Fitch Revises the Outlook on Rabobank to Negative; Affirms at 'AA-'

Fitch Ratings - Paris/London - 25 October 2019:

Fitch Ratings has affirmed Cooperatieve Rabobank U.A.'s Long-Term Issuer Default Rating (IDR) at 'AA-' and its Viability Rating (VR) at 'a+'. Fitch has also revised the Outlook on the Long-Term IDR to Negative from Stable. A full list of rating actions is at the end of this Rating Action Commentary.

The rating actions are part of a portfolio review of major rated Dutch banking groups.

Rabobank's Long-Term IDR and senior debt ratings benefit from a one-notch uplift above its VR due to a large buffer of qualifying junior debt (QJD), which would protect the bank's senior debt from default in the event of failure.

The Outlook revision reflects the increased uncertainty over whether the qualifying junior debt buffer will be maintained at a level sufficient to protect all senior obligations, including senior non-preferred debt, from default. Senior non-preferred debt is the reference liability for the Long-Term IDR.

This is because of the uncertainty over the issuance volumes of subordinated (primarily Tier 2) instruments given the relative attractiveness of senior non-preferred debt for the purposes of meeting the minimum requirement for own funds and eligible liabilities (MREL). It also reflects the likely rise in capital requirements because of a regulatory-driven increase in the bank's risk-weighted assets (RWAs) as a result of ECB's targeted review of internal models and the potential introduction of risk weight floors on Dutch mortgage loans proposed by the Dutch central bank. These would partly bring forward the impact of Basel III end-game rules, which would have otherwise been subject to a long phase-in.

RATING ACTIONS

ENTITY/DEBT	RATING		PRIOR
Cooperatieve Rabobank U.A.	LT IDR AA- ⊖ Affirmed		AA- ○
	ST IDR F1+ Affirmed		F1+
	Viability a+ Affirmed		a+
	Support 5 Affirmed		5
	Support Floor NF Affirmed		NF
	DCR AA-(dcr) Affirmed		AA-(dcr)
subordinated	LT A		A

	Affirmed		
subordinated	LT BBB Affirmed		BBB
subordinated	LT BBB- Affirmed		BBB-
Senior non-preferred	LT AA- Affirmed		AA-
Senior preferred	LT AA- Affirmed		AA-
Senior preferred	ST F1+ Affirmed		F1+

Key Rating Drivers

IDRS, DERIVATIVE COUNTERPARTY RATING AND SENIOR DEBT

Rabobank's Long-Term IDR and senior debt ratings are one notch above its VR because Fitch believes the risk of default on senior obligations, as measured by the Long-Term IDR, is lower than the risk of the bank failing, as measured by its VR. This is due to the bank's significant QJD buffer, which could be made available to protect senior obligations from default in the event of failure, either under a resolution process or as part of a private-sector solution (such as a distressed-debt exchange) to avoid a resolution action.

Without such a private-sector solution, we would expect a resolution action to be taken on Rabobank when it breaches minimum capital requirements. We have assumed that the intervention point would be around the bank's minimum common equity Tier 1 (CET1) requirement of 6.25% (Pillar 1 and Pillar 2, excluding the combined buffer requirements or CBR). We further assume Rabobank would need to meet its total minimum capital requirement immediately after a resolution action, which on a fully loaded basis, including the CBR but excluding the countercyclical buffer, amounts to 15.25% of RWAs. Taking into account additional undisclosed Pillar 2 guidance as well as a potential risk-weight increase in a stress scenario, a QJD buffer of 10% of RWAs would most likely be sufficient to restore the group's viability without hitting any senior creditors.

At end-June 2019, the QJD buffer was 10.2% of RWAs pro-forma for the EUR1.25 billion additional Tier 1 issue in early September 2019. Additional Tier 1 and Tier 2 debt, which comprises Fitch's QJD, contribute to meeting the bank's MREL requirement. However, MREL can also be met with senior non-preferred debt, which over time can partly replace more expensive Tier 2 instruments. We calculate that slightly over EUR3 billion of the instruments that comprise Rabobank's QJD (of which about EUR1.4 billion/0.7% of RWA in Tier 2 instruments) either mature or can be called until end-2020.

