Fitch Ratings

Fitch Assigns Derivative Counterparty and Deposit Ratings to German Banks

Link to Fitch Ratings' Report: Fitch Assigns Derivative Counterparty and Deposit Ratings to German Banks (https://www.fitchratings.com/site/re/891800)

Fitch Ratings-London-12 December 2016: Fitch Ratings has assigned Derivative Counterparty Ratings (DCRs) to 18 banks and Deposit Ratings to 1,397 banks based in Germany. Fitch has also upgraded 10 structured notes with embedded market risk by one notch. A full list of rating actions is in the Rating Action Report which is available at www.fitchratings.com or by clicking the link above.

All other ratings of the issuers in this Rating Action Commentary and in the accompanying Rating Action Report are unaffected by the rating actions.

KEY RATING DRIVERS
DCRS, DEPOSIT RATINGS AND UNSECURED STRUCTURED NOTES WITH EMBEDDED MARKET RISK
The rating actions mark the first time Fitch has assigned Derivative Counterparty Ratings (DCRs), having introduced them in our July 2016 Global Bank Rating Criteria with an anticipated rollout in 4Q16. Assigned on the 'AAA' scale, DCRs are a product of developments in bank resolution frameworks that mean different types of banks' senior creditors may be treated more or less favourably relative to one another. DCRs are issuer ratings and express Fitch's view on banks' relative vulnerability to default. This relates to the riskiest type of derivative contracts with third-party, non-government counterparties, which we assume (either jointly or in isolation) will be an uncollateralised derivative exposure.

Germany is the first EU jurisdiction in which Fitch is rolling out DCRs and Deposit Ratings. This is because of the legal preference attributed to derivative counterparties and depositors relative to certain other senior liabilities, notably vanilla senior debt instruments, under Germany's new bank resolution framework. In Fitch's opinion, the legal framework is sufficiently sophisticated to allow for a bank in resolution to remain current on derivative counterparty obligations and deposits while defaulting on other senior liabilities.

The German Resolution Mechanism Act passed in September 2015 will become effective on 1 January 2017, creating a new statutory hierarchy of claims within the senior creditor class that will apply retroactively to all outstanding liabilities (without necessitating changes to their terms and conditions), not only to those issued from January 2017. The new regime modifies the ranking of liabilities of institutions subject to the Capital Requirements Regulation (CRR) by extending Section 46f of the German Banking Act (KWG) and by amending the insolvency statute accordingly.

These changes effectively create two statutory classes of uninsured, senior unsecured liabilities, whereby derivatives, money-market instruments, bank deposits and wholesale/corporate deposits in excess of EUR100,000 and liabilities to public-law institutions not eligible for insolvency rank senior to vanilla senior debt. Along with enhanced resolution powers under the Bank Recovery and Resolution Directive, this could result in lower vulnerability to default for derivative counterparties and deposits relative to vanilla senior debt and potentially superior recovery prospects as well, dependent on the form of intervention in a failed bank by resolution authorities and how the scenario plays out.

In addition, on 5 August 2016, the relevant German authorities, consisting of the banking supervisors, Deutsche Bundesbank and BaFin, and the acting resolution authority, the Federal Agency for Financial Market Stabilisation (FMSA), clarified the types of liabilities assigned to each class. The authorities have clarified the hierarchy of bonds with embedded derivatives by stating that structured products which are deemed complex or a potential source of contagion during resolution proceedings (notably those whose principal or interest payment depends on an event that is uncertain at the time of the issuance) rank senior to other senior unsecured debt. The authorities have also confirmed that more simple structured products will rank pari-passu to senior unsecured debt.

The European Commission (EC) presented on 23 November 2016 a proposal to amend Directive 2014/59/EU from mid-2017 by introducing a new class of senior non-preferred debt that would rank below other senior liabilities. Details have yet to emerge on the transposition of this proposal into German law and its implications on the new German insolvency regime. However, we expect that it will leave the new German approach intact as we understand the new debt class would rank pari-passu with outstanding vanilla senior debt.

Fitch has assigned Deposit Ratings to all banks that actively take deposits and DCRs to banks that act as notable derivative counterparties nationally or internationally, act as derivative counterparties to Fitch-rated transactions (eg, structured finance), or where Fitch otherwise understands there to be market interest.

DEUTSCHE BANK, COMMERZBANK, AAREAL BANK, SFG HT: ASSIGNED UPLIFT
In Fitch's opinion, (Deutsche Bank AG (DB, A-/RWN/a-), Commerzbank AG (CBK, BBB+/Stable/bbb+) and Aareal Bank AG (BBB+/Stable/bbb+) have sufficient combined buffers of qualifying junior and vanilla senior debt that could be used to recapitalise the banks, restore viability and prevent default on other "preferred" senior liabilities upon resolution.

