FitchRatings

RATING ACTION COMMENTARY

Fitch Affirms Volksbanken-Verbund at 'BBB'; Outlook Negative

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Fitch Ratings - Frankfurt am Main - 25 Sep 2020: Fitch Ratings has affirmed Volksbanken-Verbund's (VB-Verbund) Long-Term Issuer Default Rating (IDR) at 'BBB' with a Negative Outlook, Short-Term IDR at 'F2' and Support Rating (SR) at '5'. Fitch has also affirmed the group's Viability Rating (VR) at 'bbb'. At the same time, Fitch has removed VB-Verbund's Long-Term IDR and VR from Rating Watch Negative (RWN). A full list of rating actions is below.

The removal of the VR and Long-Term IDR from RWN reflects our view that the economic fallout from the coronavirus crisis represents a medium-term risk to VB-Verbund's VR rather than a near-term risk, which was our base case when we placed the VR on RWN in April 2020. VB-Verbund's relative resilience in 1H20 and performance outlook for 2020 suggest that the bank should be able to retain a financial profile commensurate with its VR through the crisis, even though its earnings and capitalisation are likely to face some near-term pressure.

The Negative Outlook on VB-Verbund's Long-Term IDR reflects downside risks to our expectations of its relative resilience as a materially slower than expected economic recovery could weigh on the group's earnings, capital and asset quality materially more than our base case suggests.

KEY RATING DRIVERS

Fitch assigns "group" ratings to VB-Verbund and the individual primary banks in line with our criteria for rating banking structures backed by mutual support mechanisms (Annex 4 of the Bank Rating Criteria). VB-Verbund is not a legal entity but a medium-sized network of cooperative banks, whose cohesion is primarily ensured by their mutual support scheme.

The affirmation of VB-Verbund's VR and IDRs and the member banks' IDRs reflects the group's strengthened cohesion, underlined by the completed intragroup consolidation in 2019, reduced risk appetite, improving asset quality, generally stable funding and liquidity profile. Capitalisation is just adequate and earnings retention capacity is expected to be modest in the medium term, due to weak profits and the group's obligation to repay profit participation right granted to the state by end-2023.

VB-Verbund focuses on Austrian retail, self-employed and SME clients, resulting in a predominantly domestic loan book. The group entered the economic downturn with a non-performing loan (NPL; IFRS 9 Stage 3 loans) ratio of 2.1% at end-1H20, which is broadly in line with larger domestic Austria-focused peers. We expect inflows of new impaired loans to increase towards end-2020 and more significantly in 2021 when the effect of the crisis becomes more apparent. However, we expect state support measures (e.g. furlough schemes) to partially shield the banks from asset quality deterioration. We have revised the Outlook on the asset quality score to stable from negative, as we expect the bank's NPL ratio to peak at about 4% in 2021 in our base case, in line with its current asset quality score of 'bbb+'.

VB-Verbund's profitability has stabilised and considerably improved after several years of legacy-related losses and restructuring costs, but it remains modest by international standards. The group broke even in 2017 and the positive trend continued in 2018 and 2019, driven by business growth, much lower risk charges and positive one-offs (in particular gains from the sale of non-core foreign subsidiaries). The group focuses on cost discipline, but further efficiency improvements will have to be achieved against competitive pressure, continued low interest rates and a worsening economic environment.

We expect earning pressure to further intensify over the next two years as a result of high loan impairment charges (LICs). In 1H20, VB-Verbund booked EUR49million LICs, largely related to coronavirus-driven Stage 2 expected credit losses, bringing the annualised LICs/gross loans ratio to around 46bp. Our assessment of profitability assumes that in our base case, VB-Verbund will be able to maintain its four-year average operating profit/risk-weighted assets (RWAs) above 0.5% through the crisis, in line with its earnings and profitability score of 'bbb-'. However, a deeper than expected recession or a slower economic recovery could lead to higher than anticipated credit losses and negative results in the next two years.

Capitalisation is only adequate. The common equity Tier 1 (CET1) ratio stood at 13.2% at end-1H20. VB-Verbund implemented capital-enhancing measures to keep a sufficient buffer over its regulatory capital requirements and mitigate regulatory risk-weight inflation. The group's obligation to repay to the government by end-2023 the EUR224 million still due from the bailout measures received during the crisis a decade ago will constrain its medium-term earnings retention. The negative outlook on the capital score reflects the pressure on the group's profitability that could ultimately result in greater-than-expected capital erosion in our downside scenario.

