

Rating Action: Moody's upgrades DEPFA Bank and DEPFA ACS to Baa2/Prime-2; changes outlook to stable

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DEPFA's baseline credit assessment upgraded to ba3

Frankfurt am Main, October 19, 2016 -- Moody's Investors Service has today upgraded to Baa2 from Ba1 the long-term senior unsecured debt ratings of DEPFA Bank plc (DEPFA), and to Baa2/Prime-2 from Ba1/Non-Prime the deposit ratings of DEPFA and its fully-owned subsidiary DEPFA ACS BANK (DEPFA ACS). Concurrently, Moody's upgraded the Counterparty Risk Assessments of the two banks to Baa2(cr)/P-2(cr) from Baa3(cr)/P-3(cr), and their baseline credit assessments (BCAs) to ba3 from b2. The outlook on DEPFA's long-term debt and deposit ratings and on DEPFA ACS's long-term deposit ratings is stable.

Today's rating actions reflect Moody's assessment that DEPFA's and DEPFA ACS's fundamental credit profiles benefit from improving capitalisation and a stable funding profile owing to their progress in unwinding DEPFA group's assets and preserving capital in the process. The upgrade also takes account of the additional positive impact on the group's credit profile that the rating agency expects from the EUR5.3 billion asset sale which DEPFA group announced on 14 October 2016, and which Moody's understands will be concluded within the next few weeks. Given DEPFA's focus on a capital preserving run-down of its balance sheet, Moody's expects that the transaction will enhance the group's capitalisation and reduce market risk linked to the portfolios that will be sold.

In addition, Moody's affirmed the Ca(hyb) ratings of the backed hybrid securities issued by DEPFA Funding II LP and DEPFA Funding III LP, and upgraded the backed hybrid instrument issued by DEPFA Funding IV LP to Caa2(hyb) from Ca(hyb), based on its assumptions for the future impairment of these perpetual instruments from skipped coupons.

A full list of affected ratings can be found at the end of this press release.

RATINGS RATIONALE

THE BCA UPGRADES DRIVE THE UPGRADE OF THE GROUP'S LONG TERM RATINGS

The upgrade of DEPFA's debt and deposit ratings, as well as DEPFA ACS' deposit ratings, reflects the upgrade of their BCAs by two notches to ba3. In particular, this is due to a combination of DEPFA's:

- (1) Good progress in unwinding the group's balance sheet and risk-weighted assets during 2015 and 2016 to date, combined with the prospect of a material acceleration on the run-down through asset sales later in Q4 2016, which Moody's expects will be capital-accretive;
- (2) Sustained efforts to contain operating losses, which will help the group to continue the unwinding of its balance sheet in a capital-preserving fashion; and
- (3) The group's improved funding profile, which benefits from committed, unsecured funding support from its German owner, the government agency FMS Wertmanagement (FMS-WM, long-term issuer and debt ratings Aaa stable).

HIGHER GOVERNMENT SUPPORT OFFSETS EXCLUSION OF MOODY'S LOSS GIVEN FAILURE ANALYSIS

Moody's said that it has factored into the group's debt and deposit ratings higher government support of four notches (instead of two notches previously), and excluded from the group's rating architecture the result of its Advanced Loss Given Failure (LGF) analysis. The LGF analysis, which takes into account the severity of loss faced by the different liability classes in resolution, had previously resulted in two notches of rating uplift for DEPFA's and DEPFA ACS's long-term ratings. The two changes had a neutral effect on the group's ratings.

DEPFA group's debt and deposit ratings now take into account: (1) the ba3 BCA, which reflects the group's

improving financial profile, but also the banks' mono-line, highly concentrated asset profile that weighs on the ratings; and (2) four notches of rating uplift from Moody's government support assumptions.

The higher government support factored into DEPFA's ratings takes into account Moody's assessment of FMS-WM's ongoing, strongly supportive assistance in the group's unwinding, which aims at avoiding distress and subsequent resolution and ensuring a smooth run-down of DEPFA's assets and liabilities. This assistance is illustrated by FMS-WM's direct funding support, as well as its systematic purchase of DEPFA group's liabilities in order to facilitate an accelerated run-down.

Against the background of the substantial financial assistance from FMS-WM to date, Moody's takes the view that resolution measures, including the use of bail-in tools are -- although not ruled out -- unlikely to be applied to DEPFA. As a result, Moody's no longer applies its Advanced LGF analysis to DEPFA.

STABLE OUTLOOK REFLECTS MOODY'S EXPECTATION OF DEPFA'S CONTINUED SMOOTH UNWINDING

The stable outlook on the Baa2 debt and deposit ratings reflects Moody's expectation that over the next five years, DEPFA group's continued efforts of preserving its financial resources will ensure satisfactory or even very solid regulatory capital ratios and thereby an adequate capital cushion to shield senior creditors against unexpected losses.

