Dexia Credit Local (DCL), and the quality of assets remaining on the balance sheet.

In our view DKD's limited capital buffer and low profitability means it could require the bank to resort to the letter of support at some point in the future. DCL's state guarantee does not apply to its subsidiaries and the letter of support is one of many other commitments that DCL has vis-à-vis its other affiliates.

DKD'S OePf have full recourse to the issuer and a dedicated cover pool secured by eligible public sector assets predominantly from Germany. All covered bonds issued by the bank rank pari passu, regardless of whether they are issued using a standalone documentation or under an issuance programme.

Outlook: Stable

Scope has assigned a Stable Outlook to the OePf issued by DKD, which reflects: i) the cover pool's resilience against moderate adverse changes in the risk structure; ii) our view on how likely changes in the cover pool's risk structure would affect the rating; iii) and the stability of the issuer assessment. Further, a one-notch downgrade of the issuer's creditworthiness is unlikely to affect the covered bond rating.

The rating could deteriorate if the evolution of the cover pool's risk profile and cash flow structure was worse than expected. However, a cover pool deterioration driven downgrade by more than one notch is currently unlikely, as our view on the issuer and support from the legal and resolution framework, creates a floor for the covered bond rating.

The covered bond rating could be upgraded if we were to upgrade the issuer, the issuer reduces the asset-liability mismatch of the covered bonds or provides a permanently higher OC. Given the past management of OC, and our credit view on the issuer, Scope would only consider an OC driven upgrade if the issuer communicates robustly to the capital markets that additional OC levels will be kept permanently.

RATING DRIVERS AND MITIGANTS

Positive	Negative
The issuer: DKD benefits from a strong letter of support from its state-owned and partially state-funded parent. The solid quality of assets remaining on the balance sheet.	**Issuer:** DKD is managed in run-off as part of the Dexia Group's orderly resolution and is not allowed to write new business. DKD is unprofitable, leaving its capital base heavily sensitive to cyclical variations and unexpected write-offs.
Legal covered bond framework: German covered bond law is among the most comprehensive and specific in the world.	
Resolution regime assessment: Covered bonds are excluded from bail-in, and have strong systemic importance and stakeholder support.	**Resolution regime assessment:** Use of resolution tools to maintain the issuer is less likely than for other OePf issuers because of Dexia Group's orderly resolution and wind-down.
Cover pool analysis: Sound average credit quality of the cover pool and its resilience against moderate adverse changes in the covered bond's risk profile and OC.	**Cover pool analysis:** High concentration of the cover pool exposes it to single-name risk, with the top-20 exposures taking up 65%. Moderate asset-liability mismatch of 2.5 years.
Positive rating-change drivers	**Negative rating-change drivers**
The issuer: As DKD winds down, its reduction in size could lead to a parallel decrease in risk-weighted assets, allowing the bank to better absorb the impact of losses and strengthen regulatory metrics, which leads to a potential upgrade.	**The issuer:** Deterioration in the German public sector's credit quality could lead to unexpected shocks to profitability, stretching its capital position.
Cover pool support: Issuer upgrade or higher OC levels supported by robust communication on the capital markets regarding its permanence.	**Cover pool support:** Higher asset-liability mismatch and lower OC or significant negative credit migration of the cover assets.

THE ISSUER

Issuer's credit strength supported by parent's letter of comfort.

Scope Ratings has assessed DKD's credit quality as part of the covered bond analysis. This assessment highlights challenges facing the bank given Dexia Group's orderly resolution and unwinding, but helped by a letter of support from DKD's parent, Dexia Credit Local (DCL), and the quality of assets remaining on the balance sheet. In the case of unexpected shocks, we believe DKD's limited capital buffer and low profitability means it could resort to the letter of support in the future. At the same time, we do not expect the issuer's credit quality to change materially, which Scope will monitor in line with the covered bond ratings.

DCL's state guarantee does not apply to its subsidiaries; and the letter of support is one of many other commitments DCL has with other affiliates. For further details on DKD's credit assessment see Appendix I.

COVERED BOND RATING ANALYSIS

Covered bond rating reflects credit positive support from the cover pool

The credit differentiation between the bank and its covered bonds reflects the credit support of six-notches from the cover pool analysis. The fundamental framework analysis supports a five-notch credit differentiation, effectively providing a floor for the covered bond rating assuming the issuer's credit profile remains unchanged.

COVER POOL ANALYSIS

We have analysed the cover pool and its cash flows as of December and June 2015. For the rating, we have also incorporated developments in the cover pool in Q1 2016, as well as additional scenarios provided by the issuer.

Covered bonds are managed dynamically, and credit and market risks in the covered bond structure and the supporting OC can change significantly, even within the limits of the legal framework.

High concentration to top obligors and moderate mismatch risk

Characteristics of the cover pool and covered bond structure

Reporting date	31 December 2015	30 June 2015
Cover pool (in EUR bn)[1]	20.96	21.6
Covered bonds (in EUR bn)[1]	19.3	19.9
Current overcollateralisation (based on reporting convention/ regulatory OC)	7.8% (8.6)	7.5% (8.4%)
Duration/WAM[2] (cover pool)	8.3y/9.6y	8.0y/9.1y
Duration/WAM (covered bonds)	6.3y/7.1y	6.5y/7.3y
Mismatch	1.9y/2.5y	1.5y/1.8y
OC needed to support one or more additional notches[1]	+1 notch: 8.5% +2 notches: > 11%	N/D
Main cover asset type	Public-sector exposures complying with PfandBG, bank debt and other covered bonds	
Number of exposures	211	222
Top-10 exposures Top-20 exposures	48.8% 63.8%	50.5% 64.1%
WA cover pool obligor assessment[3]	a-	a
Geographic split (Top-3 countries)	65.3% (Germany) 10.0% (Italy) 6.0% (Belgium)	70.2% (Germany) 7.6% (Italy) 5.9% (Belgium)

[1] Cover pool and cash flow information used for the rating analysis differs to regulatory balances primarily because zero-coupon assets and liabilities are treated differently.
[2] WAM – weighted average maturity
[3] Expressed on Scope's rating scale.

Cover pool distribution by credit quality

Average credit quality has fallen slightly to a- from a; has since improved

The cover pool's credit quality is sound, evidenced by an average credit assessment of single a minus. However, compared to the issuer's June 2015 report, we have observed a slight deterioration. This trend reversed in the first quarter as the issuer started to manage the pool with a view to reduce single-name exposure to either lower-rated or long-dated exposures.

Replenishing grandfathered Landesbank exposures has increased cover pool WAL

The deterioration in YE 2015 mainly reflects the maturity of grandfathered and state-guaranteed public-sector bank exposures. Replenishments of the cover pool could not fully compensate for the relatively higher credit quality of the matured cover assets. In combination, the above-average active management of the cover pool resulted in a slight change in its credit quality and a higher weighted average life of the cover assets.

Material changes to the cover pool composition not expected

Restrictions on DKD's parent means the bank's ability to underwrite new business is limited, but the cover pool's composition will still change. The issuer can still use other assets on its balance sheet (most of which are eligible for the cover pool) to continue managing the pool. We understand that above-average changes in its composition between June and December 2015 were a one-off, and Scope expects moderate changes going forward.

To identify the impact of further cover pool changes on the rating, we have taken into account changes since year end and other likely adjustments to the portfolio. The envisaged changes have been rating-neutral, also supporting the Stable Outlook assigned.