It is uncertain to what extent these will be refinanced. While Rabobank aims to maintain a significant layer of subordinated instruments that protects senior non-preferred creditors, it no longer targets a total capital ratio of above 25% and expects it to slightly decline. Previously, Rabobank's CET1 and total capital ratios targets of at least 14% and at least 25% respectively suggested that a sustainable QJD buffer of around 10% was likely to be maintained.

The Derivative Counterparty Rating (DCR) is at the same level as the Long-Term IDR because derivative counterparties have no preferential status over other senior obligations in a resolution scenario under Dutch legislation. The Short-Term IDR is the only option mapping to a 'AA-' Long-Term IDR under Fitch's criteria.

VR

Rabobank's VR is underpinned by its modest risk appetite, which Fitch believes will remain central to the bank's strategy. The rating is also supported by Rabobank's leading market position in Dutch retail banking, complemented by a solid franchise in the global food and agriculture sectors. The rating is based on the expectation that Rabobank's capital ratios will remain sound while the amount of unreserved non-performing loans (NPLs) will decrease and that the bank will maintain prudent liquidity and diversified funding.

We expect Rabobank to maintain a prudent approach to risk, reflected in low-risk underwriting standards which benefit from Rabobank's focus on sectors and products where it has extensive expertise, and a conservative approach to capital and liquidity management.

Rabobank's higher-than-peers non-performing loans (NPLs, calculated by Fitch at 3.9% of gross loans at end-June 2019) partly reflect several one-offs and a conservative NPL definition, which was tightened at the beginning of 2018. From 2017, Rabobank's reported NPLs have also included exposures outside of its private sector loan book. For this reason, the Fitch-calculated NPL ratio, which uses gross customer loans in the denominator, is slightly overstated. On a like-for-like basis, Rabobank's NPL stock has decreased by about a third between end-2014 and end-June 2019. The ratings factor in our expectation that NPLs will continue to decrease, and setbacks to this expectation, could put ratings under pressure.

We also expect the bank to be more proactive in managing its NPL stock, particularly given the recently introduced backstop regulation and supervisory expectations on NPL coverage, which envisage full coverage of NPLs by loss allowances after a certain period of time. The NPL coverage by loan-loss allowances of 24% at end-June 2019 reflects a highly collateralised loan book but is low by international standards.

Rabobank's profitability has improved in recent years, largely as a result of very low loan impairment charges (LICs) but also since the bank's cost-efficiency measures have started to pay off. The bank has also strengthened its pricing discipline in recent years, although the positive impact on the net interest margin has been partly offset by persistently low interest rates. The outlook on earnings is now more challenging, however. We expect interest rates to stay lower for longer and depress revenues, while further large-scale cost cuts will be difficult to deliver in the near term. As a result, the bank is unlikely to achieve its 2020 cost/income ambition of 53%-54%. We expect Rabobank's LICs to remain below the long-term average level estimated by the bank at 20bp-25bp of average gross loans (18bp in 1H19) as the Dutch economy continues to grow, though at a slower rate. This should support Rabobank's bottom line. At the same time, we do not expect the LICs to return to the unsustainably low levels of recent years given that growth has moderated and the macro-economic outlook has become less certain.

Rabobank's fully loaded CET1 ratio was a solid 15.8% at end-June 2019, well above the bank's conservative target of at least 14% and compares well with peers'. The FCC ratio was similarly solid at 16.8%, and the fully loaded Basel III leverage ratio was a sound 5.8%. Our assessment of Rabobank's capitalisation takes into account the bank's elevated but decreasing exposure to unreserved NPLs (37% of FCC at end-June 2019), which makes capitalisation sensitive to a reduction in collateral values.

Rabobank estimates that proposed Basel III end-game rules would indicatively result in an increase of RWA of about 30%-35% based on the end-2018 balance sheet. Management believes that mitigating measures can bring the RWA inflation down to below 30%. RWA increase could be partially brought forward by the ECB's targeted review of internal models and by risk-weight floors on Dutch mortgage loans not covered by the national mortgage guarantee proposed by the Dutch central bank. If approved, the latter measure could come into force in late 2020. The effects should be manageable for Rabobank, despite its large exposure to Dutch mortgage loans, given its healthy capital ratios.

