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CREDIT OPINION
3 July 2017

Update

Rate this Research

RATINGS

HSH Nordbank AG

Domicile	Hamburg, Germany
Long Term Debt	Baa3
Type	Senior Unsecured - Fgn Curr
Outlook	Developing
Long Term Deposit	Baa3
Type	LT Bank Deposits - Fgn Curr
Outlook	Developing

Please see the ratings section at the end of this report for more information. The ratings and outlook shown reflect information as of the publication date.

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HSH Nordbank AG

Semiannual Update

Summary Rating Rationale

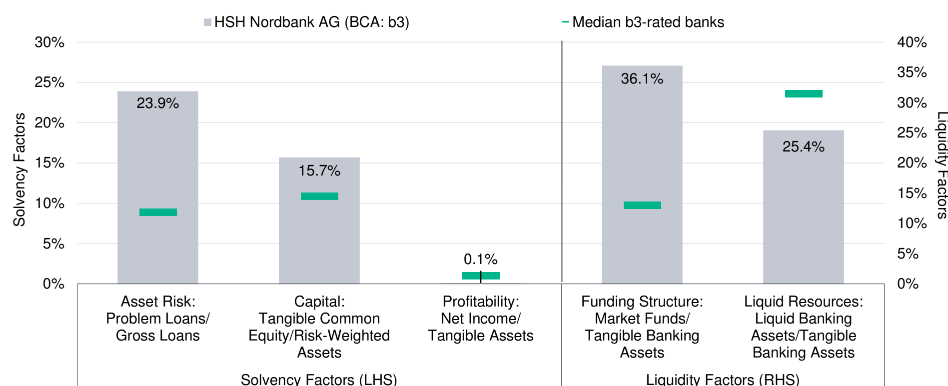
We rate HSH Nordbank AG's (HSH) senior unsecured debt and deposits Baa3 developing and its subordinated debt program (P)B2. Further we assign a b3 Baseline Credit Assessment (BCA) and a Baa3(cr)/P-3(cr) Counterparty Risk Assessment (CR Assessment).

HSH's ratings reflect (1) its b3 BCA; (2) the b1 adjusted BCA, which includes two notches of rating uplift for affiliate support from Sparkassen-Finanzgruppe (Aa2 stable, BCA a2[1]); (3) the result of our advanced Loss Given Failure (LGF) analysis which provides three notches of rating uplift; and (4) our moderate government support assumptions, equivalent to one notch of rating uplift. The LGF analysis incorporates HSH's substantial subordinated debt maturities in Q1 2017 that have reduced subordination in HSH's liability structure. While this implies lower loss absorption buffers in resolution, we take into account that HSH's ongoing balance sheet reduction could offset the adverse effect in the course of 2017 or early 2018.

HSH's b3 BCA reflects the bank's weak financial profile, in particular its very poor asset quality and limited capital resources in the context of its high-risk asset profile. The European Commission's (EC) requirement that HSH must be privatised by 28 February 2018 - or otherwise unwound - in compensation for state aid received, creates additional uncertainty, as reflected in the developing outlooks on the ratings.

Exhibit 1

Scorecard Ratios of HSH Nordbank AG



Source: Moody's Investors Service

Credit Strengths and Challenges

» Capital ratios are intact for now, but risks to capital remain considerable as the shipping sector crisis persists and the loss absorption capacity of HSH's €10 billion asset guaranty is fully utilised

» Asset risk pressures are high and nonperforming loan (NPL) ratios will remain high relative to peers even after envisaged portfolio sales

» Business model adjustments will continue over the next few quarters and major efforts will be necessary to mitigate earnings pressure and reduce costs

» As material subordinated debt instruments matured in Q1 2017, HSH's capabilities to sustain the current rating benefit for senior debt instrument resulting from our LGF analysis will rest on its progress in reducing (non-core) assets

» The opacity of the bank's future in the context of its required sale by February 2018 could increasingly weigh on investor confidence with adverse implications for HSH's ability to access the debt capital markets

» If HSH's privatisation fails, explicit support commitments may be required from key stakeholders to ensure an orderly wind-down that protects senior creditors from sharing losses

Rating Outlook

» The developing outlook reflects the high degree of uncertainty stemming from prospective changes of the bank's financial profile and liability structure.

