Research Update:
German Cooperative Banking Sector
Core Banks Affirmed At 'AA-/A-1+';
Outlook Stable

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Overview

- We expect that the German cooperative banking sector will maintain adequate levels of profitability and sustain strong capitalization despite margin pressure from low interest rates.
- We are affirming our 'AA-/A-1+' ratings on the local banks and other core member banks of the sector (together approximately 1,000 entities).
- The stable outlook on these entities reflects our expectation that the solidarity support within the sector will remain unchanged, and that the network will continue to adapt to ensure that it retains a strong franchise and remains comfortably profitable.

Rating Action

On Oct. 27, 2016, S&P Global Ratings affirmed its 'AA-/A-1+' long- and short-term issuer credit ratings on the core group member banks of the cooperative banking sector in Germany ("genossenschaftliche FinanzGruppe"), including its central bank, DZ BANK AG Deutsche Zentral-Genossenschaftsbank (DZ BANK). The outlooks are stable.

For rating actions we took today on the highly strategic subsidiaries of the sector subsequent to our review of the sector, see "German Commercial Real Estate Lender DG Hyp Affirmed At 'A+/A-1' On Stronger Capitalization; Outlook Stable" and "Transport Finance Bank DVB Bank Outlook Revised To Negative On Potentially Lower Group Status; Affirmed At 'A+/A-1'."

Rationale

The affirmations reflect our view that the group credit profile of the sector is unchanged at 'aa-'. The affirmations are also based on our unchanged assessment of group members' strategic importance and the effectiveness of the sector's protection scheme. The level of integration and strategic coordination within the sector, governed by the National Association of German Cooperative Banks (Bundesverband der Deutschen Volksbanken und Raiffeisenbanken e.V.), remain high.

This includes our projection that the group's strong No. 2 market position in German retail banking—including sound product diversification in Germany—will enable the group to sustain profitability that comfortably covers normalized losses and allows further strengthening of capitalization. We anticipate that the sector will partly offset margin pressure by continued
cross-selling, pricing initiatives, and cost-efficiency measures. This also includes anticipated synergies from 2018 resulting from the recent merger of the sector's formerly two central banks into a single entity, DZ BANK.

As a result, we project that the group will increase its risk-adjusted capital (RAC) ratio to between 12.5% and 13.5% over the next 12-18 months. The strengthening is at a slower pace than in the past, given pressure on net interest margins, and our assumption that loan-loss provision will inch up after very favorable net provisions of €74 million in 2015 only. Similarly, the sector's ability to cover normalized losses will decline, but should remain comfortable. Moreover, we anticipate that a low earnings payout of about 10% on net earnings only should support capital sustainability.

Furthermore, we project that the sector will maintain a strong, stable deposit inflow and sizable surplus liquidity from local cooperative banks that allows funding of loan growth mainly in domestic retail mortgage and SME lending. We anticipate that the sector's risk exposures will remain focused on Germany, and that the banks will not increase their risk appetite materially to counter earnings challenges. Key risk areas remain DZ BANK's and its subsidiaries' credit exposure to eurozone economies in Southern Europe (mainly public sector and covered bonds exposures) and in ship finance. Although each area represents somewhat more than 10% of the sector's consolidated adjusted total capital, we believe that ultimate losses for the sector should be limited compared with its earnings capacity and the current carrying values of these portfolios in consolidated accounts. We also consider the diversification within these portfolios and the demonstrated prudent management.

**Outlook**

Our stable outlook on the core group members of Germany's cooperative banking sector, including DZ BANK, reflects that the group credit profile of the sector is unlikely to change over the next one to two years, as well as our opinion that the solidarity support within the sector will also remain unchanged. Although we anticipate pressure on interest margins from sustained low interest rates, we believe that the sector's key credit metrics should stay more resilient than, and superior to, the average for the German banking industry.

We consider positive or negative rating actions unlikely at present, because they would require more fundamental changes to the sector's strengths or weaknesses or to economic and industry risk in Germany.

The following could have negative rating implications:

- A heightening of economic risk in Germany,
- Gradual erosion of the sector's market position and ability to cover normalized credit losses,
- A deterioration of the sector's aggregate RAC ratio to lower than 10%, or
- A strategic shift of the sector into higher-risk areas.
We believe that the potential for an upgrade from the sector's current rating level is remote over the outlook horizon. This would require successful execution of a holistic strategy to address the sector's traditional weaknesses, such as cost efficiency and a below-average market position in corporate and private banking.

Related Criteria And Research

Related Criteria

- General Criteria: S&P Global Ratings' National And Regional Scale Mapping Tables - June 01, 2016
- General Criteria: National And Regional Scale Credit Ratings - September 22, 2014
- General Criteria: Use Of CreditWatch And Outlooks - September 14, 2009
- General Criteria: Group Rating Methodology - November 19, 2013
- Criteria - Financial Institutions - Banks: Bank Capital Methodology And Assumptions - December 06, 2010
- Criteria - Financial Institutions - Banks: Bank Hybrid Capital And Nondeferrable Subordinated Debt Methodology And Assumptions - January 29, 2015
- Criteria - Financial Institutions - Banks: Banks: Rating Methodology And Assumptions - November 09, 2011
- Criteria - Financial Institutions - Banks: Methodology For Mapping Short-And Long-Term Issuer Credit Ratings For Banks - May 04, 2010

Related Research

- German Commercial Real Estate Lender DG Hyp Affirmed At 'A+/A-1' On Stronger Capitalization; Outlook Stable, Oct. 27, 2016

Ratings List

Ratings Affirmed
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DZ BANK AG Deutsche Zentral-Genossenschaftsbank
Counterparty Credit Rating       AA-/Stable/A-1+
Senior Unsecured                AA-
Senior Unsecured                cnAAA
Subordinated                    A
Junior Subordinated             BBB
Commercial Paper                A-1+
Commercial Paper                AA-

DZ BANK Perpetual Funding Issuer (Jersey) Ltd.
Preferred Stock                 BBB+
Preference Stock                BBB+

DZ Bank Capital Funding Trust I
Junior Subordinated             BBB+

DZ Bank Capital Funding Trust II
Preferred Stock                 BBB+

DZ Bank Capital Funding Trust III
Preferred Stock                 BBB+

DZ PRIVATBANK S.A.
Commercial Paper                A-1+

Deutsche Apotheker- und Aerztebank eG
Counterparty Credit Rating      AA-/Stable/A-1+
Senior Unsecured                AA-
Commercial Paper                A-1+

WL BANK AG Westfaelische Landschaft Bodenkreditbank
Counterparty Credit Rating      AA-/Stable/A-1+
Senior Unsecured                AA-

N.B.--This list does not include all ratings affected.

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(44) 20-7176-3605; Paris (33) 1-4420-6708; Frankfurt (49) 69-33-999-225; Stockholm (46) 8-440-5914; or Moscow 7 (495) 783-4009.
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