FitchRatings

RATING ACTION COMMENTARY

Fitch Revises Volksbanken-Verbund's Outlook to Positive; Affirms Long-Term IDR at 'BBB'

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Fitch Ratings - Frankfurt am Main - 14 Sep 2021: Fitch Ratings has revised Volksbanken-Verbund's (VB-Verbund) Outlook to Positive from Negative, while affirming the group's Long-Term Issuer Default Rating (IDR) at 'BBB', and Viability Rating (VR) at 'bbb'. A list of rating actions is below.

The Outlook revision reflects VB-Verbund's improving financial profile amid easing pandemic-induced risks. We have also revised the outlook on the group's operating environment score (aa-) to stable from negative, as Austria's economy continues to recover firmly from last year's recession, and performs better than we expected in mid-2020. Comprehensive state support has so far underpinned the banking sector's resilient asset quality and profitability by strongly containing unemployment and corporate failures.

We have revised to positive from negative the outlook on VB-Verbund's risk appetite (bbb+) and asset quality (bbb+) to reflect the group's resilient and gradually improving loan quality, underpinned by a low-risk business model and low risk appetite, including prudent underwriting standards. The two scores could be raised by one notch once VB-Verbund establishes a record of operating under its post-restructuring risk management framework and asset-quality metrics remaining resilient during the post-pandemic recovery.

We have also revised to stable from negative the outlook on the group's profitability (bbb-) and capitalisation (bbb) scores, which we now expect to remain resilient to plausible stress scenarios.

KEY RATING DRIVERS

Fitch assigns 'group' ratings to VB-Verbund and each of its member 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 regional cooperative banks, whose strong cohesion is primarily ensured by their mutual support scheme, which underpins the group ratings. The group's smaller domestic franchise and less diverse business model than higher-rated peers' results in below-average operating profitability and cost efficiency, and somewhat limits its financial flexibility.

We expect asset quality to remain resilient, as VB-Verbund's focus on retail, self-employed and SME clients in Austria, prudent underwriting, conservative loan collateralisation and low loan concentrations reflect the group's moderate appetite for credit risk. We expect the four-year average non-performing loan (NPL; Stage 3) ratio (1.8% end-1H21) to remain below 3%, even though NPLs could rise temporarily and moderately in the short term as state support (e.g. furlough schemes) recedes and the impact from the pandemic on more vulnerable self-employed and SME clients becomes more apparent.

VB-Verbund's profitability remains modest by international standards, and the group would benefit from efficiency improvements to cope with competitive pressure and low interest rates. We expect the four-year average operating profit/risk-weighted assets (RWAs) to remain above 0.5% through the crisis. The ratio strongly rebounded to 1.7% in 1H21 (annualised), from a weak 0.2% in 2020 that was burdened by loan impairment charges (LICs) largely related to expected Stage 2 credit losses. However, the level of profitability achieved in 1H21 is, in our view, not sustainable, because it was inflated by LIC reversals as the expected credit losses did not materialise.

Since the group broke even in 2017 following several years of restructuring and legacy-driven losses, performance has considerably improved and stabilised. We expect the group's continued focus on cost discipline to support profitability when the operating environment normalises.

Capitalisation is adequate in light of VB-Verbund's low risk profile, although modest profits and the obligation to repay by end-2023 to the Austrian state the remaining

EUR224 million due after the bailout in 2012 will limit capital generation in the medium term.

Capitalisation improved in 2020 and 1H21, with a common equity Tier 1 (CET1) ratio of 14.5% and a solid Basel leverage ratio of 6.6% at end-1H21, as the group's focus on SME lending led to a significant decrease in RWAs. The latter was due to regulatory relief resulting from application of the prudential SME supporting factor under the EU capital regulation requirement. IFRS 9 transitional rules temporarily increase the group's capital ratios, while the fully loaded CET1 ratio was 13.9% at end-1H21. Our stable outlook on capitalisation reflects our expectation that VB-Verbund will maintain sufficient buffers over its regulatory requirements.

VB-Verbund's stable, increasingly diversified funding mix is underpinned by granular retail and small-SME deposits. The group has gradually restored its access to capital markets through covered bond, Tier 2, Additional Tier 1 and senior non-preferred notes issuance. The latter (EUR500 million in 1H21) contributes to achieving VB-Verbund's minimum requirement for own funds and eligible liabilities of 26.2% by 2025. VB-Verbund's and the member banks' Short-Term IDRs of 'F2' are the higher option mapping to a 'BBB' Long-Term IDR and reflects the group's funding and liquidity score of 'bbb+'.

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

VB-Verbund's '5' SR and 'No Floor' SRF reflect Fitch's view that senior creditors can no longer rely on full extraordinary state support. The EU's Bank Recovery and Resolution Directive and Single Resolution Mechanism provide a resolution framework that is likely to require senior creditors participating in losses, if necessary, instead, or ahead of banks receiving sovereign support.

RATING SENSITIVITIES

IDRS AND VR

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

An upgrade of the IDRs and VR would require asset quality to remain resilient over the next one to two years, ie the group's NPL ratio remaining below 3%, and evidence that the group will not relax its prudent risk standards post-pandemic. An upgrade would also be contingent on VB-Verbund sustainably maintaining operating profit/RWA comfortably above 0.5% and a CET1 ratio above 12.5%, following full repayment to the Austrian government.

An upgrade of the Short-Term IDRs is unlikely, as it would require a two-notch upgrade of the funding and liquidity score to 'a', in conjunction with an upgrade of the Long-Term IDRs.

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

A downgrade of the IDRs and VR is unlikely in the short term as indicated by the Positive Outlook. Pressure on the ratings could arise in the longer term from a durable and material deterioration in asset quality, earnings and capitalisation, with an NPL ratio above 4%, operating profit/RWA below 0.5% or a CET1 ratio below 11.5% without clear recovery prospects.

The Short-Term IDRs are sensitive to a downgrade of the Long-Term IDRs or to a deterioration of the group's funding and liquidity profile.

SR AND SRF

An upgrade of VB-Verbund's SR and upward revision of the SRF would require a positive change in the sovereign's propensity to support banks. 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

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
Volksbank Wien AG	LT IDR	BBB Rating Outlook Positive	Affirmed	BBB Rating Outlook Negative
	ST IDR	F2	Affirmed	F2
Volksbank Salzburg eG	LT IDR	BBB Rating Outlook Positive	Affirmed	BBB Rating Outlook Negative
	ST IDR	F2	Affirmed	F2
Volksbank Niederoesterreich AG	LT IDR	BBB Rating Outlook Positive	Affirmed	BBB Rating Outlook Negative

VIEW ADDITIONAL RATING DETAILS

FITCH RATINGS ANALYSTS

Markus Glabach
Director
Primary Rating Analyst
+49 69 768076 195
markus.glabach@fitchratings.com
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
marco.diamantini@fitchratings.com

Christian Kuendig
Senior Director
Committee Chairperson
+44 20 3530 1399
christian.kuendig@fitchratings.com

MEDIA CONTACTS

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

Additional information is available on www.fitchratings.com

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APPLICABLE CRITERIA

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

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Dodd-Frank Rating Information Disclosure Form

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Endorsement Policy

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