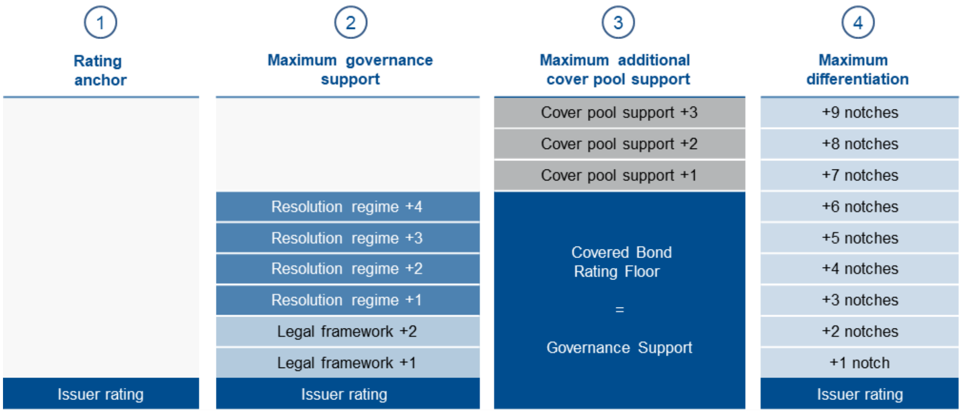
Governance support in Austria's new covered bond framework allows for six-notch uplift

Higher systemic importance, stronger cohesiveness and a harmonised legal framework allow us to increase the potential governance support for Austrian covered bonds to up to six notches above the issuer rating. This report provides Scope's view on the governance support factors common to Austrian covered bonds and their issuers.

The governance support assessment in Scope's covered bond methodology provides a floor to how much a covered bond can be rated above its issuer's rating and constitutes an anchor for additional credit differentiation based on cover pool support.

Figure 1: Maximum rating differentiation for Austrian covered bonds



Source: Scope; credit differentiation is expressed as a rating notch above the issuer's rating.

Our view on the two-notch uplift driven by legislative support remains unchanged. However, we now have a more credit-positive view on Austria's covered bond legal framework, which previously "just met" our expectations. The updated legislation will come into force on 8 July 2022 and transposes the European Covered Bond Directive into local law. The new framework consolidates the three sets of existing legislation, improves and aligns it more closely with best practice as seen in other covered bond frameworks across Europe.

We have increased to up to four additional notches (from three) the credit benefit Austrian covered bonds can receive based on analysis of how regulators would maintain the issuer and its covered bonds upon regulatory intervention, the preferential status of covered bonds in a resolution scenario as well as their systemic importance.

Austrian covered bonds are excluded from bail-in and we have adjusted our view to "moderately high" systemic importance. As of end-2021, the outstanding volume of covered bonds accounted for more than 20% of Austrian GDP, which puts them into the upper third among European peers. Annual issuance since 2010 has averaged EUR 12bn, peaking at EUR 27bn in 2020 owing to the TLTRO. Currently, 26 banks, comprising all large and most mid-size banks, are covered bond issuers and they are increasingly placing bonds with international investors.

The long-awaited consolidation of the country's three sets of covered bond legislation into one, ongoing industry efforts to create a common Austrian covered bond brand and the regular use of public placements by large and mid-size banks has led to stronger visibility. We have also observed stronger cohesiveness among domestic stakeholders.

In summary, this allows us to assign up to six notches of credit uplift based on governance support to Austrian covered bonds. Issuer and programme-specific considerations can lead to an uplift of up to two notches lower.

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Legal framework assessment

Covered bond framework

Consolidation of Austrian covered bond acts into one

The main provisions for the Austrian covered bond framework are now stipulated in the Covered Bond Act (Pfandbriefgesetz or PfandBG). The legislation has been approved and will come into force on 8 July 2022, transposing the European Covered Bond Directive into local law. The new covered bond framework consolidates the three slightly different sets of existing legislation and brings it fully into line with best practice as seen in other covered bond frameworks across Europe

Segregation of cover pool

On-balance sheet structure

The Austrian framework sees an 'on-balance sheet' cover pool, where cover assets are ringfenced by registration in the cover register. Setting off against the cover pool is not allowed. When the issuer becomes insolvent, the cover pool receives the status of a special estate (Sondermasse), which segregates it from the remaining insolvency estate. The insolvency of the issuer will generally not impact the structure, terms and conditions of loans granted or the covered bonds issued. Covered bonds will not accelerate upon the insolvency or resolution of the issuer.

