FitchRatings

RATING ACTION COMMENTARY

Fitch Revises Sparkassen-Finanzgruppe's Outlook to Stable from Negative; Affirms at 'A+'

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Fitch Ratings - Frankfurt am Main - 30 Jun 2021: Fitch Ratings has revised the Outlook on German savings bank group Sparkassen-Finanzgruppe's (SFG) Long-Term Issuer Default Rating (IDR) to Stable from Negative and affirmed the IDR at 'A+', Short-Term IDR at 'F1+' and Viability Rating (VR) at 'a+'. A full list of rating actions is at the end of this rating action commentary.

The revision of the Outlook reflects our expectation that SFG will retain a financial profile commensurate with its 'a+' VR through the Covid-19 crisis. We consider that the comprehensive state support to the German economy has significantly reduced the risk that SFG's asset quality and earnings could deteriorate as a result of the pandemic. Consequently, we have revised our outlooks on the group's asset quality (a+) and earnings (a) to stable from negative as we expect both VR factors to remain resilient to plausible downside scenarios. This view is underpinned by a revision of the outlook on the operating environment score to stable from negative as the economic recovery in Germany strengthens, despite persistent structural challenges in the German banking sector.

Fitch has withdrawn the ratings of five savings banks following the reorganisation of these entities.

KEY RATING DRIVERS

IDRS AND VR

SFG is not a legal entity but a savings bank network, whose cohesion is supported by a mutual support scheme. Fitch assigns "group" ratings to SFG and the savings banks. The IDRs are based on the group's VR and apply to each individual savings bank in accordance with Annex 4 of Fitch's Bank Rating Criteria regarding rating banking structures backed by mutual support mechanisms. The group's mutual support scheme is designed as an institutional protection scheme (IPS) and recognised by the regulator as a deposit guarantee scheme. The scheme has an impeccable record of providing protection to depositors by safeguarding its member banks' viability. Members of the group share a common strategy, brand and joint marketing activities.

However, we view SFG's cohesion as weaker than those of peers, i.e. other European mutual banking groups rated under Annex 4. This drives SFG's ESG relevance score of '4' for group structure. SFG does not produce consolidated financial accounts, and its aggregated risk reporting is less advanced than peers. The ECB and BaFin criticised SFG's IPS for its structure and organisation, resulting in complex decision-making processes within SFG, which could compromise the IPS's responsiveness to support larger members, whenever required. Fitch believes that DSGV, the German savings banks association, is addressing the scheme's identified weaknesses, which will improve transparency and decision making.

SFG's VR reflects its very strong domestic retail and SME franchise and stable business model, granular and sound credit exposure, strong capitalisation and strong deposit-driven funding and liquidity. The VR also factors in SFG's moderating profitability due to the prolonged decline in net interest income.

In 2020, SFG's operating profit/risk-weighted assets (RWA) remained robust at 0.9% (1.1% in 2019), comfortably within our expectations for an earnings & profitability score of 'a', when adjusted to neutralise the group's strongly overstated RWA density that results from the savings banks' use of the standardised approach to assess their credit risks. SFG's profits remained resilient thanks to its strong market position, despite loan impairment charges (LICs) rising to 18bp of gross loans (7bp in 2019). We expect operating profitability to remain challenged in 2021 by higher than historical average LICs, despite a recovery in business activity.

We expect that SFG's asset quality will deteriorate only modestly, as the group's appetite for credit risk is low, driven by conservative underwriting standards, strong collateral and low concentrations. In addition, the comprehensive state support programmes have resulted in a contained increase in unemployment since the start of the pandemic.

We expect SFG's impaired loans to rise moderately by end-2021 as support measures (e.g. furlough schemes) recede and the effects of the crisis become more apparent. However, we expect the four-year-average impaired loan ratio (about 1.3% - 1.5% at end-2020, by Fitch's estimate) to remain below 2% in the medium term.

Capitalisation is a rating strength of the group, reflecting consistently high profit retention of the local savings banks and is materially stronger than the German banking sector average. SFG's common equity Tier 1 capital ratio was 16.4% at end-2020 (2019: 16%), supported by profit retention. The group's leverage ratio remained stable at 8.5%, which is strong in both the domestic and international context.