We have analysed cover pool exposures line by line to assess credit quality, assigning credit estimates to rank the obligors in the cover pool.

Figure 1. **Distribution of cover pool by credit quality**

Credit equivalent	Dec 2015 % of cover pool	June 2015 % of cover pool
aaa	6.6%	7.8%
aa	37.4%	39.9%
a	35.6%	36.9%
bbb	11.6%	9.6%
Non-IG	8.7%	5.8%
Weighted average	a-	a

Sound credit quality results in low expected loss of only 2%

We have used our portfolio modelling tool to calculate the expected credit loss for the cover pool. We used the credit assessments in Figure 1, applied a correlation framework and added our obligor-specific recovery assumptions. We used an average weighted recovery rate of 51.3% for the portfolio. Based on the December 2015 composition, we have calculated an expected credit loss of 1.9%. For further information on our modelling approach and assumptions see Appendix II.

Cover pool distribution by loan size

Top 20 obligors comprise 65% and have a slightly lower credit quality than the average cover pool.

DKD's cover pool exhibits a high concentration typical among public-sector cover pools, which also highlights the single-name risk exposure. The top-10 borrowers comprise almost 50% of the cover pool; while the top 20 have almost two-thirds. With a weighted average credit risk of bbb+[1], the top borrowers have a slightly lower – but adequate – credit risk compared to the rest of the cover pool.

The effective number of obligors in the cover pool is 32 (based on the inverse of the Herfindahl index), which supports our view of the concentration risk. However, the cover pool comprises more than 200 individual exposures.

[1] This measure is expressed on Scope's rating scale applicable to the relevant assets and ranging from AAA down to C. We express this measure with small letters because it does refer to credit assessments and not to ratings.

Figure 2. **Cumulative obligor distribution of the cover pool by loan size**

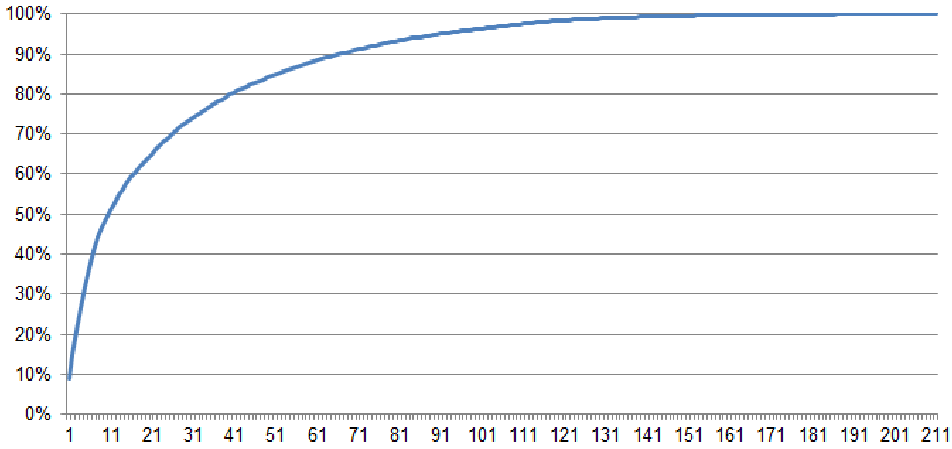


Figure 3. **Top-20 cover pool exposures**

#	Exposurename	internal assessment	Exposure in % of the cover pool	Cumulative exposure
1	German Federal State	a	9.1%	9.1%
2	Austrian Federal State	aa+	6.0%	15.1%
3	European Sovereign	bbb	6.0%	21.0%
4	German Federal State	aa-	5.5%	26.5%
5	German Federal State	aa-	5.5%	32.0%
6	German Federal State	a	4.5%	36.5%
7	Belgian Federal State	a+	4.3%	40.8%
8	German Federal State	aa	3.5%	44.3%
9	Spanish Region	bb	2.3%	46.6%
10	German Federal State	aa-	2.2%	48.8%
11	Asian Sovereign	a+	2.1%	50.9%
12	German Federal State	aa	1.9%	52.8%
13	European Sovereign	bb+	1.9%	54.7%
14	German Federal State	a-	1.7%	56.4%
15	Belgian Federal State	aa	1.5%	57.8%
16	German Federal State	aaa	1.2%	59.1%
17	German Federal State	aa-	1.2%	60.3%
18	German Federal State	a-	1.2%	61.5%
19	German Federal State	aa-	1.2%	62.7%
20	German City	bbb-	1.1%	63.8%

Geographic distribution of the cover pool

DKD's past focus on domestic public-sector lending also shows in the cover pool's composition – which is focused strongly on German obligors. International exposures were either sourced with other group members active in those countries (Italy/Belgium) or on the secondary market.

Focus on German exposures supports cover pools credit quality

Figure 4. **Geographical split of the cover pool**

Country	December 2015 % of cover pool	June 2015 % of cover pool
Germany	65.3%	70.2%
Italy	10.0%	7.6%
Belgium	6.0%	5.9%
Austria	5.2%	4.9%
Japan	3.2%	2.9%
Other	10.3%	8.5%

Distribution by obligor type

Focus on sub-sovereign exposures

In line with other public-sector issuers, DKD focuses mainly on subsovereigns and lower-tier public-sector entities. In our view, the credit quality of lower-tier subsovereigns is typically lower than the respective sovereign. The cross-support systems and oversight over such entities often limits significant deterioration, effectively resulting in a credit floor for these guaranteed exposures

Figure 5. **Split by obligor type**

By public-sector obligor type	December 2015 % of cover pool	June 2015 % of cover pool
Subsovereign	57.1%	54.7%
Municipalities and public sector companies	26.4%	27.0%
Sovereigns	13.1%	9.7%
public sector banks	1.0%	4.6%
other	2.4%	4.1%

Cash flow characteristics

Asset and liability characteristics

Figure 6. **Asset Liability profile as per Dec. 2015**

Asset data	% of Total assets	Cover Assets (in Eur mn)	WAM (years)	Duration (years)	Fixed Assets (in Eur mn)	Fixed in % of CCY	WAM (years)	Duration (years)	Max Maturity (years)	Floating Assets (in Eur mn)	Floating in % of CCY	WAM (years)	Duration (years)	Max Maturity (years)
Eur	91.31%	**19,602.4**	8.95	7.83	17,480.8	89.18%	9.14	7.92	55.25	2,121.6	10.82%	7.37	6.28	40.75
USD	1.26%	**270.7**	11.43	8.93	270.7	100.00%	11.43	9.11	17.50	-	-	-	-	-
SEK	0.38%	**81.8**	2.08	2.01	70.9	86.67%	2.37	2.26	3.00	10.9	13.33%	0.25	0.25	0.25
CHF	0.43%	**92.9**	1.49	1.49	0.8	0.88%	0.71	0.71	0.75	92.1	99.12%	1.50	1.50	1.50
GBP	0.57%	**121.9**	8.86	7.43	121.9	100.00%	8.86	7.64	3.00	-	-	-	-	-
JPY	6.05%	**1,298.5**	19.91	16.20	1,298.5	100.00%	19.91	15.95	22.75	-	-	-	-	-
Total Assets	**100.00%**	**21,468.3**	**9.59**	**8.27**	**19,243.6**	**89.64%**			**55.25**	**2,224.6**	**10.68%**			**40.75**

