FitchRatings

RATING ACTION COMMENTARY

Fitch Affirms ProCredit Holding and 6 Subsidiary Banks

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Fitch Ratings - Warsaw - 02 Apr 2020: Fitch Ratings has affirmed ProCredit Holding AG & Co. KGaA's (PCH) Long-Term Issuer Default Rating (IDR) at 'BBB' with a Stable Outlook and its Viability Rating (VR) at 'bb'. The agency has also affirmed the 'BBB' Long-Term IDR of PCH's German subsidiary bank ProCredit Bank AG (PCBDE).

At the same time, Fitch has affirmed the Long-Term IDRs and VRs of five subsidiary banks of PCH in Albania (ProCredit Bank Sh.a., PCBA), Bosnia & Herzegovina (ProCredit Bank d.d. Sarajevo, PCBBiH), Kosovo (ProCredit Bank SH.A., PCBK), North Macedonia (ProCredit AD Skopje, PCBNM) and Serbia (ProCredit Bank ad Beograd, PCBS). The Outlooks are Stable.

ProCredit Bank AG	LT IDR	BBB	Affirmed
	ST IDR	F2	Affirmed
	Support	2	Affirmed

ENTITY/DEBT	RATING		
• long-term deposits	LT	BBB	Affirmed
• short-term deposits	ST	F2	Affirmed
ProCredit Holding AG & Co. KGaA	LT IDR	BBB	Affirmed
	ST IDR	F2	Affirmed

VIEW ADDITIONAL RATING DETAILS

KEY RATING DRIVERS

PCH'S IDRS AND SUPPORT RATING

PCH's IDRs and Support Rating are driven by Fitch's view of the potential support it can expect to receive from its core international financial institution (IFI) shareholders: KfW (AAA/Stable), IFC and DOEN Foundation (combined stake of around 36% according to the last voluntary disclosure of voting rights). Apart from the three IFIs, Fitch views Zeitinger Invest (formerly IPC) and ProCredit Staff Invest as core shareholders in PCH. These entities have strategic control over the group through their status as general partners within PCH's KGaA structure.

Fitch's view of support is based on the long-term and strategic commitment of the IFI shareholders, as highlighted by their role within PCH's structure, the alignment of their own missions of development finance with that of PCH, and a record of debt and capital support to PCH and its subsidiary banks.

PCH's VR

ProCredit group's primary business focus is on lending to SMEs in South Eastern Europe (SEE) and Eastern Europe (EE). Given the potential significant weakening of the operating environments of these (and neighboring) countries from the coronavirus, we believe that the balance of risks for PCH's intrinsic creditworthiness is skewed to the downside.

We expect the group's asset quality and profitability metrics to be negatively affected by increasing borrower financial difficulties and higher loan loss allowances, and reduced lending volumes. This will also weigh on the group's ability to execute its strategic and financial targets. We weigh these risks against PCH's existing capital buffers and historically low level of problem loans at end-2019.

PCH's 'bb' VR continues to reflect the relatively narrow (except PCBK) franchises of its subsidiary banks in their respective jurisdictions and credit risks inherent in PCH's business model. PCH's VR benefits from the group's consolidated supervision by the German regulator (BaFin), strong corporate governance and prudent risk management, which have resulted in the group's asset quality that consistently outperformed the markets it operates in. PCH's VR also reflects its centralised liquidity management and the expectation that the funding profiles of its subsidiary banks will remain healthy.

PCH's VR is based on Fitch's assessment of the consolidated group's financial profile, and does not incorporate any downward notching at the holding company level. This reflects the following factors: i) the group being subject to consolidated supervision and required to meet regulatory requirements at the consolidated level; ii) there are no major regulatory restrictions on upstreaming capital or liquidity from subsidiaries to PCH; iii) integrated liquidity management, with contingency plans in place; iv) moderate double leverage; v) a simple group structure with full ownership of banking subsidiaries.

We view the recently introduced restrictions on dividend payments by banks in selected ProCredit markets (Bulgaria, Serbia, Ukraine) as temporary. However, if such restrictions stay in place for longer, this would clearly constrain capital and liquidity fungibility in the group and inflate HoldCo's double leverage.