Factors that Could Lead to an Upgrade

» An upgrade of HSH's ratings would be subject to (1) an upgrade of HSH's b3 BCA, whereby the BCA upgrade would have to be sufficient to more than offset any potentially adverse effects from our advanced LGF analysis; and/or (2) an explicit commitment from Sparkassen-Finanzgruppe which could result in additional rating uplift for affiliate support.

» An upgrade of the BCA will depend on prospects of a recovery in the shipping sector, improving asset quality and stronger and more predictable profits. Furthermore, the bank would need to maintain stable solvency metrics and continued access to debt capital markets.

Factors that Could Lead to a Downgrade

» A downgrade of HSH's ratings could result from (1) a downgrade of the BCA; and/or (2) indications of a weakening commitment from Sparkassen-Finanzgruppe to supporting HSH; and/or (3) a development of HSH's liability structure which may indicate a lasting higher loss severity in resolution and therefore result in fewer notches of uplift from our LGF analysis. In particular, the LGF result for HSH's senior debt remains vulnerable to diminishing volumes of subordinated instruments relative to total banking assets.

» We may consider downgrading the BCA if HSH's access to debt capital markets for long-term unsecured funding is not sustained, or HSH's prospective capital metrics prove to be insufficient in our forecasts under an adverse scenario. The latter could be triggered chiefly by capital erosion due to persistent asset risk.

This publication does not announce a credit rating action. For any credit ratings referenced in this publication, please see the ratings tab on the issuer/entity page on www.moodys.com for the most updated credit rating action information and rating history.

Key Indicators

Exhibit 2

HSH Nordbank AG (Consolidated Financials) [1]

	12-16[2]	12-15[2]	12-14[2]	12-13[3]	12-12[3]	CAGR/Avg.[4]
Total Assets (EUR billion)	81	93	105	105	123	-9.9[5]
Total Assets (USD billion)	86	101	127	144	162	-14.8[5]
Tangible Common Equity (EUR billion)	4.5	4.5	3.7	3.6	4.3	0.9[5]
Tangible Common Equity (USD billion)	4.7	4.8	4.5	5.0	5.7	-4.6[5]
Problem Loans / Gross Loans (%)	22.5	26.4	22.8	23.1	18.5	22.7[6]
Tangible Common Equity / Risk Weighted Assets (%)	15.7	11.9	9.5	10.2	7.1	12.4[7]
Net Interest Margin (%)	0.7	1.0	0.5	0.8	1.1	0.8[6]
PPI / Average RWA (%)	0.2	0.5	-0.5	1.0	1.2	0.1[7]
Net Income / Tangible Assets (%)	0.1	0.2	0.3	-0.6	0.0	0.0[6]
Cost / Income Ratio (%)	93.3	85.2	118.7	71.4	63.0	86.3[6]
Market Funds / Tangible Banking Assets (%)	36.1	39.8	45.7	48.6	54.8	45.0[6]
Liquid Banking Assets / Tangible Banking Assets (%)	25.4	25.3	25.1	23.5	20.6	24.0[6]
Gross Loans / Due to Customers (%)	130.2	138.3	156.0	168.4	195.0	157.6[6]

[1] All figures and ratios are adjusted using Moody's standard adjustments [2] Basel III - fully-loaded or transitional phase-in; IFRS [3] Basel II; IFRS [4] May include rounding differences due to scale of reported amounts [5] Compound Annual Growth Rate (%) based on time period presented for the latest accounting regime [6] Simple average of periods presented for the latest accounting regime. [7] Simple average of Basel III periods presented

Source: Moody's Financial Metrics

Detailed Rating Considerations

Restructuring measures are on track

With the conclusion of the state aid proceedings in early 2016, HSH obtained the European Commission's (EC) formal approval for the reinstatement of a second-loss asset guaranty of €10 billion, representing a €3 billion raise of the previous ceiling. The guaranty was initially provided in 2009 by the bank's public-sector owners, i.e. the federal state of Schleswig-Holstein (unrated) and the city state of Hamburg (unrated).