Liability Data	% of Total assets	Covered Bonds (in Eur mn)	WAM (years)	Duration (years)	Fixed CB's (in Eur mn)	Fixed in % of CCY	WAM (years)	Duration (years)	Max Maturity (years)	Floating CB's (in Eur mn)	Floating in % of CCY	WAM (years)	Duration (years)	Max Maturity (years)
Eur	99.88%	**19,901.1**	7.13	6.34	18,938	95.16%	7.19	6.38	25.00	963.2	4.83%	5.90	5.46	25.50
USD	0.07%	**13.3**	1.00	1.00	-	-	-	-	-	13.3	0.06%	1.00	1.00	1.00
NOK	0.05%	**10.4**	1.50	1.45	10	100.00%	1.50	1.45	1.50	-	-	-	-	-
Total Liabilities	**100.00%**	**19,924.8**	**7.12**	**6.34**	**18,948**	**94.94%**			**25.00**	**976.5**	**5.06%**			**25.50**

Market risk exposure

Moderate interest rate and FX risk:

Assets: 10.7% floating; 91.3% EUR
CBs: 5.1% floating; 99.9% EUR

The issuer manages the covered bonds' market risk in line with regulations. There are no derivatives registered in the cover pool, which means upon regulatory intervention – which might decouple the cover pool from the non-viable issuer – the cover pool would be exposed to both interest rate and foreign-exchange risk (FX).

Interest rate risk is limited, in our view, reflecting both the currently low interest rates and higher share of floating-rate assets than covered bonds issued as floaters. Similarly, we view foreign-exchange risk to be limited. The cover pool has about 9% of non-euro-denominated assets, making the pool susceptible to devaluations in the respective currencies. The euro-denominated assets cover 98.5% of the outstanding covered bonds, significantly reducing the exposure to currency devaluations. Further, as only 0.12% of outstanding covered bonds are denominated in non-euro currencies, the risk is immaterial.

Asset Liability mismatch risk

Difference of 2.5 years' in WAM highlights refinancing risk:
WAM assets: about 9.6 years
WAM liabilities: about 7.1 years

Figure 7. **Cumulative net cash flow in EUR**

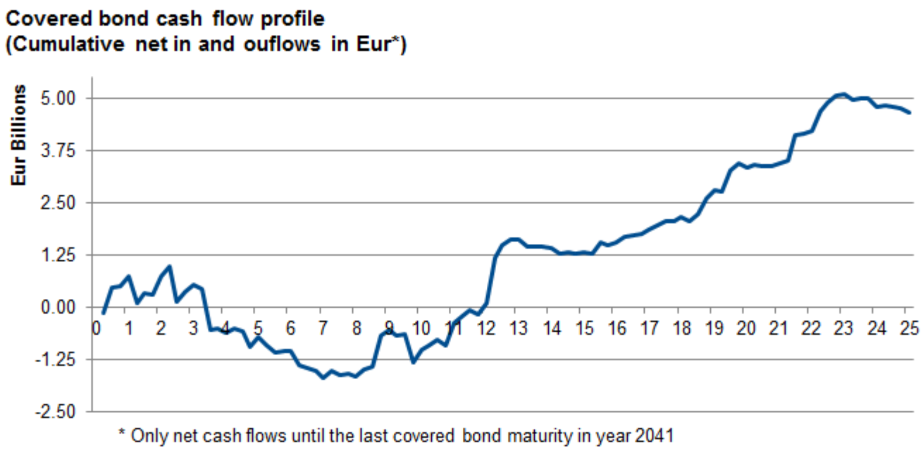


Figure 7 illustrates the cash flow profile of the 'standalone' cover pool – that is, the net proceeds per quarter from maturing assets, as well as covered bonds' principle and interest due. Any previous quarter's balances are carried forward and added to the respective quarter's net position. This profile does not consider any rating relevant-stresses we apply to the cash flows to reflect credit, market and refinancing risk.

Figure 7 also highlights the importance of an ongoing, active management of the cover pool's cash flow profile. If the cover pool were to remain static, upcoming covered bond maturities would exceed scheduled cash flows from the third year, which could require assets to be sold. Also, payment interruption caused by an obligor in distress could amplify those mismatches.

As noted, we only expect a relatively limited credit loss due to the high quality of the cover assets. However, a payment moratorium on those assets might create extra shortfalls, and the pure credit loss could worsen by the need to sell assets to cover additional mismatches and the need to service maturing covered bonds on time.

We take comfort that the issuer has enough time to address mismatches, the liquidity of most cover assets and the issuer's active management of the covered bond structure. In addition, the Pfandbrief Act requires that highly liquid collateral in the cover pool can cover immediate liquidity needs in the first 180 days

Overcollateralisation (OC)

Current OC comfortably supports current rating uplift. About 80% of OC needed to mitigate market and refinancing risk

Covered bonds currently have recourse to a 8.6% regulatory OC as of 31 December 2015, and the current levels support the six-notch differentiation to our issuer assessment. Currently, about 83% of the OC is needed to mitigate market and refinancing risks, and only 17% of OC is needed to cover the expected credit loss.

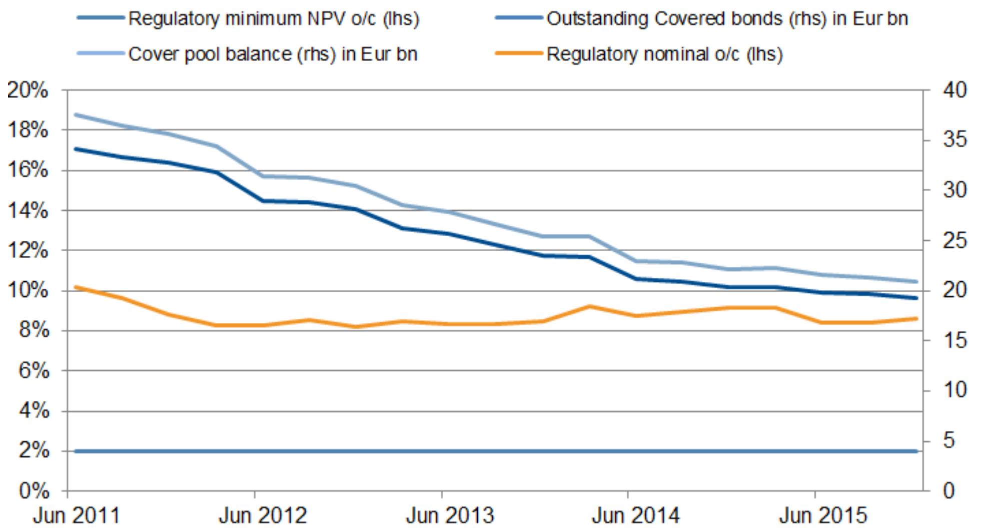
When assessing the cover pool's ability to support a covered bond rating above the level suggested by the legal framework and resolution regime analysis, we need to reflect the issuer's ability and willingness to provide overcollateralisation above the legal minimum.

Full credit to the available OC, reflecting transparent communication by issuer on OC levels

To fully reflect the OC above the legal minimum without further adjustments, we monitor past developments. For low investment grade issuers we also expect they provide clear and transparent communication to the capital markets on the permanence of current OC levels to fully consider the available OC.

In the 2015 annual report, DKD provided guidance that they plan to keep OC above 8%. While we understand this is not legally binding, we take comfort that the issuer has consistently kept OC above this level. We therefore have taken into account the full, available OC in our rating analysis.

