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DEPFA Bank PLC

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DEPFA Bank PLC

SACP	bbb-	+	Support	+3	+	Additional Factors	0

Anchor	bbb	
Business Position	Moderate	-1
Capital and Earnings	Very Strong	+2
Risk Position	Weak	-2
Funding	Average	0
Liquidity	Adequate	

ALAC Support	0
GRE Support	+3
Group Support	0
Sovereign Support	0

Issuer Credit Rating
A-/Stable/A-2

Major Rating Factors

Strengths:

- High likelihood of extraordinary government support from Germany, underpinned by DEPFA's ownership by German government-owned FMS Wertmanagement Anstalt des oeffentlichen Rechts (FMSW).
- Very strong capitalization, supported by the accelerated wind-down of the balance sheet.
- Advanced integration of operational units and processes with the FSMW, including funding and liquidity support.

Weaknesses:

- Insufficient net interest income to cover operating costs.
- Concentration risk in the public sector.
- Constraints for the accelerated wind-down of some assets.

Outlook: Stable

The stable outlook on DEPFA Bank PLC reflects S&P Global Ratings' view that the bank will remain a wind-down unit under FMSW, and that DEPFA (via FMSW) will continue to benefit from the strong commitment of the German government until its wind-down is completed. Notably, we anticipate our risk-adjusted capital (RAC) ratio for DEPFA will remain well above 15%. However, we note that the German state has no obligation to support DEPFA directly, in contrast to its obligation to support FMSW.

We could raise our ratings in the next 12-24 months if DEPFA's remaining exposures became increasingly weighted toward countries with low economic risk, and if we believed that credit losses and nonperforming loans would remain low at the same time despite the risk concentrations. A clearer view on the FSMW group's long-term capital policy could indicate that the bank will sustain its ability to absorb significant unexpected losses should they arise. We could also upgrade DEPFA if Germany's already high commitment to the bank via FMSW were to strengthen.

We could downgrade DEPFA if, for example, decisions of its parent FMSW, or any potential sizable losses, caused a sharp and significant fall in the bank's capitalization, or if we saw FMSW becoming less supportive of DEPFA.

Rationale

Our ratings on DEPFA reflect its anchor of 'bbb', which represents our view of economic conditions in the countries in which the bank operates and banking industry risk in the Republic of Ireland.

We assess DEPFA's stand-alone credit profile (SACP) at 'bbb-', incorporating our view of the support DEPFA has received from the German government through capital injections and asset transfers. We also take into account ongoing government support and further operational integration with FMSW, because we cannot segregate benefits deriving from government ownership through FMSW from our stand-alone analysis of the bank.

We assume that management will continue the orderly wind-down of the balance sheet, with ongoing implicit support from FMSW, but we consider DEPFA's business position to be moderate, given that it is weaker than that of a typical bank active in a similar banking industry risk environment. We assess the bank's capital as very strong. We see DEPFA's risk position as weak, mainly owing to the bank's high concentration risks and uncertainty about our base-case capitalization forecast because of its reliance on decisions by FMSW. We view the bank's funding as average and its liquidity as adequate, reflecting its current sound funding and liquidity and our expectation of the ongoing implicit government support.

Although DEPFA is based in Ireland, we consider the German government to be a more likely source of support in the event of stress due to its indirect 100% ownership of DEPFA via FMSW. Our long-term counterparty credit rating on DEPFA is three notches higher than the SACP, reflecting our view that we regard DEPFA as a government-related entity (GRE) and consider that there is a high likelihood of timely and sufficient extraordinary support from the German government to DEPFA if needed.

Anchor: 'bbb', one level higher than for banks operating solely in Ireland

Under our bank criteria, we use our Banking Industry Country Risk Assessment economic risk and industry risk scores to determine a bank's anchor, the starting point in assigning an issuer credit rating. Our anchor for a commercial bank operating solely in Ireland is 'bbb-', based on economic and industry risk scores of '5'.

To assess the economic risk for DEPFA, we use the weighted-average of its exposures in countries of operation. Because DEPFA's lending business is outside Ireland and its borrowers are located predominantly in Western European countries with stronger economic conditions than Ireland, our weighted economic risk score on the bank is better than that on Irish lending institutions with higher proportions of domestic loans. As a result, the economic and banking industry risk assessments we combine currently result in a higher anchor for DEPFA than for other domestic financial institutions in Ireland.

It remains possible that the geographic breakdown of DEPFA's residual portfolio will fluctuate in the event of further accelerated wind-down transactions, but we do not expect this factor alone to have an immediate impact on the rating. Based on the weighted economic risk score of '3' and the industry score of '5', we determine the anchor for DEPFA at 'bbb'.

