FitchRatings

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

Link to Fitch Ratings' Report(s): German Cooperative Banks and DZ BANK - Rating Action Report

Fitch Ratings-Frankfurt-18 September 2019: Fitch Ratings has affirmed Genossenschaftliche FinanzGruppe's (GFG) Long-Term Issuer Default Rating (IDR) at 'AA-' with a Stable Outlook, and Viability Rating (VR) at 'aa-'.

Fitch has also affirmed at 'AA-'/Stable the Long-Term IDRs of GFG's central institution, DZ BANK AG Deutsche Zentral-Genossenschaftsbank, and of about 870 local bank members of GFG's mutual support scheme. A full list of rating actions is at the end of this rating action commentary. A full list of rated GFG members 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). Its 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 a 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.

KEY RATING DRIVERS

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

The strong capitalisation and low leverage of GFG have a high influence on its VR, which drives the group's and its members' IDRs and debt ratings. The ratings also reflect GFG's strong domestic franchise in retail and small SME banking, sound asset quality, strong funding and liquidity, and sound earnings. The ratings also factor in a high unhedged exposure to structural interest rate risk in its banking book. We expect this exposure to put increasing pressure on the group's profitability as interest rates are likely to remain very low in the coming years.

GFG's profitability is unlikely to decline significantly in 2019. The local banks structurally generate the vast majority of profits and ensured resilient performance and internal capital generation in 2018. Their loan books continued to grow more than the rest of the domestic banking sector and Germany's GDP, easing the erosion of GFG's net interest income. The local banks also mitigated interest margin erosion by charging higher fees, underpinned by GFG's strong collective franchise and pricing power. The reversal of valuation charges incurred on GFG's securities portfolio in 2018, driven by market volatility in 4Q18, should be another stabilising factor in 2019.

However, we expect the group's performance to decline in the medium term as intense pricing pressure in the German banking sector is likely to increasingly constrain the ability of GFG's local banks to sustainably counter the erosion of interest margins. The primary banks' gradual consolidation process continues to generate efficiency gains, albeit with limited relief at GFG's consolidated level.

A rapidly deteriorating economic outlook should limit GFG's scope to further increase its fee income and is likely to rapidly end years of negligible risk costs. The local banks' small sizes and local focus considerably limit GFG's loan concentration, which is only notable in DZ BANK's wholesale unsecured corporate portfolio. GFG's good and still improving asset quality reflect the group members' prudent underwriting and a decade of exceptionally strong German economic environment. During most of the current credit cycle, credit margins have largely absorbed the strong competition in the German banking sector. However, low average margins on new business are increasingly likely to give way to looser underwriting standards at German banks in general. GFG's strong franchise only partly insulates the group from this risk.

The risk profile of DZ BANK benefits from its modest capital-market activities, low traded market risk and a 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 is primarily focused on cross-selling with the 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, such as legacy investments in ABS and southern European public-sector bonds. Over the last year, the bank has also significantly progressed with the restructuring of its troubled transportation lender DVB BANK, whose maritime lending portfolio has been, despite its modest size, responsible for the vast majority of GFG's loan impairment charges over the last couple of years.

DVB BANK's non-maritime portfolios have been or are in the process of being sold and DZ BANK is working out the shipping and offshore loan books with an aim to limit negative performance implications. While the quality of the maritime portfolios remains poor due to difficult market conditions, their drag on DZ BANK's earnings significantly eased in 2018 and 1H19 after loan impairment charges peaked in 2017. We believe that the ongoing restructuring is likely to eventually lead to a wind-down of DVB BANK. We would view this positively as the bank has never been a core business for GFG, and this would further align DZ BANK's strategic focus with the local banks.

GFG's funding and liquidity are very stable and remain a key strength of the group. The local banks are predominantly funded through granular 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 instruments and the largest German covered bond issuer to an established and reasonably geographically diversified investor base, DZ BANK provides the group with reliable access to wholesale markets.

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 Deposit Ratings of the about 880 rated members, DZ BANK's DCR and the SP debt ratings of DZ BANK and its rated subsidiaries are aligned with GFG's IDRs. We do not assign Deposit Ratings or a DCR to GFG as it is not a legal entity. As a domestically systemically important institution, DZ BANK is required to maintain a substantial buffer of junior and SNP debt. Due to retroactive legislation that gives SNP status to the vast majority of German banks' legacy senior unsecured debt, its buffer already significantly exceeds its regulatory requirements. However, we consider that, at GFG's consolidated level, the protection offered by this buffer to preferred creditors, depositors and derivative counterparties in a resolution does not warrant rating uplift, nor does it give sufficient assurance that recoveries on deposits in a default would be above-average.

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. GFG's junior and SNP debt buffer is concentrated at DZ BANK, which is the group's predominant senior debt issuer. However, DZ BANK places a large share of its debt issuance within GFG, and DZ BANK's debt issuance needs are limited by the modest size of the bank's wholesale business relative to the predominantly retail deposit-funded GFG. This results in a relatively modest junior and SNP debt buffer relative to GFG's large risk-weighted assets (RWAs).

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 will collectively ensure that all due payments on these notes are met.

