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Ratings

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Hamburg Commercial Bank AG

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Hamburg Commercial Bank AG

SACP	bbb-	+	Support	+2	+	Additional Factors	-1

Anchor	a-	
Business Position	Weak	-2
Capital and Earnings	Strong	+1
Risk Position	Moderate	-1
Funding	Below Average	-1
Liquidity	Adequate	

ALAC Support	+2
GRE Support	0
Group Support	0
Sovereign Support	0

Issuer Credit Rating
BBB/Stable/A-2

Resolution Counterparty Rating
BBB+/--/A-2

Major Rating Factors

Strengths:

- Clean balance sheet after nonperforming asset (NPA) carve-out.
- Strong capitalization.
- Very strong buffer of bail-in capital.

Weaknesses:

- Little operating track record under the new, niche business model.
- Exposure to more pronounced credit cycles in commercial real estate, shipping, energy, and infrastructure financing.
- Execution risk in the transforming funding profile.
- Very low risk-adjusted profitability.

Outlook: Stable

The stable outlook on Hamburg Commercial Bank (HCOB), previously incorporated as HSH Nordbank AG, 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 HCOB will maintain its strong financial profile, supporting its confidence-sensitive transformation over the coming years. Indeed, HCOB's future profitability and internal capital generation hinge on its ability to attract lower cost funding, expand its client franchise, and reduce its cost base as planned.

Downside scenario

We could lower the ratings on HCOB 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. A prolonged reduction of the risk-adjusted capital ratio to less than 10% could also trigger a downgrade. This could result from aggressive risk-weighted asset growth that runs ahead of earnings retention or, though less likely, financial damage from litigation with hybrid investors.

If these negative indicators appear, we would expect to reflect them in the stand-alone credit profile (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 HCOB versus similarly rated peers.

Upside scenario

Although unlikely within the two-year outlook horizon, we could consider an upgrade if HCOB, 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 in 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 HCOB establishing a sustainable funding franchise, including creating further diversification in funding sources and an increase in the average duration of wholesale funding.

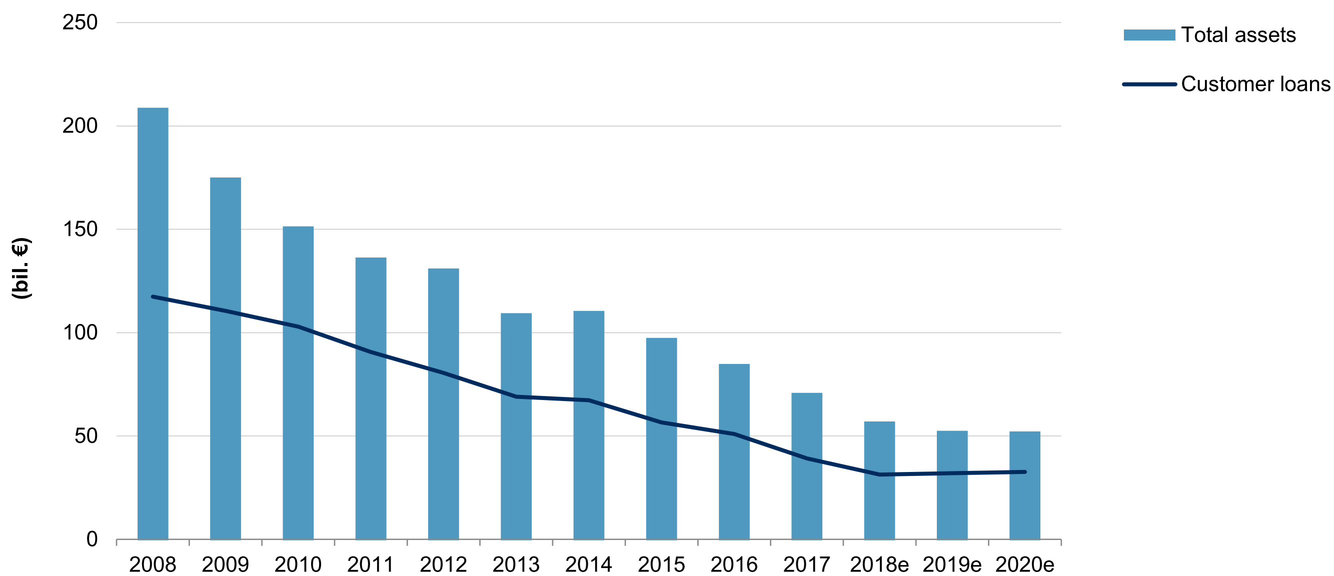
Rationale

HCOB is a German midsize corporate bank that was sold to a private equity consortium in November 2018, constituting the first privatization of a German Landesbank.

