FitchRatings

Banks
Other Banks
Germany

Erste Abwicklungsanstalt

Ratings

Foreign Currency

Long-Term IDR	AAA
Short-Term IDR	F1+
Derivative Counterparty Rating	AAA(dcr)
Support Rating	1

EAA's senior unsecured, grandfathered guaranteed debt ratings and Derivative Counterparty Rating are equalised with its Long-Term IDR, which is at the top of Fitch's rating scale.

Sovereign Risk

LT Foreign-Currency IDR	AAA
LT Local-Currency IDR	AAA

Outlooks

Long-Term Foreign-Currency IDR	Stable
Sovereign Long-Term Foreign-Currency IDR	Stable
Sovereign Long-Term Local-Currency IDR	Stable

Applicable Criteria

Short-Term Ratings Criteria (May 2019)

Bank Rating Criteria (October 2018)

Related Research

Fitch Affirms EAA at 'AAA'; Outlook Stable (November 2019)

Key Rating Drivers

Support Drives IDRs: Erste Abwicklungsanstalt's (EAA) Issuer Default Ratings (IDRs) are based on Fitch Ratings' view that EAA benefits from an extremely high likelihood of support from its public owners, primarily the German regional State of North Rhine-Westphalia (NRW; AAA/Stable) and the Federal Agency for Financial Market Stabilisation (FMSA), an institution legally and operationally supervised by Germany's Ministry of Finance. The statutory loss-absorption obligations stipulated in EAA's statutes underpin our view of support.

NRW Is Main Minority Owner: EAA is owned by NRW (48.2%), the regional savings banks associations of Westphalia-Lippe and Rhineland (25% each) and the local public authorities of Westphalia-Lippe and Rhineland (0.9% each). All stakeholders are, to varying degrees, liable for timely compensation of EAA's losses according to a scheme laid down in EAA's statutes.

Loss-Absorption Obligation: NRW and the FMSA share unlimited liability for losses above a cap of EUR9.5 billion. Below this cap, EAA's statutes define all owners' and the FMSA's loss compensation obligations as well as NRW's deficiency guarantee, should the other owners be unable to fulfil their liabilities. Based on this support mechanism, we equalise EAA's ratings with those of NRW, and thus of Germany, as the solidarity system that links the German federal states' creditworthiness to that of Germany (AAA/Stable) underpins NRW's ratings.

Wind-Down Mandate Underpins Support: EAA's owners have high political and economic incentives to provide support in a timely manner, due to the significant reputational and financial risks of not doing so. We do not assign a Viability Rating to EAA due to its business model, which is limited to winding down legacy assets and relies on state support.

Wind-Down Costs Erode Earnings: EAA optimises its wind-down strategy on a hold-or-sale basis by seeking a balance between maintaining sufficient interest income to cover its operating costs and generating disposal gains by accelerating the wind-down. As the run-off progress inevitably and rapidly reduces gross interest income, EAA has become loss-making in 3Q19 and is likely to remain so until the planned completion of the wind-down in 2027. However, it expects to maintain positive equity until then by containing losses.

Rating Sensitivities

NRW's IDRs; Support Mechanism: EAA's IDRs are primarily sensitive to NRW's ability and propensity to support and, consequently, to changes in the IDRs of NRW and, ultimately, of Germany. We view changes to the support mechanism's terms and legal structure as unlikely.

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Significant Changes

Becoming Structurally Loss Making

EAA has been modestly profitable until 2018, but after a small net loss of EUR9 million in 3Q19 we expect it to remain loss-making in the next years. Its shrinking asset base and revenue no longer generate sufficient income at this advanced stage of its wind-down to cover its operating cost base, which is neither fully variable nor scalable.

EAA envisages accelerating its wind-down plan and completing it before 2027 to mitigate losses by countering the rising cost pressure. We view this as realistic given EAA's good run-off progress so far. Balance-sheet liquidity management measures and the revaluation of its trading portfolio inflated the institution's total assets in 3Q19, but this trend is unlikely to be long-lasting.

EAA expects to complete its wind-down without drawing on its stakeholders' loss-absorption commitments. Absent unexpectedly adverse market developments, we view this as feasible. EAA updates each quarter its estimate of the changes in its equity until 2027, using multiple market parameters and assessing their impact on the wind-down plan. At end-3Q19, the institution expected that cumulated future losses will not exceed its current equity position by 2027.

Legal Disputes with Municipalities Settled

EAA had inherited from WestLB swap contracts and related legal disputes with dozens of municipalities in NRW. The municipalities accused WestLB of not disclosing relevant risks, because the benefits they expected from the contracts did not materialise. EAA has settled all remaining pending claims over the past two years and no longer faces related financial risk.

