Rating Action: Moody’s downgrades senior unsecured debt instruments of 14 German banks following change in bank insolvency law

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Action to remove government support from banks’ ratings follows introduction of new senior unsecured debt class in Germany which ranks above outstanding (statutorily subordinated) senior unsecured debt instruments

Frankfurt am Main, August 03, 2018 -- Moody's Investors Service today took rating actions on 23 German banks, their subsidiaries and branches. The rating actions were prompted by a legal change to the German banks’ insolvency rank order which took effect on 21 July 2018. The legal changes re-introduced an option for banks to issue plain vanilla preferred senior unsecured liabilities (“senior unsecured debt class”), as well as to issue new contractually non-preferred debt (“junior senior unsecured debt class”) which will rank alongside outstanding legacy plain vanilla senior unsecured instruments. Moody’s believes that following the legal change, the likelihood of government support being available for most of the senior unsecured instruments outstanding on 20 July 2018 has declined, as under the revised legislation those instruments remain subordinated to future (preferred) senior unsecured bank debt.

Following the change in law, the legal hierarchy of bank claims in Germany is now consistent with most other European Union (EU) countries, where statutes do not provide full preference to deposits over senior unsecured debt; the amended application of Moody's Advanced Loss Given Failure (LGF) analysis reflects the revised hierarchy of claims. The decline in government support and the revision of the rating agency’s LGF approach has resulted in rating actions on German banks' ratings as detailed below:

- Downgrade of the long-term senior unsecured instruments of 14 banks by one notch owing to the reduction of government support assumptions for these securities to low from moderate previously. This resulted from the removal of one notch of rating uplift, previously factored into these ratings. The rating agency affirmed these ratings for two banks for which its government support assumption remained low. At the same time, Moody’s reclassified such rated instruments as junior senior unsecured debt from senior unsecured debt previously.

- Affirmation of the long-term senior unsecured instruments with structural features issued by 10 banks, reflecting the results from Moody's Advanced LGF analysis and unchanged moderate likelihood assumption for government support. At the same time, Moody's reclassified these rated instruments as senior unsecured debt from senior senior unsecured debt previously.

- Upgrade of the long-term issuer ratings by one to three notches for 11 banks, and affirmation for one bank, reflecting that Moody’s assigns issuer ratings at the level of the most senior plain vanilla unsecured debt class available in any jurisdiction.

- Affirmation of the long-term and short-term deposit ratings for 20 banks, reflecting unchanged results and rating uplift under Moody's Advanced LGF analysis as well as unchanged government support assumptions.

- Affirmation of the short-term program and issuer ratings, where applicable, for 17 banks.

- For HSH Nordbank AG, all unguaranteed long-term and short-term deposit and senior unsecured debt ratings as well as junior senior debt and issuer ratings remain on review for upgrade, while the bank's affected rated securities have been reclassified in accordance with the approach applied for all other entities in this rating action (from senior senior unsecured debt to senior unsecured debt and from senior unsecured debt to junior senior unsecured debt).

- Affirmation of the long-term backed senior unsecured instruments for seven banks; these instruments continue to benefit from recourse to German public sector entities. At the same time, Moody's reclassified these rated instruments as backed junior senior unsecured debt from backed senior unsecured debt previously.

- Withdrawal of all senior senior unsecured program ratings where these were in place and upgrade of senior unsecured program ratings for 15 banks. At the same time, new assignment of junior senior program ratings to
11 issuers’ programs where the issuer has the option to issue junior senior debt. All other rating assessments and ratings of banks that are part of today’s rating action are unaffected.

Please click on this link http://www.moodys.com/viewresearchdoc.aspx?docid=PBC_200292 for the List of Affected Credit Ratings. This list is an integral part of this Press Release and identifies each affected issuer.

RATINGS RATIONALE

(1) CHANGES IN LEGISLATION LEAD MOODY’S TO APPLY STANDARD EU LIABILITY RANKING UNDER ITS ADVANCED LGF ANALYSIS

LEGAL BACKGROUND IN MORE DETAIL

On 21 July 2018, Germany's transposition into national law of an amendment to the EU's Bank Recovery and Resolution Directive (BRRD) took effect and has enabled banks to issue contractually subordinated senior unsecured bonds ("non-preferred", or junior senior bonds) that would fully count against the banks' regulatory minimum requirements for own funds and eligible liabilities (MREL) as well as ("preferred") senior unsecured bonds that rank alongside other senior unsecured liabilities, including the most junior class of deposits. Based on the changes in law, the legal hierarchy of bank claims in Germany is now consistent with most EU countries, where statutes do not provide full preference to deposits over senior unsecured debt.

