FitchRatings

13 Aug 2020 | Affirmation

Fitch Affirms German Cooperative Banks and DZ BANK at 'AA-'; Outlook Negative

Fitch Ratings-Frankfurt am Main-13 August 2020:

Fitch Ratings has affirmed the Long-Term Issuer Default Rating (IDR) of Genossenschaftliche FinanzGruppe (GFG), of its central institution DZ BANK AG Deutsche Zentral-Genossenschaftsbank and of about 840 local bank members of GFG's mutual support scheme at 'AA-' with a Negative Outlook. GFG's Viability Rating (VR) has been affirmed at 'aa-'.

Fitch has also upgraded the long-term deposit and senior preferred debt ratings of DZ BANK, of its five banking subsidiaries, and the long-term Deposit Ratings of GFG's members, Deutsche Apotheker- und Aerztebank eG (apoBank) and Muenchener Hypothekenbank eG (Muenchener Hyp), to 'AA' from 'AA-', as well as DZ BANK's Derivative Counterparty Rating (DCR) to 'AA(dcr)' from 'AA-(dcr)'. The upgrades reflect the protection that would accrue to depositors, derivative counterparties and senior preferred creditors from the respective banks' more junior resolution debt and equity buffers in a resolution.

Fitch has also withdrawn the ratings of 30 local cooperative banks because they no longer exist as separate entities following their mergers with other members of the group. As a result, Fitch will no longer provide ratings or analytical coverage for these merged entities.

A full list of rating actions for all rated members of GFG is available at www.fitchratings.com.

GFG is not a legal entity but a cooperative banking network whose cohesion is ensured by a mutual support scheme managed by the National Association of German Cooperative Banks (BVR). GFG's IDRs apply to each member bank, in accordance with Annex 4 of Fitch's criteria for rating banking structures backed by mutual support schemes. The ratings are underpinned by the scheme's high effectiveness given its long and successful record of ensuring GFG's cohesion, monitoring members' risks and enforcing corrective measures when needed. The scheme has effectively protected its members' viability and averted losses by their creditors since its inception.

The ratings were withdrawn with the following reason Reorganization Of Rated Entity

Key Rating Drivers

IDRS, VR AND SENIOR NON-PREFERRED (SNP) DEBT RATINGS

We have affirmed the IDRs of GFG and its members as well as GFG's VR as the group entered the economic downturn driven by the coronavirus outbreak from a position of strength compared with its German commercial banking peers. Therefore, we believe GFG has enough flexibility to absorb the short-term shock from the pandemic while maintaining its current rating. GFG's strong risk-adjusted capitalisation and low leverage have a high influence on the group's VR, which drives the IDRs and debt ratings of the group and its members. The ratings also reflect GFG's strong domestic franchise in retail and small SME banking, sound asset quality and strong funding and liquidity. The group's resilient pre-impairment earnings represent a robust defence against an expected rise in loan impairment charges (LICs) over the next two years.

The banking books of GFG's local banks are exposed to high structural interest-rate risk, which is predominantly unhedged. We expect this exposure to further erode the local banks' net interest margins and, consequently, increase pressure on the group's profitability in the long term as interest rates are likely to remain low for a long period. We have maintained the Negative Outlook on the Long-Term IDRs of GFG and its members to reflect this pressure as well as the risk of prolonged deterioration of the German operating environment (which we score 'aa-'/negative), which would exacerbate the expected weakening of the group's profitability and asset quality from the COVID-19 crisis.

Strong economic conditions in Germany before the outbreak of the pandemic, a predominant focus on the granular retail housing and small SME markets, high collateralisation levels in secured lending as well as low single-name and sector concentrations have driven a significant and steady improvement of GFG's asset quality over the past decade. Geographic diversification is limited, but its focus on domestic lending is rating-positive on balance given the strength and the size of the domestic economy and Fitch's expectation that Germany will fare better than other large European economies through the crisis.

The historical cyclicality of GFG's asset quality has been rather moderate and strongly correlates with the number of corporate insolvencies in Germany, which has further decreased at the start of the COVID-19 crisis due to state-support measures. However, we expect insolvencies to rise significantly when the legal suspension of the obligation to file for bankruptcy ends after 3Q20. We therefore expect in our baseline scenario a material increase of defaults in the local banks' SME portfolios over the next two years.

