FitchRatings

RATING ACTION COMMENTARY

Fitch Downgrades HVB to 'BBB' Following UniCredit Downgrade; Outlook Negative

Thu 14 May, 2020 - 12:28 PM ET

Fitch Ratings - Frankfurt am Main - 14 May 2020: Fitch Ratings has downgraded UniCredit Bank AG's (HVB) Long-Term Issuer Default Rating (IDR) to 'BBB' from 'BBB+'. The Outlook remains Negative. A full list of rating actions is below.

The rating action follows the downgrade of HVB's parent, Unicredit S.p.A. (UC), to 'BBB-'/Stable/'F3' from 'BBB'/Negative/'F2'. Given the close linkage with UC, Fitch believes that HVB's ability to do business could be affected by it having a weaker parent. We also believe that a weakening of UC's financial strength increases the risk of it upstreaming further capital from HVB.

KEY RATING DRIVERS

HVB's IDRs and senior non-preferred debt ratings reflect its standalone credit strength as expressed by its Viability Rating (VR). The VR reflects our view that HVB's strong capitalisation offers substantial flexibility to absorb a deterioration of the bank's asset quality and profitability in the economic fallout from the coronavirus crisis. It also reflects the deep integration of HVB's mostly wholesale business model - primarily based on a well-established domestic corporate and investment banking (CIB) franchise - into the UC group.

The Negative Outlook on HVB reflects Fitch's expectation that capital and funding will become more fungible within the UC group entities that operate in the eurozone. In particular, a material capital upstreaming that could constrain HVB's financial flexibility could become more likely under the European Single Supervision and Single Resolution Mechanisms as long as UC maintains a single-point-of-entry resolution strategy as its preferred option.

HVB's Tier 1 capital ratio decreased to 17.5% at end-2019 from 19.9% at end-2018. This includes a EUR2.5 billion special dividend HVB plans to upstream to its parent in 2020 in addition to the 2019 consolidated profit of EUR0.8 billion. The bank's intention to continue to distribute the majority of its net profits to UC in the next few years should result in minimal profit retention. However, we expect HVB's reported capital ratios to remain sound, well above the peer group average, and to comfortably exceed regulatory requirements. UC and HVB have agreed with their respective national regulators that HVB's total capital ratio will not fall below 13%.This supports HVB's VR, which is one notch above UC's.

HVB has considerably reduced its exposure to UC over the past 10 years. Fitch expects an increasing portion of HVB's funding to be down-streamed from its parent to meet regulatory requirements under the group's currently preferred single-point-of-entry (SPE) resolution strategy, as UC will be the issuing entity for instruments intended to meet total loss absorbing capacity (TLAC) requirements and minimum requirement for own funds and eligible liabilities (MREL).

HVB's profitability is weak compared with European peers'. We expect higher loan impairment charges to exacerbate the pressure from low interest margins in 2020 and 2021. We also expect decreasing commission income in HVB's corporate and CIB business, which is significantly exposed to larger German corporates and multinationals. The bank's trading result could come under pressure on the back of widening credit spreads while HVB's commercial franchise could suffer from a weakening of UC in the medium term. HVB still has room to reduce its cost base mainly through streamlining and automating its processes, but progress in this area is expected to be slow. Net positive one-offs contributed to increase pre-tax profit to EUR1.4 billion in 2019 from EUR736 million in 2018.

We believe that the bank's business model and in particular its inherently riskier CIB business with large sector and single-name concentrations is likely to result in a deterioration of asset quality in a downturn. Exposure to industries Fitch views as particularly exposed to the crisis was equal to 165% and 10% of HVB's own funds and total exposure at end-2019, respectively. We view this as manageable, although we expect Stage 3 loans to increase materially from 2.1% at end-2019 over the next two years.

HVB's largely wholesale funding profile exposes the bank to rising funding costs. Customer deposits, mostly from corporate clients, account for about half of HVB's total funding. Market funding reliance is mitigated by the bank's large outstanding stock of covered bonds and by the relatively long average debt maturities. At the same time, the bank benefits from ample liquidity that offers a sufficient buffer against EUR52 billion in credit commitments at end-2019. HVB's Short-Term IDR is the higher of two possible ratings that map to a 'BBB' Long-Term IDR on Fitch's rating scale, driven by HVB's funding and liquidity score of 'a-'.

DERIVATIVE COUNTERPARTY RATING (DCR), DEPOSIT RATINGS AND SENIOR PREFERRED DEBT

HVB's DCR, long-term senior preferred debt rating and long-term Deposit Ratings are rated one notch higher than the bank's IDR to reflect the protection that could accrue to these creditors from the build-up of junior resolution debt and equity buffers.

HVB's short-term instrument ratings are the lower of the two ratings that map to a 'BBB+' long-term rating because our assessment of HVB's funding and liquidity score is not sufficiently high to achieve a higher short-term rating.

SUPPORT RATING

HVB's Support Rating (SR) of '3' indicates a 'BB-' long-term rating floor based on institutional support. It reflects Fitch's opinion that despite UC's strong propensity to support HVB, the parent's constrained ability to do so results in a moderate likelihood of extraordinary support. This is because of the large solvency support that HVB would likely require relative to the capital available in the rest of the group, given that a large share of UC's consolidated equity is in HVB. Our view of UC's strong propensity to support primarily reflects HVB's role as the group's investment banking hub and sizeable corporate banking operations in Europe's largest economy.

SUBORDINATED DEBT AND HYBRID SECURITIES

The subordinated Tier 2 debt rating reflects a baseline notching of two notches for loss severity from the bank's VR. The notching reflects our expectation that the bank will not maintain buffers of Tier 2 and AT1 debt exceeding 10% of its respective risk-weighted assets.