Outsourcing Is Key Component of Wind-Down Process

EAA has transferred significant duties to two dedicated service providers to cut staff costs without compromising operational stability or losing the expertise required to complete the wind-down. We believe these arrangements do not increase disruption or operational risk.

Operating Environment Significantly Influences Wind-Down Success

The operating environment affects EAA's performance and asset quality despite the absence of new business. Market developments influence demand and prices achievable for financial assets and, thus, the pace and financial implications of the wind-down process. In 2019, EAA benefited from benign developments. In particular, the ECB's government bond purchase programme positively influenced the liquidity and marketability of EAA's sovereign bond portfolio. EAA benefits from the low interest-rate environment, in contrast to other financial institutions. Investors continue to look for higher-yielding assets, which supports EAA's asset divestments.

Company Summary and Key Qualitative Assessment Factors

Wind-Down Mandate Defines Business Model; No New Business Origination

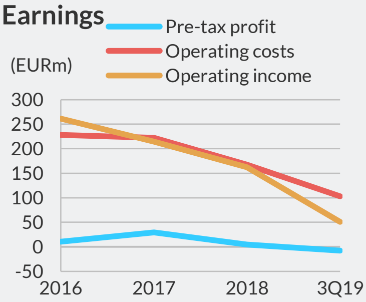
EAA was established at end-2009 to wind down in a value-preserving manner a large portfolio of WestLB, a former German Landesbank. WestLB's liquidation was ordered by the European Commission following multiple support measures from its public-sector owners before and during the 2008 global financial crisis. EAA's creation aimed to prevent the market disruption that an unorderly exit of the relatively large and interconnected WestLB could have triggered.

EAA's assets peaked above EUR120 billion at end-2012 after it received selected assets and grandfathered state-guaranteed liabilities of WestLB in several tranches from 2009 to 2012. Its public stakeholders' support obligation facilitates stable access to low-cost funding, which is a cornerstone of EAA's business model as it helps to mitigate wind-down losses.

Loss-Absorption Obligation of Owners and FMSA

EAA's IDRs are based on support from its owners and FMSA that arises from their loss-absorption obligation. EAA's statutes outline the liability cascade and the individual guarantors' contributions for predefined loss thresholds.

Wind-Down Costs Erode Earnings



Source: Fitch Ratings, EAA

Loss-Absorption Cascade

	Loss (EURm)
First loss up to EUR850 million is carried by: • NRW: 48.2% • Savings banks associations Westphalia-Lippe and Rhineland: each 25.0% • Local authorities of Westphalia-Lippe and Rhineland: each 0.9%	0 ⇩ 850
Second loss up to further EUR2,670 million is carried by: • NRW: 36.1% • Savings banks associations Westphalia-Lippe and Rhineland: each 18.7% • Local authorities of Westphalia-Lippe and Rhineland: each 0.7% • FMSA: 25.1%	851 ⇩ 3,520
Third loss up to further EUR6,000 million is carried by: • NRW: 50.0% • Savings banks associations Westphalia-Lippe and Rhineland: each 25%	3,521 ⇩ 9,520
Any loss above EUR9,520 million carried by: • NRW: 50.0% • NRW and FMSA: 50% (in proportions agreed by NRW and FMSA)	9,521 ⇩ Unlimited

Source: Fitch Ratings, Fitch Solutions, EAA

EAA must request loss compensation from its liable stakeholders within a reasonable time prior to an imminent insolvency. The stakeholders' loss compensation is triggered if such losses are likely to deplete EAA's paid-in equity (EUR650 million at end-3Q19) and undrawn capital (EUR480 million). The loss absorption must ensure EAA's ability to honour its liabilities on first demand. NRW's deficiency guarantee caps and covers the other owners' obligations. These loss-absorption commitments have never been drawn upon since EAA has been set up.

Support Unaffected by EU Bank Regulation

EAA is not a bank pursuant to the German Banking Act. It can conduct banking activities if these serve its wind-down purpose, but it is not allowed to originate new business. We do not expect any changes to the nature of the support arrangements and do not believe EAA's senior debt could become subject to bail-in measures.

Proven Record of Wind-Down Execution; Adequate Corporate Governance

EAA's management has a proven record of managing a complex portfolio diversified by region, sector, counterparty and structure, including riskier assets that require restructuring. EAA prepares comprehensive quarterly financial reports based on German GAAP. The FMSA monitors the implementation of its wind-down plan, and the federal and NRW regional audit courts monitor its commercial and budgetary performance. The German regulator supervises EAA to the limited extent that local banking regulation is applicable. EAA adheres to most minimum regulatory requirements on risk management of financial institutions. It includes its subsidiaries in its wind-down plan and risk reporting, although it is exempt from the obligation to prepare consolidated financial statements.

