Moody's

Rating Action: Moody's affirms IKB Deutsche Industriebank AG's Baa1 long-term deposit and issuer ratings, changes outlook to negative from stable

13 Sep 2023

Frankfurt am Main, September 13, 2023 -- Moody's Investors Service (Moody's) has today affirmed IKB Deutsche Industriebank AG's (IKB's) Baa1/P-2 long- and short-term deposit and issuer ratings as well as the bank's A3/P-2 long- and short-term Counterparty Risk Ratings (CRRs); the outlook on the long-term deposit and issuer ratings was changed to negative from stable. Concurrently, the rating agency affirmed IKB's baa3 Baseline Credit Assessment (BCA) and baa3 Adjusted BCA and its A3(cr)/P-2(cr) long- and short-term Counterparty Risk Assessment (CR Assessment).

RATINGS RATIONALE

--AFFIRMATION OF BASELINE CREDIT ASSESSMENT AND ADJUSTED BASELINE CREDIT ASSESSMENT

The affirmation of IKB's baa3 BCA reflects its sustained good asset quality with a non-performing loan ratio of below 2% as a specialized lender to mostly German mid-sized corporates (Mittelstand), paired with sound capitalization as well as good core profitability above the German sector average. Further, IKB's quasi-monoline business model remains captured in the baa3 BCA, highlighting limited business diversification for its revenues and profits. Despite IKB's reliance on stable and fully matched development bank funding for most of its lending activities, the affirmation also incorporates the bank's overall relatively weaker funding and liquidity profile, with dependencies on price-sensitive deposits, central bank and other short-term (repurchase agreement, or repo) funding and a reduced volume of available liquidity to compensate for any unexpected funding outflows.

Despite weaker economic growth, higher interest rate costs for corporates, as well as cyclical and structural challenges for the automotive and high energy-consuming sectors in Germany, Moody's expects only a mild deterioration in IKB's asset quality, in line with a typical economic cycle development.

The bank's profitability has recovered from a hit in earnings in 2022, though Moody's expects the bank's profitability to be challenged by the more adverse economic environment through rising risk costs and higher refinancing costs, which will largely balance stronger interest income. Further, significantly reduced market risks imply lower future earnings volatility. In 2022, IKB recorded almost half a billion in losses from its securities book after the increase in rates, while the gains on related hedges and derivatives remain largely unrealized. Regulatory findings mainly related to market risk management shortcomings have led to a capital add-on since spring 2022.

IKB's capitalisation continues to provide a buffer to regulatory requirements, though the rating agency expects the bank to reduce its regulatory Common Equity Tier 1 (CET1), reported 15.8% as of half-year 2023 - once the above-mentioned capital-add on will be removed - to previous management target levels of 13.0-14.0%.

IKB's funding profile is characterized by a significant market funding dependence, combined with a narrowing and ver limited liquidity cushion. A key driver is the bank's repo business with the European central bank, implying very high asset encumbrance, particularly as the bank reduced its securities portfolio over time. In Moody's opinion, the available volume of unencumbered liquid resources now stands at a level that is providing a limited cushion in a more challenging market funding environment, particularly in a context of an online deposit franchise (85% deposit insured), that the rating agency considers as more exposed to volatility and reputational risks.

Moody's regards the shift to lower, freely available liquidity resources indicative of the bank's elevated risk appetite, an important factor under the assessment of governance. While the rating agency still regards governance risks to be moderate as reflected in a governance issuer profile score (IPS) of G-3, it considers the tighter liquidity management in the changed funding environment a critical development and the a key driver for the change in rating outlook to negative from stable.

The affirmation of IKB's Adjusted BCA of baa3 follows the affirmation of the BCA.

--AFFIRMATION OF DEPOSIT AND ISSUER RATINGS

The Baa1 long-term deposit and issuer ratings are based on the bank's baa3 BCA and Adjusted BCA and the outcome of Moody's Advanced Loss Given Failure (LGF) analysis. Moody's does not apply rating uplift from government support, which the rating agency assumes to be low because of IKB's small importance to the German banking system.