Figure 8. **Development of cover pool balances and supporting OC**



Counterparty Risk

Covered bonds have significant counterparty exposure to DKD, which is reflected in the link to the issuer

The covered bonds are significantly exposed to DKD, reflected in the link of the covered bond rating to the issuer.

The main counterparty, in addition to DKD, is the Bundesbank, which holds DKD's main euro-denominated account. For foreign-currency payments, DKD takes recourse to highly rated banks. However, these bank accounts do not have structural mitigants which ensure an account bank is replaced if its credit quality deteriorates, avoiding potential negative impacts.

We view positively the short exposure time, as monies are typically only held intraday, and DKD's active monitoring of the credit quality of these counterparties.

We expect potential regulatory intervention would result in maintaining the issuer by using available resolution tools. We also take comfort in the regulator's ability to introduce a special cover pool administrator (Sachwalter) if the issuer is placed into a moratorium. Scope therefore does not expect active management to be severely impacted.

FUNDAMENTAL CREDIT SUPPORT FACTORS

The German covered bond framework and our credit-positive view on the beneficial resolution regime allows Scope to assign a positive credit differentiation of five notches. This assessment takes into account Dexia Group's orderly wind-down after receiving state support and being bailed-out. We therefore expect it is less likely for DKD, than for other OePf issuers, that regulators would use all available resolution tools to preserve critical functions.

LEGAL FRAMEWORK ANALYSIS

Two notch credit differentiation for the covered bond framework applicable to German public sector covered bonds

We have established a two-notch credit differentiation for German OePf. Germany's covered bonds were the first of its kind, dating back to 1769. The German Pfandbrief Act (Pfandbriefgesetz) is therefore among the most comprehensive of its kind and is updated the most regularly. Basic principles are maintained, and amendments usually add clarifications and – when necessary – extra provisions for the benefit of investors. The act was the first to acknowledge liquidity risk on 'hard bullet' covered bonds, introducing mandatory liquidity coverage of 180 days. Further, the latest amendment clarified the cover pool's legal status in case a manager wants to enter into repo operations, for example, with central banks after the issuer's insolvency.

We also note that the Pfandbrief Act provides supplementary laws that establish transparent and harmonised rules on creating a prudently assessed LTV or conducting ongoing market-risk stress tests (regulation on determining mortgage lending value as well as the NPV regulation).

Preferential regulatory treatment

DKD's OePf can benefit from preferential regulatory treatment as they comply with both the broad UCITS guidelines and more-prescriptive requirements in Article 129 of the Capital Requirements Regulation (CRR).

Legal regime for covered bonds

Germany's Pfandbrief Act governs the issuance and maintenance of covered bonds

Germany's Pfandbrief Act (last amended in January 2015) and relevant supplementary legislations govern covered bond issuance in Germany. The issuance of 'Pfandbriefe' requires a product-specific license from the German financial supervisor, BaFin. According to the act (§ 2) all regulated domestic banks can obtain a licence if they can show:

- At least EUR 25m of core capital,
- A general banking licence allowing lending business,
- Suitable risk management procedures and instruments,
- A business plan showing regular and sustainable issues, as well as a organisational structure

DKD is one of the largest and most active issuers in German OePf.

Definition of eligible assets

Public sector loan-eligibility criteria

Eligible cover assets, including public-sector loans, and auxiliary assets are defined in paragraph 20 of the Pfandbrief Act and can comprise:

- Sovereigns (in the EEA and selected OECD countries, typically the US, Canada, Switzerland and Japan
- Agencies and multilateral development banks – guaranteed by sovereigns (EU, EBRD, the World Bank)
- Subsovereigns, regional and local authorities, member states and the selected OECD countries as above (German 'Länder', departments and smaller districts with taxation powers and the ability to levy fees)
- Municipalities
- Public-sector companies (in general: have to be fully guaranteed by an eligible guarantor as above; are smaller utilities but can also be larger such as sovereign railway operators or even state-guaranteed securitisations/SPVs)
- Export credit agencies

Substitute collateral

Substitute collateral possible

The cover pool can also comprise up to 10% of substitute collateral. Substitute collateral typically comprises senior unsecured exposures to banks in member states with a defined rating (Credit Quality Step 1 and 2) and with a maximum concentration of 2% against the respective institution. Substitute collateral can also be composed of other covered bonds, as these are also considered bank debt.

Overcollateralisation requirements

Overcollateralisation requirements: 2% based on NPV after stresses

German covered bonds benefit from a 2% minimum OC based on NPV – after applying market risk stresses in line with specific risk management laws (the NPV regulation).

BaFin can also require supplementary OC if they deem the 2% level to be insufficient.

Effectively, NPV regulations also introduce market risk limits. In contrast to other jurisdictions, market risk is managed by matching risks, rather than using derivatives to reduce them. If derivatives are registered in the cover pool, they will not accelerate in line with the other obligations of the issuer.

Cover pool risk management

Cover pool risk management: Only FX risk addressed

The Pfandbrief Act allows mortgage loans and covered bonds to be denominated in foreign currency. The bank, however, must cover the potential FX risk. Upon the bank's insolvency, covered bonds could become exposed to FX risk as hedges might no longer be available for the covered bond estate. OePf issuers typically have 'natural' hedging strategies, covering FX risk through extra overcollateralisation.

The act also addresses continuing the payments on covered bonds after the issuer becomes insolvent. Covered bonds have priority rights on the cash flows from assets registered in the cover pool. The legal requirement on liquidity also gives additional means, as highly liquid assets kept in the cover pool must cover shortfalls for 180 days. Further, as the cover pool's entity has a special banking status, covered bonds can also manage liquidity by tapping the central bank's repo operations.

Supervision and regulatory oversight

Regular supervision and cover pool monitoring

Regulators actively monitor the various risk management and valuation obligations for covered bonds as stipulated in the act, as well as regularly inspecting onsite. The independent trustee acts as a gatekeeper for the cover pool: checking eligibility prior to registration, approving new issuances, and monitoring the issuer's risk management obligations. Upon insolvency, a special trustee (Sachwalter) takes over the programme's management.

Status of covered bonds upon the issuer's insolvency

Covered bonds benefit from a preferential claim on all assets registered in the cover pool. Additions and deletions of cover assets are also supervised and need the trustee's approval to be valid. Before the issuer becomes insolvent, regulators can already appoint a Sachwalter to take over the cover pool's management. Upon the issuer's insolvency, the cover pool (comprising all registered eligible assets and related covered bonds) is separated from the issuer's general insolvency estate and is managed to ensure full and timely payments are made. The issuer's insolvency does not trigger an acceleration of covered bonds compared to the issuer's other debts.

RESOLUTION REGIME ANALYSIS

Resolution regime analysis supports extra credit uplift…

DKD's covered bonds can benefit from extra credit differentiation of three notches based on our assessment of the resolution regime. The differentiation primarily reflects the preferential treatment of covered bonds when a regulator intervenes in the issuer. It also reflects the high systemic importance of covered bonds in Germany, which, in our view, would mobilise stakeholders to actively deal with the negative credit implications of a German covered bond once its issuer is in distress.

..but is constrained as DKD is already in an orderly wind-down

For DKD we have reflected that Dexia Group is in orderly wind-down after receiving state support and being bailed-out. We therefore expect it is less likely for DKD, than for other OePf issuers, that regulators will use all available resolution tools to preserve critical functions.

