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Research Update:

Germany-Based HSH Nordbank AG Rated 'BBB/A-2'; Outlook Stable; Assigned 'BBB+/A-2' Resolution Counterparty Ratings

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Overview

- Following the successful privatization, HSH Nordbank can now execute its multiyear transformation to a more sustainable and efficient mid-size corporate lender, supported by a clean balance sheet and large liquidity buffer.
- HSH Nordbank's sizable buffer of subordinated debt would likely help to protect senior unsecured creditors if the bank failed and was subject to a bail-in resolution action.
- We are assigning HSH Nordbank our 'BBB/A-2' issuer credit ratings and 'BBB+/A-2' resolution counterparty ratings.
- The stable outlook reflects our view that the privatization and ensuing transformation enables HSH Nordbank's management to build on its solid capitalization and current good asset quality, and that results will materialize only over the coming two to three years.

Rating Action

On Dec. 6, 2018, S&P Global Ratings assigned its 'BBB/A-2' long- and short-term issuer credit ratings to Germany-based HSH Nordbank AG (HSH). The outlook is stable.

We also assigned our 'BBB+/A-2' long- and short-term resolution counterparty ratings (RCRs) to HSH.

Rationale

HSH is a German midsize corporate bank, previously under public ownership, that was recently sold to a consortium led by private equity firms Cerberus and JC Flowers.

Over the past few years, HSH has materially deleveraged, as required under the terms of the EC state aid approval in 2011 after the bank's rescue by its public owners during the financial crisis. Following the privatization and sale of its non-core, nonperforming portfolio, HSH's loan exposure is now predominantly to German clients. While the bank is now in a position to focus on exploiting new business opportunities, also in international markets, we expect HSH will remain a niche player in European corporate banking, therefore enjoying less diversification and business stability than larger and more established peers.

Following the sale of its non-core, nonperforming portfolio, HSH has a healthy balance sheet, with a strong pro forma risk-adjusted capital (RAC) ratio of 12.4% as of year-end 2017. Although the RAC ratio could decline by about 1% over the coming two years as loan growth picks up, our projection of about 11.5% at year-end 2020 would remain comfortably above the 10% threshold for strong capitalization. However, we note that the bank's weak profitability limits the capacity of earnings to buffer potential losses. For 2020, we project a return on equity of about 1.9% and an earnings buffer of 9 basis points (bps), well below the 30-50 bps we see among German peers such as Commerzbank or Deutsche Pfandbriefbank.

Additionally, despite a nonperforming loan level of less than 2%, we note the bank's focus on German commercial real estate and corporate business in more volatile sectors like shipping, energy, and infrastructure. In our view, this exposes HSH to more pronounced credit cycles than its better-diversified peers. Furthermore, we understand that HSH will expand its business beyond Germany to countries where it has not conducted business in recent years.

We believe that the quality of HSH's new lending will only be proven over the economic cycle. Going forward, key rating considerations will be based on the relative pace of credit growth, impacts on sector diversification, and the quality of the loan book, as we still consider that underwriting standards could weaken in the pursuit of new business. However, in our view, the close oversight by BdB (the Association of German Banks), especially over the multiyear transition period, will restrain HSH from increasing its risk appetite or deviate from its business plan. We expect HSH to comply with all agreed terms to ensure the targeted senior membership in the private deposit protection scheme from 2021 onwards.

Overall, and despite current favorable funding and liquidity metrics, we still see HSH as having a more confidence-sensitive, less deposit-rich funding profile than its German peers'. In June 2018, HSH's stable funding ratio stood at 105% and its broad liquid assets to short-term wholesale funding at 1.7x. In our view, HSH will need to re-establish its funding franchise after several years of intense deleveraging and limited long-term funding issuances. Furthermore, management will need to deliver on the agreed way of transferring from public sector deposit insurance to private.

We do not apply any ratings uplift to our assessment of HSH's stand-alone credit profile (SACP) for government support. We consider the prospect of extraordinary government support for German banks to be uncertain, following the full implementation of the EU Bank Recovery and Resolution Directive, including bail-in powers, in January 2015.

