FitchRatings

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

Link to Fitch Ratings' Report(s): Fitch Affirms German Cooperative Banks and DZ BANK at 'AA-'; Outlook Stable (https://www.fitchratings.com/site/re/10053480)

Fitch Ratings-Frankfurt/London-27 November 2018: 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 900 local bank members of GFG's mutual support scheme.

GFG is not a legal entity but a cooperative banking network whose cohesion is ensured by a mutual support scheme. Its IDRs apply to each individual member bank, in line with Fitch's criteria for rating banking structures backed by mutual support schemes. 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 or via the link above.

KEY RATING DRIVERS
IDRS, VR AND SENIOR DEBT RATINGS
GFG's solid capitalisation has a high influence on its VR, which drives the IDRs and debt ratings. The ratings also reflect GFG's strong domestic franchise in retail and small SME banking, sound asset quality, stable funding and earnings, but also its high exposure to structural interest rate risk in its banking book.

The ratings are underpinned by the strong mutual support scheme managed by the National Association of German Cooperative Banks (BVR), which ensures GFG's cohesiveness and has protected the viability of even GFG's largest members, having averted any losses by their creditors since its inception.

The local banks structurally contribute to the vast majority of GFG's profits. They ensured resilient consolidated profitability again in 2017, mostly by maintaining net loan growth well above the overall domestic banking sector and Germany's GDP, as well as by extending longer maturities for housing loans to partly alleviate margin erosion from prevailing low interest rates. The local banks also compensate for margin pressure by charging higher fees for account management and payments, and expanding their securities and funds business. This confirms the strength of GFG's franchise (particularly entrenched with the about 60% of clients that are also the local banks owners) and pricing power.

GFG's profitability will likely remain resilient in 2018, but in Fitch's view should decline materially from its current strong level in the medium term as a substantial rate increase is unlikely any time soon. Moreover, evidence is mounting that the economic cycle is turning, which should limit the scope to further increase fee income and could result in a gradual deterioration of asset quality. However, GFG's strong capitalisation and internal capital generation offer a comfortable buffer, as evidenced by the group's strong leverage ratio of 6.8% at end-2017.

BVR is monitoring the risk profiles of all members of GFG. The group's above-average housing loan origination is unlikely to materially weaken the group's risk profile, in our view, as the strong competition in German retail banking translates into margin erosion rather than loosened underwriting standards. Despite ongoing cost-driven mergers, the primary banks' small sizes and local focus considerably limit loan concentration, which is only sizeable in DZ BANK's wholesale corporate and commercial real estate portfolios. GFG's good and still slightly improving asset quality (the local banks are still collectively releasing net loan loss provisions) reflect its members' prudent underwriting and eight years of an exceptionally strong German economic environment.

However, the local banks' vast unhedged maturity mismatches expose GFG to a sudden interest rate hike, in Fitch's view.

DZ BANK's risk profile benefits from its highly diversified and retail-focused universal banking model with modest capital market exposure. It has also improved following years of run-off of its most vulnerable asset classes, such as ABS and southern European public-sector bonds. Several of its subsidiaries are domestic market leaders in segments ranging from insurance to asset management and home savings.

Following its merger with WGZ BANK AG Westdeutsche Genossenschafts-Zentralbank, DZ BANK became GFG's unique central institution in 2016. In 2018, it merged its two commercial real estate and public-sector lenders into DZ HYP, which became Germany's largest covered bond issuer. In parallel, DZ BANK has continued to deepen cross-selling with the local banks while scaling down its remaining non-core businesses. DZ BANK is also evaluating strategic options (including portfolio sales) for its international infrastructure and transport lender DVB BANK, which has generated the vast majority of GFG's risk costs in recent years following a sudden and severe deterioration of its (offshore) shipping loan portfolio. Curtailing DVB BANK, which has never been a core business for GFG, should further align DZ BANK with the local banks' strategic focus on low-risk domestic retail banking.

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 a significant share of DZ BANK's short-term funding needs. Moreover, as a frequent issuer of unsecured debt instruments, and as 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. Fitch has also withdrawn the short-term ratings of DZ HYP's senior unsecured debt issuance programme (DIP). These are no longer relevant for Fitch's coverage because the DIP's current ratings only cover non-preferred senior debt, and any debt issued out of the programme with original maturities of less than one year would have preferred status under the new German resolution regime. Moreover, Fitch has withdrawn DVB's DIP ratings because the programme was not updated and is therefore no longer relevant for Fitch's coverage.

DERIVATIVE COUNTERPARTY (DCR) AND DEPOSIT RATINGS

The Deposit Ratings of the around 900 rated members and DZ BANK's DCR are aligned with GFG's IDRs. We do not assign Deposit Ratings to GFG, as it is not a legal entity. In our view, GFG's consolidated layer of junior and vanilla senior debt does not sufficiently protect the group's preferred creditors, such as depositors and derivative counterparties, in a resolution scenario to merit a rating uplift or to give sufficient comfort that recoveries on deposits in a default scenario would be above average.