We expect LICs to rise accordingly at local cooperative banks, in addition to continued provisioning needs for DZ BANK's weak shipping and offshore financing portfolios. LICs should substantially weaken GFG's profitability in 2020, and even more so in 2021, compared with the EUR10.2 billion earned before tax in 2019, its second-highest result ever. The EUR2.4 billion increase in the group's pre-tax profit in 2019 yoy was mainly driven by valuation gains in the securities portfolios of DZ BANK and its insurance subsidiary R+V on the back of strong capital-market developments, which we deem unlikely to recur in the next two years due to the pandemic.

The sound risk profile of DZ BANK benefits from its modest capital-market activities, low traded market risk as well as from its diversified and retail-heavy universal banking model. It has several market-leading subsidiaries in domestic segments ranging from insurance to asset management and home savings and has a strong record of cross-selling with GFG's local banks and servicing their lower-risk household and small SME clients.

DZ BANK's risk profile also benefits from years of run-down of the bank's most vulnerable asset classes, including southern European public-sector bonds. In 2019, the bank made significantly progress with the wind-down of its troubled transportation lender DVB BANK, whose maritime lending portfolio has been responsible for the majority of GFG's LICs in recent years. Despite the particularly weak quality of loans to the offshore oil services sector and their vulnerability to the challenging global oil market, the modest size of the residual maritime lending portfolio does not represent a significant risk for DZ BANK's profitability.

We also expect GFG's profitability to gradually decline in the medium term as the COVID-19 crisis is unlikely to end the intense pricing pressure prevailing in the German banking sector. This will increasingly constrain the ability of GFG's local banks to sustainably counter the erosion of their net interest margins. So far, the strong growth of their loan books and net commission income has offset this erosion, but further fee increases will be increasingly challenging to impose on clients. Despite about 500 branch closures p.a. in recent years, GFG's cost savings have failed to keep pace with the attrition of net interest income. However, we expect the local banks to increasingly use their ample cost-cutting potential (they still operated 9,300 branches at end-2019) should charging negative interest rates on depositors prove challenging.

We expect GFG's loan growth to continue exceeding the German sector average - albeit at a slower pace than in previous years - as the group continues to gain market shares from weaker competitors. The combination of moderating organic capital generation and growing balance sheet will exert pressure on GFG's CET1 ratio in the next years. However, we expect capitalisation to remain commensurate with the current VR throughout our rating horizon. Our assessment takes into account the standardised approach used by GFG's local banks to measure credit risk for all asset classes. We believe this considerably overstates the riskiness of GFG's balance sheet compared with similar European peers that use the internal-rating based approach. We therefore adjust positively our assessment of GFG's capitalisation accordingly.

GFG's very stable funding and liquidity remain a rating strength. The local banks are predominantly funded by granular domestic retail deposits, and their structurally large excess liquidity covers most of DZ BANK's short-term funding needs. As a frequent issuer of unsecured debt and the largest German covered bond issuer to an established and geographically diversified investor base, DZ BANK provides GFG with reliable access to wholesale markets (including with short-term instruments) and has proven the adaptability of its funding sources at the height of the COVID-19 market dislocations. The group's Short-Term IDR of 'F1+' is the only option mapping to the Long-Term IDR of 'AA-'.

The IDRs and debt ratings of DZ BANK and its subsidiaries are group ratings and, as such, their key rating drivers are identical to those of GFG's ratings.

DERIVATIVE COUNTERPARTY (DCR), SENIOR PREFERRED (SP) DEBT AND DEPOSIT RATINGS

The long-term Deposit Ratings and long-term SP debt ratings of DZ BANK and its banking subsidiaries, the long-term Deposit Ratings of apoBank and Muenchener Hyp as well as DZ BANK's DCR are one notch above their respective Long-Term IDRs because of the protection provided by resolution buffers to preferred creditors. In our view, resolution would only occur in the extremely unlikely event that GFG's mutual support scheme would fail to protect group members' viability.

The Deposit Ratings of the about 840 local cooperative banks are aligned with GFG's IDRs due to the absence of significant resolution debt buffers at these entities. Each local bank is regulated individually as a less significant institution. Consequently, the German regulator's preferred resolution strategy for these banks consists of standard insolvency procedures, versus the preferred resolution strategy of bail-in for the DZ BANK group as well as for apoBank and Muenchener Hyp, each of which is directly supervised by the European Single Resolution Board and follows a single-point-of-entry approach. Therefore, the predominantly deposit-funded local banks have no incentive to build up resolution buffers.

