FitchRatings

RATING ACTION COMMENTARY

Fitch Takes Rating Action on HSH Nordbank on Privatisation

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Fitch Ratings-Frankfurt-06 December 2018: Fitch Ratings has upgraded HSH Nordbank AG's Viability Rating (VR) to 'bb+' from 'bb-' and removed it from Rating Watch Positive (RWP) following the sale of the former public sector bank to a consortium of private investors on 28 November 2018.

At the same time, Fitch has downgraded HSH's support-driven Long-Term Issuer Default Rating (IDR) to 'BB+' from 'BBB-' and Short-Term IDR to 'B' from 'F3' and removed both IDRs from Rating Watch Negative (RWN). The Outlook on the Long-Term IDR is Stable.

At the same time, Fitch affirmed the bank's Long- and Short-term deposit ratings at 'BBB-' and 'F3', respectively, and removed them from RWN. Fitch also affirmed the ratings of several legacy senior bonds with embedded derivatives that rank pari passu with senior preferred debt at 'BBB-' and removed them from RWN and assigned Long- and Short-term programme ratings of 'BBB-' and 'F3' to HSH's senior preferred debt.

A full list of rating actions is at the end of this rating action commentary.

The rating action follows the sale of the bank by its former public sector owners. Following the privatisation HSH's IDRs and senior debt ratings are driven by the bank's VR as Fitch no longer factors institutional support from the bank's former public sector owners into HSH's ratings.

KEY RATING DRIVERS

VR, IDRS AND SENIOR DEBT

The VR, IDRs and senior debt ratings of HSH reflect its corporate banking focused business model, significantly improved asset quality and capitalisation balanced by low operating profit, which Fitch expects to improve gradually, and a predominantly wholesale-driven funding profile despite plans to increase retail funding. HSH maintains its business focus on

Germany, where we expect the operating environment to remain solid.

Fitch expects HSH to develop its business model under new ownership and with a cleaned-up balance sheet. However, we view HSH's franchise as moderate as it operates in the highly competitive German corporate banking sector, with a less diverse business model than universal bank peers, by concentrating on corporate customers.

Fitch expects profitability to be supported by lower loan impairment charges following the clean-up of HSH's balance sheet, and by the bank's plans to significantly increase cost-efficiency, apply sound pricing discipline, increase fee-generating businesses and lower funding costs. Fitch believes that the bank will face challenges in improving revenue given HSH's role as a commercial bank in a competitive sector, with relatively high funding costs that should improve only gradually. Moreover, we believe that the bank's business model and exposure to cyclical industries, including commercial real estate, could make the bank's profitability more volatile through economic cycles.

HSH's asset quality has improved significantly following the disposal and further run-down of non-core and non-performing assets. We expect the gross non-performing loan (NPL) ratio to drop and stabilise at around 2%-3% in the next five years as NPLs fall to below EUR1 billion at end-2018 from EUR7.4 billion at end-2017. However, Fitch's assessment of asset quality also reflects concentration risk in HSH's commercial real estate and shipping credit exposures, and in the bank's corporates book remaining skewed towards the home regions in northern Germany.

HSH's common equity tier 1 (CET1) ratio should improve substantially by end-2018 following the announced repurchase of hybrid Tier 1 silent participations well below par value. For the next four years, we therefore expect the CET1 ratio to remain comfortably above 15%, which Fitch views as adequate given reduction in HSH's risk appetite and exposure on the bank's balance sheet. However, Fitch's assessment of capitalisation also factors in weak internal capital generation, given low net income expected in the coming years, which we believe is vulnerable to cyclical performance swings.

Fitch's assessment of funding and liquidity are based on the expectation that HSH will remain predominantly wholesale-funded and that its customer loans/deposits ratio will increase. We believe that the agreement reached between the bank and the German banking association (Bundesverband Deutscher Banken; BdB) for a smooth transition to a senior membership in its voluntary deposit protection fund (DPF) of the private sector banks by 2022 should compensate the loss of funding benefits that HSH has had to date as a member in the institutional support scheme of the Landesbanken and savings banks.

The reliance on wholesale funding is mitigated by the bank's plans to increase its retail deposits base and to raise about EUR8 billion retail deposits by 2022, representing over half of total deposits. HSH has already raised more than EUR3 billion retail deposits this year, which indicates that its target is realistic. HSH has access to other funding sources, including covered bonds, asset-backed financing and funding from development banks. Finally, the implementation of Bank Resolution and Recovery Directive (BRRD) 2 in Germany allows HSH to issue senior preferred debt, which ranks senior to senior non-preferred debt and should allow the bank to reduce funding costs.

Fitch has also withdrawn the short-term ratings of HSH's senior unsecured debt that ranks pari passu with senior non-preferred debt, including the debt issuance programme, because these are no longer relevant for Fitch's coverage.