Moody's said that it does not rule out further fundamental improvements during the unwinding, with potential positive implications on the banks' ba3 BCAs; however, rating upside will remain constrained by the long-term uncertainties linked to the group's structural losses that will gradually reduce its capital resources over a potentially very long time horizon.

AFFIRMATION OF TWO HYBRID RATINGS AND UPGRADE OF ONE HYBRID INSTRUMENT

Moody's affirmed the backed Ca(hyb) ratings of the Tier 1 preferred securities of DEPFA Funding II and III LP, based on its expectation that DEPFA will never pay any coupons on these non-performing, perpetual instruments. The ratings reflect Moody's approach of discounting expected coupon losses, in DEPFA's case for a term of 15 years, to calculate the respective expected total impairment.

Moody's upgraded the backed rating of DEPFA Funding IV LP to Caa2(hyb) from Ca(hyb) based on the same assumptions it made for DEPFA Funding II and III LP, but taking into account the lower contractual coupon, and therefore a lower present value of the impairment from coupon losses of this instrument.

WHAT COULD CHANGE THE RATINGS UP/DOWN

The banks' long-term ratings could be up- (or down-) graded due to revisions of the banks' BCAs and/or Moody's assumptions for government support. A single-notch upgrade (or downgrade) of the BCAs will not necessarily lead to higher (or lower) long-term ratings, as Moody's may consider an offsetting reduction (or increase) of government support.

The banks' BCAs could be upgraded due to: (i) a sustainable reduction of operating losses; (ii) higher capital levels; and/or (iii) measures that will materially shorten the expected duration of the banks' unwinding.

The banks' BCAs could be downgraded due to: (i) a material deterioration in its asset quality; and/or (ii) a failure to contain operating losses, especially if these losses reduce capital levels faster than currently anticipated.

LIST OF AFFECTED RATINGS

DEPFA Bank plc:

The following ratings, rating inputs and rating assessments assigned to DEPFA Bank plc were upgraded:

- long- and short-term bank deposit ratings (local and foreign currency): upgrade to Baa2 stable/Prime-2, from Ba1 on review for upgrade/Non-Prime
- long-term senior unsecured debt ratings (local and foreign currency): upgrade to Baa2 stable, from Ba1 on review for upgrade
- the BCA and Adjusted BCA: upgrade to ba3 from b2

- long- and short-term Counterparty Risk Assessment: upgrade to Baa2(cr)/Prime-2(cr), from Baa3(cr)/Prime-3(cr)

DEPFA ACS BANK:

The following ratings, rating inputs and rating assessments assigned to DEPFA ACS BANK were upgraded:

- long- and short-term bank deposit ratings (local and foreign currency): upgrade to Baa2 stable/Prime-2, from Ba1 on review for upgrade/Non-Prime

- the BCA and Adjusted BCA: upgrade to ba3 from b2

- long- and short-term Counterparty Risk Assessment: upgrade to Baa2(cr)/Prime-2(cr), from Baa3(cr)/Prime-3(cr)

DEPFA Bank Plc New York Branch:

The following ratings and rating assessments assigned to DEPFA Bank Plc New York Branch were upgraded:

- long- and short-term bank deposit ratings (local and foreign currency): upgrade to Baa2 stable/Prime-2, from Ba1 on review for upgrade/Non-Prime

- long-term deposit note/CD program (local currency): upgrade to Baa2 stable, from Ba1 on review for upgrade

- long- and short-term Counterparty Risk Assessment: upgrade to Baa2(cr)/Prime-2(cr), from Baa3(cr)/Prime-3(cr)

DEPFA Funding II, III and IV LP:

The following ratings were affirmed:

- The backed Ca(hyb) ratings of the hybrid instruments issued by DEPFA Funding II and III LP

The following ratings were upgraded:

- The backed hybrid instrument rating of DEPFA Funding IV LP: upgrade to Caa2(hyb), from Ca(hyb)

PRINCIPAL METHODOLOGY

The principal methodology used in these ratings was Banks published in January 2016. Please see the Rating Methodologies page on www.moodys.com for a copy of this methodology.

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Katharina Barten
Senior Vice President
Financial Institutions Group
Moody's Deutschland GmbH
An der Welle 5
Frankfurt am Main 60322
Germany
JOURNALISTS: 44 20 7772 5456
SUBSCRIBERS: 44 20 7772 5454

Carola Schuler
MD - Banking
Financial Institutions Group
JOURNALISTS: 44 20 7772 5456
SUBSCRIBERS: 44 20 7772 5454

Releasing Office:
Moody's Deutschland GmbH
An der Welle 5
Frankfurt am Main 60322
Germany
JOURNALISTS: 44 20 7772 5456
SUBSCRIBERS: 44 20 7772 5454

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