FitchRatings

RATING ACTION COMMENTARY

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

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Fitch Ratings - Frankfurt am Main - 18 Apr 2023: Fitch Ratings has affirmed the Long-Term Issuer Default Ratings (IDRs) of Genossenschaftliche FinanzGruppe (GFG), its central institution DZ BANK AG Deutsche Zentral-Genossenschaftsbank, and of more than 730 local bank members of GFG's mutual support scheme at 'AA-' with Stable Outlooks. Fitch has also affirmed GFG's Viability Rating (VR) at 'aa-'.

Fitch has withdrawn the ratings of 37 local cooperative banks because they no longer exist as separate entities following their mergers with other members of the group. As a result, Fitch will no longer provide ratings or analytical coverage for these merged entities.

KEY RATING DRIVERS

Leading German Retail, Commercial Group: GFG's ratings reflect the group's leading and highly diversified business profile, underpinned by its strong domestic retail and small SME banking franchise, strong risk-adjusted capitalisation and low leverage, sound asset quality, a record of profitability that is considerably better than most German peers, as well as its outstanding funding profile by international standards. GFG's VR is one notch above the implied VR, reflecting the high importance of the strong business profile for GFG's ratings.

Mutual Support: GFG is not a legal entity, but a cooperative banking network whose cohesion is ensured by a mutual support scheme managed by the Bundesverband der Deutschen Volksbanken und Raiffeisenbanken e. V. (BVR). GFG's IDRs are group ratings that apply to each member bank, including its central institution DZ BANK AG Deutsche Zentral-Genossenschaftsbank and its subsidiaries.

Diversified Business Model: GFG's domestically-focused, stable universal banking business model has delivered stable profits over several economic cycles. It is based on its local banks' strong domestic retail and small SME banking franchise supported by DZ BANK's product suppliers. These include domestic market leaders in the insurance, asset management and real estate businesses. A stronger strategic alignment of DZ BANK and the local banks as well as intensified cooperation and cross-selling across GFG have also strengthened GFG's business model over the past decade.

High Interest-Rate Risk Exposure: Interest-rate risk is high in the local banks' loan books and securities portfolios due to their asset/liability duration mismatches, a high share of fixed-rate lending and absence of widespread use of interest-rate hedging derivatives. This led to high unrealised valuation losses in 2022 in the local banks' securities portfolios. However, Fitch views the banks' strong deposit franchise, liquidity and earnings as sufficient mitigating factors to prevent a forced sale of securities.

The local banks' client proximity and focus on granular lending with high collateralisation adequately mitigate credit risk. DZ BANK's risk profile is also sound, with modest capital-market activities and low traded market risk.

Sound Asset Quality: GFG's asset quality remained resilient in 2022, despite headwinds from macro-economic and geopolitical risks. We expect a modest increase of impaired loans in the next two years to about 2% of gross loans due to rising insolvencies in the group's SME and corporate portfolios, which are exposed to higher interest rates and inflation pressure.

Resilient Average Profitability: GFG's profitability has been more stable than the overall German banking sector historically. Operating profit declined significantly in 2022 due to temporary write-downs in the local banks' securities portfolios and DZ

BANK's insurance subsidiary, driven by the sharp increase of interest rates during 2022. We expect profitability to recover in 2023, but to remain below 2021, as loan growth subsides and loan impairment charges normalise upward. Higher interest rates will gradually increase the group's interest income.

Strong Capitalisation: The local banks and DZ BANK are both well-capitalised and GFG's leverage ratio is high by international standards. We adjust our assessment of GFG's risk-weighted capital ratios positively for the use of the standardised approach by GFG's local banks to measure credit risk for all asset classes, resulting in a higher risk-weight density than international peers. We expect GFG's common equity Tier 1 (CET1) ratio to remain close to or above the current 15% in the medium term, supported by slower loan growth than in previous years.

Very Stable Funding: The local banks are predominantly funded by granular, mostly price-inelastic domestic 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 and the largest German covered bond issuer to an established and geographically diversified investor base, DZ BANK provides GFG with reliable access to the wholesale markets.

RATING SENSITIVITIES

Factors that could, individually or collectively, lead to negative rating action/downgrade:

We could downgrade GFG's and its members' ratings if GFG's impaired loan ratio durably rises above 3%, its average operating profit/risk-weighted assets (RWAs) ratio declines below 1% or its regulatory CET1 ratio falls durably below 13%. A downgrade of our operating environment score for GFG (aa-/stable) would also put pressure on its ratings.

Factors that could, individually or collectively, lead to positive rating action/upgrade:

An upgrade of GFG's and its members' ratings is unlikely, given the already high ratings and in light of the increased economic and financial uncertainties. In addition to a domestic environment that would allow higher lending margins, an upgrade would also require greater cost efficiency, which is likely to necessitate a protracted streamlining of the group's structure, especially at the local banks.

