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Fitch Revises Outlooks on 18 EU State-sponsored Banks to Negative on Weakening Support

Ratings Endorsement Policy
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Link to Fitch Ratings' Report: European State Sponsored Banks -- Rating Action Report

Fitch Ratings-London-26 March 2014: Fitch Ratings has revised the Outlook on 18 EU state-sponsored banks' Long-term Issuer Default Ratings (IDR) to Negative from Stable, including Austria's Volksbanken Verbund, a group made up of 63 banks. A further seven banks remain on Negative Outlook. The Outlook on 14 European banks' IDRs, including Zuercher Kantonalbank, the only bank in this commentary that is outside the EU, is Stable.

Fitch has also affirmed these banks' Long-term and Short-term IDRs, senior debt ratings (where assigned), Support Rating Floors (SRF, where assigned) and Support Ratings (SR). The rating action is in conjunction with other actions on support-based ratings taken today globally.

All of these banks' Long-term IDRs are driven by assumptions of sovereign support, as reflected in their own, their group's or their parent banks' SRFs. While Fitch has today affirmed these banks' SRs and SRFs where assigned, for most of the banks these ratings are likely to be downgraded or revised downwards within the next one to two years. The likelihood of a downgrade or downward revision is based on further progress being made in implementing the legislative and practical aspects of enabling effective bank resolution frameworks, which is likely to reduce implicit sovereign support for banks in the EU.

In contrast to banks covered in a simultaneous commentary today "Fitch Revises Outlooks on 18 EU Banks to Negative on Weakening Support", most banks covered in this commentary are unlikely to have their SRFs revised to 'No Floor' within the next one to two years. In the majority of cases SRFs and support-driven IDRs are likely to remain in investment grade.

Outlooks on Long-term IDRs remain Stable for banks concentrated on a specific policy function and effectively operating as an arm of the state and for banks with state guarantees for all liabilities and/or solvency guarantees. SRs and SFRs for these banks are unlikely to be revised downwards within the next one to two years as we do not expect progress on resolution frameworks to affect sovereign support for these banks.

For the banks on Negative Outlook, the degree of downward revisions of SRFs will determine the extent of downgrades of their Long-term IDRs. Almost all of them will benefit from some form of continued state sponsorship or institutional support considerations that Fitch is likely to continue to factor into their SRs and, where applicable, SRFs. Some banks' SRs are likely to switch to being based on institutional rather than on state support and their SRFs (which only measure sovereign support) are consequently likely to be withdrawn.

A full list of rating actions with key drivers and sensitivities is provided in the attached spread-sheet, but in summary banks' IDRs are likely to continue to benefit from support mainly for the following three reasons: (i) policy or partial policy role (10 banks), (ii) state-sponsored run-down of business (seven banking groups), and (iii) other strategic ownership by a sovereign, German federal state or Swiss canton (nine banks and their subsidiaries, including Landesbanken, see below).

There are five entities we believe are likely to continue to benefit from support that do not fit into the categories above. These are: Hypothekenbank Frankfurt AG (Eurohypo), Hypothekenbank Frankfurt International S.A. (Eurohypo), Volksbanken Verbund, Deutsche Pfandbriefbank and Duesseldorfer Hypothekenbank.

Hypothekenbank Frankfurt AG (Eurohypo) is a subsidiary of Commerzbank AG. Its SR and SRF are currently driven by its systemic importance as a major Pfandbrief issuer, but its business is being run down to a much smaller level. Although Hypothekenbank Frankfurt AG (Eurohypo) is owned by Commerzbank and its unsecured financing comes almost exclusively from its parent, Fitch has based its SR to date on state support because of its size in relation to Commerzbank. During the next one to two years, we expect that Hypothekenbank Frankfurt AG (Eurohypo)'s balance sheet will have been run down to a much more manageable size for Commerzbank and, given strong integration, we expect to equalise the IDRs of the two banks. At that time, Commerzbank's own SRF is likely to be revised to 'No Floor', which means that the IDRs for the two banks will likely be based on Commerzbank's VR, subject to potential mitigating considerations mentioned in Fitch's commentary "Fitch Revises Outlooks on 18 EU Banks to Negative on Weakening Support".