The bank's hybrid capital notes issued through HVB Funding Trusts I and II are rated four notches below the VR: two notches for loss severity and two notches for incremental non-performance risk. While the regulator could order a coupon deferral in line with the terms and conditions of these profit-linked instruments, we view such intervention as unlikely in light of HVB's solid standalone financial profile.

RATING SENSITIVITIES

IDRS, VR AND SENIOR NON-PREFERRED DEBT

Factors that could lead to negative rating action/downgrade:

We could downgrade HVB's ratings, aligning them with UC's, if fungibility of capital within the UC group increases further or following a downgrade of UC's ratings. HVB's ratings could also be downgraded if recurring operating profitability declines, which could be caused by higher LICs if the economic disruption from the COVID-19 crisis results in a prolonged economic disruption.

Factors that could lead to positive rating action/upgrade:

The Outlook on HVB's Long-Term IDR could be revised to Stable if HVB is more effectively ring-fenced and contingency risk is reduced, resulting in a greater de-linkage of both entities' ratings, provided that COVID-19 related disruptions turns out to be short-lived and the bank manages to maintain adequate earnings and asset quality. An upgrade of HVB's ratings would require an upgrade of UC's ratings.

DERIVATIVE COUNTERPARTY RATING (DCR), DEPOSIT RATINGS AND SENIOR PREFERRED DEBT

Factors that could lead to negative ration action/downgrade:

We would downgrade the ratings if HVB's IDR is downgraded or if HVB's qualifying junior and SNP debt buffers are insufficient to restore viability and protect preferred creditors after a failure.

Factors that could lead to positive rating action/upgrade:

An upgrade would require an upgrade of HVB's IDR.

SUPPORT RATING

Factors that could lead to negative rating action/downgrade:

We could downgrade the rating upon a negative change in our view of UC's ability to support HVB, which could be indicated by a downgrade of UC's ratings. The rating is also sensitive to negative changes to Fitch's view of UC's propensity to provide support, which we currently do not expect.

Factors that could lead to positive rating action/upgrade:

An upgrade would require a strengthening of UC's financial profile and a material change in the size of HVB relative to the parent, which we consider unlikely.

SUBORDINATED DEBT AND HYBRID SECURITIES

Factors that could lead to negative rating action/downgrade:

We would downgrade HVB's subordinated debt and hybrid securities' ratings upon a downgrade of the bank's VR or upon a widening in the securities' notching, which could arise if we change our assessment of the notes' loss severity or relative non-performance risk.

Factors that could lead to positive rating action/upgrade:

We would upgrade HVB's subordinated debt and hybrid securities' ratings upon an upgrade of the bank's VR or upon a narrowing in the securities' notching, which could arise if we change our assessment of the notes' loss severity or relative non-performance risk.

BEST/WORST CASE RATING SCENARIO

International scale credit ratings of Financial Institutions 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.

PUBLIC RATINGS WITH CREDIT LINKAGE TO OTHER RATINGS

HVB's ratings are sensitive to changes in Unicredit S.p.A.'s IDRs.

ESG CONSIDERATIONS

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

RATING ACTIONS

ENTITY/DEBT	RATING

ENTITY/DEBT	RATING		
HVB Funding Trust II			
• preferred	LT	BB-	Downgrade
UniCredit Bank AG	LT IDR	BBB	Downgrade
	ST IDR	F2	Affirmed
	Viability	bbb	Downgrade

VIEW ADDITIONAL RATING DETAILS

FITCH RATINGS ANALYSTS

Markus Glabach
Director
Primary Rating Analyst
+49 69 768076 195
Fitch Deutschland GmbH Neue Mainzer Strasse 46 - 50 Frankfurt am Main D-60311

Marco Diamantini
Associate Director
Secondary Rating Analyst
+49 69 768076 114

Christian Kuendig
Senior Director
Committee Chairperson
+44 20 3530 1399

MEDIA CONTACTS

Louisa Williams
London
+44 20 3530 2452
louisa.williams@thefitchgroup.com

Additional information is available on www.fitchratings.com

APPLICABLE CRITERIA

Bank Rating Criteria (pub. 28 Feb 2020) (including rating assumption sensitivity)

ADDITIONAL DISCLOSURES

Dodd-Frank Rating Information Disclosure Form

Solicitation Status

Endorsement Policy

ENDORSEMENT STATUS

HVB Funding Trust I	EU Issued
HVB Funding Trust II	EU Issued
UniCredit Bank AG	EU Issued

DISCLAIMER

READ LESS

COPYRIGHT

(see https://www.fitchratings.com/site/regulatory), other credit rating subsidiaries are not listed on Form NRSRO (the "non-NRSROs") and therefore credit ratings issued by those subsidiaries are not issued on behalf of the NRSRO. However, non-NRSRO personnel may participate in determining credit ratings issued by or on behalf of the NRSRO.

READ LESS

SOLICITATION STATUS

The ratings above were solicited and assigned or maintained at the request of the rated entity/issuer or a related third party. Any exceptions follow below.

ENDORSEMENT POLICY

Fitch's approach to ratings endorsement so that ratings produced outside the EU may be used by regulated entities within the EU for regulatory purposes, pursuant to the terms of the EU Regulation with respect to credit rating agencies, can be found on the EU Regulatory Disclosures page. The endorsement status of all International ratings is provided within the entity summary page for each rated entity and in the transaction detail pages for all structured finance transactions on the Fitch website. These disclosures are updated on a daily basis.

Structured Finance: Covered Bonds   Structured Finance   Banks   Europe   Germany