The protection afforded to "preferred" senior debt, deposits and derivative counterparties by those buffers means DCRs, Long-Term Deposit Ratings and certain structured notes with embedded market risk are rated one notch higher than banks' respective Long-Term Issuer Default Ratings (IDR) to reflect these liabilities' lower vulnerability to default than vanilla senior debt. In assigning the uplift, we have assumed that the resolution tools will be used in time to avoid prolonged deposit freezes or interruption to derivative payments (apart from short-term stays). DB's Deposit Ratings and DCR are on Rating Watch Negative (RWN), in line with the bank's IDRs.

In Fitch's opinion, S-Finanzgruppe Hessen-Thueringen's (SFG HT, A+/Stable/a+) consolidated layer of subordinated and vanilla senior debt is also likely to be sufficient to recapitalise member banks, restore viability and prevent default on other "preferred" senior liabilities, including deposits upon resolution. As a result, the long-term Deposit Ratings of member banks are rated one notch higher than their Long-Term IDRs, as are the DCR and Long-Term Deposit Rating of SFG HT's central institution Landesbank Hessen-Thueringen Girozentrale (Helaba, A+/Stable/No VR). We do not assign DCR or Deposit Ratings to SFG HT itself because it is not a legal entity.

This assessment of the amount needed to recapitalise the banks is based on Fitch's assumptions that the authorities will trigger a bail-in once the Common Equity Tier 1 (CET1) ratio has depleted to 6%-7% and the banks will need to meet total pillar 1 and 2 requirements plus combined buffers after being recapitalised. We acknowledge that this intervention trigger could be set at a higher level for large systemically relevant banks to protect the financial sector's stability. However, our approach takes into account the fact that the resolution authorities have yet to build up a track-record of intervention and that the banks' resolution plans are evolving.

We have aligned Short-Term Deposit Ratings with the banks' Short-Term IDRs. For DB, this is in line with the implied mapping from its 'A' Long-Term Deposit Rating. For CBK and Aareal, we have assigned the lower of the two options available at a 'A-' level. This is because high uncertainty regarding what banks' balance sheets would look like upon default and how a resolution scenario may play out in Germany, given lack of precedent presents no reason for favouring short-term creditors.

We have assigned a DCR to Deutsche Bank Securities, Inc. (DBSI, A-/RWN/No VR), DB's US-based broker-dealer and a notable derivative counterparty, which is aligned with its Long-Term IDR, in turn aligned with DB's Long-Term IDR, based on expected support from DB. In the US, derivative counterparties have no definitive preferential status over other senior obligations and it is uncertain whether DB's senior debt buffer will be available cross-jurisdiction in a resolution scenario.

UNICREDIT BANK AG AND DEUTSCHE POSTBANK: SUFFICIENT BUFFERS BUT NO UPLIFT
UniCredit Bank AG's (HVB, A-/Negative/a-) DCR and Deposit Ratings are aligned with its IDRs. The bank's qualifying junior and vanilla/non-structured senior debt buffers are large, but Fitch does not have sufficient visibility on their sustainability in light of the strategic review ongoing at its parent, UniCredit S.p.A. (UC, BBB+/Negative/bbb+).

UC's restructuring measures, which are expected to be announced on 13 December 2016, could affect HVB's role and positioning within the group. This could have uncertain implications on its debt issuance plans and, consequently, on the size and sustainability of its qualifying debt buffers and the relativity of its ratings relative to UC's. Therefore, its DCR and Deposit Ratings remain aligned with its IDRs for the time being.

We have assigned Deutsche Postbank (PB, BBB+/Stable/bbb+) Deposit Ratings aligned with its IDRs despite its sizeable qualifying debt buffer. We have not notched up its Deposit Ratings from its IDRs due to the uncertain sustainability of the buffer given the bank's deposit-focused funding mix and uncertainties with the expected ownership change. We have not assigned a DCR because PB is not a material derivative counterparty, in our view.

GFG, SFG, BHF-BANK: SMALL QUALIFIED DEBT BUFFER PREVENTS UPLIFT
Genossenschaftliche FinanzGruppe's (GFG, AA-/Stable/aa-) senior debt is issued predominantly out of its central institution, DZ Bank AG Deutsche Zentral-Genossenschaftsbank (DZ Bank, AA-/Stable/no VR). In our view, its consolidated layer of junior and vanilla senior/non-structured debt does not provide sufficient protection to preferred senior creditors such as depositors and derivative counterparties in a resolution of GFG to merit uplift for incremental probability of default reasons or to give sufficient comfort that recoveries on deposits in a default scenario would be above average.