After years of intense shrinking, we expect HCOB will remain a niche player in European corporate banking, demonstrating less diversification and business stability compared with larger and more established peers. Following the sale of its carve-out portfolio, HCOB has a healthy balance sheet with a strong risk-adjusted capital ratio of 10.5%-11.5% expected for 2020. We expect the bank will maintain good asset quality, with a nonperforming loan (NPL) ratio of slightly over 3%. That said, we are mindful of HCOB's focus on German commercial real estate (CRE) and corporate business in more volatile sectors, exposing it to more pronounced credit cycles than more diversified peers. HCOB will need to re-establish its funding franchise and successfully transfer from public sector deposits insurance to private. From a senior creditor perspective, the transition is supported by a material buffer of additional loss-absorbing capacity, expected at about 30% as of year-end 2018.

Chart 1

Total Assets Will Bottom Out



e-estimateSource: S&P Global Ratings.

HCOB's current underperformance in terms of profitability and the risks in its multi-year transition are incorporated in our 'BBB' long-term issuer credit rating on the bank.

Anchor:'a-' for German banks with mostly domestic exposure

We use our Banking Industry Country Risk Assessment (BICRA) economic risk and industry risk scores to determine a bank's anchor, the starting point in assigning an issuer credit rating (ICR). Our 'a-' anchor for HCOB is based on an industry risk score of '3' and a blended economic risk score of '2'. We take into account the bank's headquarter in Germany and our view of the economic risks in all the markets to which HCOB has credit exposure. Since HCOB has 60% of its exposure in Germany, the anchor is still in line with financial institutions operating solely in Germany.

Germany's highly diversified, competitive, and flexible economy continues to perform well against the backdrop of a broader European recovery. The country's high degree of openness exposes it to downside risks from the external environment, but Germany's important buffers, such as a sizable net external creditor position and fiscal surpluses, should allow its economy to absorb external shocks and remain resilient. We expect Germany's strong house price growth will continue to cool, and increasing supply, falling demand, and gradually rising interest rates will ease price pressures. Moreover, dynamic house price increases were not the result of strong mortgage growth and we still consider a nationwide housing bubble unlikely over the next few years. Domestic nonperforming loans and associated credit loss provisions have bottomed out since their 2010 peak, but we expect they will remain in a favorable credit cycle for some time.

As for many European banking industries, industry risk in Germany is intermediate, in our view. Returns in the German banking industry are broadly in line with many European peers', owing to low domestic credit losses and stability from granular earnings generation, but low interest rates and strong competition drag on profitability. Rising interest rates, which we expect from the second half of 2019, should increase German banks' profitability, while cost reducing and efficiency enhancing measures will improve German banks' unfavorable cost efficiency and fee generation ability. Generally sound underwritings practices should protect German banks' profitability from a rise in risk cost that typically accompanies material interest rates increases.

Well-funded and strongly capitalized savings and cooperative banking groups will continue to dominate Germany's retail banking market. Large banks, which carry riskier concentration and business risk, have become less vulnerable to economic risks due to deleveraging, de-risking, and recapitalization. The German banking system's institutional framework benefits from implemented and expected regulatory reforms resolving major deficiencies and improving accountability and transparency. The likelihood of the German government providing extraordinary support to systemic domestic banks is uncertain.

Table 1

Hamburg Commercial Bank AG Key Figures

		--Year-ended Dec. 31--			
(Mil. €)	**2018***	**2017**	**2016**	**2015**	**2014**
Adjusted assets	61,272.0	70,372.0	84,351.0	96,957.0	110,055.0
Customer loans (gross)	38,401.0	39,174.0	50,910.0	56,575.0	67,336.0
Adjusted common equity	3,997.0	4,185.0	4,709.0	4,667.0	4,347.0
Operating revenues	552.0	1,141.0	883.0	757.0	732.0
Noninterest expenses	353.0	551.0	684.0	671.0	724.0
Core earnings	203.0	(843.0)	(826.6)	(718.3)	(470.2)

*Data as of Sept. 30.

Business position: Weak franchise requires new customer generation to stabilize business

Our business position assessment reflects HCOB's niche business operations in German corporate banking. In our view, its focus on corporates, CRE, and shipping exposes the bank to more cyclical sectors, potentially leading to a more confidence-sensitive business model. In addition, HCOB will need to prove that its long-standing regional franchise will benefit the bank under its new ownership and that it is able to successfully expand its franchise into new sectors and countries.