The group operates 12 banking subsidiaries: seven in SEE (about 70% of the loan book at end-2019), three in Eastern Europe (about 23% share), one in Ecuador (about 6% share) and one in Germany (about 1% share). PCH group ceased micro finance lending (exposures below EUR50,000) several years ago as part of its major strategic turnaround.

At end-2019, PCH's Stage 3 loans/total gross loans ratio declined to around 2.4%, driven by robust loan growth, recoveries and write-offs. The coverage of Stage 3 loans with specific loan loss allowances was moderate at around 57%, partly reflecting the highly collateralised profile of the loan book. However, overall coverage was much stronger at around 92%, resulting in a very low 1.2% of uncovered Stage 3 loans relative to common equity Tier 1 capital (CET1).

In 2019, operating profit to total risk weighted assets fell to about 1.5% from 1.7% at end-2018. Net interest income suffered from margin pressure, while net fees and commissions were stable. Margins are likely to deteriorate given cuts of policy base rates by central banks and loan impairment charges (LICs) will increase in 2020. Cost efficiency improved but was relatively weak reflecting the small sizes of the subsidiary banks.

PCH's capitalisation is moderate relative to the credit risks the group faces. At end-2019, CET1 ratio (14.1%) and total capital adequacy ratio (TCR; 15.7%) were maintained with reasonable margin over minimum regulatory requirements including buffers under Pillar 1 and Pillar 2 (about 8.2% for CET1 and 12.6% for TCR). At end-2019, common equity double leverage at PCH increased but was still moderate at about 118% (2018: 113%).

Our assessment of the group's funding and liquidity factors in the nominal standalone deposit franchises of its subsidiary banks (apart from PCBK), PCH's notable reliance on wholesale funding and reasonable group liquidity, which is managed centrally. Granular customer deposits are the group's main source of funding. At end-2019 they accounted for around 74% of total funding. Senior and subordinated debt issued by PCH, bank funding at PCH and loans from IFIs extended directly to PCH's subsidiaries (partly guaranteed by the HoldCo), complement the funding structure. Liquidity is well-managed across the group and adequate reserves are held at the group level to cover potential liquidity needs from subsidiary banks in case of stress.

SUBSIDIARY BANKS - IDRs AND SUPPORT RATINGS

The IDRs and Support Ratings of PCH's subsidiary banks - PCBA, PCBBiH, PCBK, PCBM and PCBS - reflect the likelihood of potential support from their sole shareholder. We believe that the five subsidiaries are strategically important to the group and remain an integral part of the group's SEE franchise. This view takes into account PCH's long standing presence and commitment to the region, strong integration of the subsidiary banks into the PCH group and a record of ordinary capital and funding support provided by the parent. Our assessment of support also factors in the full ownership of subsidiaries, common branding and high reputational risks that would arise from subsidiaries' default.

However, in case of PCBA, PCBBiH and PCBK, the extent to which potential support can be factored into the subsidiaries' ratings is constrained by Fitch's assessment of risks relating to their respective jurisdictions, in particular transfer and convertibility risks. Absent of country risk constraints, the subsidiaries' Long-Term IDRs would be notched down once from the parent's IDR.

PCBDE's Support Rating and the equalisation of the bank's IDRs with those of PCH reflect Fitch's view of a high likelihood of parental support. This view is based primarily on the bank's central treasury role within the group and a strong legal commitment in the form of a profit and loss transfer agreement, which obliges PCH to replenish PCBDE's equity should the latter suffer a loss. The Stable Outlook reflects that on the parent.

SUBSIDIARY BANKS - VRs

The VRs of PCH's five subsidiaries reflect to varying degrees their operating environments, exposing banks performance to inherent market shocks, which cannot be fully mitigated by the benefits of the prudent risk management framework, unique corporate culture and strong corporate governance implemented across the PCH group. These risks are exacerbated by the economic and social implications of the coronavirus outbreak and the negative impact on banks' credit risk profiles.

PCBA and PCBBiH's VRs also consider the banks' limited franchises and small scale, which constrain their profit generation ability.

