FitchRatings

29 Aug 2019 | Affirmation

Fitch Affirms Clearstream Banking and Euroclear Bank; Outlooks Stable

Fitch Ratings-Frankfurt am Main-29 August 2019:

Fitch Ratings has affirmed the Long-Term Issuer Default Ratings (IDRs) of Luxembourg-based Clearstream Banking SA at 'AA' and Belgium-based Euroclear Bank at 'AA+'. The Outlooks are Stable. Clearstream's and Euroclear Bank's Viability Ratings (VR) have been affirmed at 'aa' and 'aa+', respectively. A full list of rating actions is at the end of this commentary.

Key Rating Drivers

VRs, IDRS AND SENIOR DEBT RATINGS

Clearstream's and Euroclear Bank's ratings reflect the banks' leading franchises in the international post-trade securities services industry, in particular in settlement and custody services, as well as their very robust financial profiles. The ratings take into account the banks' resilient revenue, their very limited exposure to credit risk and low risk appetite. Furthermore, risk control frameworks are sophisticated while capitalisation remains strong and liquidity is prudently managed.

Regulatory requirements continue to evolve, notably with the ongoing implementation of the EU's Central Securities Depositories Regulation (CSDR), targeted at further reducing already low exposure to unsecured credit risk and strengthening liquidity management, among others. Clearstream and Euroclear Bank's risk appetites are very conservative, while credit risk exposures are very low, given that granted credit facilities pertain predominantly to intraday, collateralised credit lines with commercial counterparties which are used for post trade settlement. Uncollateralised lending exposure are very limited for both Clearstream and Euroclear Bank, as prevailing CSDR regulation requires central securities depositories (CSDs) to collateralise all non-sovereign lending exposures. In addition, investment policies are prudent, focusing on high-rated instruments.

Liquidity management is prudent at both banks and reflects the short-term nature of their balance sheets. Liquidity needs are largely intraday and transaction driven. One of CSDR's requirements is for CSDs to hold sufficient liquidity to cover the defaults of their two largest counterparties. In this context, Euroclear Bank has set up a euro-denominated medium-term note programme and a certificates of deposit programme and issued a number of benchmark short and medium-term senior preferred bonds to build up its qualifying liquidity sources, with a view of replacing committed bank lines put in place for this purpose. Clearstream currently manages prescribed liquidity requirements via contingent liquidity facilities, which include unused committed revolving bank lines.

The evolvement of the technological landscape continues to challenge operational infrastructures and systems in the global settlement industry, and necessitates ongoing technology investments. Both banks by their nature are mainly exposed to operational risk, and in particular system failures. In this regard, we consider risk controls very strong, and both banks continue to prioritise investments in risk management, including IT infrastructure and cyber resilience. Euroclear Bank has a strong corporate culture with high risk awareness. Clearstream is highly integrated into the Deutsche Boerse group, including in terms of the risk-management framework, which we view as sound.

Safekeeping and settlement revenue remains the primary source of income for both banks. While this earnings stream is sensitive to client transaction volumes and at a lesser extent to changes in asset prices, it has proved resilient over time. Both banks are expanding into collateral management but volumes remain somewhat subdued in the current environment. Diversification into ancillary businesses such as fund management services and collateral management is gradual, strengthening further Clearstream and Euroclear Bank's strong positions in post-trade securities services.

Earnings generation is also supported by well contained operating costs in relation to fee income, with incremental investments primarily focused on operating infrastructure and enhancing ancillary business activities. Our expectation is of a sound earnings path, as diversification benefits continue to feed through balancing higher finance costs- associated in particular with requirements to pre-fund liquidity needs under the new regulatory Cover 2 requirement.

Capitalisation is sound for both Clearstream and Euroclear Bank. However, given Euroclear Bank's comparatively stronger key indicators (i.e. common equity Tier 1 capital ratio for Euroclear Bank of 42% at end-2018 vs. 22% for Clearstream), Euroclear Bank's VR is one notch above that of Clearstream.

Euroclear Bank's strong capitalisation has a high influence on its VR and IDRs. In addition, Clearstream's capital management has to be viewed within the context of the Deutsche Boerse group, which in our opinion, typically has a strong focus on shareholder returns, usually resulting in a relatively high dividend pay-out ratio at Clearstream. Regulatory capital at both banks is small in absolute terms considering their business volumes, but they maintain healthy margins above minimum regulatory requirements.

