FitchRatings

RATING ACTION COMMENTARY

Fitch Downgrades Euroclear Bank to 'AA'; Outlook Stable

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Fitch Ratings - Paris - 09 Jul 2021: Fitch Ratings has downgraded Belgium based Euroclear Bank's Long-Term Issuer Default Rating (IDR) to 'AA' from 'AA+' and Viability Rating (VR) to 'aa' from 'aa+'. The Outlook on the Long-Term IDR is Stable. A full list of rating actions is below.

Feedback

The downgrade reflects Fitch's greater emphasis on operational risk as a rating factor. Given the bank's critical function as a provider of financial market infrastructure services, Fitch views risk appetite, which includes exposure to operational risks, as an increasingly more important VR driver relative to capitalisation. The latter remains very strong, with a sub-factor score at 'aa+'. We continue to view Euroclear Bank's risk profile as very strong in a global context.

KEY RATING DRIVERS

VR, IDR AND SENIOR DEBT RATINGS

Euroclear Bank benefits from its market-leading position in international post-trade securities services as one of the two European registered international central securities depositories (ICSDs), with particularly strong capabilities in settlement, custody and collateral management.

Euroclear Bank is part of a wider financial market infrastructure group, the Euroclear group (which also includes domestic ICSDs in France, the UK, Ireland, Sweden, Finland and Benelux).

The ratings also recognise the bank's volume-driven and scalable business model and conservative risk appetite. In addition, its financial profile, including asset quality, capitalisation and profitability, remains robust, supported in particular by an inherently low exposure to credit risk. Euroclear Bank has performed strongly in a volatile operating environment, benefiting from its strong operational capabilities and supported by ongoing investments in IT and risk infrastructure in recent years.

Operational risk, and in particular systems failure, is an important risk factor for Euroclear Bank and the sector as a whole. It continues to invest strongly in systems infrastructure with a particular focus on IT and cyber resilience, which supports its strong risk-control framework resilience. Euroclear Bank's risk-management framework is assessed as strong and the number of operational incidents is fairly stable and operational losses have so far been negligible. While not directly related to Euroclear Bank, a notable incident faced by its sister company Euroclear UK & Ireland that resulted in the temporary suspension of settlement in the UK, which Fitch believes has potential reputational implications for the bank. Fitch believes contagion risk is mitigated by the existence of different systems and business resilience processes at the different group CSDs.

Operating profitability is sound and continues to be supported by cost discipline, with increasing investments primarily focused on ensuring system resilience and strengthening ancillary business lines. Earnings generation is driven by net fee income from settlement transactions, assets under custody and securities lending, which together typically account for more than half of its revenue.

While revenue is potentially sensitive to transaction volumes and, to a lesser extent, asset prices, earnings generation from core operations has historically been resilient. This is in part aided by counter-cyclicality in its business profile as trading activity typically increases in periods of market stress (as evident at the onset of the Covid-19 pandemic in March/April 2020). Core operations performed well in 2020 with fee income up about 14%, buoyed by strong market activity. However, overall earnings generation was somewhat weighed down by a significant reduction in net interest income given a low interest-rate environment.

Euroclear Bank's capitalisation is strong, underpinned by prudent capital management. While regulatory capital is small in absolute terms considering its business volumes, Euroclear Bank maintains a healthy margin above its minimum regulatory requirement. It continues to report higher risk-weighted capital ratios than Clearstream Banking S.A. with a common equity Tier 1 (CET1) capital ratio of 35.9% at end- 2020 versus its peer's 26.6%.

EUROCLEAR INVESTMENTS - IDR AND DEBT RATINGS

Fitch has downgraded the Long-Term IDR and senior debt rating of Euroclear Investments SA (EINV) to 'AA-' from 'AA'. This follows the downgrade of 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 - calculated as equity investment in subsidiaries/total equity - should increase to around 105% (from 74% in 2019) as a result of its EUR350 million debt issued to fund part of its MFEX transaction. As such, double leverage remains below Fitch's typical threshold of 120% for adding a notch-differential for high double leverage.

Feedback

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

The rating of EINV's hybrid notes at 'A' 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', November 2019). 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 and unconstrained and long-term coupon deferability.

SUPPORT RATING AND SUPPORT RATING FLOOR

As licensed bank, Euroclear Bank is 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 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 non-viable.

