MOODY'S RATINGS

Rating Action: Moody's Ratings assigns Aaa rating to the blockchain-based digital covered bond issued by Berlin Hyp AG under its mortgage covered bonds programme

06 Aug 2024

EUR 100 million of notes affected

Frankfurt am Main, August 06, 2024 -- Moody's Ratings (Moody's) has today assigned a Aaa long-term rating to the EUR 100 million 2027-maturity fixed-rate digital covered bond with ISIN DE000BHY1BC2 issued by Berlin Hyp AG (the issuer or Berlin Hyp, senior unsecured rating Aa2 stable; baseline credit assessment ba1; counterparty risk (CR) assessment Aa2(cr)).

RATINGS RATIONALE

A covered bond benefits from (1) the issuer's promise to pay interest and principal on the bonds; and (2) following a CB anchor event, the economic benefit of a collateral pool (the cover pool). The ratings therefore reflect the following factors:

(1) The credit strength of Berlin Hyp (senior unsecured rating Aa2 stable; baseline credit assessment ba1; counterparty risk (CR) assessment Aa2(cr)) and a CB anchor of Aa1.

(2) Following a CB anchor event the value of the cover pool. The stressed level of losses on the cover pool assets following a CB anchor event (cover pool losses) for this transaction is 20.6%.

We considered the following factors in its analysis of the cover pool's value:

a) The credit quality of the assets backing the covered bonds. The mortgage covered bonds are backed by German commercial and residential mortgage loans. The collateral score for the cover pool is 15.8%.

b) The legal framework. Notable aspects of the German Pfandbrief legislation include the legal requirement for the issuer to maintain 2% over-collateralisation (OC) on a stressed present value basis plus 2% OC on a nominal value basis. The framework imposes a loan-to-value (LTV) ratio threshold of 60% based on the mortgage lending value. The issuer must also cover potential liquidity gaps over the next 180 days between payments expected to be received under the cover pool assets and the payments due under the outstanding covered bonds.

c) The exposure to market risk, which is 10.1% for this cover pool.

d) The unstressed present value over-collateralisation (OC) in the cover pool is 7.7%. The issuer provides 2% stressed present value OC plus 2% nominal value OC on a "committed" basis as required by the Pfandbrief Act (see Key Rating Assumptions/Factors, below).

The TPI assigned to this transaction is High. Our TPI framework does not constrain the rating.

The rating also considers our view that the use of blockchain technology does not add materially higher risks compared to a traditional issuance. The key difference from traditional covered bonds issued by Berlin Hyp is that the notes will be registered on the blockchain, instead of a central securities depository.

The transaction is subject to the German Electronic Securities Act (eWpG) introduced in 2021. The eWpG allows issuance of bonds in fully digital form onto a register located on a decentralised blockchain, defining these instruments as legally equivalent to traditional bonds. Additionally, the eWpG provides a legal framework for additional requirements in connection with decentralised infrastructures.

We consider technology-related risks for this transaction to be effectively mitigated or equivalent to those of a traditional issuance. All payments will be processed through traditional channels. Only a limited group of accredited participants can access the platform. A backup of the bondholder list is available for participants to use in case of a system failure. The issuer also has an option to exchange the notes into traditional covered bonds in certain circumstances.

Berlin Hyp AG will register its digital covered bond on a digital register (Kryptowertpapierregister) on the SWIAT Blockchain. SWIAT GmbH, a joint venture of DekaBank Deutsche Girozentrale (DekaBank) (Aa1/Aa1 stable, baa2), Landesbank Baden-Wuerttemberg (LBBW) (Aa2/Aa2 stable, baa2) and other institutions, operates a private permissioned system on Hyperledger Besu with 9 validators. Entities that want to use the blockchain must be onboarded by SWIAT and granted permission to participate in the platform.

