FitchRatings

RATING ACTION COMMENTARY

# Fitch Affirms BAWAG's Long-Term IDR at 'A-'; Outlook Stable; Off Negative Watch

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Fitch Ratings - Frankfurt am Main - 28 Sep 2020: Fitch Ratings has affirmed BAWAG P.S.K.'s Long-Term Issuer Default Rating (IDR) at 'A-' with a Stable Outlook and Viability Rating (VR) at 'a-', while removing the ratings from Rating Watch Negative (RWN).

The removal of the VR (and Long-Term IDR) from RWN and revision of the Outlook to Stable reflect our view that BAWAG's ratings have sufficient headroom at this rating level to absorb significant shocks under our updated assessment of various downside scenarios to our baseline economic forecast.

BAWAG'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 current VR through the crisis. This primarily reflects our assessment of the bank's profitability (a-/stable) and capitalisation (a-/stable). BAWAG's asset quality will come under pressure in 2020 and 2021, reflecting the economic impact of the coronavirus pandemic. However, we expect BAWAG's robust pre-impairment profits to uphold the bank's current ratings even in a downside scenario.

## KEY RATING DRIVERS

IDRs, VR and SENIOR PREFERRED (SP) DEBT

BAWAG's ratings reflect its healthy financial profile and the well-controlled execution of its growth strategy as well as effective risk management and fairly conservative risk appetite. The ratings also reflect BAWAG's franchise, which lacks the breadth of its larger Austrian and international peers.

BAWAG's asset quality benefits from its conservative risk appetite in its domestic Austrian market and in Germany, a core market where it has been growing through acquisitions. Its impaired loans ratio of 2.7% at end-1H20 is likely to rise over the next two years, driving the four-year average impaired loans ratio beyond the 3% threshold that implies an asset quality score in the 'a' range at end-2021. Legal risks arising from the City of Linz's lawsuit against BAWAG remain moderate, as even the worst possible outcome for BAWAG would be manageable in light of the bank's earnings.

BAWAG's international business (excluding Germany) accounts for over a fifth of the bank's lending and includes real estate and corporate loans, and manageable exposure to higher-risk leveraged finance and non-performing loan financing. The bank's appetite for highly rated collateralised loan obligations (CLOs) as a lending surrogate is also notable. These activities reflect the bank's opportunistic behaviour in search for yield, but also help diversify its credit exposure by country and asset class. Risk management appears effective.

The level and stability of BAWAG's performance compare well with peers and benefit from tight cost control, efficient processes and pricing discipline. Its higher-risk international real estate and corporate lending and targeted growth in higher-yielding asset classes such as consumer lending play an important role in maintaining its sound interest margins in an increasingly adverse interest rate environment.

We believe the bank's resilient pre-impairment profits constitute a solid buffer against higher expected credit losses even in a downside scenario. BAWAG booked EUR130 million provisions for credit losses in 1H20, half of which were related to general reserves for Stage 1 and Stage 2 loans, primarily reflecting the revised macroeconomic assumptions, under which BAWAG applied the adverse ECB euro area scenario.

BAWAG's common equity Tier 1 (CET1) ratio of 13.4% after deduction of the 2019 and 1H20 dividend accruals comfortably exceeds its regulatory requirements. Following the anticipation of the change in the Pillar 2 requirement composition, BAWAG reduced its medium-term CET1 ratio target to 12.25% from 13% and issued EUR175 million Additional Tier 1 and EUR200 million Tier 2 instruments to fill the Pillar 2 requirement bucket and create additional risk-weighted asset capacity.

We view this target as adequate, given the financial flexibility that arises from the bank's sound recurring profitability. Management has earmarked excess capital above this target for organic growth, acquisitions and profit distribution through dividends and share buybacks.

The 'F1' Short-Term IDR is the higher of the two options possible for a 'A-' Long-Term IDR, which reflects Fitch's view of BAWAG's stable liquidity and funding reflected in a score of 'a'. The bank's robust funding structure is underpinned by a large and stable customer deposit base and increasingly diversified wholesale market access.

We expect future issuance of subordinated capital to be at the level of the holding company BAWAG Group, although BAWAG P.S.K. should remain the main issuing entity for senior secured and senior unsecured debt. BAWAG plans to issue up to EUR1.5 billion of senior non-preferred (SNP) and preferred notes by end-2022 in addition to the EUR0.5 billion issued in 2019 to comply with its minimum requirement for own funds and eligible liabilities.

BAWAG's SP debt is rated at the same level as the Long-Term IDR because we expect BAWAG to include preferred instruments in its resolution buffer. Moreover, the buffer of SNP and more junior debt is not large enough to warrant a one-notch uplift of the SP debt.

SUPPORT RATING (SR) AND SUPPORT RATING FLOOR (SRF)

The SR and SRF reflect our view that the EU's Bank Recovery and Resolution Directive (BRRD) and Single Resolution Mechanism provide a resolution framework that is likely to require senior creditors to participate in losses, if necessary, instead, or ahead, of a bank receiving sovereign support.

SUBORDINATED DEBT

BAWAG's Tier 2 subordinated debt is rated two notches below the VR to reflect below-average recovery prospects. The notching reflects our expectation that the bank will not maintain buffers of Tier 2 and additional Tier 1 debt exceeding 10% of risk-weighted assets. These securities are subordinated to all senior unsecured creditors. No notching is applied for incremental non-performance risk because there is no coupon flexibility before non-viability and the notes would only be written down once the point of non-viability is reached.