In our view, resolution could only occur if its mutual support scheme fails to protect its members' viability. GFG's consolidated junior and vanilla senior debt buffer is limited by DZ BANK, which is GFG's predominant senior debt issuer, placing a large share of its senior debt issuance within GFG. In addition, DZ Bank's debt issuance needs are further limited by the modest size of its wholesale business relative to the predominantly retail deposit-funded GFG.

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.

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 off GFG's VR. The use of GFG's VR as anchor rating reflects our view that GFG will collectively ensure that the issuers are able to meet their payments on these instruments. The ratings of DZ BANK's, DZ HYP's and DVB's Tier 2 subordinated debt are one notch below 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, two notches each for loss severity and for incremental non-performance risk as, in our view, this instrument's distribution trigger is less likely to be activated than those of the other rated hybrids. The other hybrid notes (see list below) 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 SENIOR DEBT
We believe the prevailing low interest rates are increasingly likely to erode GFG's profitability in the medium term, albeit from a currently strong level. If GFG's above-average loan growth continues for several years, this could weaken its capital ratios, in Fitch's view, and eventually trigger a downgrade. A sudden interest rate increase could also weigh on earnings as the primary banks' large overnight deposit bases would reprice much more rapidly than their increasingly long-term fixed-rate asset base. However, this would not necessarily trigger a downgrade as the initial earnings pressure would eventually give way to stronger margins.

A sharp rise in interest rates could however trigger a severe deterioration of borrowers' credit quality, especially among more vulnerable small business clients. GFG's is also exposed to a weakening of Germany's economy more broadly, although the still solid economic outlook creates low downside rating pressure in the short term.

The ratings are also sensitive to adverse regulatory or strategic changes weakening the group's cohesiveness, neither of which we expect in the short term. An upgrade is unlikely given GFG's already high ratings, and would require a more positive assessment of the group's cohesiveness combined with strong risk management practices and better cost efficiency, all of which is likely to necessitate a protracted streamlining of the group's structure. DZ BANK's, DZ HYP's, DVB's and the other member banks' IDRs and senior debt are subject to the same sensitivities as GFG's IDRs.

DCR AND DEPOSIT RATINGS
DZ BANK's DCR and senior preferred debt ratings, as well as all GFG members' Deposit Ratings are primarily sensitive to changes in GFG's IDRs. We could upgrade the Long-term senior preferred and Deposit Ratings and the DCR one notch above GFG's Long-Term IDR if the group's consolidated buffers of subordinated and senior vanilla debt increase substantially, which we deem unlikely in the foreseeable future as we expect DZ BANK to continue replacing maturing senior unsecured notes primarily with senior preferred issuance.

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

SUBORDINATED DEBT AND OTHER 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.

The rating actions are as follows:
Genossenschaftliche FinanzGruppe
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+'
Debt issuance programme: affirmed at 'AA-'
Debt issuance programme: 'F1+', Withdrawn
Senior unsecured notes: 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+'
Debt issuance programme: 'AA-'/'F1+', Withdrawn
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 unsecured notes and debt issuance programme: affirmed at 'AA-'/'F1+'
Contact:

Primary Analyst
Patrick Rioual

Director
+49 69 76 80 76 123
Fitch Deutschland GmbH
Neue Mainzer Strasse 46-50
60311 Frankfurt am Main

Secondary Analyst
Marco Diamantini
Analyst
+49 69 76 80 76 114

Committee Chairperson
Bjorn Norrman
Senior Director
+44 20 3530 1330

Media Relations: Adrian Simpson, London, Tel: +44 20 3530 1010, Email: adrian.simpson@thefitchgroup.com
Louisa Williams, London, Tel: 2452, Email: louisa.williams@fitchratings.com

Additional information is available on www.fitchratings.com

Applicable Criteria

Bank Rating Criteria (pub. 12 Oct 2018) (https://www.fitchratings.com/site/re/10044408)