The digital register application (Deka Registry dApp) created by DekaBank on the SWIAT blockchain facilitates the issuance of digital bonds via token creation as defined by the eWpG. To receive tokens, investors must be onboarded by Deka, which also performs anti-money laundering and know your customer checks. The platform is compliant with the WpG, including the technical capability to restrict and reverse token transfers if necessary.

We consider operational risks in the transaction effectively addressed through a replacement mechanism for the registrar.

KEY RATING ASSUMPTIONS/FACTORS

We determine covered bond ratings using a two-step process: an expected loss analysis and a TPI framework analysis.

EXPECTED LOSS: We use our Covered Bond Model (COBOL) to determine a rating based on the expected loss on the bond. COBOL determines expected loss as (1) a function of the probability that the issuer will cease making payments under the covered bonds (such cessation, a CB anchor event); and (2) the estimated losses that will accrue to covered bondholders should a CB anchor event occur. We express the probability of a CB anchor event as a point on our alpha-numeric rating scale (i.e. the CB anchor), which is typically one notch higher than the issuer's CR assessment.

The CB anchor for this programme is Aa1, being the CR assessment of Berlin Hyp plus one notch.

The cover pool losses for this programme are 20.6%. This is an estimate of the losses we currently model following a CB anchor event. We split cover pool losses between market risk of 10.1% and collateral risk of 10.6%. Market risk measures losses stemming from refinancing risk and risks related to interest-rate and currency mismatches (these losses may also include certain legal risks). Collateral risk measures losses resulting directly from cover pool assets' credit quality. We derive collateral risk from the collateral score, which for this programme is currently 15.8%.

The unstressed present value over-collateralisation in the cover pool is 7.7%. The issuer provides 2% stressed present value OC plus 2% nominal value OC on a "committed" basis. Under our COBOL model, the minimum OC consistent with the Aaa rating is 0%, of which 0% needs to be in "committed" form to be given full value (numbers in present value terms). These numbers show that we are not relying on "uncommitted" OC in its expected loss analysis.

For further details on cover pool losses, collateral risk, market risk, collateral score and TPI Leeway across covered bond programmes rated by us please refer to "Covered Bonds Sector Update ", published quarterly.

TPI FRAMEWORK: we assign a "timely payment indicator" (TPI), which is our assessment of the likelihood of timely payment of interest and principal to covered bondholders following a CB anchor event. TPIs are assessed as Very High, High, Probable-High, Probable, Improbable or Very Improbable. The TPI framework limits the covered bond rating to a certain number of notches above the CB anchor.

RATING METHODOLOGY

The principal methodology used in this rating was "Moody's Approach to Rating Covered Bonds" published in March 2024 and available at https://ratings.moodys.com/rmc-documents/416197 . Alternatively, please see the Rating Methodologies page on https://ratings.moodys.com for a copy of this methodology.

Factors that would lead to an upgrade or downgrade of the rating:

The CB anchor is the main determinant of a covered bond programme's rating robustness. A change in the level of the CB anchor could lead to an upgrade or downgrade of the covered bonds. The TPI Leeway measures the number of notches by which we might lower the CB anchor before the rating agency downgrades the covered bonds because of TPI framework constraints.

Based on the current TPI of "High", the TPI Leeway for this programme is six notches. This implies that we might downgrade the covered bonds because of a TPI cap if it lowers the CB anchor by six notches all other variables being equal.

A multiple-notch downgrade of the covered bonds might occur in certain circumstances, such as (1) a country ceiling or sovereign downgrade capping a covered bond rating or negatively affecting the CB anchor and the TPI; (2) a multiple-notch downgrade of the CB anchor; or (3) a material reduction of the value of the cover pool.

REGULATORY DISCLOSURES

For further specification of Moody's key rating assumptions and sensitivity analysis, see the sections Methodology Assumptions and Sensitivity to Assumptions in the disclosure form. Moody's Rating Symbols and Definitions can be found on https://ratings.moodys.com/rating-definitions .

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