Preferential treatment of covered bonds upon regulatory intervention

BRRD translation affirms covered bonds are unaffected in a bail-in

Central to our resolution regime analysis how covered bonds are treated when a regulator intervenes in an issuer. Germany was among the first to fully implement the BRRD, including the bail-in tool, into national law (BRRD-Umsetzungsgesetz). The law is in line with the European Commission's directive (2014/59/EU) and excludes covered bonds from bail-in when the regulator intervenes.

In mid-2015, DKD was the second-largest OePf issuer in Germany and a visible issuer in its public-sector niche market. Public-sector lending is not very capital-intensive, allowing high absolute exposures relative to a bank's capitalisation and profitability. We therefore believe that single-name headline risk could result in the unlikely (but plausible) scenario where internal resources are insufficient for an orderly restructuring. While we take comfort that the issuer could also resort to its letter of comfort from its state-owned parent, ultimately such a scenario could result in the cover pool becoming the sole mean for repaying covered bonds.

Systemic importance of covered bonds

High covered bond intensity in Germany, further increasing by new entrants

The share of outstanding German covered bonds ranks among the highest worldwide, and these are used by most large and midsized banks (78 banks have a license to issue covered bonds). Based on available data, public-sector loans and (in particular commercial) mortgages are a significant tool among issuers which refinance wholesale. Total outstanding covered bonds as share of GDP was 13% at the end of 2015.

The amount of outstanding German covered bonds has shrunk significantly: from over EUR 1trn in 2004 to about EUR 385bn in 2015. However, we still view them as integral to the domestic capital debt markets and for refinancing commercial and public-sector loans.

Domestic stakeholder support

German investors and insurance companies in particular have among the largest holdings in covered bonds worldwide, highlighting the importance of this market for both domestic issuers and investors.

Proactive stakeholder community

German stakeholders have regularly shown a strong interest in a functioning covered bond market and support an orderly resolution if an issuer is in distress. Even before the BRRD came into force, such issuers were often resolved by means other than insolvency. We observed several market-led resolutions, with distressed issuers being merged, sold to other banks or with stakeholders maintaining support to allow the cover pool's orderly wind-down – all despite strong and robust provisions that deal with an issuer's insolvency.

The general benefits from the formal resolution regime and its domestic 'covered bond' status reflects sufficiently the benefits of the refinancing instrument. We expect covered bonds to remain systemically important for funding in Germany for the foreseeable future and the BRRD to formalise existing practices, rather than introduce new benefits.

RATING STABILITY

Changes to the issuer assessment:

Strength of the cover pool allows to buffer for a change in our credit assessment of the issuer

The cover pool's resilience against stresses means a one-notch downgrade in DKD's credit assessment would not affect the covered bond rating, in our view. An upgrade in the issuer's rating would likely lift covered bond ratings because the cover pool can maintain a six-notch rating uplift.

Changes to the overcollateralisation:

OC important, but current rating not very sensitive to moderate changes in OC

Changes to the OC by up to 1.5% are unlikely to affect the rating. A reduction to the 2% legal minimum may lead to a downgrade to A+. The one-notch downgrade also reflects our rating's floor from the legal and resolution regime analysis, which in itself would allow us to rate the cover pool up to five notches above our credit assessment of the issuer.

The highest possible credit differentiation between our assessment of the issuer and the covered bonds, resulting in a AA+ covered bond rating, needs an OC of above 11%. To allow for this we would expect the issuer to communicate strongly to the capital markets that they would keep cover pool risks within certain limits and maintain the OC level permanently. As of the date of publication, the issuer has only publicly stated it supports OC of above 8%.

Changes to the legal and resolution framework assessment not expected

In addition, changes to the legal or resolution framework could make us reassess our current classification of OePf. Though changes are not expected right now, these could also affect the rating.

SOVEREIGN RISK

Risk of institutional meltdown, legal insecurity or currency problems not material

Sovereign risk is immaterial for the rating. We see the risks of an institutional framework meltdown, legal insecurity or currency convertibility problems as extremely remote.

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.

Scope analysts are available to discuss all the details surrounding the rating analysis, the risks to which this transaction is exposed and the ongoing monitoring of the transaction.

APPLIED METHODOLOGY AND DATA ADEQUACY

To analyse DKD's OePf, Scope has applied the principles described in the "Covered Bond Rating Methodology" published July 2015 and the Rating Methodology for Counterparty Risk in Structured Finance Transactions, dated 10 August 2015. We also applied the principles as per our General Structured Finance Rating Methodology, dated 28 August 2015 for the asset and cash flow analysis. Our rating methodologies are available on the agency's website www.scoperatings.com

DKD provided Scope with public and confidential information on the cover pool composition and relevant cash flow details. We also received additional information to assess the potential impact of changes to the cover pool composition or cash flow structure. Scope Ratings considers the quality of the available information as satisfactory. We ensured that sources are reliable before drawing upon them, but did not verify each item of information independently.

APPENDIX I. ISSUER ASSESSMENT

DKD's credit assessment reflects the limits the business faces from Dexia Group's orderly resolution and unwinding, but helped by a letter of support from DKD's parent, Dexia Credit Local (DCL), and the quality of the assets remaining on the balance sheet.

We envisage DKD's limited capital buffer and low profitability means the bank could resort to the letter of support in the future. DCL's state guarantee does not apply to its subsidiaries and the letter of support is one of many other commitments that DCL has with other affiliates.

Rating drivers (Summary)

THE RATING DRIVERS, IN DECREASING ORDER OF IMPORTANCE IN THE RATING ASSIGNMENT, ARE:

- − DKD is managed in run-off as part of the orderly resolution plan for Dexia Group and is not allowed to write new business
- + The state guarantee applicable to DKD's parent Dexia Credit Local (DCL) does not extend to its subsidiaries. However, DKD benefits from a letter of support from its state-owned parent
- − DKD is unprofitable, leaving its capital base heavily sensitive to cyclical variations and unexpected write-offs
- + The solid quality of the assets remaining on the balance sheet

Rating change drivers

↑ As DKD is being wound down, its reduction in size could lead to a parallel decrease in risk-weighted assets. This would allow DKD to better absorb the impact of losses and strengthen regulatory metrics, leading to a potential upward review of the rating.

↓ A deterioration in global economic conditions could lead DKD to experience unexpected shocks to its profitability, stretching its capital position. This could lead to pressures on its ratings, even if the support letter from its parent would somewhat mitigate against such a rating action.

Rating drivers (details)

DKD is managed in run-off as part of the orderly resolution plan for Dexia Group and is not allowed to write new business.

In the Dexia Group, Dexia Kommunalbank Deutschland (DKD) is the largest subsidiary of Dexia Credit Local (DCL), with total assets of EUR 31.4bn as of 31 December 2015. DCL is fully owned by Dexia SA, the holding company of the group. DKD's business focuses mainly on public-sector finance, and the loan portfolio is funded by Öffentliche Pfandbriefe.

In 2008 Dexia found itself in distress, partly due to the FSA's involvement in the US subprime-mortgage crisis. The bank received a first capital injection and a state guarantee, capped at EUR 150bn, from France, Belgium and Luxembourg. In the following years the group kept making losses. In 2011, in the context of the sovereign-debt crisis, Dexia Group was forced to write down its Greek debt, and a second rescue was decided. In 2012 an orderly resolution plan was submitted to the shareholder states. After extra capital was posted, the state guarantee was revised to EUR 85bn, with the states owning 94.42% of the group (50.02% from Belgium and 44.4% from France).