Additional Disclosures

Dodd-Frank Rating Information Disclosure Form (https://www.fitchratings.com/site/dodd-frank-disclosure/10053464)
Solicitation Status (https://www.fitchratings.com/site/pr/10053464#solicitation)
Endorsement Policy (https://www.fitchratings.com/regulatory)

obtains will vary depending on the nature of the rated security and its issuer, the requirements and practices in the jurisdiction in which the rated security is offered and sold and/or the issuer is located, the availability and nature of relevant public information, access to the management of the issuer and its advisers, the availability of pre-existing third-party verifications such as audit reports, agreed-upon procedures letters, appraisals, actuarial reports, engineering reports, legal opinions and other reports provided by third parties, the availability of independent and competent third- party verification sources with respect to the particular security or in the particular jurisdiction of the issuer, and a variety of other factors. Users of Fitch's ratings and reports should understand that neither an enhanced factual investigation nor any third-party verification can ensure that all of the information Fitch relies on in connection with a rating or a report will be accurate and complete. Ultimately, the issuer and its advisers are responsible for the accuracy of the information they provide to Fitch and to the market in offering documents and other reports. In issuing its ratings and its reports, Fitch must rely on the work of experts, including independent auditors with respect to financial statements and attorneys with respect to legal and tax matters. Further, ratings and forecasts of financial and other information are inherently forward-looking and embody assumptions and predictions about future events that by their nature cannot be verified as facts. As a result, despite any verification of current facts, ratings and forecasts can be affected by future events or conditions that were not anticipated at the time a rating or forecast was issued or affirmed.

The information in this report is provided "as is" without any representation or warranty of any kind, and Fitch does not represent or warrant that the report or any of its contents will meet any of the requirements of a recipient of the report. A Fitch rating is an opinion as to the creditworthiness of a security. This opinion and reports made by Fitch are based on established criteria and methodologies that Fitch is continuously evaluating and updating. Therefore, ratings and reports are the collective work product of Fitch and no individual, or group of individuals, is solely responsible for a rating or a report. The rating does not address the risk of loss due to risks other than credit risk, unless such risk is specifically mentioned. Fitch is not engaged in the offer or sale of any security. All Fitch reports have shared authorship. Individuals identified in a Fitch report were involved in, but are not solely responsible for, the opinions stated therein. The individuals are named for contact purposes only. A report providing a Fitch rating is neither a prospectus nor a substitute for the information assembled, verified and presented to investors by the issuer and its agents in connection with the sale of the securities. Ratings may be changed or withdrawn at any time for any reason in the sole discretion of Fitch. Fitch does not provide investment advice of any sort. Ratings are not a recommendation to buy, sell, or hold any security. Ratings do not comment on the adequacy of market price, the suitability of any security for a particular investor, or the tax-exempt nature or taxability of payments made in respect to any security. Fitch receives fees from issuers, insurers, guarantors, other obligors, and underwriters for rating securities. Such fees generally vary from US$1,000 to US$750,000 (or the applicable currency equivalent) per issue. In certain cases, Fitch will rate all or a number of issues issued by a particular issuer, or insured or guaranteed by a particular insurer or guarantor, for a single annual fee. Such fees are expected to vary from US$10,000 to US$1,500,000 (or the applicable currency equivalent). The assignment, publication, or dissemination of a rating by Fitch shall not constitute a consent by Fitch to use its name as an expert in connection with any registration statement filed under the United States securities laws, the Financial Services and Markets Act of 2000 of the United Kingdom, or the securities laws of any particular jurisdiction. Due to the relative efficiency of electronic publishing and distribution, Fitch research may be available to electronic subscribers up to three days earlier than to print subscribers.

For Australia, New Zealand, Taiwan and South Korea only: Fitch Australia Pty Ltd holds an Australian financial services license (AFS license no. 337123) which authorizes it to provide credit ratings to wholesale clients only. Credit ratings information published by Fitch is not intended to be used by persons who are retail clients within the meaning of the Corporations Act 2001

Fitch Ratings, Inc. is registered with the U.S. Securities and Exchange Commission as a Nationally Recognized Statistical Rating Organization (the "NRSRO"). While certain of the NRSRO's credit rating subsidiaries are listed on Item 3 of Form NRSRO and as such are authorized to issue credit ratings on behalf of the NRSRO (see https://www.fitchratings.com/site/regulatory), other credit rating subsidiaries are not listed on Form NRSRO (the "non-NRSROs") and therefore credit ratings issued by those subsidiaries are not issued on behalf of the NRSRO. However, non-NRSRO personnel may participate in determining credit ratings issued by or on behalf of the NRSRO.

SOLICITATION STATUS

The ratings above were solicited and assigned or maintained at the request of the rated entity/issuer or a related third party. Any exceptions follow below.

Endorsement Policy

Fitch's approach to ratings endorsement so that ratings produced outside the EU may be used by regulated entities within the EU for regulatory purposes, pursuant to the terms of the EU Regulation with respect to credit rating agencies, can be found on the EU Regulatory Disclosures (https://www.fitchratings.com/regulatory) page. The endorsement status of all International ratings is provided within the entity summary page for each rated entity and in the transaction detail pages for all structured finance transactions on the Fitch website. These disclosures are updated on a daily basis.

Fitch Updates Terms of Use & Privacy Policy

We have updated our Terms of Use and Privacy Policies which cover all of Fitch Group’s websites. Learn more (https://www.thefitchgroup.com/site/policies).