Table 1

DEPFA Bank PLC Key Figures

		--Year-ended Dec. 31--			
(Mil. €)	**2017***	**2016**	**2015**	**2014**	**2013**
Adjusted assets	23,865.0	27,594.0	36,712.0	48,516.0	49,117.0
Customer loans (gross)	4,590.0	6,028.0	6,897.0	9,692.0	15,290.0
Adjusted common equity	890.0	892.0	844.0	864.0	1,016.0
Operating revenues	33.0	(11.0)	(1.0)	(79.0)	(24.0)
Noninterest expenses	36.0	75.0	79.0	90.0	96.0
Core earnings	(3.0)	(90.0)	(72.0)	(122.0)	(62.0)

*Data as of June 30.

Business position: Wind-down under FMSW

We view DEPFA's business position as weaker than that of a bank active in a similar banking industry risk environment. This reflects our view that DEPFA's wind-down business model, without taking any new lending, results in limitations compared with a typical Irish bank that generates new credit in an improving domestic business environment. Our assessment takes into account Germany's commitment to facilitate an acceleration where possible, while maintaining all-in-all an orderly rundown of the bank's operations under the roof of and with ongoing implicit support from FMSW.

The accelerated wind-down appears to be progressing well, as demonstrated by asset-liability transactions between DEPFA and FMSW, totaling about €7.2 billion of assets transferred to the Germany-based entity in the second half of 2016 and in 2017.

DEPFA group's remaining balance sheet of €24 billion as of the first half of 2017 (versus €39 billion in the same period in 2016) remains dominated by international public sector assets that serve as collateral for the covered bonds issued by its subsidiaries, predominantly Ireland-based DEPFA ACS Bank DAC. Another previously significant subsidiary of DEPFA group, Luxembourg-based DEPFA Pfandbrief Bank International S.A. (DEPFA PBI), is expected to be fully wound-down by January 2021. As of Nov. 8, 2017, it had a remaining outstanding nominal amount of covered bonds ("Lettres de Gage Publiques"), representing about €130 million, and the respective nominal amount of outstanding public sector assets in the cover pool of just €138 million approximately.

DEPFA's management executes a consistent strategy, in line with the resolution plan established in coordination with the owner. The set-up and the wind-down strategy of DEPFA is similar to that of other wind-down entities in Germany, apart from various wind-down acceleration or consolidation limitations that exist due to the indirect and cross-border ownership. For example, the Irish regulator demands a banking license and respective minimum capital requirements for every entity domiciled in Ireland that issues covered bonds, including DEPFA.

A high concentration of revenues is intrinsic to the bank's set-up but reflects DEPFA's status as a wind-down entity. Moreover, given DEPFA's very comfortable capital buffer, in our view, the high revenue concentration does not represent a threat to the bank's stability.

Table 2

DEPFA Bank PLC Business Position

		--Year-ended Dec. 31--			
(%)	**2017***	**2016**	**2015**	**2014**	**2013**
Total revenues from business line (mil. €)	34.0	130.0	22.0	(76.0)	74.0
Other revenues/total revenues from business line	100.0	100.0	100.0	100.0	100.0
Return on equity	(0.4)	5.6	(5.9)	(17.0)	3.7

*Data as of June 30.

Capital and earnings: Very strong capital buffer to facilitate orderly wind-down

We view DEPFA's capital and earnings as very strong. As of the end of 2016, DEPFA's RAC ratio was 37.1% and the regulatory Tier 1 ratio was 65%. We believe this capitalization should enable DEPFA to absorb its ongoing structural losses arising from having insufficient net interest income to cover operating costs. We anticipate this situation will persist.

The significant difference between the regulatory ratio and our RAC ratio results from our calculation of the bank's higher risk-weighted assets (RWAs) for the credit valuation adjustment, which we recognized for the first time in our updated capital methodology published July 20, 2017. DEPFA's outstanding derivatives credit was significant, at €8.4 billion (35% of its balance sheet) on June 30, 2017, predominantly due to numerous back-to-back derivatives following the transfers of underlying assets to FMSW. We expect this position will reduce significantly over the next 24 months, with the help of various derivative transaction-optimization steps (such as novations).

We think the RAC ratio will likely increase further in the next two years, depending on the pace of the buyback of covered bonds, accompanied by the sale of the respective assets and future capital distribution plans between FMSW and DEPFA. In addition, our RAC forecast also remains sensitive to single-obligor credit events, but we expect FMSW will provide ongoing support to DEPFA in case of tail events.