Despite uncertainty regarding the bank's viability in recent years, while approaching the European Commission (EC) deadline for privatization or wind down, HCOB was able to generate new business and materially diversify away from its significant shipping concentration.

Following the successful privatization and carve out of its noncore, nonperforming asset portfolio, HCOB now focuses on three operating segments. We expect HCOB new business will be mainly focused on CRE and corporate business, which also includes its energy and infrastructure project finance business, such that the relative size of its shipping business will further reduce.

S&P Global Ratings methodology is cautious regarding rated companies' private equity ownership because it can lead to some uncertainty regarding long-term financial policy and exit scenarios, typically greater financial risk, and more ambitious growth plans. However, for banks we see prudential regulation as a moderating influence. Furthermore, we note the experience and solid track record of HCOB's new private equity owners, a consortium led by Cerberus and J.C. Flowers & Co, as experienced investors in midsize European financial institutions.

Table 2

Hamburg Commercial Bank AG Business Position					
		--Year-ended Dec. 31--			
(%)	**2018***	**2017**	**2016**	**2015**	**2014**
Total revenues from business line (currency in millions)	552.0	2,255.0	3,167.0	1,519.0	732.0
Commercial & retail banking/total revenues from business line	73.4	21.9	18.8	37.3	108.9
Other revenues**/total revenues from business line	26.6	78.1	81.2	62.7	(8.9)
Return on average common equity	(3.2)	(11.5)	1.4	2.1	3.4

*Data as of Sept. 30. ** Other revenues include nonoperating segments and extraordinary items.

Capital and earnings: Strong capitalization following NPA carve-out

We assess HCOB's capital and earnings as strong, mainly based on our projection that the bank's risk-adjusted capital (RAC) ratio (S&P Global Ratings measure for capital adequacy) before diversification will remain sustainably above 10% going forward. Following the 2018 sale of its noncore, nonperforming portfolio, HCOB has a healthy balance sheet, with a strong pro-forma RAC ratio of 12.4% as of year-end 2017. We expect this will drop to 10.5%-11.5% by 2020, taking into account the termination of hybrid capital instruments.

Our 2020 forecast includes moderate annual credit growth of about 2%-3%, especially in CRE and corporate lending, a slight improvement in net interest margin to about 1%, and full earnings retention, though this will not be sufficient to maintain the current level of capital ratios.

Our measure of total-adjusted capital includes HCOB's silent participations and hybrid capital instruments, which we assign intermediate equity content. Our forecast incorporates the announced termination of hybrid capital instruments. While the termination will reduce the volume of eligible hybrid instruments in our capital measure, it might have a positive valuation impact, depending on the final redemption price. We currently do not incorporate any detrimental capital effects that could arise from the hybrid capital investors suing HCOB for €1.4 billion in damages, alleging improper valuation of its hybrid capital instruments. Nevertheless, we will monitor future developments in this regard and update our forecast accordingly.

In any case, we expect the bank's regulatory capital structure optimization could also include some new issuance of regulatory capital instruments until 2021.

We believe that growth opportunities for wholesale banks such as HCOB in Germany are limited due to strong competition from domestic banks. Furthermore, the generally low margins in corporate and CRE business will, in our view, render material revenue improvements difficult for the bank. Nevertheless, the elimination of guarantee fees, further potential to contain costs, and costs reduction in its liquidity portfolio could support stronger profitability going forward.

By 2020, we project a slightly increased net interest margin of over 1%, a return on equity (after tax) of about 1.9%, and an earnings buffer of about 10 basis points (bps), well below the 30-50 bps we see among German peers such as Commerzbank or Deutsche Pfandbriefbank.

HCOB's bottom line in 2017 was materially distorted by one-off effects, including the revaluation of its noncore, nonperforming assets portfolio, material restructuring charges, valuation effects from hybrid capital instruments, and realization of investment gains.

Similar one-off effects, with hybrid revaluation gains and restructuring costs being the most significant, have materially affected preliminary 2018 results. The results also provide only limited insight regarding organic business development, but nevertheless indicate solid new business generation, some higher-margin business, and significant provisions. We understand that HCOB has conservatively provisioned for restructuring charges related to its transformation process. As such, HCOB's earnings predictability will substantially improve during 2019, because we expect no further material restructuring charges over this period, and there are no guarantee fees to be paid. Also, the portfolio transaction has ensured relatively clean asset quality and normalization of credit costs. This will provide a better basis for assessing the success of HCOB's transformation plan.