OTHER DEBT AND ISSUER RATINGS: KEY RATING DRIVERS

GFG's and its members' Short-Term IDRs of 'F1+' map to the Long-Term IDR of 'AA-'.

Fitch has assigned new IDRs and deposit ratings of 'AA-'/'F1+' to Ritterschaftliches Kreditinstitut Stade Aktiengesellschaft.

The long-term deposit ratings and long-term senior preferred debt ratings of DZ BANK and its banking subsidiaries, the long-term deposit rating of Muenchener Hypothekenbank as well as DZ BANK's Derivative Counterparty Rating (DCR) are one notch above their respective Long-Term IDRs because of the protection provided by resolution buffers to preferred creditors. In our view, resolution would only occur in the extremely unlikely event that GFG's mutual support scheme fails to protect group members' viability.

The deposit ratings of Deutsche Apotheker- und Aerztebank and of the local cooperative banks are aligned with GFG's IDRs due to the absence of sustainable significant resolution debt buffers at these entities. Each local bank is regulated individually as a less significant institution. Consequently, the German regulator's preferred resolution strategy for these banks consists of standard insolvency procedures, as opposed to the preferred bail-in resolution strategy for the DZ BANK group and Muenchener Hypothekenbank, each of which is directly under the authority of the European Single Resolution Board (SRB) and follows a single-point-of-entry approach. Therefore, the predominantly deposit-funded local banks have no incentive to build up resolution buffers. This is also the case for Deutsche Apotheker- und Aerztebank, which is directly under the authority of the SRB, but is not required to maintain resolution buffers in excess of its capital requirements.

The ratings of the subordinated Tier 2 notes issued by DZ BANK and its subsidiaries are two notches below GFG's VR, which is the standard notching for this type of debt under Fitch's criteria. We use the VR as the anchor rating as we believe that GFG, by protecting the viability of DZ BANK and its subsidiaries, increases the likelihood that all due payments on these notes will continue to be met.

No Government Support Assumed: GFG's Government Support Rating (GSR) of 'no support' reflects our view that extraordinary sovereign support for EU banks is possible but cannot be relied on 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.

OTHER DEBT AND ISSUER RATINGS: RATING SENSITIVITIES

GFG's members' long-term debt and deposit ratings are sensitive to a change of GFG's Long-Term IDR. We could also downgrade DZ BANK's DCR and DZ BANK and its subsidiaries' long-term senior preferred debt and deposit ratings and Muenchener Hypothekenbank's long-term deposit rating if we no longer expect them to maintain senior non-preferred and junior debt buffers sustainably above 10% of the banks' respective RWAs.

The ratings of the subordinated Tier 2 notes issued by DZ BANK and its subsidiaries are sensitive to a change in GFG's VR.

We would upgrade GFG's GSR only if we see rising propensity from the sovereign to support systemically important banks, which is highly unlikely in the current regulatory environment.

SUBSIDIARIES & AFFILIATES: KEY RATING DRIVERS

DZ BANK's subsidiaries' issuer and debt ratings are aligned with those of DZ Bank.

SUBSIDIARIES AND AFFILIATES: RATING SENSITIVITIES

DZ BANK's subsidiaries' issuer and debt ratings are sensitive to a change in DZ BANK's issuer or debt ratings.

VR ADJUSTMENTS

The business profile score of 'aa-' is above the 'a' category implied score due to the following adjustment reason: business model (positive).

The earnings and profitability score of 'a' is above the 'bbb' category implied score due to the following adjustment reason: earnings stability (positive).

The capitalisation and leverage score of 'aa-' is above the 'a' category implied score due to the following adjustment reason: leverage and risk-weight calculation (positive).

The funding and liquidity score of 'aa' is above the 'a' category implied score due to the following adjustment reason: deposit structure (positive)

BEST/WORST CASE RATING SCENARIO

International scale credit ratings of Financial Institutions and Covered Bond issuers have a best-case rating upgrade scenario (defined as the 99th percentile of rating transitions, measured in a positive direction) of three notches over a three-year rating horizon; and a worst-case rating downgrade scenario (defined as the 99th percentile of rating transitions, measured in a negative direction) of four notches over three years. The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Best- and worst-case scenario credit ratings are based on historical performance. For more information about the methodology used to determine sector-specific best- and worst-case scenario credit ratings, visit https://www.fitchratings.com/site/re/10111579

REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING

The principal sources of information used in the analysis are described in the Applicable Criteria.

ESG CONSIDERATIONS

Unless otherwise disclosed in this section, the highest level of ESG credit relevance is a score of '3'. This means ESG issues are credit-neutral or have only a minimal credit impact on the entity, either due to their nature or the way in which they are being managed by the entity. For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com/esg

VIEW ADDITIONAL RATING DETAILS

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APPLICABLE CRITERIA

Bank Rating Criteria (pub. 07 Sep 2022) (including rating assumption sensitivity)

ADDITIONAL DISCLOSURES

Dodd-Frank Rating Information Disclosure Form

Solicitation Status

Endorsement Policy

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