If proceeds from the sale of cover pool assets are insufficient to repay the covered bonds, investors have third recourse to the general insolvency estate of the issuer.

Ability to continue payments following issuer insolvency

Following insolvency, Austria's financial market supervisor (Finanzmarktaufsicht, or FMA) appoints a special administrator (besonder Verwalter), which is tasked with ensuring the full and timely payment of covered bonds and managing the cover pool. The framework highlights that resolution or insolvency of the issuer will not affect the ability to make the promised payments on covered bonds or derivatives in the cover pool.

The special administrator has the right to collect payments, sell cover assets and enter into bridge financings.

Liquidity and other risk management guidelines

Extension triggers harmonised but details must be clarified

Austrian covered bond issuers can decide to issue hard or soft-bullet covered bonds. The new framework specifies what triggers a maturity extension. This was previously defined on a purely contractual basis.

Under the new framework, after the insolvency of the issuer, the special administrator can have sole rights to extend the maturity of a covered bond by up to 12 months. As a pre-condition, the administrator needs to be convinced that the bond can be fully repaid at the extended maturity date. An extension, however, does not alter the ranking nor the time structure of existing covered bonds. In practice, this means that the extension of one covered bond could trigger the same for subsequent bonds, even if the latter were issued without an extension option. We expect the FMA to provide further details and clarifications, ideally through secondary legislation.

In addition, issuers using soft-bullet structures are subject to additional transparency requirements, including the interest rate paid during the extension period.

New 180 day liquidity requirement

In a going-concern scenario, the issuer is required to maintain sufficient amounts of highly-liquid assets in the cover pool to cover shortfalls for at least 180 days. Shortfalls are calculated based on the initial maturity date. We understand that only cash outflows related to covered bonds issued after 8 July 2022 must be covered.

Grandfathering of existing bonds weakens provision

In itself this grandfathering will not provide investors with the benefits expected from the 180-day rule. However, we see as positive that it puts Austrian covered bonds into a better position than those of countries that solely benefit from a maturity extension.

Secondary legislation still missing and key to fully assess the updated framework

The Covered Bond Act does not provide additional expectations on the management of other market risks. It is left to the issuer's discretion to establish prudent processes and maintain adequate risk management systems to identify, assess and control risks including interest-rate and foreign-exchange risks. As for most other topics that are only vaguely addressed in the law, regulators have not yet provided secondary legislation or additional guidance that would help to assess their stringency.

Programme enhancement remains available

Effective minimum OC at 4%

Austrian covered bonds must provide a mandatory minimum nominal over-collateralisation (OC) of 2% in addition to expected wind-down costs; generally also quantified at 2%. This will effectively provide for a minimum nominal OC of 4% that issuers need to maintain at all times. Issuers can commit to higher OC levels, either on a nominal or net present value basis. The legislator highlights that this higher committed OC is often necessary to secure covered bond issuers' access to capital markets.

Derivatives in the cover pool will not terminate upon the issuer's insolvency and will remain available to service the covered bond programme. Derivatives continue to rank pari passu with covered bonds.

Excessive OC might be depleted but hard to prove

We understand that, upon issuer insolvency, excessive and not explicitly committed OC above the legal minimum could be depleted and used by the issuer. However, it will generally be challenging to prove what amounts to excessive. In addition, every removal of cover assets from the cover register and every new issue must be approved by the trustee.

Covered bond oversight

Covered bond-specific supervision now codified

The FMA must approve covered bond issuance programmes. After the approval is granted by the FMA in co-operation with the Austrian National Bank (OeNB), regulators and supervisors must perform special oversight over the programme. The FMA has the right to order special audits on the cover pool and can also order the issuer to carry out corrective measures.