Table 3

Hamburg Commercial Bank AG Capital And Earnings

		--Year-ended Dec. 31--			
(%)	**2018***	**2017**	**2016**	**2015**	**2014**
Tier 1 capital ratio	19.8	23.5	18.7	16.4	14.4
S&P Global Ratings' RAC ratio before diversification	N/A	12.4	N/A	N/A	6.5
S&P Global Ratings' RAC ratio after diversification	N/A	11.5	N/A	N/A	6.4
Adjusted common equity/total adjusted capital	75.2	75.2	75.2	75.2	75.2
Double leverage	N.M.	N.M.	N.M.	N.M.	N.M.
Net interest income/operating revenues	84.4	75.2	79.7	117.7	106.1
Fee income/operating revenues	4.0	(7.4)	(14.4)	(47.4)	(53.4)
Market-sensitive income/operating revenues	2.5	28.7	25.7	19.8	26.1
Noninterest expenses/operating revenues	63.9	48.3	77.5	88.6	98.9
Preprovision operating income/average assets	0.4	0.8	0.2	0.1	0.0
Core earnings/average managed assets	0.4	(1.1)	(0.9)	(0.7)	(0.4)

*Data as of Sept. 30. N/A--Not applicable. N.M--Not meaningful.

Risk position: Clean balance sheet, but concentration in cyclical sectors

We view HCOB' risk position as moderate, reflecting its exposure concentration in several cyclical sectors. We believe exposure to CRE, more cyclical corporate sectors such as energy or infrastructure, and the shipping sector implies higher losses in an economic crisis and exposes HCOB to more pronounced credit cycles than its better-diversified peers. Furthermore, we understand that HCOB will expand its business beyond Germany to countries where it has not conducted business in recent years. We believe our 81% risk weight for HCOB's corporate exposures (including CRE and shipping) in our RAC calculation, adequately captures the risk of the underlying exposures, but we believe that absent any material diversification across other business lines, this exposes HCOB to tail risks in an economic downturn.

We also see some regional geographic concentration in northern parts of Germany, stemming from the regional profile of German Landesbanks. However, the economic power of this region is quite strong, and going forward we expect improving diversification within the German and European market.

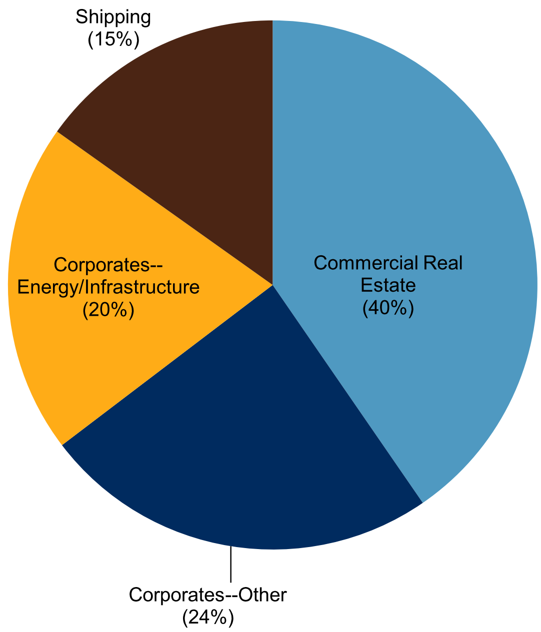
Following the carve-out of its noncore nonperforming portfolio, we assess HCOB as having a clean balance sheet with a nonperforming exposure ratio of about 2% and a NPL ratio slightly above 3%. Also, in general we see strong collateralization in HCOB's lending business. In our view, the significant sensitivity of the bank's U.S. dollar-denominated assets to the dollar to euro rate, which materially contributed to the bank crisis in 2009, has reduced to a level that we no longer assess a material risk. Nevertheless, it could still distort HCOB's financials to a small extent.

We believe that the quality of HCOB'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, effects on sector diversification, and the quality of the loan book, since we still consider that underwriting standards could weaken in the pursuit of new business. However, in our view, the BdB's (Association of German Banks) close oversight, especially over the multiyear transition period, will restrain HCOB from increasing its risk appetite or deviate from its business plan. We expect HCOB will comply with all agreed terms to ensure senior membership in the private deposit protection scheme from 2021.

