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Research Update:

DEPFA Bank PLC Affirmed At 'A-/A-2' On Continued Wind-Down Progress; Outlook Stable

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Overview

- On Oct. 12, 2017, Dublin-based DEPFA Group announced a €2 billion asset-liability transaction with its parent, German government-owned FMS Wertmanagement AöR (FMSW), to be finalized in early November 2017 to accelerate the wind-down of DEPFA's balance sheet.
- This substantiates our view that the German government will remain supportive to DEPFA via FMSW, but we still see residual risks for DEPFA regarding the wind-down process.
- We are affirming our 'A-/A-2' ratings on DEPFA Bank PLC and DEPFA ACS Bank.
- The stable outlook takes into account our expectation of the continued orderly wind-down of DEPFA group, in cooperation with its parent FMSW and in accordance with both entities' mandate.

Rating Action

On Oct. 20, 2017, S&P Global Ratings affirmed its 'A-/A-2' long- and short-term issuer credit ratings on Dublin-based DEPFA Bank PLC and DEPFA ACS Bank. The outlooks are stable.

Rationale

The affirmation follows the announcement on Oct. 12, 2017, that DEPFA Group and its parent, German government-owned company FMS Wertmanagement AöR (FMSW), would undertake a €2 billion asset-liability transaction to accelerate the orderly wind-down of DEPFA's balance sheet. This transaction is due to be finalized in early November 2017 and follows a similar asset sale of €5.2 billion to FMSW from DEPFA's subsidiaries--DEPFA ACS Bank and DEPFA Pfandbrief Bank International S.A.--in November 2016.

In our view, the forthcoming transaction is consistent with previous asset-liability transactions between DEPFA and FMSW, and aims to achieve a faster, orderly wind-down of DEPFA's remaining exposures. We continue to regard DEPFA as a government-related entity with a high likelihood of receiving support from Germany.

At the current pace, we expect that the wind-down process will likely take at least another 10 years. Although we currently anticipate no near-term upside to the rating, this could change if we believed most of the residual risks have dissipated, for example owing to a clearer view of the long-term capital policy for DEPFA. By contrast, downside risks appear limited at this time. After peaking at €249 billion in December 2008, DEPFA's total assets had declined to €23.9 billion by June 30, 2017. Although single-name concentration has increased, these exposures are mainly to EU public-sector entities in countries with stronger economic conditions than Ireland, and DEPFA's credit costs have been negligible in recent years. As of June 30, 2017, DEPFA had no nonperforming assets, but reported a contingent exposure of €101.6 million in relation to a litigated derivative.

As of Dec. 31, 2016, the risk-adjusted capital (RAC) ratio was 37.1% and the regulatory Tier 1 ratio was 65%. We believe this level of capitalization should allow 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 higher risk-weighted assets (RWAs) figure 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) in June 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).

DEPFA remains broadly secured and match-funded over the full extent of its 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).

The wind-down appears to be progressing well. However, DEPFA's inability to absorb credit losses through earnings means that our 'bbb-' assessment of its stand-alone credit profile includes an element of uncertainty. This is accentuated by our view that DEPFA may not be able to sustain its currently very strong capitalization and would therefore depend to a large extent on FMSW's capital strategy for DEPFA Group.

It remains possible that the geographic breakdown of DEPFA's residual portfolio will fluctuate in the event of further accelerated wind-down transactions. Although this could lead us to revise the anchor that starts our rating on DEPFA, we would raise the ratings only if we anticipated a sustained reduction in the associated risks. Similarly, a change in our assessment of banking industry risk in Ireland is unlikely to trigger a rating action on DEPFA.

Outlook

Our stable outlook reflects our view that DEPFA 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 the RAC ratio remaining comfortably above 15%. However, we note that Germany has no obligation to support DEPFA directly, in contrast to its obligation to support FMSW. We regard the possibility of privatization of DEPFA to be unlikely, given the increasingly advanced state of the wind-down and the increasing operational integration between DEPFA and FMSW.

We could raise the ratings in the next 12-24 months if DEPFA's remaining exposures become increasingly weighted toward countries with low economic risk, and we believe that credit losses and nonperforming loans will remain low. A clearer view on the 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.

While less likely, 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 the likelihood of government support diminished.

Ratings Score Snapshot

Issuer Credit Rating	A-/Stable/A-2
SACP	bbb-
Anchor	bbb-
Business Position	Adequate (0)
Capital and Earnings	Very Strong (+2)
Risk Position	Weak (-2)
Funding and Liquidity	Average and Adequate (0)
Support	+3
ALAC Support	0
GRE Support	+3
Group Support	0
Sovereign Support	0
Additional Factors	0

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: Germany, Oct. 11, 2017
- Banking Industry Country Risk Assessment Update: October 2017, Oct. 4, 2017
- DEPFA Bank PLC, Jan. 27, 2017
- FMS Wertmanagement Anstalt des oeffentlichen Rechts, Sept. 19, 2016

Ratings List

Ratings Affirmed

DEPFA Bank PLC	
Depfa ACS Bank	
Counterparty Credit Rating	A-/Stable/A-2
DEPFA Bank PLC	
Senior Unsecured	A-

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