Market practice will show whether internal or external trustee becomes standard

Issuers have to ensure that the risk management department is independent from the operating business and has the relevant knowledge and capacities to monitor, assess and manage the risks of the covered bond programme. In addition, issuers have to appoint either an internal or external trustee (Treuhänder).

The internal trustee would be represented by the risk management department and be headed by a natural person. We understand that the internal trustee head must be different from the issuer's head of risk, reducing potential conflicts of interest.

The external trustee must be a lawyer or an auditor. Within two weeks of their appointment, the designated external trustee must certify that no conflict of interest is present. For example, the auditor of the bank cannot also act as the trustee.

The trustee has to ensure that cover assets comply with regulations, sign off (de)-registration of cover assets, hedging agreements and the issuance of new covered bonds. Where a breach has occurred or where the trustee sees the quality of the cover pool at risk, the trustee has to notify the FMA immediately. The framework makes clear that the issuer's insolvency will not impact the trustee's role and duties to avoid negative credit impacts from adverse management.

Upon the issuer's insolvency, the insolvency court appoints a dedicated special administrator tasked with managing the cover pool (with the FMA's approval). The special administrator can be complemented by a 'Kurator', who represents joint covered bond holders.

Transparency

The Austrian framework now stipulates that mandatory cover-pool disclosures have to be published on the issuer's website at least on a quarterly basis. The law is vague on the actual content of the disclosures. It requires, for example, that interest, currency, credit and liquidity risks must be addressed. We expect the FMA to introduce secondary regulation in the course of the year defining content and structure of transparency disclosures.

Standard market practice now legally binding

In practice, most Austrian issuers already provide such information using the ECBC's 'Harmonised Transparency Template' or its Austrian surrogate, the 'Austrian Transparency Template'. We view the use of European standards positively because it fosters comparability across countries. We expect that other supervisors will also follow this format in the future.

Other legal framework considerations

Austrian covered bonds are fully UCITS compliant. Existing covered-bond types also comply with the provisions of the EU's Capital Requirements Regulation. There are no rating-relevant aspects that materially differ between covered bond types that are relevant for assessing differentiation in the legal framework. Generally, all Austrian covered bond types receive the full rating uplift for the supportive legal framework

Resolution regime assessment

Translation of BRRD into national law

Covered bonds exempt from bail-in

Austrian covered bonds are explicitly excluded from bail-in. With the 1 January 2015 enactment of the Federal Act on the Recovery and Resolution of Banks (BaSAG), Austria implemented the EU's Bank Recovery and Resolution Directive (BRRD).

Austria was among the first to actively use the restructuring provisions and also demonstrated how such provisions can work in favour of covered bond investors. When the FMA ordered a moratorium on Heta Asset Resolution AG – the workout entity of failed Hypo Alpe Adria Bank, senior unsecured debt was bailed in but Heta's public-sector covered bonds were neither impacted by the moratorium nor bailed-in. Even though covered bonds had recourse to a very high level of OC, we are not aware that any OC was released to increase the potential recoveries of unsecured debtholders.

Ability of regulators to maintain the issuer and its covered bonds as going concern

The issuer's business model, systemic importance, liability and capital structure can further incentivise regulators to use available resolution tools. We assess on an issuer-specific basis the likelihood that the covered bond programme will be maintained as an actively-managed going-concern funding programme.

Systemic relevance of covered bonds in Austria

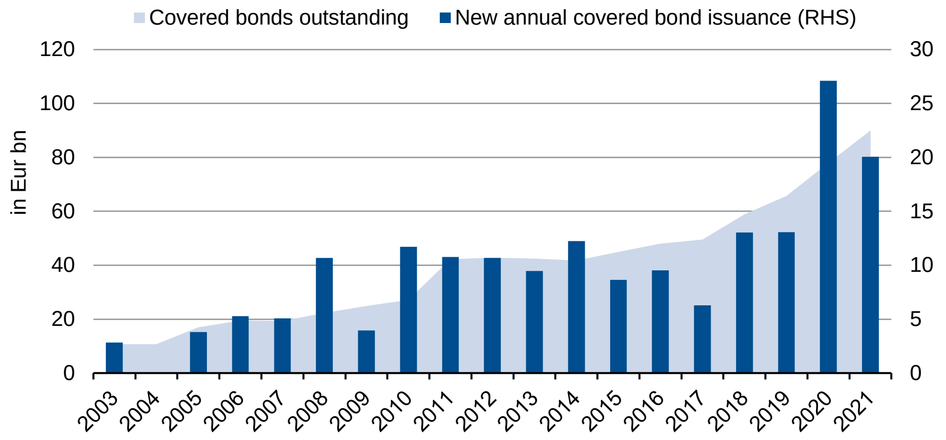
Austrian covered bonds now with moderately high systemic relevance