Clearstream's commercial paper rating is aligned with its Short-Term IDR. Euroclear Bank's short-term and long-term senior debt ratings are equalised with its Short- and Long-Term IDRs. These debt ratings are driven by Fitch's view that the likelihood of default on senior unsecured debt (preferred senior debt for Euroclear Bank) reflects the likelihood of default of the bank.

SUPPORT RATING AND SUPPORT RATING FLOOR

As licensed banks, both Clearstream and Euroclear Bank are subject to the EU Bank Resolution and Recovery Directive, which provides a resolution framework whereby it is likely senior creditors will be required to participate in losses, if necessary, instead of or ahead of the bank receiving sovereign support.

We believe that while sovereign support for Clearstream and Euroclear Bank is possible, it cannot be relied upon. Euroclear Bank's Support Rating of '5' and Support Rating Floor of 'No Floor' reflect Fitch's view that senior creditors cannot rely on receiving extraordinary support from the sovereign if the bank becomes nonviable.

In our view, Clearstream would first seek support from its parent, Deutsche Boerse. We believe that support from Deutsche Boerse AG is extremely likely given Clearstream's core position within the Deutsche Boerse group and Fitch's assessment of Deutsche Boerse group's ability to support Clearstream. This underpins the affirmation of Clearstream's Support Rating at '1'.

EUROCLEAR INVESTMENTS - IDRS AND DEBT RATINGS

Fitch has affirmed the IDRs and senior debt rating of Euroclear Investments SA (EINV). EINV's 'AA' Long-Term IDR is one notch below Euroclear Bank's Long-Term IDR, which we have used as the anchor rating due to Euroclear Bank being by far the largest operating entity in the Euroclear group.

Luxembourg-based EINV is indirectly fully owned by Euroclear Holding, the holding company of the group. EINV is the 99.9% owner of Belgium-based Euroclear SA (ESA), which in turn owns Euroclear Bank as well as the group's domestic CSDs.

The one-notch difference between EINV's and Euroclear Bank's Long-Term IDRs principally reflects that EINV is not under direct supervision of Euroclear Bank's lead regulator, the National Bank of Belgium. In our view, this gives management somewhat more flexibility in EINV's capital and liquidity planning compared with the group's directly regulated entities. EINV's double leverage ratio was 112% at end-2018, below Fitch's typical threshold of 120% for adding an additional notch for high double leverage.

The rating of EINV's senior unsecured debt is rated in line with EINV's Long-Term IDR as the debt represents direct, unsubordinated, unsecured and unconditional obligations of EINV.

The rating of EINV's dated hybrid notes is two notches below EINV's Long-Term IDR. Because EINV is as a legal entity not subject to direct prudential supervision by either the Luxembourg regulator or the National Bank of Belgium, Fitch applies its corporate notching criteria ('Non-Financial Corporates Hybrids Treatment and Notching Criteria'). The notching between EINV's Long-Term IDR and the hybrid notes' rating primarily reflect the notes' deeply subordinated status and going concern loss absorption (in the form of fully discretionary coupon deferral). Fitch has limited the differential to two notches due to the absence of more aggressive forms of loss absorption, such as easily activated mandatory deferral mechanisms, permanent write-down or easily activated mandatory conversion triggers.

Fitch has also assigned 50% equity credit to the notes, reflecting the notes' deeply subordinated status, effective permanence, absence of any material covenants, step-ups, look-back provisions or short-term call dates (the first call date is in 2028) and unconstrained and long-term coupon deferability.

RATING SENSITIVITIES

VRS, IDRS AND SENIOR DEBT RATING

The Stable Outlooks on Clearstream's and Euroclear Bank's Long-Term IDRs reflect our view that both entities should be in a position to continue generating sound profitability while maintaining their current low risk profiles and making the required investments to ensure technology platforms and risk management systems keep pace with regulatory and industry-wide changes.

Upside potential is limited, given Clearstream's and Euroclear Bank's already high ratings.

Operational risk is a key rating sensitivity, given the banks' high-volume business models and dependence on IT systems robustness, particularly considering the banks' relatively low absolute capital size. Outsized, persistent operational losses, a sustained drop in revenue arising from adverse reputational developments, an inability to adapt to regulatory changes, weakening capitalisation or a higher risk appetite could all lead to negative rating action.

