FitchRatings

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

Link to Fitch Ratings' Report: Genossenschaftliche Finanzgruppe - Rating Action Report (https://www.fitchratings.com/site/re/911876)

Fitch Ratings-Frankfurt/London-13 December 2017: 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 the Long-Term IDRs of GFG's central institution, DZ BANK AG Deutsche Zentral-Genossenschaftsbank, and of the 940 other bank members of GFG's mutual support scheme at 'AA-'/Stable.

GFG is not a legal entity but a cooperative bank network whose cohesion is ensured by a mutual support scheme. Its IDRs apply to its individual member banks, 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
The IDRs and senior debt ratings of GFG are driven by its VR, which is heavily influenced by the group's strong capitalisation.

The ratings are group ratings based on the high cohesiveness of GFG underpinned by its tested mutual support mechanism and recognised deposit protection scheme with its own dedicated fund. In 2015, GFG set up a new deposit protection scheme to fulfil statutory requirements. This was in addition to its existing mutual support fund, which is a key component of a less regulated, voluntary scheme to protect members' viability. Both funds are managed by the National Association of German Cooperative Banks (BVR), which also oversees GFG's risk monitoring.

We view GFG's mutual support mechanism as very strong in light of the group's extensive record and the group members' deep institutional integration. The support mechanism has been sufficient to protect the viability of even GFG's largest members and avert losses by their creditors.

The ratings also reflect GFG's strong franchise in domestic retail and small business banking, strong funding profile, sound and improving asset quality, and solid but eroding profits. The ratings further factor in GFG's increasing cohesion, notably demonstrated by DZ BANK's position as the group's sole central institution since the bank's merger with WGZ BANK AG Westdeutsche Genossenschafts-Zentralbank AG in 3Q16. DZ BANK, as centralised supplier of the main banking products, together with GFG's single IT provider, Fiducia & GAD, further support GFG's capacity to react swiftly to external shocks.

The merger was a major step in GFG's ongoing consolidation process, which also included about 40 mergers of local "primary" banks by 9M17 and will continue in 2018 with the merger of DZ BANK's commercial real estate (CRE) and public-sector lenders DG HYP Deutsche Genossenschafts-Hypothekenbank and WL BANK Westfaelische Landschaft Bodenkreditbank. However, we expect GFG to remain strongly committed to its decentralised structure, wide-ranging autonomy of local management and large (but gradually consolidating) branch network, as long as the onerous regulatory consequences thereof are outweighed by the benefits from the strong local franchise. We believe rising regulatory demands regarding the robustness and frequency of group-wide reporting will strengthen GFG's capacity to react swiftly to external shocks.

After several strong years, GFG's profitability has weakened since 2016 as low interest rates increase pressure on interest margins arising from structurally strong competition in German banking. This pressure is only partially and gradually mitigated by GFG's pricing power, efficiency gains from IT consolidation and investments in digitisation as well as operating and regulatory cost relief from the primary banks' mergers.

We expect profitability to weaken moderately in 2017 and 2018 but to remain sufficiently sound and diversified to absorb a further material erosion of net interest income without jeopardising the group's financial flexibility. GFG's capitalisation and internal capital generation, which benefit from low profit distribution, remain strong lines of defence as evidenced by a leverage ratio of 6.3% at end-2016. However, pressure on earnings is rising as interest rates are unlikely to rise materially in the short term.

The IDRs of DZ BANK and its subsidiaries are group ratings and as such, the key rating drivers of these banks' IDRs, senior debt and market-linked securities' ratings are identical to those of GFG's.

GFG's above-average growth in residential mortgage lending is unlikely to significantly 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. DZ BANK's risk profile benefits from the bank's large, diversified and fairly low-risk retail activities, with leading market positions in savings and loans (Bausparkasse), insurance and asset management. Years of non-core asset restructuring, run-off, disposals and repayments have significantly reduced DZ BANK's exposure to more vulnerable asset classes such as ABS and the southern European public-sector and should reduce GFG's future earnings volatility.