SUPPORT RATING (SR) AND SUPPORT RATING FLOOR (SRF)

GFG's SR and SRF reflect our view that extraordinary sovereign support for EU banks is possible but cannot be relied upon due to the Bank Recovery and Resolution Directive and the Single Resolution Mechanism's resolution tools and mechanisms. It is likely that senior creditors will be required to participate in losses, if necessary, instead of, or ahead of, the group receiving sovereign support.

SUBORDINATED DEBT AND HYBRID SECURITIES

The ratings of the subordinated Tier 2 and hybrid capital notes issued by DZ BANK and its subsidiaries are notched down from GFG's VR. We use the VR as anchor rating as we believe that GFG, by protecting the viability of DZ BANK and its subsidiaries, increases the likelihood that all due payments on these notes will continue to be met.

We have downgraded the subordinated Tier 2 ratings of DZ BANK and its subsidiaries by one notch to 'A'. This reflects the switch to a baseline notching of two notches from GFG's VR for loss severity under Fitch's Bank Rating Criteria published in February 2020, from one notch under the previous criteria. The widened notching reflects our expectation that DZ BANK will not maintain buffers of Tier 2 and AT1 debt exceeding 10% of its risk-weighted assets (RWAs).

We have downgraded by one notch to 'BBB-' the ratings of the hybrid capital notes issued by DZ BANK Capital Funding Trust II and III and by DZ BANK Perpetual Funding Issuer (Jersey) Limited that are not compliant with the EU's capital requirements regulation (CRR). DZ BANK's annual consolidated IFRS profit is a distribution trigger for these instruments, i.e. a loss would prevent DZ BANK from paying coupons on the notes. The downgrade is driven by a widening of the notching for incremental non-performance risk to four from previously three notches. The notching for loss severity remains unchanged at two notches. The widened notching for non-performance risk reflects Fitch's view that using GFG's VR as anchor rating does not fully reflect the DZ BANK Group's profit volatility, especially in the current uncertain economic and financial market environment. We believe that the pressure on DZ BANK's operating profits and heightened fair value swings resulting from the extraordinary volatile capital markets during the coronavirus crisis are moderately increasing the risk that the bank may incur an annual consolidated loss this year or next, even though Fitch's base case assumption is that DZ BANK will remain profitable.

We have affirmed the ratings of the non-CRR compliant hybrid capital notes issued by DZ Bank Capital Funding Trust I at 'BBB+', i.e. four notches below GFG's VR, twice each for loss severity and for incremental non-performance risk. In our view, the distribution trigger (solo balance-sheet profit of DZ BANK AG) is less likely to be activated than those of the previous categories of hybrids, because the bank could release part of its substantial reserves to turn a potential annual loss into a balance-sheet profit.

In accordance with Fitch's policies, the issuer appealed and provided additional information to Fitch that resulted in a rating action that is different than the original rating committee outcome with respect to securities issued by DZ BANK Capital Funding Trust II and III and by DZ BANK Perpetual Funding Issuer (Jersey) Limited.

RATING SENSITIVITIES

IDRS AND VR AND SENIOR NON-PREFERRED (SNP) DEBT RATINGS

Factors that could, individually or collectively, lead to positive rating action/upgrade:

We could revise the Outlook on GFG and its members to Stable from Negative if the economic disruptions turn out to be short-lived, if the group maintains its superior ability to navigate this severe external shock as it did during the 2008 financial crisis, or if regulatory intervention aimed at alleviating the impact of the crisis on the financial sector effectively neutralises the impact on GFG's financial strength.

An upgrade of GFG's Long-Term IDR and VR is unlikely given the already high ratings and in light of the adverse interest-rate environment that has become increasingly likely to prevail over the long term. An upgrade would also require greater cost efficiency, which is likely to necessitate a protracted streamlining of the group's structure, especially at the local banks.

The IDRs of member banks and the SNP debt ratings of DZ BANK and its subsidiaries are subject to the same sensitivities as GFG's IDRs.

Factors that could, individually or collectively, lead to negative rating action/downgrade:

GFG's and members' Long-Term IDRs may be downgraded if the economic disruptions caused by the pandemic intensify, making a swift economic recovery in 2021 and 2022 less likely. This would weaken GFG's relative resilience, and increase risks that the group may not be able to maintain financial metrics that are commensurate with its VR.