We regard the bank's earnings capacity as a weakness. DEPFA is no longer authorized to conduct new banking business, and we expect it will be operationally loss making in 2017 and in subsequent years. However, we think the negative earnings are structurally limited and unlikely to meaningfully endanger the bank's capital position in the next two years. An already existing additional buffer should come from the accelerated wind-down proceedings, and we expect it will be sufficient to protect DEPFA from any deterioration in credit quality of its portfolio.

In the long-term, DEPFA's inability to absorb credit losses through earnings may lead to deterioration of current capitalization and make it sensitive to FMSW's capital strategy for DEPFA group.

Table 3

DEPFA Bank PLC Capital And Earnings

		--Year-ended Dec. 31--			
(%)	**2017***	**2016**	**2015**	**2014**	**2013**
Criteria reflected in RAC ratios	N/A	2017 RAC criteria	2010 RAC criteria	2010 RAC criteria	2010 RAC criteria
Tier 1 capital ratio	70.3	65.3	33.0	27.2	48.3
S&P RAC ratio before diversification	N/A	37.1	29.1	25.4	22.1
S&P RAC ratio after diversification	N/A	11.6	5.7	10.0	11.8
Adjusted common equity/total adjusted capital	75.2	75.2	75.2	75.2	75.2
Net interest income/operating revenues	63.6	90.9	1,200.0	27.8	141.7
Fee income/operating revenues	3.0	27.3	100.0	2.5	62.5
Market-sensitive income/operating revenues	21.2	27.3	100.0	82.3	241.7
Noninterest expenses/operating revenues	109.1	(681.8)	(7,900.0)	(113.9)	(400.0)
Preprovision operating income/average assets	(0.0)	(0.3)	(0.2)	(0.3)	(0.2)
Core earnings/average managed assets	(0.0)	(0.3)	(0.2)	(0.2)	(0.1)

*Data as of June 30. N/A--Not applicable.

Table 4

DEPFA Bank PLC Risk-Adjusted Capital Framework Data

(Mil. €)	**Exposure***	**Basel III RWA**	**Average Basel III RW (%)**	**S&P Global Ratings' RWA**	**Average S&P Global Ratings' RW (%)**
Credit risk					
Government and central banks	12,950	352	3	925	7
Institutions and CCPs	1,099	398	36	231	21
Corporate	661	322	49	633	96
Retail	0	0	0	0	0
Of which mortgage	0	0	0	0	0
Securitization§	711	142	20	157	22
Other assets†	9	9	100	17	180
Total credit risk	15,430	1,223	8	1,962	13
Credit valuation adjustment					
Total credit valuation adjustment	--	813	--	1,221	--
Market risk					
Equity in the banking book	0	0	0	0	0
Trading book market risk	--	8	--	11	--

Table 4

DEPFA Bank PLC Risk-Adjusted Capital Framework Data (cont.)					
Total market risk	--	8	--	11	--
Operational risk					
Total operational risk	--	0	--	0	--
(Mil. €)		**Basel III RWA**		**S&P Global RWA**	**% of S&P Global RWA**
Diversification adjustments					
RWA before diversification		2,044		3,195	100
Total Diversification/Concentration Adjustments		--		7,019	220
RWA after diversification		2,044		10,214	320
(Mil. €)		**Tier 1 capital**	**Tier 1 ratio (%)**	**Total adjusted capital**	**S&P Global RAC ratio (%)**
Capital ratio					
Capital ratio before adjustments		1,334	65.3	1,186	37.1
Capital ratio after adjustments‡		1,334	65.3	1,186	11.6

*Exposure at default. §Securitization exposure includes the securitization tranches deducted from capital in the regulatory framework. †Other assets includes deferred tax assets not deducted from adjusted common equity. ‡Adjustments to Tier 1 ratio are additional regulatory requirements (e.g. transitional floor or Pillar 2 add-ons). RWA--Risk-weighted assets. RW--Risk weight. RAC--Risk-adjusted capital. Sources: Company data as of Dec. 31, 2016, S&P Global Ratings.

Risk position: High concentration risk continues

We assess DEPFA's risk position as weak, mainly reflecting high concentration risks. While not included our base case, these may result in strong fluctuations of risk costs and impair the bank's capitalization. We consider that DEPFA has high sector and single-name concentrations on public-sector entities, and we expect the concentrations will increase further, given the specifics of the wind-down process, or an accelerated reduction of its balance sheet that may predominantly address more liquid assets and liabilities in the first run.