DZ BANK has material loan exposures to higher-risk asset classes including CRE, shipping and offshore portfolios. The CRE assets are concentrated on the German market and are performing satisfactorily. However, DVB BANK's shipping and offshore loans have deteriorated rapidly since 2016 and remain vulnerable to further material losses in the short term as the global shipping and offshore markets remain weak and offer little visibility. Despite a series of measures implemented and further options envisaged by DZ BANK to address DVB BANK's problems, these could continue to dent DZ BANK's otherwise robust profits, as seen in 1H17, but should remain manageable at both DZ BANK's and GFG's level.

DERIVATIVE COUNTERPARTY (DCR) AND DEPOSIT RATINGS
The Deposit Ratings of the 939 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, the modest size of DZ BANK's wholesale business relative to the predominantly retail deposit-funded GFG limits DZ Bank's debt issuance needs.

SUPPORT RATING (SR) AND SUPPORT RATING FLOOR (SRF)
GFG's SR and SRF reflect Fitch's view that extraordinary sovereign support for EU banks is possible but cannot be relied upon due to the Bank Recovery and Resolution Directive (which includes a bail-in tool) and the Single Resolution Mechanism's resolution tools and mechanisms.

SUBORDINATED DEBT AND OTHER HYBRID SECURITIES
The ratings of subordinated Tier 2 debt and hybrid capital issued by DZ BANK and its subsidiaries are notched off GFG's VR. The use of GFG's VR as the anchor rating is based on our view that GFG will ensure the issuers are able to meet their payments on these instruments. The ratings of DZ BANK's, DG HYP's and DVB's Tier 2 subordinated debt are notched once 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
The gradual earnings erosion driven by the prevailing low interest rates is a growing constraint on GFG's financial flexibility. This pressure, in combination with sustained above-average loan growth, could result in the continuously weakening of the group's capital ratios and therefore 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 generally long-term, fixed-rate assets. However, this would not necessarily trigger a downgrade as the initial earnings pressure would eventually give way to rising asset margins.

We would also consider downgrading the ratings if we believe GFG can no longer maintain its adequate internal capital generation by improving its cost efficiency while maintaining its decentralised structure.

GFG's predominantly domestic loan book makes its performance sensitive to a weakening of Germany's economy. The solid economic outlook creates low downside rating pressure in the short term. However, a sharp rise in interest rates could trigger a severe deterioration of borrowers' credit quality, especially in more vulnerable small business clients.

The ratings are also sensitive to material adverse regulatory or strategic changes weakening the group's cohesiveness, neither of which we expect in the short term. An upgrade is unlikely in the short term as it would primarily require a change in our assessment of GFG's cohesiveness and major efficiency gains from a (likely protracted) streamlining of the group's structure.

DZ BANK's, DG HYP's, DVB's and the other member banks' IDRs, senior debt and market-linked securities' ratings are subject to the same sensitivities as GFG's IDRs.

DCR AND DEPOSIT RATINGS
The Deposit Ratings of GFG's members and DZ BANK's DCR are primarily sensitive to changes in GFG's IDRs. We could upgrade the Long-term 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.

SR AND SRF
An upgrade of GFG's SR and upward revision of its SRF would be contingent on a positive change in Fitch's view of the sovereign's propensity to support its systemically important banks. While not impossible, this is highly unlikely.

SUBORDINATED DEBT AND OTHER HYBRID SECURITIES
The subordinated debt and hybrid securities' ratings are notched from, and 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:

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'

937 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+'
Debt issuance programme and senior unsecured notes: affirmed at 'AA-'/'F1+'
Market-linked securities: affirmed at 'AA-emr'
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'

DG 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-'/'F1+'
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: 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+'
Debt issuance programme: affirmed at 'AA-'/'F1+'
Senior unsecured notes: affirmed at 'AA-'/'F1+'

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Applicable Criteria
Global Bank Rating Criteria (pub. 25 Nov 2016) (https://www.fitchratings.com/site/re/891051)

Additional Disclosures
Dodd-Frank Rating Information Disclosure Form (https://www.fitchratings.com/site/dodd-frank-disclosure/1033922)
Solicitation Status (https://www.fitchratings.com/site/pr/1033922#solicitation)
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Solicitation Status

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