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ISSUER COMMENT
11 February 2021

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Hamburg Commercial Bank AG

HCOB's capital and provisions provide strong hedge in weak credit environment

On 11 February, Hamburg Commercial Bank AG (HCOB, Baa2/Baa2 positive, ba2[1]) reported much improved financial metrics for 2020, including significantly higher capitalisation. The improvement strengthens the bank's safety buffers against the deterioration in asset quality that we expect to result from its concentrated and more cyclical asset-based exposures. Very strong capital buffers and improving profitability make HCOB likely to end 2021 with a sound solvency profile, allowing the privatised former HSH Nordbank to complete the last steps of its transition from a German public bank to a profitable private bank by year end, a credit positive.

One-off items, mainly property sales and hybrid debt valuation, made a still significant contribution to HCOB's €257 million pre-tax profit in 2020. We expect nonrecurring items to become much less relevant from 2021 onward, when the bank's balance sheet restructuring concludes. Positive one-off items helped HCOB absorb an increase in its cost of risk to 84 basis points (bp) of gross customer loans, though this is still high by German banks' standards. In 2020, we estimate German banks' cost of risk to range mostly between 40 and 60 bp.

We believe the higher cost of risk and the loan loss reserves built up over the past years appropriately reflect the credit risk in HCOB's concentrated asset-based lending book. Nonperforming exposures were 1.8% of total exposures as of year-end 2020, while the stock of loan-loss reserves, including sizable model overlay provisions of €238 million (€306 million at year-end 2019), covered a comfortable 2.5% of gross loans (and 91% of problem exposures), up from an already substantial 2.3% at year-end 2019.

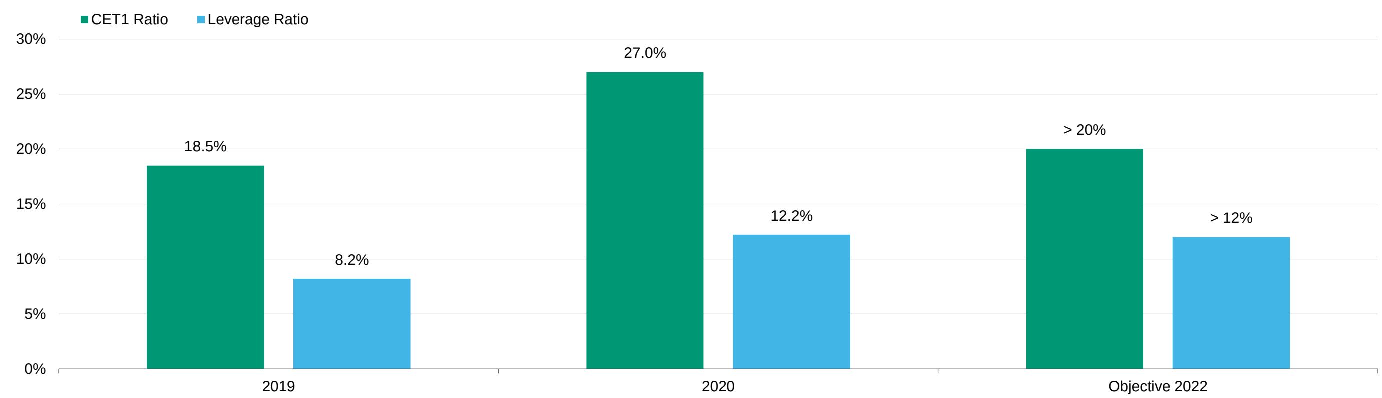
New commercial real estate (CRE) lending fell to €0.8 billion (plus €3 billion of loan term extensions) from €4.0 billion in 2019. HCOB expects to resume a more active role in CRE lending this year and next, with new business volume targets of €2 billion in 2021 and up to €3 billion in 2022. New CRE loans will focus on office, logistics, and residential properties, with no new hotel exposures and only selective lending backed by retail properties, areas we consider particularly exposed to the pandemic's economic effects.

Despite reduced new lending and continued deleveraging, HCOB's 2020 results benefitted from a strong improvement in net interest income, its key revenue pillar, to €629 million from €321 million, including a €72 million (2019: minus €181 million) contribution from the valuation of hybrid debt instruments. Strong new lending margins from asset-based lending operations, mostly shipping and moderate new CRE lending, more than offset the loss of revenue from declining interest-bearing assets. According to the bank, margins on its very selectively underwritten new CRE loans increased to more than 240 bp from 213 bp in 2019.

In line with its significant cost-reduction plan, HCOB also reported a fall in administrative expenses in 2020, to €365 million from €413 million. The bank continues to downsize its staff and operations toward a target work force of around 700 full-time employee equivalents, and we understand that it has contractually agreed the vast majority of required staff departures.

HCOB reported a regulatory Common Equity Tier 1 (CET1) capital ratio of 27.0% (December 2019: 18.5%), at the very high end of the German banks we rate. Continued deleveraging and limited new business activity caused risk-weighted assets to decline 26% in 2020 to €15.5 billion. Because HCOB has now almost fully achieved its deleveraging target, risk-weighted assets have reached a trough from which they will rebound in the next couple of years to a level below €19 billion. A rising density of risk-weighted assets stemming from a more conservative measurement of higher-yielding loans will mainly drive the increase. Nevertheless, we believe the bank will comfortably maintain its CET1 ratio above its target of 20% for 2022 (see exhibit).

Exhibit 1
HCOB's capitalisation has improved strongly and will remain comfortable
CET1 and regulatory leverage ratios as % of risk-weighted assets and leverage ratio denominator



2019 CET1 ratio is before profit appropriation
Sources: The bank and Moody's Investors Service

HCOB's financial position as of year-end 2020, particularly its strong capitalisation, mean it is well-prepared for this year's review of its financial profile by the Bundesverband deutscher Banken (BdB), Germany's association of private banks. Capital will be a key measure for the BdB when it decides on HCOB's application for full membership[2] of its voluntary deposit guarantee fund for private banks. Full membership would send a positive signal and further support HCOB's efforts to diversify its funding structure.

Moody's related publications

Rating Actions

» Moody's affirms Hamburg Commercial Bank's ratings and changes the outlook to positive from stable, December 2020

Issuer Research

» Hamburg Commercial Bank AG: Update following rating affirmation, December 2020

» Hamburg Commercial Bank AG: Results show credit-positive progress toward becoming a profitable private bank, August 2020

» Hamburg Commercial Bank AG: Rigorous shrinkage keeps HCOB on track to sector transition, February 2020

» NORD/LB and Hamburg Commercial Bank: Studies in turning around stressed shipping lenders - a peer comparison, January 2020

» Hamburg Commercial Bank AG: Hamburg Commercial's settlement with hybrid creditors is credit positive, December 2019

Sector Research

» Banks – Germany: Large cost cuts are needed to stay profitable, January 2021

» Banking - Germany: Macro profile – Strong +, January 2021

» Banking – Germany and Austria Q3 results: Profitability weakens at German banks; Austrian lenders show greater resilience, December 2020

» Banks – Germany: Lower for longer interest rates will exacerbate earnings pressures, October 2020

» Banking System Outlook Update - Germany: Growing strain of coronavirus disruption will increase pressure on German banks, March 2020

Endnotes

1 The ratings shown in this report are HCOB's deposit rating, senior unsecured debt rating and Baseline Credit Assessment.

2 HCOB has been a junior member since January 2019.

REPORT NUMBER 1262186

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