Key Financial Metrics – Latest Developments

Portfolio Reduction Across All Asset Classes

EAA's banking book and trading book exposures declined by 15% and 14%, respectively, during 9M19, and by 88% and 86%, respectively, since the beginning of 2012. The banking book exposure of EUR15.4 billion at end-3Q19 includes EUR6.2 billion of structured securities investments dominated by US mortgage-backed securities. The trading assets have a book value of EUR18.4 billion and mainly consist of interest-rate derivatives.

Large Exposures to Structured Notes

EAA's exposures include structured notes issued by Phoenix, a special-purpose vehicle, whose underlying assets are mostly high-risk US mortgage loans. EAA has reduced these notes to EUR3.6 billion (about a quarter of its banking book) at end-3Q19 from originally EUR23 billion via regular redemptions, sales, restructuring and legal procedures against US counterparties.

The remaining notes are rated investment-grade internally, but this takes into account a guarantee from EAA's owners covering a tranche of the Phoenix portfolio. EUR3.2 billion of the guarantee's initial EUR5 billion have been used to facilitate the wind-down. The undrawn EUR1.8 billion appears sufficient to cover future wind-down costs, in our view. However, we expect average wind-down costs to rise due to the remaining notes' very low marketability.

EAA's largest single-name concentrations are in its EUR2.6 billion public-sector portfolio, which is focused on Europe, especially Italy (EUR1.5 billion at end-3Q19) and Portugal (EUR0.7 billion). EAA also has material corporate and bank exposures in Italy and Spain.

Thin Capital Base but No Regulatory Capital Requirements

As a wind-down institution, EAA is not subject to the regulatory capital requirements applicable to banks. An assessment from an independent and qualified party confirms that EAA is also excluded from the scope of the Bank Recovery and Resolution Directive. This enables EAA to operate with a very thin equity base of 1.5% of its total assets. It does not disclose its risk-weighted assets, leverage and risk-weighted capital ratios as it is not obliged to do so.

Established and Stable Access to Capital Markets

As a non-bank, EAA has no deposits. Its purely wholesale funding comprises bonds and commercial papers placed mainly in euros and US dollars with institutional investors, mostly banks, central banks and asset managers, as well as repos. Its stakeholders' support commitment ensures strong access to market funding on favourable terms. Its debt benefits from a 0% risk weighting and Level 1 treatment for banks' liquidity coverage ratio.

With ongoing wind-down, medium- and long-term issuance volumes are subsequently decreasing, with new issues totalling EUR3 billion in 2018 and EUR2.1 billion during 9M19. We expect EAA to maintain a resilient capital market access as long as it remains an active benchmark issuer, which helps to preserve a substantial and diversified investor base.

We view EAA's liquidity risk as low in light of its status, stakeholders' support, large liquid assets, cash inflows from the wind-down and adequate liquidity monitoring processes. EAA performs regular liquidity stress-tests across its portfolio and for dollar assets specifically.

Summary Financials and Key Ratios

	30 September 2019	31 December 2018	31 December 2017	31 December 2016
	Interim	Year end	Year end	Year end
	Reviewed - unqualified	Audited - unqualified	Audited - unqualified	Audited - unqualified
Summary income statement (EURbn)				
Net interest & dividend income	59	110	128	154
Net fees and commissions	-13	-18	-13	12
Other operating income	5	76	167	80
Total operating income	51	167	282	246
Operating costs	103	167	222	228
Pre-impairment operating profit	-52	0	60	18
Loan & other impairment charges	-44	-5	31	8
Operating profit	-8	4	30	10
Net income	-9	3	14	10
Summary balance sheet (EURbn)				
Gross loans	8,930	9,305	10,981	14,076
Interbank	7,463	6,023	5,465	7,263
Derivatives	18,413	14,561	17,445	23,748
Other securities & earning assets	6,522	8,280	10,529	13,714
Cash and due from banks	2,982	1,401	2,044	1,697
Other assets	407	77	73	119
Total assets	44,717	39,647	46,542	60,617
Interbank and other ST funding	14,661	11,272	13,043	16,797
LT senior debt	11,199	13,269	15,497	19,885
Trading liabilities and derivatives	18,105	14,324	16,949	22,738
Other liabilities	102	124	397	556
Total equity	650	658	656	641
Total liabilities and equity	44,717	39,647	46,542	60,617
Ratios (%; annualised as appropriate)				
Profitability				
Net interest income/average earning assets	0.2	0.3	0.2	0.2
Cost/income	201.8	103.3	103.5	87.2
Net return on average equity	-1.7	0.4	2.2	1.5
Asset quality				
Loan growth	-4.0	-15.3	-22.0	-6.6
Loan impairment charges/average gross loans	-0.7	-0.1	0.2	0.1
Capitalisation				
Tangible common equity/tangible assets	1.5	1.7	1.4	1.1

Source: Fitch Ratings, Fitch Solutions, EAA

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