These risks are mitigated by the bank's significantly improved portfolio quality following the past transfers of complex and riskier noncore assets to FMSW. The current portfolio composition should display smaller losses under stress, compared with the loan-loss track record before the asset transfers.

In addition, we factor into our risk position assessment uncertainty regarding our base-case RAC projection, which may result from any capital upstream transfer decision by FMSW.

Table 5

DEPFA Bank PLC Risk Position					
		--Year-ended Dec. 31--			
(%)	**2017***	**2016**	**2015**	**2014**	**2013**
Growth in customer loans	(47.7)	(12.6)	(28.8)	(36.6)	(17.9)
Total diversification adjustment / S&P Global Ratings' RWA before diversification	N/A	219.7	413.0	152.4	86.6
Total managed assets/adjusted common equity (x)	26.8	30.9	43.5	56.2	48.4
New loan loss provisions/average customer loans	(0.0)	N.M.	(0.0)	(0.1)	(0.0)
Gross nonperforming assets/customer loans + other real estate owned	2.2	1.7	1.5	1.0	0.6

Table 5

DEPFA Bank PLC Risk Position (cont.)					
		--Year-ended Dec. 31--			
(%)	**2017***	**2016**	**2015**	**2014**	**2013**
Loan loss reserves/gross nonperforming assets	4.9	5.7	5.6	10.4	114.9

*Data as of June 30. RWA--Risk-weighted assets. N.M.--Not meaningful.

Funding and liquidity: Match-funded but with reliance on implicit government support

We view DEPFA's funding as average and its liquidity as adequate, as DEPFA remains broadly secured and match-funded until contractual run-off. But it can also rely on the liquidity facilities provided by FMSW, which are contractually agreed until 2025, such as a €4.2 billion secured repurchase facility or additional unsecured lines for any structural liquidity gaps (for example in U.S. dollars).

In our view, DEPFA remains structurally reliant on ongoing implicit government support through FMSW. However, we anticipate that the additional funding needs for DEPFA's remaining portfolio will be limited over its lifetime and will decline further during the wind-down.

S&P Global Ratings' calculated liquidity ratio (broad liquid assets/short-term wholesale funding) was at 2.4x as of end-December 2016 and our stable funding ratio was at 202%. The ratios underline the healthy balance sheet structure that also reflects DEPFA's interconnections with FMSW. We consider that the bank's high funding and liquidity ratios are not a strength compared with those of commercial bank peers because they reflect support of the parent in light of tail risks in the bank's wind-down business model. We reflect this support already in our uplift from the SACP to factor in DEPFA's GRE status.

Table 6

DEPFA Bank PLC Funding And Liquidity					
		--Year-ended Dec. 31--			
(%)	**2017***	**2016**	**2015**	**2014**	**2013**
Core deposits/funding base	26.4	22.9	3.9	4.4	10.8
Customer loans (net)/customer deposits	122.1	156.6	664.5	632.8	370.3
Long term funding ratio	80.5	73.7	68.2	71.9	85.0
Stable funding ratio	242.8	201.7	228.6	224.5	191.6
Short-term wholesale funding/funding base	21.3	28.5	33.4	29.3	15.6
Broad liquid assets/short-term wholesale funding (x)	3.4	2.4	2.0	2.2	3.7
Net broad liquid assets/short-term customer deposits	211.9	186.6	1,398.0	1,212.7	2,134.6
Short-term wholesale funding/total wholesale funding	27.7	35.6	34.0	30.1	17.2
Narrow liquid assets/3-month wholesale funding (x)	3.8	3.2	4.5	2.9	4.2

*Data as of June 30.

External support: Three-notch uplift to the SACP due to the bank's GRE status

We apply a three-notch uplift to the SACP due to the bank's GRE status.

Although DEPFA is based in Ireland, we consider the German government to be a more likely source of support in the event of stress, mainly due to its indirect 100% ownership via FMSW. Our long-term issuer credit rating on the bank is three notches higher than the SACP, reflecting our view that DEPFA is a GRE and our view that there is a high likelihood of timely and sufficient extraordinary support from the German government to DEPFA group, if needed.

This is based on our assessment of DEPFA's:

- Important role for the German government in ensuring a controlled run-off of assets to safeguard confidence in the German banking sector and to minimize costs for the government, as the owner of the bank, and ultimately for taxpayers. Additionally, around 40% of DEPFA's overall exposure relates to Germany.
- Very strong link with the German government. Until the wind-down is complete, we believe there is a low probability of the bank changing ownership or of the German government withdrawing its support from DEPFA. This reflects the government's commitment; indirect, but full control; and track record of support.