Legally, the new non-preferred instruments will rank pari passu with the majority of outstanding senior unsecured instruments issued up until 20 July 2018, to the extent the latter instruments were subject to Germany's statutory subordination under the previous insolvency ranking.

CONSEQUENCES FOR MOODY'S ANALYTICAL APPROACH

This pari passu ranking of new junior senior unsecured debt with legacy (statutorily subordinated) senior unsecured instruments makes it less likely that German authorities would selectively support the legacy instruments (which today's rating action reclassified into junior senior unsecured debt), following clarification that the German authorities expect these liabilities to bear losses in a resolution. Furthermore, any selective support could give rise to claims by adversely selected creditors that the No Creditor Worse Off principle established in the BRRD had been breached.

In response to the change in the German insolvency and resolution hierarchy, Moody's has today reclassified certain instruments issued by German banks. Complex structured debt instruments, which were previously treated as senior senior unsecured debt, have been reclassified as senior unsecured debt. In addition, legacy (statutorily subordinated) plain vanilla debt instruments, which Moody's previously classified as senior unsecured debt will now be treated as junior senior unsecured debt.

Following the re-introduction of a class of plain vanilla senior unsecured debt that ranks alongside junior deposits, the rating agency now applies an alternative liability ranking when undertaking its Advanced LGF analysis for German banks. As with other EU countries where the most junior tranche of deposits does not enjoy preference over senior unsecured debt, Moody's considers the results of both the formal legal position (pari passu, or de jure scenario), with a 75% probability, and an alternative liability ranking reflecting resolution authority discretion (full depositor preference, or de facto scenario), to which the rating agency assigns a 25% probability. Prior to the change in the law, Moody's applied a single waterfall for German bank liabilities which reflected the full preference for German deposits over the senior unsecured instruments now reclassified as junior senior unsecured debt.

The combination of applying the amended liability ranking under Moody's Advanced LGF analysis and the revised assessment of the applicability of government support for certain debt instruments has resulted in various rating actions on affected instruments and rating classes.

(2) RATING CLASS SPECIFIC CONSIDERATIONS

DOWNGRADE AND AFFIRMATION OF INSTRUMENTS RECLASSIFIED AS JUNIOR SENIOR UNSECURED DEBT

Moody's believes that there would be a low likelihood of government support for junior senior unsecured bank bonds, which are designed to bear losses in a bank resolution. For systemically important banks, Moody's previously assigned one notch of rating uplift for (statutorily subordinated) instruments that have now been
reclassified as junior senior unsecured debt.

As a result of its re-assessment of government support, the rating agency has downgraded junior senior unsecured instrument ratings for 14 banks by one notch. In addition, due to unchanged low government support assumptions, Moody’s has affirmed junior senior unsecured instrument ratings for two banks. Furthermore, the securities reclassified as junior senior unsecured debt no longer carry rating outlooks, in line with Moody's general practice of not assigning outlooks to this debt class.

AFFIRMATION OF INSTRUMENTS RECLASSIFIED AS SENIOR UNSECURED DEBT

The results under the Advanced LGF analysis in combination with unchanged assumptions for government support led Moody's to affirm the ratings of instruments reclassified as senior unsecured debt issued by 10 banks.

The government support assumptions for all affected banks' senior unsecured ratings remained unchanged. For less systemically significant entities Moody's continues to believe that the probability of government support would be low, although for more systemic banks and members of systemic banking sectors with cross-sector support schemes the probability remains at moderate, resulting in an unchanged one notch of rating uplift from government support.

Moody's expects instruments that will henceforth be classified as senior unsecured debt and rated at the same level as issuer ratings, to gain relevance as a funding tool for German banks, now that the legislative changes enable them to issue (preferred) senior unsecured bonds in both structured and plain vanilla format and in benchmark size.

UPGRADE AND AFFIRMATION OF ISSUER RATINGS

The issuer ratings of German banks reflect their ability to honour the most senior plain vanilla (or ordinary) senior unsecured debt instruments and debt like obligations. Following the reintroduction of a plain vanilla (preferred) senior unsecured debt class, for most banks the issuer rating now reflects the increased volume of subordination that this class of debt benefits from Moody's Advanced LGF analysis therefore results in more rating uplift for issuer ratings than was previously the case. As a result, German banks' issuer ratings were today upgraded by between one and three notches, depending on individual banks' Advanced LGF results. Moody’s affirmed one issuer rating at its current level, because the issuer rating already benefitted from the maximum three-notch uplift under Moody's Advanced LGF analysis.

