FitchRatings

RATING ACTION COMMENTARY

Fitch Downgrades IKB Deutsche Industriebank to 'BBB-'; Stable Outlook

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Fitch Ratings - Frankfurt am Main - 07 Dec 2022: Fitch Ratings has downgraded IKB Deutsche Industriebank AG's (IKB) Long-Term Issuer Default Rating (IDR) to 'BBB-' from 'BBB' and Viability Rating (VR) to 'bbb-' from 'bbb'. The Outlook on the Long-Term IDR is Stable. The Short-Term IDR has been affirmed at 'F3'.

The downgrade reflects IKB's weaker financial metrics following the bank's reduction in profitability and a release of capital reserves. This reduces the bank's financial flexibility to respond to potentially adverse market developments ahead of an expected recession in Germany, and to grow its business.

The Stable Outlook on the Long-Term IDR reflects our view that IKB's profitability should recover in the coming years despite remaining more volatile in the short term due to changes in market valuations. This could further constrain its internal capital generation.

KEY RATING DRIVERS

Profitability Constrains Ratings: IKB's ratings reflect its modest profitability prospects, stable asset quality, which is underpinned by the resilience of its good quality mid-cap corporate borrowers, adequate capitalisation, and a satisfactory funding and liquidity profile. The VR is one notch below the 'bbb' implied VR, as weak earnings and profitability, scored at 'bb+', has a high importance to the bank's credit profile.

Lower Growth Expectations: We expect IKB's business profile to remain stable during the expected recession, reflecting the resilience of its corporate 'Mittelstand' portfolio. However, IKB's more selective new business and temporarily increased regulatory capital requirements constrain its growth opportunities and revenue generation.

Healthy Underwriting Standards but Concentration: IKB has improved its risk profile over the past 12 months by tightening underwriting standards and concentration of new business toward high quality corporates. IKB implemented various measures to address regulatory findings on its risk management framework in 2021, including the calibration of its risk-bearing capacity and market risk models, and also reduced market risks in its securities portfolio in 2022.

Resilient Asset Quality: IKB's asset quality is a rating strength and remains resilient, reflecting the bank's focus on high quality German mid-caps. We believe it will be challenging for IKB to keep its asset quality at current levels in a recessionary environment. However, we expect a gradual rise in the impaired loan ratio, contained to below 3% over the next two years, as we view IKB's exposure to cyclical and energy-intensive sectors as manageable.

Valuation Losses Weaken Profitability: We expect an operating loss in 2022 under Fitch's methodology due to one-off write-downs and disposal losses in the securities portfolio, reflecting rising rates and spread volatility. Reduced new business volumes and lower interest earning assets will constrain IKB's earnings. Revenue diversification remains modest with a strong reliance on net interest income. IKB's profitability benefits from low costs, due to lean processes and the reluctance of larger competitors (for strategic or cost reasons) to dedicate more resources to the structuring-intensive part of the public development loan (PDL) market.

Weakened but Still Adequate Capitalisation: IKB has released material capital reserves (built under §340g German GAAP, which are eligible as common equity Tier 1 (CET1) capital) to compensate for material write-downs and disposal losses in its securities portfolio. These losses have been partly compensated by unrealised gains in the derivative portfolio, which are not reflected in the bank's profit and loss statement under German GAAP.

The lowered score at 'bbb' reflects a smaller amount of capital available for loss absorption, despite various measures IKB has taken to improve its capital base such as profit retention and risk reduction. We believe that IKB can restore its capital base and will maintain its CET1 ratio above 13% in the near to medium term. IKB's fully phased CET1 ratio was 14.9 % at end-June 2022. Our assessment of capitalisation is constrained by concentration in corporate lending.

Satisfactory Funding and Liquidity: IKB's weak capital market franchise is balanced by its sound deposit taking from corporate and retail customers and secured central bank funding capacity. IKB benefits from maturity-matched funding provided by 'AAA' rated German state-owned development banks (predominantly KfW) for the entire PDL portfolio. Its liquidity profile is adequate but the bank has higher liquidity requirements over the next 12 months due to maturing targeted longer-term refinancing operations drawings.

RATING SENSITIVITIES

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

IKB's ratings have sufficient headroom at current levels but would come under pressure in the event of structural operating losses for an extended period and a decline of the CET1 ratio below 12% without clear recovery prospects. A material and structural deterioration in the impaired loan ratio to above 3% without a credible plan to reduce it would also put pressure on the ratings.

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

An upgrade of the bank's ratings would require a sustainable recovery in its profitability with an operating profit/risk-weighted assets (RWAs) converging towards 1% and a proven record of operations with the current reduced risk appetite. It would also require maintenance of good asset quality metrics through the weakening operating environment as well as reasonable buffers over its capital requirements.

OTHER DEBT AND ISSUER RATINGS: KEY RATING DRIVERS

The bank's 'F3' Short-Term IDR is the only option mapping to its 'BBB-' Long-Term IDR.

IKB's deposit ratings are aligned with the bank's IDRs. IKB's preferred resolution strategy is liquidation. Therefore, we do not expect the bank to be subject to a minimum requirement for own funds and eligible liabilities and to build or maintain buffers of junior and senior non-preferred debt in excess of 10% of RWAs.

Government Support Rating (GSR): IKB's GSR of 'no support' reflects Fitch's view that senior creditors can no longer rely on full extraordinary state support. This is driven by the EU's Bank Recovery and Resolution Directive and the Single Resolution Mechanism, which provide a resolution framework that is likely to require senior creditors participating in losses, if necessary, instead or ahead of a bank receiving government support.

OTHER DEBT AND ISSUER RATINGS: RATING SENSITIVITIES

IKB's deposit ratings are sensitive to changes in its IDRs.

IKB's GSR is at the bottom of Fitch's rating scale and therefore cannot be downgraded.

An upgrade of the GSR would require a higher propensity of sovereign support. While not impossible, the Bank Recovery and Resolution Directive makes this highly unlikely.

VR ADJUSTMENTS

The asset quality score of 'bbb+' has been assigned below the 'a' category implied score, due to the following adjustment reason: concentrations (negative).

The earnings and profitability score of 'bb+' has been assigned below the 'bbb' category implied score, due to the following adjustment reason: historical and future metrics (negative).

The capitalisation and leverage score of 'bbb' has been assigned below the 'aa' category implied score, due to the following adjustment reason: risk profile and business model (negative) and regulatory capitalisation (negative).

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
IKB Deutsche Industriebank AG	LT IDR	BBB- Rating Outlook Stable	Downgrade	BBB Rating Outlook Stable
	ST IDR	F3	Affirmed	F3
	Viability	bbb-	Downgrade	bbb
	Government Support	ns	Affirmed	ns
long-term deposits	LT	BBB-	Downgrade	BBB
short-term deposits	ST	F3	Affirmed	F3

VIEW ADDITIONAL RATING DETAILS

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APPLICABLE CRITERIA

Bank Rating Criteria (pub. 07 Sep 2022) (including rating assumption sensitivity)

ADDITIONAL DISCLOSURES

Dodd-Frank Rating Information Disclosure Form

Solicitation Status

Endorsement Policy

ENDORSEMENT STATUS

IKB Deutsche Industriebank AG	EU Issued, UK Endorsed

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