Excluding its treasury and corporate center activities, HCOB focuses on three operating segments: corporates, CRE and shipping.

Chart 2

HCOB's Operating Segments--Concentration on Shipping Has Reduced



Source: S&P Global Ratings.

Its corporate business will account for about 45% of exposure at default (EAD) and comprise its German small and medium enterprises and larger corporate business, as well as some concentrations in European renewable energy and infrastructure finance. HCOB's CRE business focuses on German metropolitan areas, but going forward will likely also include business in selected European countries, constituting about 40% of EADs. We do not expect this new business will weaken asset quality, but assume that international exposure could amount to 5%-10% of its CRE business. In light of the EC's restrictions, HCOB has massively reduced its shipping exposure over recent years through very selective new business, active restructuring, and sale of problem loans, such that it will only contribute about 15% of EADs.

We expect, that despite the prolonged shipping crisis, HCOB will use its sector expertise to selectively conduct new business, although the relative share will likely decrease further.

Table 4

Hamburg Commercial Bank AG Risk Position

		--Year-ended Dec. 31--			
(%)	**2018***	**2017**	**2016**	**2015**	**2014**
Growth in customer loans	(2.6)	(23.1)	(10.0)	(16.0)	(2.5)
Total diversification adjustment/S&P Global Ratings' RWA before diversification	N/A	7.5	N/A	N/A	1.8
Total managed assets/adjusted common equity (x)	15.3	16.8	17.9	20.8	25.3

Table 4

Hamburg Commercial Bank AG Risk Position (cont.)					
		--Year-ended Dec. 31--			
(%)	**2018***	**2017**	**2016**	**2015**	**2014**
New loan loss provisions/average customer loans	(0.4)	3.0	3.1	5.5	1.2
Net charge-offs/average customer loans	N.M.	(0.1)	0.4	(0.0)	0.0
Gross nonperforming assets/customer loans + other real estate owned	N/A	17.4	19.0	19.2	19.8
Loan loss reserves/gross nonperforming assets	N/A	(10.1)	(11.8)	9.7	15.4

*Data as of Sept. 30. N/A--Not applicable. N.M.--Not meaningful.

Funding and liquidity: Reliance on capital markets, and transition risks in switching protection schemes

We assess HCOB's funding profile as below average relative to that of German peers, and its liquidity position as adequate. This assessment takes into account the execution risk in HCOB' planned transformation, which will eventually result in a more diversified and less confidence-sensitive funding profile.

Currently, its stronger reliance on wholesale funding and some uncertainty during the transition to the deposit protection scheme of German private banks, limit our funding assessment. This assessment also takes into account our generally favorable view of system-wide funding in the overall German banking sector.

We expect HCOB's reliance on confidence sensitive funding sources such as secured and unsecured capital market funding, as well as interbank funding, will remain higher than the average for German banks.

Our stable funding ratio of 100% for HCOB as of third-quarter 2018 includes retail deposits as stable funding, although most of these are overnight deposits. We understand HCOB intends to substantially expand its online retail deposit base over online funding platforms, from the current level of about €3 billion. However, we will continue to view online deposits as more volatile than more relationship-based savings, unless we see an established franchise providing for more stable deposits. We believe that the bank's corporate deposits are more franchised based, though still subject to the uncertainty regarding membership in the voluntary deposit protection scheme. The regulatory stable funding ratio was at 122% according to preliminary 2018 results.

Our assessment of HCOB's liquidity as adequate primarily reflects the bank's prudent liquidity management and comfortable liquidity reserves. The coverage of short-term wholesale funding by broad liquid assets (blast ratio), was relatively high at 2x at year-end 2017 and reduced to about 1.7 in third-quarter 2018. This compares to a regulatory liquidity coverage ratio of 153% as of third-quarter 2018 and 225% as of end-2018. We expect HCOB will further reduce its liquidity buffers following successful privatization, but expect the bank will maintain an adequate liquidity profile, with a blast ratio sustainably above 1x.

