

Fitch Upgrades mBank Hipoteczny to 'A'; Outlook Revised to Positive

Fitch Ratings-Frankfurt/London-01 July 2016: Fitch Ratings has upgraded mBank Hipoteczny's (mBH: BBB/Stable/F2) mortgage covered bond programme to 'A' from 'BBB+' and removed the Rating Watch Positive. The Outlook is Positive.

KEY RATING DRIVERS

The resolved rating watch as well as the upgrade of the programme follows a review of the legal opinions and the historical performance data and reflects legislative amendments to the Polish covered bonds framework, effective 1st January 2016.

The Outlook is revised to Positive as Fitch expects the cover pool's credit risk and the open foreign currency position to decrease over the next 12 months, following a shift in the portfolio towards a higher share of PLN-denominated residential mortgage loans.

The rating is based on mBH's Long-Term Issuer Default Rating (IDR) of 'BBB', an unchanged IDR uplift of 0 notches, an increased Discontinuity Cap (D-Cap) of three notches (moderate high risk) and the 19.6% overcollateralisation (OC) that Fitch takes into account, which provides more protection than the 17.5% 'A' breakeven OC.

The D-Cap assessment of three notches (moderate high discontinuity) from 0 notches previously (full discontinuity) reflects the new legal liquidity risk protection, in particular the introduction of a conditional pass-through (CPT) maturity profile and a six-month interest reserve. The D-cap has been limited to three notches because of the risk of interest payment suspension before the announcement of insolvency and the interest reserve being invested in Polish sovereign bonds (A-/F2) that do not fully meet Fitch's expectations for liquid assets.

The OC Fitch relies upon is 19.6%. It is based on the lowest OC of the last 12 months, which stands at 32.1%, reduced for the unhedged foreign currency position exceeding a 10% limit, which amount to PLN553.9m. As of end-March 2016, the total net open position accounted for 18.5% of total assets, with PLN1.01bn-equivalent of assets denominated in EUR and PLN70m-equivalent of assets denominated in USD.

The main driver of the 17.5% 'A' breakeven OC is the credit loss component of 20.8%. It results from an 'A' weighted average (WA) rating default rate (RDR) of 37.8% and an 'A' WA recovery rate of 54.5%. The total credit loss is predominantly driven by loss expectations on the commercial real estate sub-portfolio (WA loss of 25.5%) compared to the residential sub-portfolio (6.2%).

As of end-March 2016, the residential sub-portfolio accounted for PLN2.3bn, the commercial for PLN3.5bn (60%) and substitute assets for PLN90m (2%). The share of residential assets has continuously increased from 1% in March 2014, to 38% in March 2016. This trend is expected to continue.

The low cash flow valuation component of the breakeven OC for the rating, of 0.9%, mostly reflects the impact of currency mismatches between assets and liabilities, which is largely offset by a positive excess spread.

The asset disposal loss component is nil, as the programme's conditional pass-through feature eliminates refinancing risk.

Fitch has not assigned an IDR uplift, assuming that the ease and motivation of resolution methods other than liquidation is limited, as mBH is not considered systematically important for its domestic market. Further, no bail-in buffer from senior unsecured debt exceeding 5% of its adjusted balance sheet is present and Fitch does not view Poland as a covered bonds-intensive market. Additional uncertainty remains, as despite the regulatory framework being progressively enhanced, final implementation of the Bank Recovery and Resolution Directive remains outstanding.

The agency applied a variation from its Counterparty Criteria for Structured Finance and Covered Bonds, published 14 May 2014 and did not deduct cash flows commingled before an issuer default. mBH is rated in line with the counterparty minimum rating, as outlined in the Exposure Draft: Counterparty Criteria for

Structured Finance and Covered Bonds, dated 14 April 2016, whereas mBH would not be eligible as account bank if the current criteria were applied. Should this aspect not become criteria, the programme would be subject to further review. The variation is reflected in the cash flow analysis and has no impact on the rating of mBH's mortgage covered bonds.