According to the agreement, HSH needs to execute various compensation measures, the most challenging of which is the bank's privatisation by the end of February 2018. Mandatory nonperforming portfolio sales of €8.2 billion were to a large extent executed in 2016, and we understand that the bank is on track to sell the remaining €3.2 billion in 2017. HSH has signed transactions comprising €2.3 billion as of early June 2017. This is principally beneficial for HSH's asset risk profile. However, the €5 billion NPLs offloaded to a wind-down vehicle last year (which had to be transferred at a 52% discount to their par value), combined with further provisioning needs in late 2016 and Q1 2017 fully exhausted the loss absorption capacity of the €10 billion asset guaranty. The latter implies that HSH's risk provisions are no longer compensated for, but need to be absorbed in the income statement.

HSH's mandatory privatisation implies uncertainty

HSH's mandatory privatisation by 28 February 2018 calls into question the bank's long-term viability because, according to the EC's decision, a failure of the sale would result in the wind-down of the bank. The EC demands the privatisation to be achieved through an "aid-free, positive price offer", and maintains the right of assessing HSH's viability as an independent bank once a bidder has been identified. HSH's mandatory privatisation implies major uncertainty for investors.

A successful privatisation will rest on whether HSH's capital resources will be sufficient to absorb potential losses on the sale of its non-core unit which houses most of the €14.3 billion nonperforming assets, as of March 2017, and still leave the core bank adequately capitalised in a transaction that could be orchestrated as a club deal. We do not rule out that HSH will be sold as it is, but consider it unlikely because regulators will probably approve a transaction only if the emerging going concern is freed from the burden of high-risk legacy loans. This scenario would also entail that HSH's €10 billion asset guaranty will become obsolete. The asset guaranty has effectively impaired the transparency of HSH's regulatory capitalisation. As a result, the benchmarking of its financial metrics with peers has been constrained.

We consider the risk that HSH cannot be successfully privatised to be considerable because the bank's high-risk profile is only partially addressed by ongoing restructuring measures. That said, the bank's unwinding is not necessarily the highest-risk scenario for senior investors. The incentives to orchestrate and support a coordinated unwinding which protects senior creditors from incurring losses are high for several stakeholders, in particular for Sparkassen Finanzgruppe. Considerable amounts of HSH's debt are held by savings banks and their clients.

Despite large NPL divestments, HSH's asset quality remains poor and NPL ratios high compared with peers

The €5.0 billion transfer of NPLs in 2016 has reduced HSH's NPL volume by 28% year-on-year to €11.8 billion as of December 2016. HSH's problem loan ratio (impaired customer loans + loans 90 days past due relative to gross loans) therefore reduced to 22.5%, from 26.4% as of December 2015 in accordance with our calculations.

The transaction offered some relief but was accomplished against the headwinds of major new loan impairments in the bank's ship fiance book. Despite the substantial problem loan reduction last year HSH still has excessive problem loans and, based on the 22.5% problem loan ratio, the highest NPLs in the German banking sector.

Assuming that the €3.2 billion problem assets that HSH intends to sell by the end of 2017 comprise exclusively of nonperforming customer loans, the pro forma problem loan ratio will go down to 17.4% (all else being equal). HSH made some progress in Q1 2017, as reflected in the reported nonperforming exposure (NPE) ratio of 16.5% which improved from 17.5% as of year-end 2016, owing to some sales transactions, but also a slightly higher total exposure.

Notwithstanding ongoing NPL sales, HSH's risk profile will remain burdened by the high potential for further credit losses from its €16.1 billion ship finance exposure as of December 2016. This amount still represents 3.6 times its €4.5 billion tangible common equity as of year-end 2016, and contains a high €9.0 billion, or 61%, of the bank's total nonperforming exposures (NPE). NPEs on ship finance rose by a substantial €3.2 billion during H2 2016, illustrating the strongly negative trend in the industry late last year. Judging from the €187 million risk charges booked in the noncore unit in Q1 2017, the pressure from new NPLs in shipping is not abating. We expect that HSH will reduce its large ship finance portfolio organically, but probably not through major portfolio sales ahead of its privatisation, considering that demand for impaired ship finance assets remains muted.

Further constraints for our assessment of asset risk include (i) HSH's lending focus on cyclical sectors (HSH also has a €14.2 billion exposure to commercial real estate as of December 2016); (ii) material single borrower concentrations; and (iii) market risk from the largely US-dollar-denominated ship-finance book. At the same time we take into account that 87% of total problem assets is protected by the €10 billion risk shield, as of December 2016. Of the €83.6 billion total exposure as of last December, 34% was covered by the guaranty. To reflect this substantial transfer of risk, we have adjusted the Asset Risk score upwards to b3.