However, we note that while HSH appears less systemically important than larger and more complex German peers. Moreover, it is a sizable institution that is subject to direct supervision by the ECB and oversight by the Single Resolution Board. We therefore assume that. in the event of failure, it might be targeted for a bail-in led resolution. The bank's material buffer of subordinated instruments, which provide material protection to senior unsecured creditors, would facilitate a recapitalization. We calculate that HSH's additional-loss absorbing capacity (ALAC) was about 29% of S&P Global Ratings' risk-weighted assets (RWA) at year-end 2017, far beyond our 8% threshold for a two-notch uplift. This incorporates the statutory subordination of plain vanilla senior unsecured instruments under the German law change on Jan. 1, 2017. While the ALAC buffer will likely reduce over the coming two years, we expect it to remain well above the 8% threshold.

The one-notch negative adjustment to the issuer credit rating reflects our holistic view on the risks in HSH's multi-year transition. It also incorporates the bank's currently depressed profitability, which is low even relative to German peers.

The 'BBB+/A-2' RCR reflects our RCR jurisdiction assessment on Germany, and our review of its relevance for HSH. We consider that there is an effective resolution regime in Germany and that HSH would be covered by the group's single point-of-entry resolution strategy if it were to reach a point of nonviability. An RCR is a forward-looking opinion of the relative default risk of certain senior liabilities that may be protected from default through an effective bail-in resolution process for the issuing financial institution.

Outlook

The stable outlook on HSH reflects our view that the successful privatization should enable the bank to continue its transformation, leading to a more sustainable and predictable performance over the next two years. We anticipate that HSH will maintain its strong financial profile, supporting its confidence-sensitive transformation over the coming years. Indeed, HSH's future profitability and internal capital generation hinge on its ability to attract lower cost funding and expand its client franchise.

Downside scenario

We could lower the ratings on HSH if it fails to stabilize its franchise and to cut costs, or if it encounters troubles in meeting the membership terms of the protection scheme. In addition, we could consider a downgrade if we observe a deterioration in asset quality and significantly increasing risk appetite, materializing in rapid loan growth or higher credit losses than currently anticipated. Notably, aggressive growth of RWAs that runs ahead of earnings retention could risk a reduction in the risk-adjusted capital ratio to less than 10%.

If these negative indicators appear, we would expect to reflect them in the SACP. A downward revision of the SACP would lead us to lower our issue credit ratings on any rated hybrid instruments. Whether we also lowered the issuer credit rating would depend also on our broader analysis of HSH versus similarly rated peers.

Upside scenario

Although unlikely within the two-year outlook horizon, we could consider an upgrade if HSH, under its new ownership, builds a track record of substantial improvements in revenue generation, cost structure, and risk-adjusted profitability. An upgrade would likely hinge on the bank's progress on delivering its business plan and remaining compliant with the protection scheme's covenants. We look in particular for a cautious approach to growth, and the maintenance of solid capitalization, together giving us continued confidence regarding the bank's exposure to credit losses and its ability to absorb them through capital and, to an increasing extent, earnings. However, an upgrade would also depend on HSH establishing a sustainable funding franchise, including creating further diversification in funding sources and an increase in the average duration of wholesale funding.

Ratings Score Snapshot

Issuer Credit Rating	BBB/Stable/A-2
SACP	bbb-
Anchor	a-
Business Position	Weak (-2)
Capital and Earnings	Strong (+1)
Risk Position	Moderate (-1)
Funding	Below Average (-1)
Liquidity	Adequate
Support	(+2)
ALAC Support	(+2)
GRE Support	0
Group Support	0
Sovereign Support	0
Additional Factors	(-1)

Related Criteria

- Criteria - Financial Institutions - General: Methodology For Assigning Financial Institution Resolution Counterparty Ratings, April 19, 2018
- 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
- 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

Ratings List

New Rating

HSH Nordbank AG

Issuer Credit Rating	BBB/Stable/A-2
Resolution Counterparty Rating	BBB+/--/A-2

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.standardandpoors.com for further information. Complete ratings information is available to subscribers of RatingsDirect at www.capitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public website at www.standardandpoors.com. Use the Ratings search box located in the left column. Alternatively, call one of the following S&P Global Ratings numbers: Client Support Europe (44) 20-7176-7176; London Press Office (44) 20-7176-3605; Paris (33) 1-4420-6708; Frankfurt (49) 69-33-999-225; Stockholm (46) 8-440-5914; or Moscow 7 (495) 783-4009.