This is primarily driven by the fact that DZ Bank traditionally places a large share of its senior debt issuance within GFG. It also reflects DZ Bank's limited debt issuance needs due to the modest size of its wholesale business relative to the predominantly retail deposit-funded GFG. Consequently, the Deposit Ratings of DZ Bank and of the 980 other cooperative bank 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 the case of Sparkassen Finanzgruppe (SFG, A+/Stable/a+), in Fitch's opinion the junior and vanilla/non-structured debt is far from offering material incremental probability of default protection to depositors or to provide comfort that recoveries in a default scenario would be above average. This is because we define SFG as consisting of the predominantly retail deposit-funded savings banks only and do not include their central institutions, i.e. the Landesbanken. Therefore, the Deposit Ratings of each savings bank are aligned with SFG's IDRs. We have not assigned Deposit Ratings to SFG as it is not a legal entity.

Similar to GFG and SFG, BHF-BANK (BBB-/Positive/bbb-) has been assigned Deposit Ratings aligned with its IDRs because its deposit-driven funding mix results in a very small qualifying debt buffer. Consequently, it is far from offering material incremental probability of default protection to depositors or to provide comfort that recoveries in a default scenario would be above average. It is not a major derivative counterparty, so we have not assigned a DCR.

LANDESBANKEN, LARGE DEVELOPMENT BANKS, WIND-DOWN INSTITUTIONS, BERLIN HYP: SUPPORT-DRIVEN IDRS, LACK OF INTEGRATION INTO OWNERS PREVENT UPLIFT
Fitch has assigned DCRs to publicly-owned institutions including the Landesbanken, development banks and wind-down institutions. We view all Landesbanken as notable derivative counterparties irrespective of their size in light the hedging activities inherent in their business model. The DCRs of these banks are all aligned with their respective Long-Term IDRs. None of these issuers is eligible for a one-notch DCR uplift under our criteria because their IDRs are all driven by support from the central or regional governments (in addition to support from the regional savings banks and, ultimately, SFG in the Landesbanken's case).

We have not given any Deposit Rating uplift to the Landesbanken and their Deposit Ratings are thus aligned with their IDRs. In Fitch's opinion, debt buffers do not afford any obvious incremental probability of default benefit over and above the support benefit already factored into their IDRs. We do not apply any uplift for above-average recovery prospects in the event of default because of the limited visibility into recovery levels in such circumstances. In the highly unlikely event that Landesbanken failed and were not supported by their savings bank and regional state owners, their balance sheets would most likely differ substantially from the ones reported at end-1H16 or 3Q16.

A significant amount of the Landesbanken's debt is held by the savings banks and other Landesbanken, and it would be in the owners' and the savings bank support funds' interests to protect these obligations from default or loss if they could. In the event that the savings banks were no longer strong enough to prevent default, the asset value of Landesbanken's obligations on the savings bank balance sheets, and we believe of most other German assets, would likely be under high stress.

We do not assign Deposit Ratings to the wind-down institutions Erste Abwicklungsanstalt (EAA) and FMS Wertmanagement (both rated AAA), which do not actively collect deposits as both are non-bank institutions pursuant to the KWG. Similarly, we do not assign Deposit Ratings to the development banks KfW (also a non-bank pursuant to KWG), Landwirtschaftliche Rentenbank and NRW.BANK (all rated AAA) because with some exceptions, their statutes allow them to collect deposits only if there is a direct link to the fulfilment of their statutory duties. In practice, these banks are wholesale-funded and have no or no meaningful customer deposits. However, they are notable derivative counterparties and we have assigned DCRs in line with their 'AAA' Long-Term IDRs.

We do not believe that above-mentioned state-guaranteed non-banks could become subject to bail-in measures. Therefore, we consider it highly unlikely that they could become eligible for DCR uplift even if their Long-Term IDRs were downgraded below 'AAA'.

Berlin Hyp AG (A+/Stable/bbb-) has been assigned Deposit Ratings aligned with its IDRs. The bank's IDRs are driven by the strong support from its collective owners, the savings banks members of SFG. However, we do not consider Berlin Hyp to be highly integrated into SFG.

Moreover, we have not given any Deposit Rating uplift as, in Fitch's opinion, debt buffers do not afford any obvious incremental probability of default benefit over and above the support benefit already factored into Berlin Hyp's IDRs. We have also not assigned any uplift for above-average recovery prospects in the event of default because of the limited visibility into recovery levels in such circumstances. In a hypothetical scenario, where Berlin Hyp could not be supported, losses would likely be large and recoveries unlikely to be above-average.