Risks to capital remain considerable, even though capital ratios have improved

HSH's capital ratios remain intact for now. Its transitional Common Equity Tier 1 (CET1) ratio under the Capital Requirements Regulation and Directive (CRR/CRD4) has improved to 14.9% as of March 2017, from 14.1% as of December 2016. The fully phased-in CET1 ratio was 14.4% (13.4%).

The 14.9% transitional CET1 ratio implies some headroom against HSH's individual capital requirement for 2017 which has been set at 10.5%, as defined in the supervisory review and evaluation (SREP) process. The 10.5%, on a transitional basis, is composed of an 8.9% SREP minimum requirement (Pillar 2 Requirement) plus a 1.6% buffer (Pillar 2 Guidance).

HSH's loss-absorption buffers no longer benefit from headroom under the €10 billion asset guaranty. The guaranty was fully utilised as of March 2017, implying that future credit losses will diminish HSH capital base unless the bank can otherwise compensate for them (as it did during Q1 2017). Notwithstanding its full utilisation, the guaranty continues to offer risk-weighted asset (RWA) relief.

Despite the improved ratios, we consider the risks to HSH's capitalisation to be considerable, for several reasons:

» The persistent shipping crisis continues to drive adverse rating migration, additional provisioning needs and defaults in HSH's ship finance portfolio, exerting pressure on profits.

» The €10 billion asset guaranty no longer secures the 20% standard risk weight for the whole third loss tranche of the guaranteed portfolio. To maintain RWA relief, HSH needs to deduct from CET1 capital a new “sub-senior tranche”, reported at €700 million as of March 2017. This tranche will change in size, depending on the risk content and size of the total guaranteed portfolio.

» HSH's large US dollar exposure implies that a rising USD/EUR rate drives RWAs up, for which the guaranty does not offer protection, although HSH has made progress in limiting its FX-related risk.

» HSH's capital resources will not only have to satisfy regulators against minimum requirements, but also need to be sufficient to allow a sale of the bank for a positive consideration which will likely require a cleanup of its nonperforming assets.

That said, we understand HSH still has some scope for RWA reduction measures. HSH cannot pay dividends, and will also not service coupons on its Tier 1 instruments until 2020.

To reflect the risks stated above, we adjust HSH's Capital score downward to b1.

Despite a reduction in the cost of support, core profitability will remain weak

HSH reported last August that it estimates that, in 2018, its core bank targets an annual pretax profit of €200 million to €300 million which, however, will be largely absorbed by losses of €150 million to €200 million generated by the restructuring unit. While these numbers address investor interest for the core bank, the numbers highlight the high costs relating to the bank's legacy assets and the resulting unsustainable returns.

Notwithstanding the relief offered by lower guaranty fees agreed last year and gradual progress in cost reduction, we expect HSH's weak profits to remain under pressure and volatile. This is chiefly because persistent credit losses on the ship finance exposure can no longer be absorbed by pre-provision income because the €10 billion asset guaranty is fully utilised and therefore no longer available to compensate for credit losses on guaranteed legacy assets.

The earnings pressure from risk charges was illustrated by the Q1 2017 pre-tax result of €128 million which, adjusted for a €189 million one-off gain on the sale of securities, was a €61 million loss. The poor result was heavily impacted by the €101 million pre-tax loss reported for the noncore segment, which had to absorb a gross provision expense of €187 million (although on a net basis, this was a more manageable €38 million). HSH reported that it sold in Q1 the majority of securities it had earmarked for sale in 2017, which we believe implies diminished potential for one-off gains in the coming quarters. HSH pays a reduced fee of 2.2%, instead of 4.0%, on the amount not utilised (after settled losses) under the guaranty which amounted to €41 million in the first quarter. In 2016, the €121 million pre-tax profit reported for the year benefitted from a major positive compensation effect, given that it included a total compensation amount under the guaranty of €1.73 billion for risk charges (including FX effects) of €1.58 billion.

While it will be a major challenge during 2017 for the bank to reduce persistently high risk charges, HSH reiterated in its Q1 report published on 16 June that it targets a similar pre-tax profit for 2017 as the €121 million reported for 2016. To balance these aspects, we adjust HSH's Profitability score upward to b1.