Fitch notes recent events at Clearstream and Deutsche Boerse AG relating to ongoing 'cum ex' investigations by the German Prosecuting Authority. The searches of premises of Deutsche Boerse Group concern clients and a number of employees of Deutsche Boerse Group entities; as previously reported, Clearstream and Clearstream Banking AG had been notified in 2018 of being treated as potential secondary participants. Nonetheless, this highlights general reputational risks related to Clearstream's business model. Repercussions relating to recent events are difficult to assess at this stage. However, should Fitch conclude that Clearstream would be faced with notable reputational implications and /or financial claims arising from these events, it could have an adverse impact on Clearstream's rating.

Maintaining sound risk-weighted capital ratios is relevant for the banks' ratings, and a reduction in the banks' absolute capital base would put pressure on their ratings.

Clearstream's ratings are also sensitive to a marked deterioration in Deutsche Boerse AG's creditworthiness, impacting negatively on Clearstream's franchise, risk appetite or capitalisation (via outsized earnings upstream)

Euroclear Bank's Long-Term IDR is two notches above the Belgian sovereign's Long-Term IDR (AA-/Stable). Euroclear Bank is significantly less exposed to sovereign-associated reputation, business and operational risks than Belgian commercial banks, because there is little direct Belgian risk in the bank's balance sheet. A sovereign downgrade into the 'A' category could trigger a downgrade of the bank's rating because in accordance with Fitch's criteria, the potential uplift of bank ratings above the sovereign in the eurozone is typically limited to a maximum of two notches.

Clearstream's commercial paper rating is primarily sensitive to a change in Clearstream's Short-Term IDR. The senior debt ratings of Euroclear Bank are primarily sensitive to changes in the bank's Long- and Short- Term IDRs.

SUPPORT RATING AND SUPPORT RATING FLOOR

Euroclear Bank's Support Rating and Support Rating Floor are primarily sensitive to legislative changes at the national and European level, increasing the propensity of sovereigns to support institutions like Euroclear Bank without imposing losses on senior creditors. While not impossible, this is not expected by Fitch.

Clearstream's Support Rating is primarily sensitive to any perceived change in the propensity and ability of Deutsche Boerse AG to support Clearstream.

EUROCLEAR INVESTMENTS - IDRS AND DEBT RATINGS

EINV's IDRs and senior debt rating are primarily sensitive to a change in Euroclear Bank's IDRs. In addition, the ratings are sensitive to material changes in the group's dividend upstream policies negatively affecting EINV's interest cover and repayment capacity during the tenor of the bond. Any intragroup transaction reducing EINV's repayment capacity at maturity of the bond or increasing EINV's double leverage would also be rating-negative.

Similar to the senior debt rating, EINV's hybrid capital instrument rating is principally sensitive to a change in EINV's and, ultimately, Euroclear Bank's Long-Term IDR. In addition, changes to the terms of the notes which increased the risk of going concern loss absorption (e.g. an easily triggered mandatory deferral mechanism) could lead to wider notching and, therefore, a downgrade.

Euroclear Bank; Long Term Issuer Default Rating; Affirmed; AA+; RO:Sta
; Short Term Issuer Default Rating; Affirmed; F1+
; Viability Rating; Affirmed; aa+
; Support Rating; Affirmed; 5
; Support Rating Floor; Affirmed; NF
----Senior preferred; Long Term Rating; Affirmed; AA+
----Senior preferred; Short Term Rating; Affirmed; F1+
----senior unsecured; Short Term Rating; Affirmed; F1+
Euroclear Investments SA; Long Term Issuer Default Rating; Affirmed; AA; RO:Sta
; Short Term Issuer Default Rating; Affirmed; F1+
----senior unsecured; Long Term Rating; Affirmed; AA
----junior subordinated; Long Term Rating; Affirmed; A+
Clearstream Banking SA; Long Term Issuer Default Rating; Affirmed; AA; RO:Sta
; Short Term Issuer Default Rating; Affirmed; F1+
; Viability Rating; Affirmed; aa
; Support Rating; Affirmed; 1
----senior unsecured; Short Term Rating; Affirmed; F1+

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Additional information is available on www.fitchratings.com

Applicable Criteria

Bank Rating Criteria (pub. 12 Oct 2018)

Short-Term Ratings Criteria (pub. 02 May 2019)

Additional Disclosures

Dodd-Frank Rating Information Disclosure Form

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