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CREDIT OPINION
17 July 2023

Update

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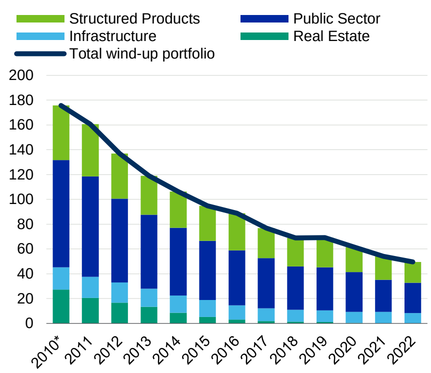
FMS Wertmanagement – Aaa Stable

Regular update

Summary

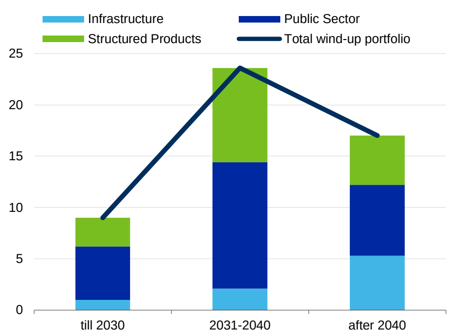
Our credit view of FMS Wertmanagement (FMS-WM) reflects its very close relationship and linkages with the Government of Germany (Aaa stable) and a consistent track record of financial support. FMS-WM benefits from an explicit guarantee and loss compensation through the Financial Market Stabilisation Fund (FMS or SoFFin). This effectively eliminates risks stemming from weak asset quality and the large asset-liability maturity mismatch, and FMS-WM's debt ultimately becomes an obligation of the German sovereign. We therefore rate the institution on par with Germany at Aaa with a stable outlook.

Exhibit 1
FMS-WM's wind-up portfolio declined by 72% since the portfolio transfer
€ billion, end-of-period



*Refers to the transfer date (1 October 2010)
Sources: FMS Wertmanagement and Moody's Investors Service

Exhibit 2
Most of FMS-WM's portfolio matures between 2030 and 2040
€ billion (as of end-2022)



Sources: FMS Wertmanagement and Moody's Investors Service

Credit strengths

» Explicit guarantee and loss compensation through the FMS

» Strong track record in implementing wind-up plan

Credit challenges

» Very weak asset quality as a result of portfolio concentrations of long-maturity, complex and illiquid assets as well as low margins

» Large maturity mismatch between assets and liabilities

Rating outlook

The rating outlook for FMS-WM's Aaa rating is stable, in line with the stable outlook on Germany's sovereign rating.

Factors that could lead to a downgrade

Any change to the rating of the Government of Germany would have a direct impact on the rating of FMS-WM. Although not expected, any changes to the current legal and contractual framework that would weaken the link to the German sovereign might also negatively affect FMW-WM's rating.

Key indicators

Exhibit 3

FMS Wertmanagment	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
Total assets (EUR bn)	333.3	341.8	246.4	187.7	183.6	171.1	177.2	157.3	144.7	146.5	145.8	124.3	99.0
Wind-up portfolio (EUR bn) [1]	174.3	160.7	136.9	119.1	106.3	94.7	88.9	76.8	69.0	69.3	61.6	54.1	49.6
Amount of debt issued on capital market (EUR bn) [2]	10.2	20.8	34.9	11.0	11.6	12.3	15.8	19.3	5.7	30.0	11.7	31.7	6.3
Own capital (EUR bn)	0.00	0.00	0.04	0.12	0.43	0.73	1.04	1.40	1.52	1.75	1.77	1.82	1.87
Operating result (EUR bn)	-3.04	-9.96	0.04	0.15	0.37	0.41	0.39	0.43	0.11	0.25	0.03	0.04	0.08
Provisions & net income from investments (EUR bn)	-2.97	-10.25	-0.43	-0.26	0.03	0.04	-0.14	-0.20	-0.11	0.02	-0.26	-0.18	-0.18

Note: Data refers to year-end. [1] The initial wind-up portfolio transferred from HRE Group to FMS-WM amounted to €175.694 billion in October 2010. [2] Includes long-term EUR-denominated capital market funding through the FMS since 2019.
Source: FMS Wertmanagement and Moody's Investors Service

Detailed credit considerations

FMS-WM is a German wind-up institution established in 2010 to wind up a €175.7 billion[1] portfolio of risk exposures and non-strategic assets from the Hypo Real Estate Group (HRE). While FMS-WM may engage in those banking and financial service transactions that serve its purposes, FMS-WM does not hold a banking license and therefore has no access to European Central Bank (ECB) funding. At the same time, FMS-WM is not subject to banking regulation and is free from regulatory requirements relating to capital and liquidity. FMS-WM is supervised by the Federal Agency for Financial Market Stabilisation (FMSA).

We rate FMS-WM Aaa with a stable outlook, on par with the Government of Germany. This is because of the explicit guarantee provided by FMS for FMS-WM's liabilities (with a grandfathering of the outstanding debt of FMS-WM). This guarantee has been in place since January 2014 and means that FMS will be directly liable to third parties. It allows debtholders of FMS-WM to apply a 0% risk weight under Basel III rules for FMS-WM debt issues.