The ratings of DZ BANK's, DZ HYP's and DVB BANK's Tier 2 subordinated debt are notched down once from GFG's VR to reflect their higher loss severity. The hybrid capital notes issued by DZ Bank Capital Funding Trust I are rated four notches below GFG's VR, twice each for loss severity and for incremental non-performance risk as, in our view, its distribution trigger is less likely to be triggered than those of the other rated hybrids. The other hybrids are rated five notches below GFG's VR, twice for loss severity and three times for incremental non-performance risk.

RATING SENSITIVITIES
IDRs, VRs AND SNP DEBT
A persistence of the low interest rate environment could eventually trigger a downgrade of GFG's ratings. Low interest rates are increasingly likely to erode GFG's profitability below the range that we consider to be commensurate with the group's VR. At the same time, a continuation of above-average loan growth could soon start to erode GFG's strong capitalisation, which is the main driver underpinning the VR.

An extended period of strong loan growth at the current late stage of the credit cycle could also signal looser underwriting standards and add pressure to the group's earnings in the medium term by risk costs at a higher level. GFG's predominantly domestic loan book particularly exposes the group's performance to a rapidly deteriorating outlook on the German economy.

The ratings are also sensitive to adverse regulatory or strategic changes weakening GFG's cohesiveness, neither of which we currently expect.

An upgrade is unlikely given the already high ratings and in light of the adverse interest rate environment expected in the medium term. An upgrade would also require better cost efficiency, which is likely to necessitate a protracted streamlining of the group's structure, especially at the local banks' level. The member banks' IDRs and the SNP debt ratings of DZ BANK and its subsidiaries are subject to the same sensitivities as GFG's IDRs.

DCR, SP DEBT AND DEPOSIT RATINGS
The ratings of the preferred obligation of GFG's members are primarily sensitive to changes in GFG's IDRs. An upgrade of the long-term preferred ratings by one notch above GFG's Long-Term IDR could be triggered by Fitch's reassessment of the level of protection available to the bank's preferred creditors and counterparties, should the bank become non-viable.

SR AND SRF
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.

SUBORDINATED DEBT AND HYBRID SECURITIES
The subordinated debt and hybrid securities' ratings are primarily sensitive to a change in GFG's VR. They are also sensitive to a change in their notching, which could be triggered by a reassessment of loss severity or relative non-performance risk.

ESG CONSIDERATIONS
GFG's highest level of ESG credit relevance is a score of 3. This means that ESG issues are credit-neutral

or have only a minimal credit impact on GFG, either due to their nature or to the way in which they are being managed by the group. For more information on our ESG Relevance Scores, visit www .fitchratings.com/esg.

The rating actions are as follows:

GFG
Long-Term IDR: affirmed at 'AA-', Stable Outlook
Short-Term IDR: affirmed at 'F1+'
Viability Rating: affirmed at 'aa-'
Support Rating: affirmed at '5'
Support Rating Floor: affirmed at 'No Floor'

Bank members of GFG's mutual support scheme
Long-Term IDRs: affirmed at 'AA-', Stable Outlook
Short-Term IDRs: affirmed at 'F1+'
Deposit Ratings: affirmed at 'AA-'/'F1+'

DZ BANK
Long-Term IDR: affirmed at 'AA-', Stable Outlook
Short-Term IDR: affirmed at 'F1+'
DCR: affirmed at 'AA-(dcr)'
Deposit Ratings: affirmed at 'AA-'/'F1+'
Senior preferred notes and debt issuance programme: affirmed at 'AA-'/'F1+'
Senior unsecured notes and debt issuance programmes: affirmed at 'AA-'
Subordinated Tier 2 notes: affirmed at 'A+'

DZ BANK's hybrid capital instruments (preferred stocks):
DZ Bank Capital Funding Trust I (DE0009078337): affirmed at 'BBB+'
DZ Bank Capital Funding Trust II and III (DE000A0DCXA0, DE000A0DZTE1): affirmed at 'BBB'
DZ Bank Perpetual Funding Issuer (Jersey) Limited Series I, VI, VII, VIII and IX (DE000A0GN869, DE000A0GLDZ3, DE000A0GMRS6, DE000A0GWWW7, DE000A0NTTT1): affirmed at 'BBB'

DZ HYP
Long-Term IDR: affirmed at 'AA-', Stable Outlook
Short-Term IDR: affirmed at 'F1+'
Deposit Ratings: affirmed at 'AA-'/'F1+'
Senior preferred notes and debt issuance programme: affirmed at 'AA-'/'F1+'
Senior unsecured notes and debt issuance programme: affirmed at 'AA-'
Subordinated Tier 2 notes: affirmed at 'A+'

DVB BANK
Long-Term IDR: affirmed at 'AA-', Stable Outlook
Short-Term IDR: affirmed at 'F1+'
Deposit Ratings: affirmed at 'AA-'/'F1+'
Senior unsecured notes: affirmed at 'AA-'
Subordinated Tier 2 notes: affirmed at 'A+'

DZ PRIVATBANK
Long-Term IDR: affirmed at 'AA-', Stable Outlook
Short-Term IDR: affirmed at 'F1+'
Senior preferred notes and debt issuance programme: affirmed at 'AA-'/'F1+'
Commercial paper programme: affirmed at 'F1+'

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Additional information is available on www.fitchratings.com
Applicable Criteria
Bank Rating Criteria (pub. 12 Oct 2018)
Short-Term Ratings Criteria (pub. 02 May 2019)

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