Under the orderly resolution plan (EC decision JOCE L/110/2014) the group sells commercial franchises and manages the run-down of its asset portfolio. DKD is part of Dexia Group's wind-down. New lending is done solely for liquidity management and the cover pool's management, while the bank only prolongs loans when contractually obliged. On the liability side, deposits are still used to refinance the maturing unsecured debt portfolio, together with repo transactions and ECB financing.

The state guarantee on DKD's state-owned parent does not extend to its subsidiaries. However DKD benefits from a letter of support from its parent.

DCL benefits from a guarantee on its payment obligations, capped at EUR 85bn, and granted by the French, Luxembourg and Belgian governments. This guarantee does not apply to DCL subsidiaries, including DKD, but is only applicable to instruments issued by DCL. Therefore the guarantee only indirectly applies to DKD as it invests the instruments issued by the parent company.

DKD benefits from the letter of support (Patronatserklärung) issued by DCL in 2011, which also legally obliges DCL to ensure DKD meets financial commitments and BaFin requirements. Moreover, DCL has granted a EUR 1bn revolving liquidity facility which expires in October 2016, which DKD has not used as of YE 2015 . This means that a short review of DCL’s financials is necessary.

DCL’s state guarantee of EUR 61.3bn at YE 2015 covered 67% of the group’s debt securities. If the guarantee were to reach the EUR 85bn cap, it would cover almost all of Dexia’s outstanding debt securities.

This guarantee may sound comprehensive, but we note that DCL has registered losses every year since 2008 (except in 2009), mostly on the back of its negatively performing trading portfolio and high cost base.

DCL’s cost-to-income ratio (excluding trading) peaked at 323% in 2011. The group’s capital position is still relatively strong: in 2015 it reported a CET1 ratio of 15.9%, compared to 12.8% at YE 2014. Dexia Group and DCL must keep the CET1 ratio at 8% at least, plus a capital-conservation buffer of 0.625% p.a. to be phased in between 2016 and 2019 (therefore reaching 10.5% on a fully loaded basis). The gap to the minimum requirement as of YE 2015, including the capital-conservation buffer, stood at 729 bps or EUR 3.7bn; excluding the capital-conservation buffer, 790 bps or EUR4bn.

Overall, we believe DCL’s standalone financial strength is not enough to assume DKD could benefit from direct parent support. Even if the state guarantee protects the holders of DCL’s debt, it would not help in the context of problems at DKD. The letter of support is indeed helpful in a ‘business as usual’ context for DCL, but if DKD is in trouble, DCL’s ability to provide support is limited to its standalone strength. In this respect we calculated a EUR 3.7bn capital buffer for DCL and relate it to the forthcoming profitability of DCL.

As a result of the above, the rating assessment depends significantly on DKD’s strength. As DKD is in run-off, and because it cannot write new business, it is structurally unprofitable, leaving its capital base heavily sensitive to cyclical variations and unexpected write-offs.

DKD’s exposure to HETA is a good example. In the context of HETA’s resolution, a temporary moratorium was imposed on its debt instruments. As of 31 December 2015, DKD had risk provisions of EUR 175m on the nominal amount of claims, resulting in a valuation of about 55.8% of the EUR 395m guaranteed by the Austrian state of Carinthia.

As a result of the provisioning, DKD posted a loss in 2015 and its CET1 ratio fell to 17.3% at the end of 2015 from 21.8% in 2014. In the medium to long term we expect the cost base to reduce more slowly compared to total assets, considering the rigidity of the bank’s cost base. This could result in more pronounced losses going forward.

As of YE 2015, CET1 was at EUR 588.8m compared with the EUR 744.7m in 2014, which we view as quite stretched, as further unexpected shocks could trigger the letter of support.

Selected Financial Information DKD

	2008	2009	2010	2011	2012	2013	2014	2015
Balance Sheet summary (EUR mn)								
Assets								
Cash and Interbank Assets	8,231.2	7,716.4	8,918.5	9,943.9	8,283.9	5,909.1	5,939.1	6,288.1
Total Securities	19,345	18,346.7	17,943.2	16,660.1	18,279.2	15,843.8	13,899.0	9,353.0
Net Loans to Customers	20,972.6	20,855.0	21,393.7	20,343.4	19,039.3	17,499.7	16,632.1	15,469.7
Other Assets	420	373.1	439.1	393.6	334.2	293.1	267.6	284.5
Total assets	**48,969.2**	**47,291.2**	**48,694.6**	**47,341.1**	**45,936.5**	**39,545.7**	**36,737.8**	**31,395.4**
of which Cover Pool	*38,474.8*	*36,335.7*	*37,795.4*	*35,643.2*	*30,484.1*	*25,472.3*	*22,197.9*	*20,959.5*
Liabilities								
Due to banks	8,782.6	9,265.2	9,633.3	9,409.1	9,203.2	8,075.9	9,297.1	4,329.0
Pfandbriefe	37,306.2	35,165.4	34,919.0	33,315.1	29,739.0	24,345.7	20,885.1	19,678.6
Deposits	1,986.5	1,900.4	2,423.4	2,587.5	5,369.0	5,892.0	5,343.1	6,104.0
Senior Unsecured Debt	74.4	50.4	30.5	30.5	30.5	30.5	30.5	30.5
Subordinated debt	131.5	126.5	106.0	96.0	70.0	60.0	60.0	60.0
Provisions	7.8	7.4	8.1	95.9	5.6	4.6	4.9	5.8
Other liabilities	389.7	444.7	1,042.4	1,055.7	779.1	392.1	369.5	529.7
Total Liabilities	**48,678.7**	**46,960.1**	**48,162.7**	**46,589.8**	**45,196.3**	**38,800.8**	**35,990.0**	**30,737.6**
Equity	290.5	331.1	531.9	751.3	740.2	745.0	747.8	657.7
Total Liabilities and Equity	**48,969.2**	**47,291.2**	**48,694.6**	**47,341.1**	**45,936.5**	**39,545.7**	**36,737.8**	**31,395.4**
Core Tier 1 / Common Equity Tier 1 Capital	*282.0*	*323.7*	*526.0*	*828.9*	*750.2*	*739.8*	*744.7*	*588.8*
Income Statement summary (EUR mn)								
Net Interest Income	80.6	45.2	41.5	61.8	13.1	24.0	24.3	80.8
Net Fee & Commission Income	-0.6	-1.4	-2.2	-9.9	-4.5	-4.0	-2.9	-2.6
Net Trading Income	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other income	0.2	0.2	2.1	0.3	1.2	1.1	0.0	0.3
Operating Income	**80.2**	**44.0**	**41.5**	**52.2**	**9.8**	**21.2**	**21.4**	**78.4**
Operating Expense	22.3	19.1	18.4	18.5	18.2	19.6	20.6	35.6
Pre-provision Income	**57.9**	**24.8**	**23.1**	**33.7**	**-8.4**	**1.6**	**0.8**	**42.8**
Loan Loss Provision charges	54.7	20.3	18.5	119.7	11.5	3.3	1.4	50.8
Other Impairments	0.2	-0.8	0.0	-6.3	-0.2	-0.2	-0.2	91.5
Non-recurring items	-2.5	-4.5	-3.6	-11.3	0.0	0.0	0.0	0.0
Pre-tax Profit	**0.5**	**0.9**	**1.0**	**-91.0**	**-19.6**	**-1.6**	**-0.4**	**-99.5**
Discontinued Operations	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Income Tax Expense	0.1	0.4	0.2	1.2	0.0	0.0	0.0	0.0
Net Profit Attributable to Minority Interests	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Net Profit Attributable to Parent	**0.4**	**0.6**	**0.8**	**-92.1**	**-19.6**	**-1.6**	**-0.4**	**-99.5**