This explicit guarantee is stronger than the loss compensation clause, which obliges FMS to pay promptly, and no later than on the third business day following a request, any amount which the Executive Board of FMS-WM deems necessary to meet FMS-WM's liabilities in full and in a timely manner. Although the loss compensation clause only constitutes an implicit guarantee, we viewed it as sufficiently strong to link FMS-WM's rating directly to that of the German sovereign.

The methodological approach for rating FMS-WM on par with the German sovereign is found in Moody's cross-sector rating methodology "Guarantees, Letters of Credit and Other Forms of Credit Substitution Methodology", whereby FMS-WM's credit rating is fully substituted by that of the German sovereign. As a consequence, FMS-WM's credit metrics such as asset quality and capital adequacy do not have an impact on the credit rating of FMS-WM. Under the credit substitution approach, the credit rating of FMS-WM is driven solely by the German sovereign credit rating.

FMS-WM was established as a public law entity pursuant to Section 8a of the Financial Market Stabilisation Fund Act (FMStFG). The legal basis for the application of credit substitution to FMS-WM's rating is its charter and the FMStFG. The loss compensation obligation is established by §7 of the FMS-WM Charter, and the general liability for FMS' obligations by the German sovereign is set out in Section 5 of the FMStFG.

In May 2014, FMS-WM was mandated to wind up DEPFA Bank plc, with total assets of €48.5 billion[2] as of December 2014. DEPFA was a subsidiary of HRE Group, which transferred certain non-strategic assets to FMS-WM in 2010. Following a decision by the European Commission in July 2011, DEPFA was not allowed to generate new business, subject to certain exceptions, unless the company was privatised. Since this privatisation did not occur in 2014, the interministerial steering committee of FMSA decided to transfer the ownership of DEPFA from HRE Group to FMS-WM.

The transfer of ownership from HRE Group to FMS-WM was completed in December 2014, when FMS-WM acquired all DEPFA equity at a purchase price of €320 million. DEPFA became a 100% subsidiary of FMS-WM, managed as an independent financial investment.[3]

FMS-WM made a public sale announcement of DEPFA on 14 July 2020 to sell 100% of the shares in DEPFA Bank plc in an open, transparent and non-discriminatory auction sale process. On 15 February 2021, FMS-WM announced that it had reached a definitive agreement to sell its bank subsidiary, DEPFA, and its covered-bond-issuing subsidiary, DEPFA ACS, to the Austrian banking group BAWAG P.S.K. AG (BAWAG, A1/A1 positive, baa1[4]). The closing of the sale took place on 19 November 2021, after the necessary regulatory approval had been obtained.

ESG considerations

How environmental, social and governance risks inform our credit analysis of the FMS-WM

Since FMS-WM's rating is derived by credit substitution from Germany's rating, the FMS-WM's ESG considerations mirror those of Germany.

Recent developments

Wind-up portfolio decreased according to plan in 2022, despite headwinds

The nominal value of FMS-WM's wind-up portfolio decreased by 8.3% to €49.6 billion in 2021, down from €54.1 billion at end-2021. Overall the portfolio reduction in 2021 was as high as €4.6 billion, with small reverse foreign currency effects of €0.1 billion resulting in a nominal decrease of €4.5 billion. The pace of the wind up of the portfolio thereby met the set targets, despite the challenging market environment throughout 2022.

From its €175.7 billion nominal transfer value in October 2010, the cumulative reduction of the nominal value of the windup portfolio has reached €126.1 billion which can be decomposed into the cumulative wind-up (- €140.3 billion), the purchase of DEPFA group assets (+ €11.8 billion) and cumulative currency effects (+ €2.4 billion).

Profits increased in 2022

FMS-WM has posted profits on its ordinary activities since 2012 which partially offsets a significant loss of almost €10 billion in 2011 mainly because of a large write-down of €8.9 billion worth of Greek sovereign debt holdings. Profits on ordinary activities amounted to €77 million in 2022 up from €44 million in 2021. Net retained profits are accumulated and equity has reached €1.9 billion at the end of 2022.

Portfolio concentration remains high, quality benefits from exposure to solid public entities and sovereign guarantees

The portfolio is significantly concentrated, with about 39% of the total portfolio volume exposure represented by the 10 largest borrowers. At 2022 year-end, the public sector represented 49.2% of the total assets in the windup portfolio, structured products 33.9%, infrastructure 16.9%, while real estate assets have been completely unwound.[5] The largest exposure in terms of geography is the United Kingdom (UK, Aa3 negative) with 32.5% mainly in local authorities but also infrastructure projects, followed by 22.6% in Italy (Baa3 negative) and 16.5% in the United States (US, Aaa stable). In terms of currency, the share of EUR-denominated assets stood at 42%, USD-denominated at 29%, GBP-denominated at 25%, CAD-denominated at 3% and other currencies at 1%. In addition, 82% of the assets are maturing after 2030 and 34% after 2040.