Even if the group weathers the consequences of the COVID-19 crisis well, the likely persistence of very low interest rates could eventually trigger a downgrade of GFG's ratings. Low interest rates could erode GFG's profitability below levels that we view as commensurate with the group's VR. In addition, the VR remains sensitive to deteriorating capital ratios due to the combination of eroding net interest margins and continued strong balance-sheet growth or credit losses, although the latter would need to be exceptionally large to exceed the group's robust pre-impairment profits.

A downgrade of our operating environment score for GFG (currently 'aa-'/Negative) would trigger a downgrade of GFG's Long-Term IDR and VR.

A downgrade of the Long-Term IDR would trigger a downgrade of the group's Short-Term IDR only if our assessment of GFG's funding and liquidity profile also weakens. This is because our current assessment of the group's funding and liquidity of 'aa-' would still allow the group to achieve a Short-Term IDR of 'F1+' under our criteria.

DCR, SP DEBT AND DEPOSIT RATINGS

The DCR, senior-preferred debt and Deposit Ratings are primarily sensitive to changes in GFG's

IDRs.

Factors that could, individually or collectively, lead to positive rating action/upgrade:

An upgrade of the preferred ratings would require an upgrade of GFG's Long-Term IDR.

Factors that could, individually or collectively, lead to negative rating action/downgrade:

A downgrade of the preferred ratings could result from a downgrade of GFG's IDRs, or if we believe that the sum of SNP and more junior debt buffers at DZ BANK, apoBank or Muenchener Hyp could fall below 10% of the banks' respective RWAs.

SR AND SRF

Factors that could, individually or collectively, lead to positive rating action/upgrade:

We would upgrade GFG's SR and revise the group's SRF upward only if we believe in a rising propensity from the sovereign to support systemically important banks, which is highly unlikely in the current regulatory environment.

Factors that could, individually or collectively, lead to negative rating action/downgrade:

The SR and SRF are already at the lowest possible levels and therefore cannot be downgraded or revised downward.

SUBORDINATED DEBT AND HYBRID SECURITIES

The ratings of the subordinated Tier 2 and hybrid capital notes issued by DZ BANK and its subsidiaries are primarily sensitive to changes in GFG's VR, from which they are notched. DZ BANK's hybrid capital notes are also sensitive to Fitch's reassessment of their non-performance risk.

Factors that could, individually or collectively, lead to positive rating action/upgrade:

An upgrade of the subordinated and hybrid securities would require an upgrade of GFG's VR. We could upgrade the Tier 2 notes if we deem the buffer of Tier 1 and Tier 2 debt at DZ BANK are likely to increase to, and sustainably exceed, 10% of RWAs. DZ BANK's hybrid instruments are also sensitive to Fitch's positive reassessment of their relative non-performance risk. An upgrade of the hybrid notes that are subject to an annual profit trigger would be contingent on clear evidence that DZ BANK could implement mechanisms to ensure that the coupons are paid even if the bank incurs an annual loss.

Factors that could, individually or collectively, lead to negative rating action/downgrade:

A downgrade of GFG's VR would trigger a downgrade of the subordinated and hybrid securities. The hybrid securities could also be downgraded on a negative reassessment of their relative non-performance risk. We could downgrade - potentially by several notches - the ratings of the hybrid notes that are subject to an annual profit trigger if we believe that a further weakening of the economic and financial market environment increases the probability that DZ BANK may incur a consolidated annual loss and if we deem it unlikely that DZ BANK could implement mechanisms to prevent the coupons from being cancelled.

Best/Worst Case Rating Scenario

International scale credit ratings of Financial Institutions and Covered Bond issuers have a best-case rating upgrade scenario (defined as the 99th percentile of rating transitions, measured in a positive direction) of three notches over a three-year rating horizon; and a worst-case rating downgrade scenario (defined as the 99th percentile of rating transitions, measured in a negative direction) of four notches over three years. The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Best- and worst-case scenario credit ratings are based on historical performance. For more information about the methodology used to determine sector-specific best- and worst-case scenario credit ratings, visit [https://www.fitchratings.com/site/re/10111579]

REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING
The principal sources of information used in the analysis are described in the Applicable Criteria.

ESG Considerations
The highest level of ESG credit relevance, if present, is a score of 3. This means ESG issues are credit-neutral or have only a minimal credit impact on the entity(ies), either due to their nature or to the way in which they are being managed by the entity(ies). For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com/esg.

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Additional information is available on www.fitchratings.com

Applicable Criteria

[Bank Rating Criteria (pub. 28 Feb 2020) (including rating assumption sensitivity)]

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