We classify both Austrian mortgage and public-sector covered bonds as refinancing products with a moderately high systemic relevance. As of end-2021, the combined outstanding volume accounted for more than 20% of Austrian GDP, which puts it into the upper third among European peers. Annual issuance since 2010 has averaged EUR 12bn. Issuance peaked at EUR 27bn in 2020, mainly driven by the banks' use of ECB funding but also because of higher public placements.

The uplift from moderate to high systemic assessment also reflects the fact that the number of active covered bond issuers has more than doubled since 2003.

Twenty six banks, comprising all large and most mid-size banks in Austria, are licensed to issue covered bonds. The number of 46 active covered bond programmes indicates that most issuers use both mortgage and public-sector covered bonds, as well as different programmes under the previous legislative frameworks. Following the consolidation of the Covered Bond Law, we also expect, at least to some degree, a consolidation of covered bond programmes (with the same cover exposure).

Figure 2: Covered bonds increasing as a refinancing tool



Source: ECBC. Scope Ratings

Mortgage covered bonds still dominating but public sector could stabilise

Mortgage covered bonds make up around 75% (or around EUR 70bn) of the market and this proportion is rising. Public-sector covered bonds, after the deleveraging of the early years of the last decade, have stabilised at around EUR 20bn. Nevertheless, public-sector covered bonds remain an essential part of the banks' funding mix, which is why we generally do not distinguish between their systemic importance.

In line with increased issuance, Austrian covered bonds are now increasingly placed with international investors, evidencing their importance to the issuers' funding toolkit. Between 2019 and early 2022, 11 Austrian banks publicly placed covered bonds in benchmark format. We also see an increasing trend of publicly placed sub-benchmark covered bonds from smaller issuers. In total, issuers comprising more than 70% of the Austrian banking sector now actively use international markets to place their covered bonds.

2022 will be a record year for Austrian public issues

After publicly placing covered bonds with a total nominal of around EUR 7bn in 2019, this almost halved in 2021 given the strong preference for ECB funding. With almost EUR 6.5bn to-date in 2022, the market is back on track and this year looks to be a year of record issuance.

The broader use of covered bonds across the banking landscape reduces the concentration of relative market shares. While Austria's two largest banks, Erste Group Bank AG and UniCredit Bank Austria AG, comprised 45% of outstanding covered bonds at end-2015, their combined share had decreased to below 40% at the end of 2021.

For very small covered bond programmes – both in absolute terms and relative to issuer's balance sheet – we may assign a lower credit differentiation; for example, if an issuer uses its covered bond programme only opportunistically or for programmes in wind down.

Stakeholder support

Consolidated framework aligns interests of different groups

A main driver of our improved assessment of governance support reflects the increased cohesiveness we observe in the market. Issuers were among the main supporters of consolidating the previous three distinct covered bond frameworks. A stronger alignment of interests across the different banking groups and the establishment of a common brand, which also attracts more international investors, leads to higher cohesiveness among stakeholders.

The increasing importance of mortgage lending for banks and the use of covered bonds as their main refinancing tool supports our view that the regulator should have an increasing interest in safeguarding covered bonds as an essential bank funding tool, especially in times of crisis.

Issuer now work closer together…

The 'Banks and Insurance' section of the Austrian Federal Economic Chamber (Wirtschaftskammer Österreich or WKO) has become the main platform for issuers to discuss their interests. In addition, covered bond issuers have established a dedicated covered bonds industry lobby called 'Pfandbrief Forum', which provides information on the market, especially for international investors, and further aligns brand presence. The forum also represents issuers within the 'European Covered Bond Council', the European industry lobby.