Fitch applied variations from its Covered Bonds Master Criteria, dated 11 March 2016. The first variation relates to the calculation of the open FX positions, which are netted depending on the difference in WAL between assets and liabilities in the same currency. As mBH's mortgage covered bonds are modelled as pass-through, the maturity of the liabilities was aligned to that of the assets. Hence, Fitch compares the WAL of the assets of each foreign currency bucket with the WAL of all assets rather than using the WAL of the liabilities in each individual currency. The variation is reflected in the level of OC relied upon. If Fitch had not applied this variation, the programme's rating would not be upgraded and remain unchanged at 'BBB+'. The second variation relates to currency stresses applied to recoveries, where the property's income is in a currency other than the loan currency. In rating scenarios above the Polish sovereign rating, Fitch modelled that all loans recover in the local currency. Had Fitch not modelled this variation from its criteria, the programme's rating would likely have been upgraded to 'A+'.

The third variation relates to the calculation of the WA credit loss for mixed portfolios. Fitch did not include PLN90m of substitute assets when calculating the WA loss used as an input in its cash flow analysis; these assets mainly fund the regulatory six-month interest reserve and the amount could therefore be volatile. The variation is reflected in the cash flow analysis and has no impact on the rating of mBH's mortgage covered bonds.

RATING SENSITIVITIES

Hipoteczny's (mBH) mortgage covered bonds could be upgraded by one notch if the residential sub-portfolio's growth remains strong and the open FX position is reduced.

The mortgage covered bonds' 'A' rating would be vulnerable to a downgrade if: (i) mBH's Issuer Default Rating (IDR) was downgraded to 'BB+' or below; or (ii) the IDR uplift and the D-cap together fell by two notches; or (iii) the overcollateralisation (OC) that Fitch takes into account (19.6%) drops below the 'A' breakeven OC of 17.5%.

Fitch rates mBH's covered bonds at 'A' which is above the sovereign rating of Poland (A-). For ratings above that of the sovereign, Fitch applies additional stresses to the assets' default and recovery rates, reflecting that the economic environment could be driven by severe stresses. A change in the sovereign rating of Poland may also change the stresses applied to derive the portfolio's stressed loss levels. Consequently, upwards or downward movements of Poland's IDR may have an impact on the breakeven OC for the rating.

The Fitch breakeven OC for the covered bond rating will be affected, among others, by the profile of the cover assets relative to outstanding covered bonds, which can change over time, even in the absence of new issuance. Therefore, the breakeven OC to maintain the covered bond rating cannot be assumed to remain stable over time.

More details on the cover pool and Fitch's analysis are available in the full rating report, mBank Hipoteczny - Mortgage Covered Bonds, dated 01 July 2016 and available at www.fitchratings.com.

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Additional information is available on www.fitchratings.com
mBank Hipoteczny - Mortgage Covered Bonds
(https://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=884455)

Applicable Criteria

Counterparty Criteria for Structured Finance and Covered Bonds (pub. 14 May 2014)
(https://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=744158)
Covered Bonds Rating Criteria (pub. 11 Mar 2016)
(https://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=878761)
Covered Bonds Rating Criteria – Mortgage Liquidity and Refinancing Stress Addendum (pub. 23 Sep 2015)
(https://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=871331)
Criteria for Interest Rate Stresses in Structured Finance Transactions and Covered Bonds (pub. 17 May 2016) (https://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=879815)
Criteria for Rating Caps and Limitations in Global Structured Finance Transactions (pub. 16 Jun 2016)
(https://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=882401)
Criteria for Rating Securitizations in Emerging Markets (pub. 06 Nov 2014)
(https://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=809588)
Criteria for the Analysis of Commercial Real Estate Loans Securing Covered Bonds (pub. 10 Dec 2015)
(https://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=874686)
Exposure Draft: Counterparty Criteria for Structured Finance and Covered Bonds (pub. 14 Apr 2016)
(https://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=878412)
Fitch's Foreign Currency Stress Assumptions for Residual Foreign Exchange Exposures in Covered Bonds -
Excel file (pub. 11 Mar 2016) (https://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=878760)
Fitch's Interest Rate Stress Assumptions for Structured Finance and Covered Bonds - Excel File (pub. 17
May 2016) (https://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=880522)
Fitch's Mortgage Covered Bond Refinancing Stresses - Excel File (pub. 12 Feb 2016)
(https://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=877778)

Additional Disclosures

Dodd-Frank Rating Information Disclosure Form
(https://www.fitchratings.com/creditdesk/press_releases/content/ridf_frame.cfm?pr_id=1008367)
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