IKB's funding structure relies primarily on development bank and central bank funding. It is complemented by retail and some corporate deposits, a limited volume of senior and junior senior liabilities and a more significant, but declining amount of subordinated debt. While the overall volume of bail-in-able debt in relation to total liabilities has gradually declined, the rating agency continues to apply two notches of uplift from its Advanced LGF analysis for the deposit and issuer ratings, thereby taking into account available options in the bank's liability structure to address a temporary reduced level of protection for senior creditors.

-- CHANGE IN OUTLOOK TO NEGATIVE FROM STABLE

The change in outlook on the long-term deposit and issuer ratings to negative from stable reflects the potential downwards pressure on the bank's intrinsic strength, unless the bank strengthens its liquidity profile again and better protects itself from unexpected funding challenges. The negative outlook further reflects a possible sustainable increase in loss severity for these instrument classes, provided that IKB will not reduce its balance sheet further or issue liabilities ranking below senior unsecured. A sustainably lower volume of liabilities subordinated to senior unsecured liabilities would provide lower loss protection to investors.

FACTORS THAT COULD LEAD TO AN UPGRADE OR DOWNGRADE OF THE RATINGS

A ratings upgrade could be prompted by an upgrade of the BCA or by an additional rating uplift from Moody's Advanced LGF analysis for the deposit and issuer ratings as a result of a significantly higher volume of instruments designed to absorb losses in resolution.

An upgrade of IKB's baa3 BCA could be prompted by a combined significant improvement of solvency scores, including a sustainable increase of capital beyond the bank's medium-term target and a material better profitability. Alternatively, IKB's BCA could be upgraded if the bank substantially diversifies its business profile without taking undue strategic and operational risks as a result of such a shift.

Further, a material increase in the available buffers for investors from Moody's Advanced LGF analysis by the issuance of senior non-preferred, subordinate liabilities or a significant reduction in its balance sheet size to reduce the loss severity for deposits and senior unsecured liabilities are factors that could result in an upgrade.

A downgrade of IKB's issuer and deposit ratings could be prompted by a BCA downgrade or a sustainably weaker result from Moody's Advanced LGF analysis as a result of a decline in instruments designed to absorb losses in case of failure.

IKB's BCA could be downgraded in case of a sustainably weakened liquidity profile, with a persistent level of very limited, unencumbered liquidity buffers or a higher recourse to market funding. Further, a deterioration in solvency metrics, with risk-weighted capitalisation declining beyond Moody's expectations, the bank's underlying profitability plummeting on a sustained basis and a marked increase in asset risk could impose downwards pressure on the bank's BCA.

A sustainable shift in the bank's liability structure, mainly a persistent reduction in senior non-preferred or subordinated liabilities, in the volume of junior deposits or an unchanged very high recourse on secured funding, may reduce the uplift provided by Moody's Advanced LGF analysis and result in a downgrade of the bank's ratings.

PRINCIPAL METHODOLOGY

The principal methodology used in these ratings was Banks Methodology published in July 2021 and available at https://ratings.moodys.com/rmc-documents/71997. Alternatively, please see the Rating Methodologies page on https://ratings.moodys.com for a copy of this methodology.

REGULATORY DISCLOSURES

For further specification of Moody's key rating assumptions and sensitivity analysis, see the sections Methodology Assumptions and Sensitivity to Assumptions in the disclosure form. Moody's Rating Symbols and Definitions can be found on https://ratings.moodys.com/rating-definitions.

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Regulatory disclosures contained in this press release apply to the credit rating and, if applicable, the related rating outlook or rating review.

Moody's general principles for assessing environmental, social and governance (ESG) risks in our credit analysis can be found at https://ratings.moodys.com/documents/PBC_1288235.

At least one ESG consideration was material to the credit rating action(s) announced and described above.

The Global Scale Credit Rating on this Credit Rating Announcement was issued by one of Moody's affiliates outside the UK and is endorsed by Moody's Investors Service Limited, One Canada Square, Canary Wharf, London E14 5FA under the law applicable to credit rating agencies in the UK. Further information on the UK endorsement status and on the Moody's office that issued the credit rating is available on https://ratings.moodys.com.

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