AFFIRMATION OF LONG- AND SHORT-TERM DEPOSIT RATINGS

The deposit ratings of most banks subject to this rating action have been affirmed, reflecting that the changes to the Advanced LGF analysis have had no rating impact.

At the same time, the previous government support assumptions for all affected banks' deposit ratings remained unchanged.

RATIONALE FOR SHORT-TERM PROGRAM AND ISSUER RATINGS

Following today's rating action, Moody's short-term issuer and program ratings map to the long-term senior unsecured debt rating category. In January 2016, because of the statutory subordination of long-term senior unsecured bonds, but not money market obligations, the rating agency anchored short-term debt ratings to deposits, reflecting the preferred legal position of short-term instruments. With the change in legislation and the resulting pari passu ranking of senior unsecured debt with deposits, short-term instruments are appropriately positioned by re-anchoring these instruments to long-term senior unsecured debt.

Today's affirmations of most short-term issuer and program ratings follows the affirmation or upgrade of the banks' long-term senior unsecured debt or program and/or issuer ratings.

AFFIRMATION OF DEBT OBLIGATIONS GUARANTEED BY PUBLIC SECTOR ENTITIES

Whereas most of the German banks' state-guaranteed senior unsecured debt matured before year-end 2015, several German banks continue to have instruments outstanding that are statutorily backed by German public sector entities. Such debt instruments are subject to bail-in and are treated pari passu with all other unsecured debt of equal seniority. However, the guarantee status ensures unchanged recourse in resolution to the public sector guarantors.
Because the rating levels of these instruments are determined based on the creditworthiness of the guarantors, Moody's affirmed all backed obligations affected by today's rating action. At the same time, Moody's reclassified plain vanilla instruments issued by seven banks as backed junior senior unsecured debt, previously treated as backed senior unsecured debt, to reflect the less favourable seniority status of these legacy bonds. Furthermore, the securities reclassified as backed junior senior unsecured debt no longer carry rating outlooks, in line with Moody's general practice of not assigning outlooks to this debt class.

UPDATE OF PROGRAM RATINGS

Since 21 July 2018, German banks can make use of the option to issue either contractually non-preferred (junior) senior unsecured debt or senior unsecured debt without such contractual clarifications that would benefit from a higher priority position in the bank insolvency ranking.

Moody's reflects these distinct issuance options through today's assignment of junior senior unsecured program ratings for those programs of issuers that explicitly foresee both options. The newly assigned ratings of junior senior unsecured programs reflect the rating levels of outstanding bonds of the same respective seniority level. For all German banks with senior unsecured program ratings in place, these program ratings now reflect the ranking of (preferred) senior unsecured debt new issuances. Accordingly, the rating agency upgraded the senior unsecured program ratings of 15 German banks.

At the same time, Moody's withdrew the previously assigned senior senior unsecured program ratings, as far as these ratings had been in place. This reflects that the statutory distinction of seniority levels based on structural coupon and principal repayment components of bonds issued under these programs has legally ceased to exist for bonds newly issued since 21 July 2018.

WHAT COULD CHANGE THE RATINGS UP/DOWN?

Pressure in either direction on the German banks' ratings may arise due to: (1) Fundamental developments that result in upgrades or downgrades to a bank's BCA; (2) Any change in Moody's assessment of the strength and/or availability of parental support or cross-sector support -- the latter is generally applicable to banks that are members of an institutional protection scheme; (3) alterations in a bank's liability structure that changes the expected loss severity for particular liability classes; and/or (4) any change in Moody's assumptions regarding the likelihood of government support being available.

Changes in the severity of loss for certain liability classes -- and therefore pressure on the results of Moody's Advanced LGF analysis -- may develop if the individual banks' subordinated instruments increase (or decrease), and/or if senior unsecured debt increases (or decreases) relative to their tangible banking assets. This could result in additional (or fewer) notches of rating uplift resulting from Moody's LGF analysis.

In relation to junior senior unsecured debt ratings, the rating agency expects downward pressure to develop over time. This is because the current stack of outstanding junior senior debt obligations which qualifies for regulatory MREL recognition by far exceeds the anticipated minimum MREL requirements in most cases. Consequently, Moody's expects that German banks' liability structures will alter over time. In particular, the expected shifts between the volume of preferred and non-preferred senior unsecured debt obligations has the potential to reduce the rating uplift available under Moody's Advanced LGF analysis for junior senior debt instruments.

For backed instruments, ratings would change if the creditworthiness of the guarantors improves or deteriorates.

PRINCIPAL METHODOLOGY

The principal methodology used in these ratings was Banks published in August 2018. Please see the Rating Methodologies page on www.moodys.com for a copy of this methodology.

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