VB-Verbund's funding mix is underpinned by a stable and granular retail and small SME deposit base. The group has been gradually restoring its access to capital markets through covered bonds and Tier 2 capital issuances, as well as Additional Tier 1 capital notes (EUR220 million in 1H19). VB-Verbund's total capital ratio increased to 17.9% at end-1H20 from 14.7% at end-1H17.

VB-Verbund's minimum requirement for own funds and eligible liabilities (MREL) is 26.2%. We expect its relatively large junior debt buffer to cover a potential subordination requirement. VB-Verbund plans to issue EUR1.2 billion senior preferred and senior non-preferred debt to meet its MREL requirement by January 2025, which seems realistic.

VB-Verbund's and the member banks' Short-Term IDRs of 'F2' correspond to the higher option mapping to a 'BBB' Long-Term IDR and reflects Fitch's assessment of VB-Verbund's funding and liquidity.

SR AND SUPPORT RATING FLOOR

VB-Verbund's SR and Support Rating Floor (SRF) reflect Fitch's view that senior creditors can no longer rely on full extraordinary state support. This is driven by the EU's Bank Recovery and Resolution Directive and the Single Resolution Mechanism, which provide a resolution framework that is likely to require senior creditors participating in losses, if necessary, instead, or ahead of a bank receiving sovereign support.

RATING SENSITIVITIES

The member banks' IDRs are equalised with, and sensitive to, the same drivers as VB-Verbund's IDRs. The Short-Term IDRs are sensitive to deterioration in the funding and liquidity profile.

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

The Outlook could be revised to Stable if the bank's operating environment stabilises and the group successfully manages the challenges arising from the economic downturn, limiting downside risks to its asset quality and profitability, while maintaining current capital levels.

Rating upside is currently limited. Fitch believes that an upgrade of the group's IDRs and VR, and of the member banks' IDRs would be contingent on VB-Verbund achieving a significant and sustainable improvement in cost efficiency and operating profitability. The VR is unlikely to rise above the 'bbb' category, because of VB-Verbund's modest operating profit generation, also driven by a fairly small market share in the generally low-margin, high-cost Austrian retail banking market.

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

The Negative Outlook on VB-Verbund reflects medium-term risks to its ratings from the coronavirus outbreak.

The most immediate downside sensitivity for VB-Verbund's ratings relates to the economic and financial market fallout arising from the coronavirus crisis. The bank's ratings could be downgraded if there is a more substantial and prolonged deterioration in profitability or capitalisation than we currently envisage, without credible prospects to restore over the medium to long term. These circumstances could stem, for example, from a further downward revision of Fitch's expectations for the Austrian economy, triggering prolonged lower business activity or higher-than-expected asset quality deterioration.

SR AND SRF

An upgrade of VB-Verbund's SR and upward revision of the SRF would be contingent on a positive change in the sovereign's propensity to support the bank. This is highly unlikely in light of the prevailing regulatory environment, in our view.

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

The highest level of ESG credit relevance, if present, is a score of 3. This means ESG issues are credit-neutral or have only a minimal credit impact on the entity(ies), either due to their nature or to the way in which they are being managed by the entity(ies). For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com/esg.

RATING ACTIONS

ENTITY/DEBT	RATING			PRIOR
Volksbank Wien AG	LT IDR	BBB Rating Outlook Negative	Affirmed	BBB Rating Watch Negative
	ST IDR	F2	Affirmed	F2
Volksbank Salzburg eG	LT IDR	BBB Rating Outlook Negative	Affirmed	BBB Rating Watch Negative
	ST IDR	F2	Affirmed	F2
Volksbank Niederoesterreich AG	LT IDR	BBB Rating Outlook Negative	Affirmed	BBB Rating Watch Negative

VIEW ADDITIONAL RATING DETAILS

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APPLICABLE CRITERIA

Bank Rating Criteria (pub. 28 Feb 2020) (including rating assumption sensitivity)

ADDITIONAL DISCLOSURES

Dodd-Frank Rating Information Disclosure Form

Solicitation Status

Endorsement Policy

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Volksbank Kaernten eG	EU Issued
Volksbank Niederoesterreich AG	EU Issued
Volksbank Oberoesterreich AG	EU Issued

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Volksbank Wien AG	EU Issued
Volksbanken-Verbund	EU Issued

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