RATING SENSITIVITIES

Factors that could, individually or collectively, lead to positive rating action/upgrade:

VRS, IDRS AND SENIOR DEBT RATING

Factors that could, individually or collectively, lead to positive rating action/upgrade:

Given the already high ratings of Euroclear Bank, upside is limited. An upgrade is subject to a notable improvement in the company profile, including greater business diversification, thereby further enhancing the risk profile; a very low appetite for risk (particularly operational risk); and stronger key financial metrics, in particular strengthening earning generation, including the maintenance of industry-leading levels of capitalisation.

Euroclear Bank's long-term senior preferred ratings could be upgraded by one notch if we obtain more clarity and certainty on the bank's minimum requirement for own funds and eligible liabilities (MREL) requirement and on the bank's ability to use intra-group subordinated and senior non-preferred debt to comply with MREL.

Factors that could, individually or collectively, lead to negative rating action/downgrade:

Worsening risk appetite, in particular, risk control, given the bank's high-volume business model and dependence on IT systems robustness, considering the bank's low absolute capital size.

Significant and/or sustained reputational damage, in particular if arising from persistent operational incidents, adverse legal proceedings and leading to permanent damage in the franchise value and impairing the bank's ability to attract transaction flows, could give rise to downward rating pressure.

Maintaining sound risk-weighted capital ratios is relevant for Euroclear Bank's ratings, and a reduction in the bank's absolute capital base would put pressure on its ratings.

Euroclear Bank is significantly less exposed to sovereign-associated reputation, business and operational risks than Belgian commercial banks, due to little direct Belgian risk in the bank's balance sheet (accounting for about 13% of its equity at end-2020). Fitch typically constrains commercial bank ratings to no more than two notches above that of the sovereign under its "Bank Rating Criteria", but exceptionally strong specialist banks such as Euroclear Bank can achieve a rating that is more than two notches above that of the sovereign. As Euroclear Bank's Long-Term IDR is one notch above the Belgian sovereign's (AA-/Negative) a downgrade of the latter into the 'A' category would not immediately trigger a downgrade of Euroclear Bank's Long-Term IDR (as reflected in its Stable Outlook), assuming that the bank's direct exposure to Belgian sovereign risk remains low.

The senior debt ratings of Euroclear Bank are 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.

EUROCLEAR INVESTMENTS (EINV) - IDRS AND DEBT RATINGS

EINV's IDRs and senior debt rating are primarily sensitive to a un upgrade or a downgrade of 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 prior to the 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 that increase the risk of going-concern loss absorption (e.g. an easily triggered mandatory deferral mechanism) could lead to wider notching and, therefore, a downgrade.

Feedback

BEST/WORST CASE RATING SCENARIO

International scale credit ratings of Financial Institutions and Covered Bond issuers have a best-case rating upgrade scenario (defined as the 99th percentile of rating transitions, measured in a positive direction) of three notches over a three-year rating horizon; and a worst-case rating downgrade scenario (defined as the 99th percentile of rating transitions, measured in a negative direction) of four notches over three years. The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Best- and worst-case scenario credit ratings are based on historical performance. For more information about the methodology used to determine sector-specific best- and worst-case scenario credit ratings, visit https://www.fitchratings.com/site/re/10111579

REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING

The principal sources of information used in the analysis are described in the Applicable Criteria.

ESG CONSIDERATIONS

Unless otherwise disclosed in this section, the highest level of ESG credit relevance is a score of '3'. This means ESG issues are credit-neutral or have only a minimal credit impact on the entity, either due to their nature or the way in which they are being managed by the entity. For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com/esg

RATING ACTIONS

ENTITY/DEBT	RATING			PRIOR
Euroclear Bank	LT IDR	AA Rating Outlook Stable	Downgrade	AA+ Rating Outlook Stable
	ST IDR	F1+	Affirmed	F1+
	Viability	aa	Downgrade	aa+
	Support	5	Affirmed	5

ENTITY/DEBT	RATING			PRIOR
	Support Floor	NF	Affirmed	NF
• Senior	LT	AA	Downgrade	AA+

VIEW ADDITIONAL RATING DETAILS

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Additional information is available on www.fitchratings.com

APPLICABLE CRITERIA

Bank Rating Criteria (pub. 28 Feb 2020) (including rating assumption sensitivity)

Corporate Hybrids Treatment and Notching Criteria (pub. 12 Nov 2020)

ADDITIONAL DISCLOSURES

Dodd-Frank Rating Information Disclosure Form

Solicitation Status

Endorsement Policy

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Euroclear Bank	EU Issued, UK Endorsed
Euroclear Investments SA	EU Issued, UK Endorsed

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Non-Bank Financial Institutions Europe Belgium Luxembourg

Feedback