The significant concentration combined with long maturities poses certain challenges for the future windup of the portfolio. In addition, contractual repayments which have to a large extent driven the pace of the sales of assets are set to fall. Consequently, the reduction of FMS-WM's windup portfolio is likely to slow down further over the coming years as it will become increasingly difficult to sell the remaining assets. That said, FMS-WM expects the windup portfolio to reduce in the range of €4 billion to €6 billion nominally in 2023 mostly driven by the public sector and structured products.

Moreover, the bonds and securities held by FMS-WM are typically part of an asset swap package attached to derivatives which are mostly used to hedge interest-rate, inflation or currency risk. Selling those assets ahead of schedule would imply that the derivatives would have to be closed ahead of the original maturity and therefore with significant losses. As a consequence, a hold-to-maturity strategy promises better results in line with the value maximisation objective of FMS-WM in interest with the German taxpayer. Simultaneously to the asset reduction, FMS-WM will also further reduce its operating costs. Total administrative costs were down to €129 million in 2022 from €348 million in 2011, but slightly up compared to 2021 (€124 billion) mostly driven by a one-off effect (€15 million in 2022) from the IT transition.

In FMS-WM's loan portfolio credit quality is supported through exposure to public sector entities, and in part backing through sovereign guarantees. Ratings of assets in the bond porfolio are mainly investment grade. Only about 3% of the total portfolio are classified as “watchlist” or “problem” assets, and the share and amount (€1.9 billion at end-2022) have been stable compared to 2021.

Limited impact from military conflict in Ukraine, high inflation and rising interest rates

Regarding the Russia-Ukraine (Ca stable) military conflict, overall there has been a limited impact on FMS-WM's asset portfolio so far. FMS-WM has no direct exposure to Ukraine, Russia or Belarus (C stable), but some exposure related to countries, including Finland (Aa1 stable), Hungary (Baa2 stable), Latvia (A3 stable), Poland (A2 stable) and Slovenia (A3 stable), amounting to less than €0.9 billion.

However, amongst other, the conflict has been pushing inflation higher, impacting FMS-WM as a significant part of its portfolio (ca. €10 billion) is inflation-linked. However, as FMS-WM hedged inflation-linked assets, the effect of higher inflation is risk neutral. Rising interest rates as result of tightening monetary policy combating inflation, volatile markets and higher credit spreads has had a limited impact on FMS-WM's asset portfolio to date, but going forward may burden public sector and structured products.

Funding costs have benefitted from federal onlending

FMS-WM is an established issuer on international capital markets with a euro-denominated benchmark curve and issuances of USD- and GBP-denominated bonds. By means of its own issuances, FMS-WM was able to replace all ECB funding on its liability side, inherited from HRE, by March 2012. By 30 June 2014, FMS-WM has achieved its targeted Term Funding Ratio of 50%/50% between Money and Capital Markets which was maintained or overachieved since then. The share of money market funding was 12% at end-2022 compared to 24% at end-2021. FMS-WM's debt market issuances have also contributed to an improvement in its asset-liability maturity mismatch relative to its launch in 2010.

The Finance Agency of the Federal Republic of Germany took over long-term EUR-denominated capital market funding through the FMS as scheduled at the beginning of 2019 which not only lowered funding costs for FMS-WM, but also increased the average maturity of FMS-WM's outstanding debt. The maximum amount that FMS-WM can raise through the FMS is €60 billion, which was increased from an initial amount of €30 billion at the end of 2020. In 2022, FMS-WM received €59.4 billion of funding through the FMS with an average original maturity of 5.4 years after €30.4 billion in 2021.[6] FMS-WM had used €58.9 billion funding through FMS by end-May 2023.

That said, FMS-WM keeps its presence on the international capital markets by raising short-term funding (in EUR and foreign currencies in particular USD and GBP) and long-term funding in foreign currencies. Because of the explicit guarantee by FMS, investors can apply a 0% risk weighting to FMS-WM bonds. FMS-WM issued €1.3 billion with an average maturity of 2.1 years in 2022 in capital instruments with a term of more than one year. This was in line with the initially planned issuance volume in the range of €0.4 billion to €1.5 billion. On FMS-WM's money market funding, the switch to its US commercial paper programme from USD-denominated money market funding reduced operating efforts and related costs. Issuances under its US commercial paper programme amounted to only $0.5 billion as of end-2022, down from $7.3 billion one year prior.

For 2023, funding needs of below €60 billion will be predominantly be covered through over long-term EUR-denominated capital market funding through the FMS and FMS-WM's money market funding, while FMS-WM is not planning own capital market funding.

Endnotes

1 According to German GAAP accounting standards.

2 According to IFRS accounting standards.

3 DEPFA remained a regulated bank under Irish law and, unlike FMS-WM, subject to the EU Bank Resolution and Recovery Directive (BRRD).

4 The ratings shown are BAWAG's deposit rating, senior unsecured debt rating and baseline credit assessment (BCA).

5 There are currently five remaining real estate-related assets, which are, however, grouped under "Infrastructure" since December 2021.

6 As of 31 December 2022, total outstanding funding had an average original maturity of 6.3 years and remaining average maturity of 4 years.

REPORT NUMBER 1374270

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