STATE-GUARANTEED DEBT

BAWAG's state-guaranteed SP and Tier 2 debt ratings reflect our understanding that the Austrian Postsparkassen Act (Postsparkassen-gesetz), on which the guarantee is based, does not oblige the government to honour the guarantee on first demand. We believe there is an extremely high probability that the federal government would fully reimburse grandfathered creditors, should the guarantee be triggered by a default of BAWAG.

However, in our opinion, there is no certainty that a reimbursement would be carried out on a timely basis. To reflect this uncertainty, the ratings are not derived from the Austrian sovereign rating (AA+/Positive). Instead, they are notched up three times from BAWAG's Long-Term IDR of 'A-'. The three-notch uplift reflects the outstanding recovery prospects arising from the guarantee.

## RATING SENSITIVITIES

KEY RATING SENSITIVITIES

IDRs, VR and SP Debt

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

BAWAG's ratings have sufficient headroom to withstand various downside scenarios to Fitch's baseline economic forecast. However, the bank's ratings could be downgraded if the economic and financial market disruption arising from the pandemic is materially worse than expected, without credible prospects to restore it over the medium to long term, which would place severe and sustained pressure on earnings and capitalization.

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.

A downgrade of the ratings could also arise from excessive or inadequately managed growth putting pressure on the bank's sound capital and profitability ratios, or deterioration in the bank's risk profile or material increase in risk appetite. This could include sizeable acquisition or a significant growth in asset classes that we view as inherently higher risk, such as investments in CLOs and leveraged loans.

A downgrade of the Short-Term IDR could be triggered by a downgrade of BAWAG's Long-Term IDR or a weakening of the bank's funding and liquidity. A downgrade of the SP notes' rating is contingent on a downgrade of the Long-Term IDR.

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

An upgrade of BAWAG's ratings is unlikely in the near term given the risks posed by the coronavirus shock. In the longer term, an upgrade would require a successful expansion and diversification of BAWAG's asset base, particularly the establishment of a solid franchise in the bank's targeted international markets, while maintaining a conservative risk appetite and a focus on retail banking.

An upgrade of the ratings would also require a record of resilient earnings and sound asset quality through the current adverse economic environment. An upgrade of the Long-Term IDR would lead to an upgrade of the long-term SP notes' rating. The long-term SP notes' rating could also be upgraded if we expect BAWAG to meet its Minimum Requirement for own Funds and Eligible Liabilities with SNP and more junior instruments only or if we expect BAWAG's SNP and more junior debt buffers to sustainably exceed 10% of the group's risk-weighted assets.

SR AND SRF

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

The SR and SRF are already at the lowest possible levels and therefore cannot be downgraded or revised downward.

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

An upgrade of the SR and upward revision of the SRF would be contingent on a positive change in the sovereign's propensity to provide support. This is highly unlikely, in our view, in light of the regulatory regime in place since the implementation of BRRD.

SUBORDINATED DEBT

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

A downgrade of BAWAG's VR would trigger a downgrade of the Tier 2 notes.

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

An upgrade of the subordinated and hybrid securities would require an upgrade of BAWAG's VR. We could upgrade the Tier 2 notes if we consider the buffer of Tier 1 and Tier 2 debt at BAWAG likely to increase to, and sustainably exceed, 10% of risk-weighted assets.

STATE-GUARANTEED DEBT

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

The state-guaranteed SP and Tier 2 notes' ratings are sensitive to a multi-notch downgrade of Austria's Long-Term IDR, and to potential changes to the relevant legislation, in particular the Postsparkassen Act. In addition, they are sensitive to timely execution of the guarantee by the sovereign in a scenario in which BAWAG would be unable to honour its obligations.

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

We could upgrade the state-guaranteed SP and Tier 2 notes' ratings if we upgrade the bank's Long-Term IDR.

## 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

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

## RATING ACTIONS

| ENTITY/DEBT | RATING | | | PRIOR |
|---|---|---|---|---|
| BAWAG P.S.K. | LT IDR | A- Rating Outlook Stable | Affirmed | A- Rating Watch Negative |
| | ST IDR | F1 | Affirmed | F1 |
| | Viability | a- | Affirmed | a- Rating Watch Negative |
| | Support | 5 | Affirmed | 5 |
| | Support Floor | NF | Affirmed | NF |
| • subordinated | LT | AA- | Affirmed | AA- |

VIEW ADDITIONAL RATING DETAILS

## FITCH RATINGS ANALYSTS

**Markus Glabach**
Director
Primary Rating Analyst
+49 69 768076 195
Fitch Ratings – a branch of Fitch Ratings Ireland Limited
Neue Mainzer Strasse 46 - 50 Frankfurt am Main D-60311

**Marco Diamantini**
Associate Director
Secondary Rating Analyst
+49 69 768076 114

**Christian Kuendig**
Senior Director
Committee Chairperson
+44 20 3530 1399

## MEDIA CONTACTS

**Adrian Simpson**
London
+44 20 3530 1010
adrian.simpson@thefitchgroup.com

**Louisa Williams**
London
+44 20 3530 2452
louisa.williams@thefitchgroup.com

Additional information is available on www.fitchratings.com

## 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

## ENDORSEMENT STATUS

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|---|---|
| BAWAG P.S.K. | EU Issued |

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