Hypothekenbank Frankfurt International S.A. (Eurohypo) was sold earlier this week by Hypothekenbank Frankfurt AG to Commerzbank. This strengthens the linkage between Commerzbank and the Luxembourg subsidiary. We expect to equalise Hypothekenbank Frankfurt International S.A. (Eurohypo)'s IDRs with those of Commerzbank within the next one to two years.

Fitch will decide within the next one to two years whether or not any state support should be retained in Volksbanken Verbund's SR and SRF. We may determine that its SR is downgraded to '5' and its SRF revised down to 'No Floor', and consequently a likely downgrade of the LT IDR to the level of the VR, which is currently 'bb-'. Even if we decide to retain some support in the ratings, we would probably be slightly less convinced about it than we are for the Austrian banks that are in run-down, for example, so would likely keep the Long-term IDR just inside investment grade. The argument for retaining some support in the ratings is that Volksbanken Verbund's central institution, Oesterreichische Volksbanken AG (OeVAG), is 43% owned by the Austrian state and will remain too large for the rest of the mutual group to support on their own until it is able to wind-down its non-core assets. In Fitch's view the state will want to protect its investment until that point, also considering that a sale of its stake outside the Volksbanken Verbund group would face some political challenges.

Deutsche Pfandbriefbank is targeted for sale by end-2015 but we believe that it will be very difficult to find a buyer given the bank's sizeable public-sector assets and potentially large senior unsecured refinancing needs. If it cannot be sold there is a high likelihood that the German Financial Market Stabilisation Fund (SoFFin) will assume ownership responsibility and would run the bank down. This contrasts with our opinion on banks in temporary and unwilling state ownership in several other countries. We would, therefore, likely maintain its SRF in investment grade, but in the 'BBB' range. SoFFin owns 100% of Deutsche Pfandbriefbank's owner, Hypo Real Estate Holding AG, whose Long-term IDR Outlook was also revised to Negative as part of this review.
While our view of state support for Duesseldorfer Hypothekenbank is likely to diminish to a 'No Floor' level within the next one to two years, we believe that Germany's Deposit Protection Fund (a voluntary deposit insurance scheme for Germany's private-sector banks) is likely to step in and provide support if necessary. The Deposit Protection Fund would, in any case, be liable as guarantor for almost all of the bank's unsecured

liabilities and it has in the past opted to support small banks, including by taking over ownership. This would likely result in a Long Term IDR for the bank in the 'BB' category.

The German Landesbanken fall under reason (iii) above for Fitch being likely to retain some support in banks' ratings. We have revised the Outlooks on the six Landesbanken, whose IDRs are driven by their SRFs, to Negative to reflect our expectation of further progress on the Bank Recovery and Resolution Directive (BRRD) and Banking Union within the next one to two years. Only one of the Landesbanken rated by Fitch, Landesbank Hessen-Thueringen, has IDRs that are not driven by state support, so were unaffected by today's Outlook revisions, and has a Stable Outlook. As part of S - Finanzgruppe Hessen-Thueringen, a mutual support group with its regional savings banks, its Long-term IDR is driven by S - Finanzgruppe Hessen-Thueringen's VR.

This new regulatory framework along with EU State Aid considerations will make it more challenging for a federal state to support its bank as a strategic owner. We are likely to switch the basis of our support considerations from systemic sovereign support via the owners to direct institutional support from the respective federal states (Laender) and savings bank owners, given that this would result in higher IDRs than the alternative likely 'No Floor' from sovereign support, and so we would withdraw SRFs. Within the next one to two years, we will likely downgrade the support-driven Long-term IDRs of the six Landesbanken by one to two notches.