Source: SNL Financial and Scope Ratings estimates
Please refer to the Bank Rating Methodology for the definition of Ratios
[1] CRD 4 transitional basis from 2014

Ratios – DKD

	2008	2009	2010	2011	2012	2013	2014	2015
Funding/Liquidity								
Gross loans % Total deposits	115.5%	110.3%	106.4%	102.6%	87.0%	81.3%	81.2%	75.6%
Total deposits % Total funds	37.5%	40.5%	42.5%	43.5%	49.2%	55.9%	57.4%	67.6%
Wholesale funds % Total funds	62.5%	59.5%	57.5%	56.5%	50.8%	44.1%	42.6%	32.4%
Asset Mix, Quality and Growth								
Gross loans % Funded assets	42.8%	44.1%	43.9%	43.0%	41.4%	44.3%	45.3%	49.3%
Impaired loans % Gross loans	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Loan loss reserves % Impaired loans	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Gross loan growth (%)	-2.4%	-0.6%	2.6%	-4.9%	-6.4%	-8.1%	-5.0%	-7.0%
Impaired loan growth (%)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Funded assets growth (%)	6.0%	-3.4%	3.0%	-2.8%	-3.0%	-13.9%	-7.1%	-14.5%
Earnings								
Net interest income % Revenues	100.5%	102.8%	100.2%	118.4%	134.2%	113.4%	113.5%	103.0%
Fees & commissions % Revenues	-0.7%	-3.2%	-5.3%	-19.0%	-46.4%	-18.7%	-13.7%	-3.4%
Trading income % Revenues	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Other income % Revenues	0.3%	0.4%	5.1%	0.6%	12.2%	5.3%	0.2%	0.3%
Net interest margin (%)	0.2%	0.1%	0.1%	0.1%	0.0%	0.1%	0.1%	0.2%
Pre-provision Income % Risk-weighted assets (RWAs)	n.a.	n.a.	0.7%	1.0%	-0.2%	0.1%	0.0%	1.3%
Loan loss provision charges % Pre-provision income	94.4%	81.6%	80.1%	355.1%	-136.8%	214.0%	171.6%	118.6%
Loan loss provision charges % Gross loans (cost of risk)	0.3%	0.1%	0.1%	0.6%	0.1%	0.0%	0.0%	0.3%
Cost income ratio (%)	27.8%	43.5%	44.3%	35.4%	185.8%	92.6%	96.2%	45.4%
Net Interest Income / Loan loss charges (x)	1.5	2.2	2.2	0.5	1.1	7.2	17.2	1.6
Return on average equity (ROAE) (%)	0.2%	0.2%	0.2%	-14.4%	-2.6%	-0.2%	-0.1%	-14.2%
Return on average funded assets (%)	0.0%	0.0%	0.0%	-0.1%	0.0%	0.0%	0.0%	-0.2%
Retained earnings % Prior year's book equity	0.1%	0.2%	0.2%	-17.3%	-2.6%	-0.2%	-0.1%	-13.3%
Pre-tax return on common equity tier 1 capital	0.2%	0.3%	0.2%	-11.0%	-2.6%	-0.2%	-0.1%	-16.9%
Capital and Risk Protection								
Common equity tier 1 ratio (common equity tier 1 capital % RWAs) [1]	n.a.	n.a.	16.4%	24.5%	21.8%	25.0%	21.8%	17.3%
Tier 1 leverage ratio (%) [2]	0.6%	0.7%	1.1%	1.8%	1.6%	1.9%	2.0%	1.9%
Mean of tier 1 leverage ratio and common equity tier 1 ratio (%)	n.a.	n.a.	8.7%	13.1%	11.7%	13.4%	11.9%	9.6%
Total loss coverage (CET 1 capital + loan loss provisions) % RWAs	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Asset risk intensity (RWAs % total assets)	n.a.	n.a.	6.6%	7.1%	7.5%	7.5%	9.3%	10.8%

Source: SNL Financial and Scope Ratings estimates
Please refer to the Bank Rating Methodology for the definition of Ratios
[1] CRD 4 transitional basis from 2014

APPENDIX II. COVERED BOND MODELLING – TECHNICAL NOTE

Portfolio credit risk modelling

Public-sector cover pools are often concentrated and do not have a very high diversification. We therefore developed Scope's portfolio modelling tool to estimate default statistics for a loan portfolio based on the amortisation profile of the individual loans, their default rates through time and correlation assumptions between the assets.

We analysed the exposures in the cover pool and formed credit opinions on each asset. We established a correlation framework for the cover pool assets. Our asset correlations take into account a global correlation assumption, to which we add country- and industry-specific factors, reflecting the differing transfer mechanisms, oversight and guarantee structures observed between eligible exposures. Correlation assumptions range from a low 15% for public-sector-guaranteed corporate exposures in different countries up to 50% for public-sector covered bonds with same country collateral.

The defaults are determined in a single-period Monte Carlo simulation using a Merton approach. Asset defaults are driven by a set of common stochastic factors correlated via a Gaussian copula and an idiosyncratic component. The model calculates the estimated cumulative density function of default rates and default frequencies, and provides estimates for the default timings.

Cash flow modelling

The results of the portfolio credit risk modelling of the cover pool feeds into a stressing of future cash flows in the structure. The main inputs of the simulation are the credit-related characteristic parameters of the pool (e.g. amortisation profile, default distribution, default timings, recoveries) and market-scenario parameters (e.g. interest rate term structures, FX rates). The modelling of the covered bonds' cash flow waterfall assumes that asset sales can cover any liquidity shortfalls. Proceeds for asset sales are determined by calculating a present value by discounting of all future expected cash flows, and adding a cover-pool-specific liquidity premium.

The simulation for different default rates, together with the already determined default distribution, allows us to calculate the expected loss and expected average life of the structure. Along with Scope's idealised expected loss curves, this allows us to determine the covered bond's rating under the given scenario. Scope applies a set of increasing stress scenarios specific to the covered bond programme, to tests the cover pool's ability to service the covered bonds. The stress scenarios are rating-dependent changes to the input parameters, i.e. recovery rates, market parameters and liquidity premiums. The structure has 'passed' a certain rating level when the model result supports a rating equal or higher than the target rating of the scenario.

The covered bond rating is anchored at the issuer's rating. Scope's methodology reflects this by considering stress scenarios as rating-distance-dependent, with the base case scenario set at the issuer's rating, i.e. we allow the issuer to cover for rating scenarios up to its rating. The cover pool therefore only needs to support scenarios above this threshold. We translate the stresses commensurate with the potential uplift into a potential quantitative covered bond rating (e.g. issuer rating: BBB; cover pool uplift test +3; cover pool rating benchmark: A).