Asset quality is expected to come under strain for all subsidiary banks due to the coronavirus-related economic slowdown. To date, all five banks' asset quality has continued to improve, driven by healthy new loan origination, problem loans write offs and recoveries, tight group control and hitherto supportive economic conditions. At end-2019, impaired loans (Stage 3 loans) were the highest at PCBA (about 6% of gross loans), while in the remaining subsidiaries they were below 3% of total gross loans. Coverage of Stage 3 loans by specific loan loss allowances was only moderate, but against mostly collateralised lending.

Fitch expects reduced earnings at all subsidiaries due to rising LICs, lower lending volumes and further margin pressures from monetary easing in Albania, North Macedonia and Serbia. In 9M19 PCBNM and PCBS's operating profit/ risk-weighted assets ratios were modest at 0.9%. PCBK's strong position in its small domestic market (18% market share in total banking sector assets at end-1H19) and healthy margins support its stable and recurring profitability. The Kosovar subsidiary reported the strongest operating profit/ risk-weighted assets ratios at 3.8% at end-2019.

PCBA and PCBBiH remain reliant on capital support from their shareholder due to weak pre-impairment operating profitability, bottom line loss making and, in case of PCBA, sizable costs of restructuring measures. With parental support both banks maintained capital ratios over regulatory requirements and PCBBiH realised growth of business in 2019. PCBBiH holds an adequate capital buffer with a CET1 ratio of 14.8% at end-3Q19. We view PCBA's CET1 ratio of 12.1% (2019) as providing only a modest buffer given the bank's higher problem loans.

PCBK's capitalisation (CET1 ratio of 15.2% at end-2019) is a rating strength, supported by decent profitability and high reserve coverage. Capitalisation at PCBM (CET 1 ratio at 12.1%) was adequate, with satisfactory buffers over regulatory minimums. PCBS's capital (CET1 ratio at 16.6% at end-3Q19) was maintained with significant buffers over regulatory requirements.

The funding mix at all five banks is dominated by customer deposits, which are supplemented by long-term loans from IFIs earmarked for SME development projects and funding from the group. Loans/deposits ratios were largely stable.

The banks' liquidity is underpinned by their liquid assets comprising cash, local government bonds and other highly rated debt securities. The liquidity coverage and net stable funding ratios were above 100% at end-2019.

Fitch does not assign a VR to PCBDE because the bank does not have a meaningful standalone franchise, and its operations rely strongly on integration within the broader group.

PCBDE's role in the group is focused on providing treasury, clearing and liquidity management services to sister banks. Placements from sister companies and PCH tend to be short term and are therefore reinvested in highly liquid assets. Funding provided to sister banks is sourced from deposits attracted on the German market. PCBDE maintains a net short position in operations with its sister banks.

At end-2019, about 51% of PCBDE's total assets were cash and other liquid assets, mainly central bank deposits and interbank placements with highly rated German banks. Loans to the sister banks and co-financing of some of their large credit exposures accounted for about 37% and 9% of total assets, respectively. The group's international payments clearing has been centralised at PCBDE.

PCBDE's other operations still have a narrow focus with a medium-term goal of widening the business with German firms active in SEE. PCBDE acts as a central treasury for the group and sister banks place surplus liquidity there. Placements from sister banks and other group companies (including the holding company) accounted for about 61% of the bank's liabilities at end-2019. PCBDE is also attracting deposits from German customers (both retail and institutional). They accounted for about 37% of total liabilities.

PCBDE is a regulatory anchor for the group's consolidated supervision by BaFin and Bundesbank. Fitch believes the regulator would be supportive of any measures by PCH to protect German deposits and ensure the bank's viability. A profit and loss transfer agreement between the holding and PCBDE includes a provision requiring a capital injection by the parent if PCBDE's regulatory total capital ratio falls below 13%.

PCBDE DEPOSIT RATINGS

PCBDE's Deposit Ratings are aligned with the bank's IDRs. We have not given any Deposit Rating uplift because in Fitch's view, the bank's qualifying debt buffers would not afford any obvious additional benefit over and above the support benefit already factored into the bank's IDRs, even if they reach a sufficient size in future.