Customer deposits are Rabobank's main source of funding and the bank has a strong franchise in the Netherlands. Rabobank maintains some reliance on wholesale funding because of the structural shortage of deposits in the Dutch banking system. This is largely mitigated by sound market access and the group's prudent liquidity management. Its liquidity buffer is ample at about EUR114 billion at end-June 2019 (about 20% of assets) and a liquidity coverage ratio of 124%.

SUPPORT RATING AND SUPPORT RATING FLOOR

The Support Rating of '5' and Support Rating Floor of 'No Floor' reflect Fitch's view that senior creditors can no longer rely on receiving full extraordinary support from the sovereign if Rabobank becomes non-viable. The EU's Bank Recovery and Resolution Directive and the Single Resolution Mechanism for eurozone banks provide a framework for resolving banks that is likely to require senior creditors participating in losses, if necessary, instead of, or ahead of, a bank receiving sovereign support.

SUBORDINATED DEBT AND OTHER HYBRID SECURITIES

Subordinated debt and hybrid securities issued by Rabobank are notched off its VR. In accordance with Fitch's criteria, subordinated (lower Tier 2) debt is rated one notch below Rabobank's VR to reflect the higher loss severity of this type of debt compared with average recoveries.

The non-innovative old-style Tier 1 securities are rated four notches below Rabobank's VR to reflect the higher loss severity risk of these securities than average recoveries (two notches from the VR) and the high risk of non-performance (an additional two notches).

The additional Tier 1 capital notes are rated five notches below Rabobank's VR. Two notches represent the potentially high loss severity associated with the deeply subordinated securities. The other three notches represent Fitch's assessment of the incremental non-performance risk of the securities, taking into account their fully discretionary coupon payments, which Fitch considers the most easily triggered form of loss absorption.

RATING SENSITIVITIES

IDRS, DCR AND SENIOR DEBT

The Long-Term IDR, DCR and senior debt ratings are sensitive to a change in the bank's VR as they are notched up from its VR.

The Long-Term IDR and senior non-preferred debt ratings are likely to be downgraded by one notch if there is a clear indication that the QJD buffer will fall below 10% of RWAs. The downgrade of the Long-Term IDR is also likely to result in a downgrade of the Short-Term IDR to 'F1', in accordance with Fitch mapping for short-term ratings and given our assessment of Rabobank's funding and liquidity at 'a+'.

The DCR and senior preferred debt ratings might in this case receive a one-notch uplift from the Long-Term IDR and affirmed, provided the combined buffer of QJD and senior non-preferred debt is above 10% of RWAs (end-June 2019: 12.7% of RWA pro-forma for the September additional Tier 1 issue).

The notching is also sensitive to changes in assumptions on the resolution intervention point and post-resolution capital needs, and the development of resolution planning more generally.

VR

Rabobank's VR could be downgraded if the improving trend in its NPLs, and the ratio of net NPLs to capital, reverses. A reduced focus on maintaining a high liquidity buffer, while not expected, would also put pressure on the ratings, due to the group's wholesale funding reliance. An upgrade of the VR is unlikely and would require a significant and structural improvement in profitability and asset quality.

SUPPORT RATING AND SUPPORT RATING FLOOR

An upgrade of the Support Rating or upward revision of the Support Rating Floor would be contingent on a positive change in the Dutch sovereign's propensity to support its banks. This is highly unlikely in Fitch's view.

SUBORDINATED DEBT AND OTHER HYBRID SECURITIES

Subordinated debt and other hybrid capital are all notched down from the bank's VR in accordance with Fitch's assessment of each instrument's respective non-performance and relative loss severity risk profiles, which vary considerably. Their ratings are primarily sensitive to any change in Rabobank's VR.

Additional Tier 1 capital notes are also sensitive to Fitch changing its assessment of the probability of their non-performance relative to the risk captured in Rabobank's VR.

ESG Considerations

The highest level of ESG credit relevance for Rabobank is a score of 3. This means that ESG issues are credit-neutral or have only a minimal credit impact on Rabobank, either due to their nature or to the way in which they are being managed by Rabobank. For more information on our ESG Relevance Scores, visit www.fitchratings.com/esg.

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Applicable Criteria

Bank Rating Criteria (pub. 12 Oct 2018)
Short-Term Ratings Criteria (pub. 02 May 2019)

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