KEY RATING DRIVERS

Policy roles, systemic importance and liability structures are key drivers behind the SRs and SRFs. In addition, SRs and SRFs of 12 entities from eight banking groups reflect their run-down status following approval from the European Commission under state ownership and/or with the assistance of state funding guarantees. LT and ST IDRs and senior debt ratings (including market-linked notes, where rated) are driven by banks' SRFs or those of their parents or mutual groups. Guaranteed debt ratings are driven by state guarantees. Key Drivers are summarised in the attached spread-sheet.

RATING SENSITIVITIES

The Long-term IDRs, Long-term senior debt ratings, SRs and SRFs are either directly or indirectly sensitive to a weakening in Fitch's assumptions around either the ability or propensity of relevant sovereigns to provide timely support.

For policy banks or state-guaranteed banks whose LT IDRs have Stable Outlooks and for guaranteed debt ratings, the greatest rating sensitivity is to a change in sovereign rating.

For those banks whose Long Term IDRs are on Negative Outlook, the greatest sensitivity is to a weakening of support propensity in respect of further progress being made in addressing legislative and practical impediments to effective bank resolution. In the EU, where the extent of legislative powers and the practical complexity of applying resolution tools vary by country, this is likely to occur through national implementation of the provisions of the BRRD, which has been tabled for a vote by the European Parliament next month.

Most of BRRD's provisions have to be in place by end-2014, where not already available. Only the bail-in tool has a later, January 2016 deadline. Resolution and supervisory powers will also be enhanced in order to address practical impediments to resolution. While extraordinary support for banks will still be possible after implementation of the provisions of BRRD, the hurdles to provide support will be higher.

In Banking Union countries of the EU, where the vast majority of the banks covered in this commentary are based, the Single Supervisory Mechanism will reduce national influence over supervision and licensing decisions in favour of the European Central Bank (ECB). Reaching political consensus on the Single Resolution Mechanism (SRM) was more troublesome than was the case with BRRD. While still involving multiple parties in resolution decisions, the SRM will result in a dilution of national influence over resolution decisions for large banks.

Where SRFs are assigned, Fitch's base case is that sufficient progress is likely to have been made for banks' Support Ratings and SRFs to be downgraded and revised downwards, respectively, within the next one to two years, likely to levels indicated in the attached spread-sheet. At this stage, this is likely to be some point in late 2014 or in 1H15 and could vary by country. The timing could also be influenced by idiosyncratic events, for example should there be risks to the availability of sovereign support for a bank that is likely to meet the conditions for resolution during 2014, whether as part of an asset quality review or another event.

The banks' Short-term IDRs and Short-term debt ratings are sensitive to downward revisions of SRFs apart from Caixa Geral de Depositos whose Viability Rating is at a level that could justify the current Short-term IDR and potentially some others if SRF revisions are kept to one notch and the banks' liquidity profiles and access are sufficiently strong.

The topic of bank resolution is explored in more detail in a Special Report entitled 'Sovereign Support for Banks: Rating Path Expectations' and the support nuances of banks covered in this commentary are expanded upon in two accompanying Special Reports, 'Rating Paths for EU State-sponsored Banks' and ''Various Support Rating Paths for German Banks', which will all shortly be published on www.fitchratings.com.

Fitch will hold a teleconference to discuss sovereign support for banks and give an update on rating paths on Friday, March 28 at 15:00 GMT. Callers must register in advance using the link below and are requested to dial in early:

http://event.onlineseminarsolutions.com/r.htm?e=773507&s=1&k=E99B5BCE23C11883F75DA40C4B1FED21

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Additional information is available at www.fitchratings.com.

Applicable criteria, 'Global Financial Institutions Rating Criteria', dated 31 January 2014, are available at www.fitchratings.com.

Contact details for Primary and Secondary Analysts and Chair for each institution are detailed in the attached spread-sheet.

Applicable Criteria and Related Research:
Global Financial Institutions Rating Criteria

Additional Disclosure
Solicitation Status

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