RATING SENSITIVITIES

PCH AND PCBDE - IDRS AND SUPPORT RATINGS

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

A weakening of support available to PCH due to, for example, an exit of one or more core IFI shareholders, or a change in their support stance, could lead to a downgrade of PCH's IDRs.

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

The IDRs could be upgraded if PCH's strategic importance for its core IFI shareholders increases.

The Stable Outlook reflects Fitch's view that the propensity and ability of PCH's owners to provide support are unlikely to change in the near to medium term.

As PCBDE's IDRs are equalised with PCH, its ratings will move in tandem with PCH's ratings.

SUBSIDIARY BANKS - IDRS AND SUPPORT RATINGS

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

The IDRs of the five subsidiary banks would likely be downgraded if PCH's ability and propensity to support them weaken, with the former being reflected in PCH's ratings. The latter is primarily based on our view on the PCH's commitment to the respective countries. We do not expect any such changes in the near to medium-term future.

Changes in Fitch's perception of country risks, in particular an increase in transfer and convertibility risks in Albania, Bosnia & Herzegovina and Kosovo, could also result in downgrades of the respective subsidiaries' IDRs. PCBNM and PCBS's IDRs could be downgraded if the respective jurisdictions' Country Ceilings are revised downwards.

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

PCBNM and PCBS could be upgraded if the parent's rating is upgraded, which is less likely given the Stable Outlook on PCH's IDR. PCBA, PCBBiH and PCBK could be upgraded as a result of diminished country risks, which we view as unlikely in the medium term.

PCH - VR

An upgrade of PCH's VR would require an improvement of the operating environments of the jurisdictions where the group operates, maintaining asset quality, sustainable improvement in profitability and strengthening of capitalisation.

PCH's VR could be downgraded as a result of a significant deterioration of the operating environments, which could for example result from the economic fallout from COVID-19, if combined with asset quality weakening and reduced capital buffers. PCH's VR could be also downgraded if we find that the capital and liquidity fungibility in the group has been materially and sustainably constrained, putting pressure on the group's liquidity profile and the holding's double leverage.

SUBSIDIARY BANKS - VRs

The subsidiary banks' VRs could be downgraded in the event of a material worsening of their respective operating environments sparked by the coronavirus outbreak, especially if accompanied by significant deterioration in their asset quality and profitability.

PCBK, PCBNM and PCBS could be upgraded if their operating environments improve and their internal capital generation strengthens. An upgrade of PCBA and PCBBiH would additionally require a broadening of their franchises and a material improvement in core profitability metrics. We believe it is unlikely in the medium term given the expected negative impact of the pandemic on their operating environments and performance.

BEST/WORST CASE RATING SCENARIO

Ratings of Financial Institutions 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 https://www.fitchratings.com/site/re/10111579.

SUMMARY OF FINANCIAL ADJUSTMENTS

Fitch has adjusted the impaired loan ratio as reported under local regulatory standards for PCBBiH to bring it in line with the reporting standards of PCH and other subsidiaries. The major difference is treatment of written-off loans, which under local standards are part of both gross loans and impaired loans figures.

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.

PUBLIC RATINGS WITH CREDIT LINKAGE TO OTHER RATINGS

PCH's IDRs and Support Rating reflect potential support from its core IFI shareholders, of which KfW is the only entity rated by Fitch. The IDRs and Support Ratings of the six subsidiary banks are driven by support from PCH.

ESG CONSIDERATIONS

ESG issues are credit neutral or have only a minimal credit impact on the entity(ies), either due to their nature or 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.

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

ProCredit Bank ad Beograd	EU Issued
ProCredit Bank AD Skopje	EU Issued
ProCredit Bank AG	EU Issued
ProCredit Bank d.d. Sarajevo	EU Issued
ProCredit Bank Sh.a.	EU Issued
ProCredit Bank SH.A.	EU Issued
ProCredit Holding AG & Co. KGaA	EU Issued

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Structured Finance: Structured Credit Structured Finance Banks Europe Serbia

Germany Albania North Macedonia Kosovo Bosnia & Herzegovina