We note some market speculation that FMSW may reconsider selling DEPFA at some point. However, our base case remains that FMSW will see through the wind-down process, supporting DEPFA's continued servicing of its funding obligations.

We believe that the prospect of extraordinary government support for German banks is uncertain, following the full implementation of the EU Bank Recovery and Resolution Directive, including bail-in powers, in January 2015. However, we generally believe that resolution frameworks are less likely to impede state owners' willingness to provide extraordinary support to banks we consider as GREs, including DEPFA group. In addition, the government has sufficient financial resources to further support the DEPFA group via FMSW if needed.

Additional rating factors: None

No additional factors affect this rating.

DEPFA ACS Bank DAC

We base our rating on DEPFA ACS Bank DAC on its core group status to DEPFA and equalize our ratings on DEPFA ACS Bank DAC with those on DEPFA.

Related Criteria

- Criteria - Financial Institutions - General: Risk-Adjusted Capital Framework Methodology, July 20, 2017
- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings, April 7, 2017
- Criteria - Financial Institutions - Banks: Bank Rating Methodology And Assumptions: Additional Loss-Absorbing Capacity, April 27, 2015
- General Criteria: Rating Government-Related Entities: Methodology And Assumptions, March 25, 2015
- Criteria - Financial Institutions - Banks: Bank Hybrid Capital And Nondeferrable Subordinated Debt Methodology And Assumptions, Jan. 29, 2015
- General Criteria: Group Rating Methodology, Nov. 19, 2013
- Criteria - Financial Institutions - Banks: Quantitative Metrics For Rating Banks Globally: Methodology And Assumptions, July 17, 2013
- Criteria - Financial Institutions - Banks: Banks: Rating Methodology And Assumptions, Nov. 9, 2011
- Criteria - Financial Institutions - Banks: Banking Industry Country Risk Assessment Methodology And Assumptions, Nov. 9, 2011
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Related Research

- Banking Industry Country Risk Assessment Update: January 2018 , Jan. 4, 2018
- DEPFA Bank PLC Ratings Affirmed At 'A-/A-2'; Improving Irish Banking Risk Neutral To The Rating; Outlook Stable, Dec. 12, 2017
- FMS Wertmanagement Anstalt des oeffentlichen Rechts, Oct. 30, 2017
- DEPFA Bank PLC Affirmed At 'A-/A-2' On Continued Wind-Down Progress; Outlook Stable, Oct. 20, 2017
- Banking Industry Country Risk Assessment: Germany, Oct. 11, 2017

Anchor Matrix

Industry Risk	Economic Risk									
	1	2	**3**	4	5	6	7	8	9	10
1	a	a	a-	bbb+	bbb+	bbb	-	-	-	-
2	a	a-	a-	bbb+	bbb	bbb	bbb-	-	-	-
3	a-	a-	bbb+	bbb+	bbb	bbb-	bbb-	bb+	-	-
4	bbb+	bbb+	bbb+	bbb	bbb	bbb-	bb+	bb	bb	-
5	bbb+	bbb	**bbb**	bbb	bbb-	bbb-	bb+	bb	bb-	b+
6	bbb	bbb	bbb-	bbb-	bbb-	bb+	bb	bb	bb-	b+
7	-	bbb-	bbb-	bb+	bb+	bb	bb	bb-	b+	b+
8	-	-	bb+	bb	bb	bb	bb-	bb-	b+	b
9	-	-	-	bb	bb-	bb-	b+	b+	b+	b
10	-	-	-	-	b+	b+	b+	b	b	b-

Ratings Detail (As Of January 19, 2018)

DEPFA Bank PLC	
Counterparty Credit Rating	A-/Stable/A-2
Senior Unsecured	A-
Counterparty Credit Ratings History	
01-Dec-2014	A-/Stable/A-2
19-May-2014	BBB/Positive/A-2
14-Feb-2014	BBB/Watch Neg/A-2
Sovereign Rating	
Ireland (Republic of)	A+/Stable/A-1
Related Entities	
Depfa ACS Bank DAC	
Issuer Credit Rating	A-/Stable/A-2
FMS Wertmanagement Anstalt des oeffentlichen Rechts	
Issuer Credit Rating	AAA/Stable/A-1+
Commercial Paper	A-1+

*Unless otherwise noted, all ratings in this report are global scale ratings. S&P Global Ratings' credit ratings on the global scale are comparable across countries. S&P Global Ratings' credit ratings on a national scale are relative to obligors or obligations within that specific country. Issue and debt ratings could include debt guaranteed by another entity, and rated debt that an entity guarantees.

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