Key modelling parameters

Based on the composition of the cover pool we determine an average recovery rate specific to the cover pool. We also base the relevant average liquidity premium on the cover pool's composition. The highest stress assumptions only apply in the scenario which, if passed, allows us to assign the maximum credit differentiation between the issuer and its covered bonds.[2]

Recoveries: Asset-specific recoveries used in our analysis mainly reflect the asset characteristics, country-specific transfer and equalisation systems, as well as the tiering of the public-sector exposures. We generally assume the lowest recovery rates for sovereign exposures, applying 40%; for subsovereigns or municipalities, this can be as high as 60%. We have used a 50% recovery for public-sector companies or other eligible guaranteed exposures.

Liquidity premium: We determine the blended liquidity premiums specific to the cover pool by applying stressed country-specific spreads or CDSs for the respective asset types, ranging from 100 bps to 1,250 bps.

Market risk stresses: We assume deterministic interest rate and FX stresses in our cash flow modelling. We apply a common framework to establish the stresses, but tailor this to individual cover pools by identifying which market rate developments the cover pool is most sensitive to. The analysis allows us to establish stresses that equate to the maximum achievable rating uplift.

Interest rate modelling: Based on historical interest rate developments dating back to the German hyperinflation in the 1920s, we established interest rate scenarios which continuously increase up to 15%. We also assumed a spike of up to 20% for a relatively short period of time, after which rates decrease back to about 5% in the long term.

Foreign-exchange risk modelling: Based on the development of FX rates since 1953, we have identified all-time lows and highs for the respective currency pairs. Depending on the cover pool's composition and, whether there are more currency assets or

[2] The maximum credit differentiation between the rating of the issuer and 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 DKD, we have determined a fundamental support of five notches. According to our methodology, the maximum achievable uplift is eight notches (5+3).

liabilities, we test the cover pool's resilience against either a rise or fall in the relevant currency. Based on current exchange rates, appreciation can be as high as 110% of the current rates, and depreciation up to 76%.

APPENDIX III. SUMMARY OF COVERED BOND CHARACTERISTICS

Reporting date	31 December 2015
Issuer name:	Dexia Kommunalbank Deutschland AG
Country	Germany
Cover pool type	Public sector
ICSR	N/D
Current covered bond rating:	AA-/Stable
Fundamental cover pool support floor:	a+
Max. achievable covered bond rating:	aa+
Covered bond rating buffer[1]:	N/A

Cover pool (in EUR bn):	20.96
Covered bonds (in EUR bn):	19.3
Current overcollateralisation[2]:	7.8%/8.6%
WAM assets:	9.6 years
WAM liabilities:	7.1 years
WAM GAP:	2.5 years

Number of different obligors	211
Effective number of obligors[3]:	32
% share top-20 obligors:	63.80%
Average credit quality:	a-

Expected loss (credit risk):	1.90%
OC needed to quantitatively support the max. rating uplift[4]:	11.00%
Min OC to support current rating[4]	6.50%

Default measure:	Default distribution
WA recovery assumption:	51.30%
IR stresses (max./min.; CCY dependent):	0% to 20%
FX stresses (max./min.; CCY dependent)[4]:	+110%/-76%
WA liquidity premium:	260 bps
Servicing fee	10 bps

N/D - not disclosed; N/A – not available

[1] Number of notches the issuer's ICSR could be downgraded without affecting the covered bond rating. This rating buffer is available in case the cover pool analysis supports a higher uplift.
[2] Rating-relevant OC based on repayment obligation/ regulatory OC definition
[3] Effective numbers of equally distributed obligors (inverse of the Herfindahl index)
[4] Rating relevant oc based on the repayment obligation.
[5] Relative appreciation and depreciation based on current exchange rates

APPENDIX IV. REGULATORY AND LEGAL DISCLOSURES

Important information

Information pursuant to Regulation (EC) No 1060/2009 on credit rating agencies, as amended by Regulations (EU) No. 513/2011 and (EU) No. 462/2013

Responsibility

The party responsible for the dissemination of the financial analysis is Scope Ratings AG, Berlin, District Court for Berlin (Charlottenburg) HRB 161306 B, Executive Board: Torsten Hinrichs (CEO), Dr. Stefan Bund and Dr. Sven Janssen.

The covered bond rating analysis has been prepared by Karlo Fuchs, Lead Analyst
Responsible for approving the covered bond rating: Guillaume Jolivet, Committee Chair

Rating history of public sector covered bonds (OePf) issued by Dexia Kommunalbank Deutschland AG

Date	Rating action	Seniority	Rating/ Outlook
04.05.2016	First assignment	senior secured public sector covered bond	AA-/ Stable

The rating concerns a debt type of issuer which was evaluated for the first time by Scope Ratings AG. Scope had already assigned private ratings for the rated instruments in accordance with Regulation (EC) No 1060/2009 on rating agencies, as amended by Regulations (EU) No 513/2011 and (EU) No 462/2013.

Information on interests and conflicts of interest

The rating was prepared independently by Scope Ratings but with a mandate by Dexia Kommunalbank Deutschland AG (solicited)

As at the time of the analysis, neither Scope Ratings AG nor companies affiliated with it hold any interests in the rated entity or in companies directly or indirectly affiliated to it. Likewise, neither the rated entity nor companies directly or indirectly affiliated with it hold any interests in Scope Ratings AG or any companies affiliated to it. Neither the rating agency, the rating analysts who participated in this rating, nor any other persons who participated in the provision of the rating and/or its approval hold, either directly or indirectly, any shares in the rated entity or in third parties affiliated to it. Notwithstanding this, it is permitted for the above-mentioned persons to hold interests through shares in diversified undertakings for collective investment, including managed funds such as pension funds or life insurance companies, pursuant to EU Rating Regulation (EC) No 1060/2009. Neither Scope Ratings nor companies affiliated with it are involved in the brokering or distribution of capital investment products. In principle, there is a possibility that family relationships may exist between the personnel of Scope Ratings and that of the rated entity. However, no persons for whom a conflict of interests could exist due to family relationships or other close relationships will participate in the preparation or approval of a rating.

Key sources of Information for the rating

Website of the rated entity/issuer, Annual reports/quarterly reports of the rated entity/issuer as well as other public covered bond specific reports, Program documentation and terms and conditions of the covered bonds issued, Current performance information as well as confidential information on the composition of the cover pool composition and related cash flow structures, Data provided by external data providers, Interview with the rated entity, Press reports, official publications and data series by the central bank and research from reputable market participants.

Scope Ratings considers the quality of the available information on the evaluated entity to be satisfactory. Scope ensured as far as possible that the sources are reliable before drawing upon them, but did not verify each item of information specified in the sources independently.

Examination of the rating by the rated entity prior to publication

Prior to publication, the rated entity was given the opportunity to examine the rating and the rating drivers, including the principal grounds on which the credit rating or rating outlook is based. The rated entity was subsequently provided with at least one full working day, to point out any factual errors, or to appeal the rating decision and deliver additional material information. Following that examination, the rating was not modified.

Methodology

The main methodologies applicable for the covered bond rating are: “Covered Bond Rating Methodology”, published July 2015, ‘Rating Methodology for Counterparty Risk in Structured Finance Transactions’ published 10 August 2015, “General Structured Finance Rating Methodology”, published 28 August 2015.
For the private rating of the issuer we also applied the principles contained in the “Bank Rating Methodology” dated May 2015.
The historical default rates of Scope Ratings can be viewed on 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 default rating, definitions of rating notations and further information on the analysis components of a rating can be found in the documents on methodologies on the rating agency's website.

Rating issued by

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