We have not assigned a DCR to Berlin Hyp because we do not consider the bank to be a notable derivative counterparty.

HSBC TRINKAUS, AKBANK AG, SEB AG: IDRS DRIVEN BY SUPPORT FROM FOREIGN PARENTS PREVENT UPLIFT
These banks' IDRs are driven by Fitch's expectations of extraordinary support from their respective parents, as indicated by their IDRs, which are aligned with their parents' IDRs. We have not given any Deposit Rating uplift to these institutionally support-driven banks and their Deposit Ratings are thus aligned with their IDRs. In Fitch's opinion, debt buffers do not afford any obvious incremental probability of default benefit over and above the support benefit already factored into their IDRs.

We have also not assigned any uplift for above-average recovery prospects in the event of default because of the limited visibility into recovery levels in such circumstances. In a hypothetical scenario where these banks' parent banks are unable to support their subsidiaries, losses on any of the banks' riskiest material uninsured depositor class existing at such a time would likely be very large and recoveries unlikely to be above average.

STRUCTURED NOTES WITH EMBEDDED MARKET RISK
We have reviewed the terms and conditions of the unsecured structured notes with embedded market risk rated by Fitch, identified with the 'emr' suffix and issued by DB and CBK. Eight of these securities are from Deutsche Bank and two from CBK.

We estimate that the characteristics of these 10 instruments are in line with those that would lead to a preferred treatment relative to vanilla senior debt as outlined in the German authorities' guidance on KWG Section 46f. Therefore, we have upgraded DB and CBK's securities by one notch from their respective Long-Term IDRs to the same level as their respective Long-Term Deposit Ratings to reflect their lower vulnerability to default. Please refer to the linked Rating Action Report for ISINs.

These 10 rated notes represent only a small proportion of the total number of unsecured structured notes outstanding at both banks. Other notes could also be rated in line with them if they fulfil the characteristics of preferred liabilities.

RATING SENSITIVITIES
DCRS, DEPOSIT RATINGS AND UNSECURED STRUCTURED NOTES WITH EMBEDDED MARKET RISK
For all banks, DCRs, Deposit Ratings and ratings of the structured notes with embedded market risk are primarily sensitive to changes in the respective banks' IDRs.

For banks where the DCRs, Deposit Ratings and ratings of the structured notes with embedded market risk benefit from uplift relative to the banks' Long-Term IDRs (DB, CBK, SFG HT, Helaba, Aareal), they are also sensitive to the amount of subordinated and senior vanilla debt buffers relative to the recapitalisation amount likely to be need to restore viability and prevent default on more senior derivative obligations, deposits and structured notes with embedded market risk.

A strong short-term volatility or long-term inflation of risk-weighted assets as a direct result of the implementation of more stringent regulatory requirements could materially increase the debt buffer needed to recapitalise the banks upon failure and justify uplift.

The DCRs, Deposit Ratings and ratings of the structured notes with embedded market risk are also sensitive to increases in the banks' individual pillar 2 regulatory requirements as we assume that these determine the level to which the banks would have to be recapitalised upon resolution.

Furthermore, the DCRs, Deposit Ratings and ratings of the structured notes with embedded market risk are sensitive to Fitch's assumptions regarding the individual points of non-viability at which the regulator is likely to require a recapitalisation by way of bail-in of junior and standard senior instruments.

Subsequent changes to the resolution regime which may alter the hierarchy of the various instruments in resolution could also trigger a change in the DCRs and Deposit Ratings.

HVB's DCR and Long-Term Deposit Rating could be upgraded should Fitch gain sufficient comfort over the sustainability of its subordinated and vanilla senior debt buffers following UC's strategic review, but it will also depend on Fitch's assessment of the overall relativity of its ratings relative to those of UC. Likewise, we could upgrade PB's Long-Term Deposit Rating of PB should there be more clarity over the sustainability of its buffers.

Larger subordinated and senior vanilla debt buffers at the GFG and SFG levels could lead to an upgrade of the Long-Term Deposit Ratings assigned to GFG and SFG member banks and to an upgrade of the DCR and Long-Term Deposit Rating assigned to DZ Bank. Larger buffers could also benefit BHF-BANK's Long-Term Deposit Rating.

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The following issuer(s) did not participate in the rating process, or provide additional information, beyond the issuer's available public disclosure: SEB AG

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

Related Research
Derivative Counterparty Ratings - A New Rating for Banks (https://www.fitchratings.com/site/re/877242)

Additional Disclosures
Solicitation Status (https://www.fitchratings.com/gws/en/disclosure/solicitation?pr_id=1016343)
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