… already showing positive results

Within the consultation process for the new covered bond framework, issuers effectively lobbied for voting rights on the use of an internal or external trustee. Their efforts have previously resulted in the introduction of minimum OC requirements and voluntary, harmonised transparency reporting guidelines. This effectively allows most Austrian covered bonds to benefit from preferential regulatory risk weightings and favourable treatment for their Liquidity Coverage Ratio.

This is very different to the past where we observed a less cohesive and less vocal stakeholder group compared with other European covered-bond jurisdictions. The different banking groups issued under "their" covered bond framework and with differing support mechanisms, which did not speak to joint support.

Regulators have learned from the past

Supervisors have honoured the BRRD in previous situations and covered bonds have not been impacted. At the same, the application of the BRRD in the case of Heta as well as Austrian Kommunalkredit provided examples of how communication did not assuage investor concerns about the credit quality of covered bonds. We would expect investor communication to differ today as the lack of transparent communication effectively excluded issuers from the market and Austrian issuers needed to pay a premium compared with other European covered bonds.

Appendix I: Key characteristics of the Austrian covered bond framework

Issuer	Financial institutions with a special licence to issue covered bonds. This includes universal banks, specialised mortgage banks and building societies. The issuer does not need to be the originator, as issuers can pool cover assets originated by other banks, for example through a true-sale of assets but also commonly through fiduciary arrangements (Treuhandschaft). The legal framework also allows for intra-group covered bond structures. Here, covered bonds issued by members of the same group are sold to the credit institution issuing covered bonds to external investors. The cover pool of these external covered bonds then comprises the internally-issued covered bonds (not actively used currently).
Cover assets	Mortgage assets (residential and commercial assets) within the EEA, Switzerland and the United Kingdom. Underlying properties must be adequately insured against physical damage and the insurance must be part of the cover pool. Building plots and buildings under construction are eligible for up to 10% of the cover pool. Exposures to public-sector entities or public-sector-guaranteed entities in the EEA, Switzerland and the United Kingdom. Substitute and liquid assets (max. 15% of the covered bonds outstanding) can comprise exposures to eligible public-sector issuers, financial institutions, deposits and cash. Other 'high-quality' assets, given that these are credit claims with appropriate collateral. Derivatives (only to hedge risks – no specific restrictions on volumes)
Loan-to-value restrictions	Residential mortgage loans are eligible up to 80% of the properties' market or mortgage lending value; commercial mortgage loans are eligible up to 60%. of the properties' market or mortgage lending value. Full loan amount is part of the cover pool register. Covered bond investors have a preferential claim on cover assets, including recovery proceeds from non-eligible loan parts above the LTV threshold. Valuation must be conducted by a party not involved in the mortgage lending process and be current at the time of inclusion into the cover pool. Values of commercial properties must be monitored at least once a year, at least every three years for residential properties.
Market and liquidity risk guidelines	Minimum 180 day of liquidity coverage, including interest and principal payments. Outflows already covered by the 30-day Liquidity Coverage Ratio are excluded from the requirement. In addition, the framework allows soft-bullet structures of up to 12 months. No detailed regulations exist with regard to other market risks. Issuers must establish prudent processes and risk management systems to identify, assess and control risks including interest-rate and foreign-exchange risks.
Coverage principle/minimum OC	2% over-collateralisation on a nominal basis for covered bonds in addition to expected wind-down costs, generally also quantified at 2%.
Treatment upon insolvency	Insolvency of the issuer does not impact the ability to make uninterrupted payments on the covered bonds; no acceleration upon insolvency.
Mandatory transparency	Yes; information need to be provided on a quarterly basis .
UCITS/CRR compliance	Austrian covered bond types generally comply with UCITS and Capital Requirements Regulation and are eligible for LCR purposes.
Trustee/special supervision	Internal or external trustee (Treuhänder), appointed by the issuer, and the Austrian FMA.

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