SUPPORT RATING AND SUPPORT RATING FLOOR

Following the privatisation, HSH's Support Rating and Support Rating Floor reflect Fitch's view on support from the authorities in case of need. Institutional support from HSH's former owners is no longer factored into the bank's ratings, and in our opinion, institutional support from the new private-sector owners, while possible, cannot be relied on.

The Support Rating assessment of '5' and Support Rating Floor assessment of 'No Floor' reflect our view that, following the implementation of legislation and resolution tools pursuant to the BRRD in Germany in 2015, senior creditors can no longer rely on receiving full extraordinary support from the German sovereign, should HSH become non-viable.

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

Fitch rates HSH's debt that ranks pari passu with senior preferred debt, Deposit Ratings and DCR one notch above HSH's Long-Term IDR. Under German insolvency law, senior unsecured bonds that were issued prior to July 2018 and which are not deemed 'plain vanilla', rank senior to other senior unsecured bonds issued before that date and rank pari passu with senior preferred debt issued after that date.

The debt ratings at one notch above the Long-Term IDR reflect our view that HSH's consolidated buffer of subordinated debt and debt that ranks pari passu with senior non-preferred debt is likely to be maintained well above 8% of the bank's risk-weighted assets (RWAs) and will therefore be sufficient to recapitalise the bank, preventing a default on other senior preferred liabilities, including deposits, upon resolution.

STATE-GUARANTEED/GRANDFATHERED SECURITIES

The rating of HSH's state-guaranteed and grandfathered senior debt and subordinated debt reflect the credit strength of the guarantor - the federal state of Schleswig Holstein and the City of Hamburg - and our view that they will continue to honour their guarantees after the sale of HSH.

RATING SENSITIVITIES

VR, IDRS, AND SENIOR DEBT

HSH's VR, IDRS and senior debt ratings are primarily sensitive to the bank's ability to improve profitability and to maintain sound capitalisation. An upgrade of the ratings could follow a material improvement in operating profitability in line with the bank's business plan, driven by diversified income sources, adequate margins and achievement of cost and efficiency targets, which would translate into a proven record of sound organic capital generation.

Downward pressure on ratings would arise from an increased risk appetite, which we do not expect under its new owners, but which could be signalled by an increased focus on higher-risk structures or assets. Fitch expects NPLs to increase only gradually over the next years, and the bank's ratings would come under pressure if asset quality deteriorates more than expected, which could be caused by single-name losses. The ratings are also sensitive to the bank's ability to maintain a sound franchise in the funding market and to attract sufficient long-term funding from the wholesale market.

SENIOR PREFERRED, DCR AND DEPOSIT RATINGS

The ratings of HSH's senior preferred debt, DCR and deposit ratings are primarily sensitive to a decline of HSH's buffer of subordinated and senior non-preferred debt to below the bank's recapitalisation amount, which we estimate at about 8% of RWAs. We would downgrade these ratings and equalise them with the bank's IDRs if this buffer falls below the recapitalisation amount. The ratings are also sensitive to changes in the bank's IDRs.

STATE-GUARANTEED/GRANDFATHERED SECURITIES

The ratings of HSH's state-guaranteed/grandfathered senior debt, subordinated debt and market-linked securities are sensitive to changes in Fitch's view of the creditworthiness of the guarantors or to a change in the guarantors' propensity to provide support, which we do not expect.

The rating actions are as follows:

HSH Nordbank AG Bank
Long-Term IDR: downgraded to 'BB+' from 'BBB-', removed from RWN; Outlook Stable
Short-Term IDR: downgraded to 'B' from 'F3', removed from RWN
Support Rating: downgraded to '5' from '2', removed from RWN
Support Rating Floor: assigned at No Floor
Derivative Counterparty Rating: affirmed at 'BBB-(dcr)', removed from RWN
Viability Rating: upgraded to 'bb+' from 'bb-', removed from RWP
Long-term senior unsecured debt, including programme rating: downgraded to 'BB+' from 'BBB-', removed from RWN
Long term senior preferred debt: affirmed at 'BBB-', removed from RWN
Long term senior preferred debt issuance programme: assigned at 'BBB-'
Short term senior preferred debt issuance programme: assigned at 'F3'
Short-term senior unsecured debt, including programme rating: 'F3' withdrawn
Long-term deposits: affirmed at 'BBB-', removed from RWN
Short-term deposits: affirmed at 'F3', removed from RWN
State-guaranteed/grandfathered senior and subordinated debt: affirmed at 'AAA'

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Summary of Financial Statement Adjustments
Fitch re-classifies the hedge effect of the second-loss guarantee as an offset to loan impairment charges and removes the balance sheet impact of the compensation from impaired loans reserves to better reflect the economic effect of the second-loss guarantee. These adjustments affect financial statements starting end-2011 as well as interim results in 2018.

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Additional information is available on www.fitchratings.com

Applicable Criteria

Bank Rating Criteria (pub. 12 Oct 2018)

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Dodd-Frank Rating Information Disclosure Form

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