SFG's ratings factor in contingent risks from the savings banks' exposure (both participations and funding) to the Landesbanken. We believe these risks remain manageable, despite the challenging environment particularly for banks that undergo significant restructurings.

The savings banks' large and rising retail deposits base and a stable market share strongly support the group's funding and liquidity profile. They ensure low funding costs and low sensitivity to market sentiment and underpin the 'F1+' Short-Term IDR. The 'F1+' Short-Term IDR is the higher of two options mapping to a 'A+' Long-Term IDR and reflects the group's 'aa-' score for funding and liquidity.

DEPOSIT RATINGS

The savings banks' deposit ratings are aligned with their IDRs because SFG's aggregated junior and senior non-preferred debt buffers do not offer sufficient default protection to depositors or 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, excluding their central institutions, the Landesbanken. Should the group's IPS ever fail, the regulatory resolution scenario is likely to be an insolvency of the saving banks. We do not assign a deposit rating to SFG as it is not a legal entity.

SUPPORT RATING (SR) AND SUPPORT RATING FLOOR (SRF)

SFG's SR and SRF reflect Fitch's view that extraordinary sovereign support for EU banks is possible but cannot be relied upon due to the Bank Recovery and Resolution Directive and 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.

SUBSIDIARIES AND AFFILIATED ENTITIES

Fitch has also revised to Stable from Negative the Outlooks on the Long-Term IDRs of the 318 savings banks rated as members of SFG (out of a total of 371 German savings banks at 1 June 2021) and affirmed the IDRs at 'A+'/'F1+'.

Fitch has withdrawn the ratings of five savings 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 of these merged issuers. A full list of rated SFG members is available at www.fitchratings.com

All statements regarding SFG's 2020 performance and balance-sheet items refer to preliminary data released by Deutscher Sparkassen- and Giroverband (DSGV), the national savings bank association, for the financial year 2020.

RATING SENSITIVITIES

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

Any upside momentum for SFG's ratings would require stronger cohesion, significant improvements in its decision-making processes and materially improved disclosure.

The Long-Term IDRs and Deposit Ratings of SFG's members would likely be upgraded if SFG's IDRs was upgraded. We view a rating uplift above SFG's Long-Term IDR as highly unlikely in light of the savings banks' modest senior unsecured issuance. As a result, we do not expect the group to build and maintain a large buffer of subordinated and senior non-preferred debt above 10% of the group's RWA, which would be required for an uplift of the long-term deposit ratings to one notch above their Long-Term IDRs.

An upgrade of the SR and upward revision of the SRF would be contingent on a positive change in Fitch's view of the sovereign's propensity to support its systemically important banks. While not impossible, in Fitch's opinion, this is highly unlikely.

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

SFG's Long-Term IDR has headroom to withstand various downside scenarios to Fitch's baseline economic forecast. However, the group's ratings might come under pressure from a material deterioration in asset quality and earnings, with an impaired loan ratio sustainably above 3%, operating profit/RWA below 0.5%, and if the CET1 ratio falls below 13% based on current RWA calculations.

The Short-Term IDR is sensitive to our assessment of the group's funding and liquidity and could be downgraded if SFG's funding and liquidity score dropped below 'aa-'.

The IDRs and Deposit Ratings of SFG's members are likely to be downgraded if SFG's IDRs were downgraded.

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

SFG's highest level of ESG credit relevance is a score of '4' for group structure in contrast to a typical relevance score of '3' for comparable banks. This reflects our view that SFG is one of the least cohesive groups to which Fitch assigns group ratings. SFG does not produce consolidated financial accounts and its aggregated risk reporting is less advanced than other European mutual support banking groups rated by Fitch. This means that ESG issues are credit relevant to the issuer, but not a key rating driver by itself. However, the score has a moderate negative impact on the rating in combination with other factors. The score also reflects the often lengthy and complex decision-making process of the group and limited enforcement rights, because SFG is not a consolidated legal entity.

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