Table 5

Hamburg Commercial Bank AG Funding And Liquidity					
		--Year-ended Dec. 31--			
(%)	**2018***	**2017**	**2016**	**2015**	**2014**
Core deposits/funding base	62.9	63.0	59.3	56.4	48.6
Customer loans (net)/customer deposits	124.9	110.1	129.6	124.6	151.3

Table 5

Hamburg Commercial Bank AG Funding And Liquidity (cont.)					
		--Year-ended Dec. 31--			
(%)	2018*	2017	2016	2015	2014
Long-term funding ratio	86.8	86.8	88.9	85.5	72.7
Stable funding ratio	100.3	112.4	103.5	101.3	88.1
Short-term wholesale funding/funding base	14.8	14.6	12.2	15.7	29.4
Broad liquid assets/short-term wholesale funding (x)	1.7	2.0	1.8	1.4	0.8
Net broad liquid assets/short-term customer deposits	22.5	31.7	21.4	14.9	(12.2)
Short-term wholesale funding/total wholesale funding	36.4	36.6	27.9	34.1	54.7
Narrow liquid assets/3-month wholesale funding (x)	2.5	3.2	3.2	1.7	2.7

*Data as of Sept. 30.

Support:Two notches of uplift for substantial ALAC buffer

While HCOB appears less systemically important than larger and more complex German peers, it is still a sizable institution and subject to direct supervision by the European Central Bank and oversight by the Single Resolution Board. We 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 provides material protection to senior unsecured creditors, would facilitate recapitalization.

We calculate that HCOB's additional-loss absorbing capacity (ALAC) was about 29% of S&P Global Ratings' risk-weighted assets at year-end 2017, far beyond our 8% threshold for a two-notch uplift. While the ALAC buffer will likely reduce over the coming two years, driven by maturing issues and the announced termination of hybrid capital instruments, we expect it will remain well above the 8%, the threshold for two notches of uplift. According to our criteria, we include most of HCOB's consolidated junior instruments that are not yet included in our capital measure in our ALAC assessment. The ALAC buffer also incorporates a sizeable volume of senior nonpreferred liabilities in the form of plain vanilla senior unsecured instruments. We believe they have the capacity to absorb losses without triggering a default on HCOB's senior obligations.

Additional rating factors:Weak profitability and transition risks

The one-notch negative peer adjustment that we include in our long-term rating on HCOB reflects our view that the bank is a relative underperformer versus peer banks with similar credit profiles. This is based on its protracted privatization and restructuring process, which translates into currently very low profitability, limiting the capacity of earnings to buffer potential losses. We expect an earnings buffer, which measures the capacity for a bank's earnings to cover normalized losses, of only 0.1% in 2019.

Nevertheless, we expect HCOB will deliver on its business plan, which will gradually improve its operating performance and profitability in the coming years. We acknowledge potential to further improve its costs base, but see execution risk especially on the generation of new business and related income generation.

Should HCOB fail to materially improve its risk-adjusted profitability to a level more in line with peers, or diverge from its business plan by increasing its risk-appetite, we would consider incorporating the peer adjustment into the SACP, indicating a sustainable weakness compared to peers. This would also be the case if HCOB's overall loan mix should turn out materially riskier than that of peers.

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

Anchor Matrix

Industry Risk	Economic Risk									
	1	**2**	3	4	5	6	7	8	9	10
1	a	a	a-	bbb+	bbb+	bbb	-	-	-	-
2	a	a-	a-	bbb+	bbb	bbb	bbb-	-	-	-
3	a-	**a-**	bbb+	bbb+	bbb	bbb-	bbb-	bb+	-	-
4	bbb+	bbb+	bbb+	bbb	bbb	bbb-	bb+	bb	bb	-
5	bbb+	bbb	bbb	bbb	bbb-	bbb-	bb+	bb	bb-	b+
6	bbb	bbb	bbb-	bbb-	bbb-	bb+	bb	bb	bb-	b+
7	-	bbb-	bbb-	bb+	bb+	bb	bb	bb-	b+	b+
8	-	-	bb+	bb	bb	bb	bb-	bb-	b+	b
9	-	-	-	bb	bb-	bb-	b+	b+	b+	b
10	-	-	-	-	b+	b+	b+	b	b	b-

Ratings Detail (As Of March 14, 2019)

Hamburg Commercial Bank AG	
Issuer Credit Rating	BBB/Stable/A-2
Resolution Counterparty Rating	BBB+/--/A-2

Ratings Detail (As Of March 14, 2019) (cont.)	
Issuer Credit Ratings History	
06-Dec-2018	BBB/Stable/A-2
Sovereign Rating	
Germany	AAA/Stable/A-1+

*Unless otherwise noted, all ratings in this report are global scale ratings. S&P Global Ratings' credit ratings on the global scale are comparable across countries. S&P Global Ratings' credit ratings on a national scale are relative to obligors or obligations within that specific country. Issue and debt ratings could include debt guaranteed by another entity, and rated debt that an entity guarantees.