Wholesale funding dependence coupled with significant US dollar funding requirements implies confidence sensitivity

Funding risks have reduced during 2016, which has been supporting the stability of HSH's b3 BCA. However, the bank's predominantly asset-based lending model requires substantial amounts of long-term funding, with a large portion in US dollars, in order to match the asset profile. HSH had intermittently suspended its issuing activities and recorded deposit outflows when it reported the postponement of the publication of its 2015 financials in March 2016, highlighting the bank's vulnerability to negative news flow. The situation has improved since then; HSH has issued several benchmark covered bonds and debt collateralised with infrastructure and other loans.

HSH's portfolio divestments have resulted in a better matched maturity profile. The €5.0 billion NPLs transferred out in June 2016 and ongoing asset sales imply structural benefits. Barring major market shocks, HSH will be able to maintain a liquidity coverage ratio (LCR) above 100%. Its LCR was a very satisfactory 203% at the end of March 2017, although down from 229% three months earlier. Its net stable funding ratio is also satisfactory at 111%.

HSH's access to long-term senior unsecured funding markets is unlikely to improve to a level that is comparable with its German peers given the required privatisation by the end of February 2018. HSH's funding risks are partly mitigated by its access to the deposit base

of the German savings banks which fund 10% - 20% of HSH's annual long-term funding activities. HSH will continue to rely strongly on asset-based funding through secured loans and covered bonds.

Low business diversification and the complexity of HSH's capital structure constrain the bank's BCA

We apply two qualitative adjustments to the calculated b1 Financial Profile Score. In consideration of the bank's very high business concentrations, and the resulting low diversification of its assets, revenues and profits, we apply a negative adjustment by one notch. We apply a second negative adjustment by one notch to capture the considerable complexity of the bank's capital structure in the context of the €10 billion asset guaranty, and the resulting limitations to forecasting regulatory capital ratios. The low predictability as to whether the bank's mandatory privatisation will be successful implies additional uncertainty.

Notching Considerations

Affiliate Support

HSH benefits from cross-sector support from Sparkassen-Finanzgruppe, reducing the probability of default as such support would be available to stabilise a distressed member bank and not just compensate for losses in resolution.

We continue to consider the readiness of the sector to support its members to be high, which results in two notches of rating uplift from the b3 BCA to HSH's debt and deposit ratings.

Loss Given Failure

In our advanced LGF analysis, we consider the risks faced by the different debt and deposit classes across the liability structure in resolution. We assume residual tangible common equity of 3% and losses post-failure of 8% of tangible banking assets, a 25% run-off in “junior” wholesale deposits and a 5% run-off in preferred deposits. These ratios are in line with our standard assumptions. We base our calculation on the assumption that deposits are preferred to most senior unsecured debt instruments, in line with the new German insolvency legislation, effective since January 2017, that subordinates non-structured senior bonds and notes to deposits in resolution.

- For ***deposits*** and ***senior-senior unsecured debt***, rated Baa3, our LGF analysis indicates an extremely low loss-given-failure, leading to a three-notch uplift, respectively, above the b1 Adjusted BCA.
- For ***senior unsecured debt***, rated Baa3, our LGF analysis also indicates an extremely low loss-given-failure, leading to a three-notch uplift above the b1 Adjusted BCA.
- For ***senior subordinated debt***, rated B2, our LGF analysis indicates a high loss-given-failure, leading us to position these instruments one notch below the b1 adjusted BCA.
- ***Trust-preferred securities*** and ***silent participations*** (Stille Einlagen) are rated Ca(hyb). These ratings relate to the entities HSH N Funding I, HSH N Funding II, RESPARCS Funding I Limited Partnership, and RESPARCS Funding II Limited Partnership, and are based on our expected-loss calculation. The Ca(hyb) ratings reflects (1) principal write-downs to 52.4% of the nominal amounts in 2015 and no further write-down since; (2) the requirement for HSH to abstain from servicing its hybrid instruments until the bank is privatised, which we understand allows resumption of coupon payments in 2020 for 2019 at the earliest. We note that there is no clarity yet as to what extent HSH may write back amounts written-down during the next few years.

Government Support

Although German banks operate in an environment of materially weakened prospects for financial assistance from the government, we maintain one notch of rating uplift in our senior unsecured debt and deposit ratings for members of the Sparkassen-Finanzgruppe, reflecting our assumptions of a moderate support probability. Our government support assumptions reflect the large size and high systemic relevance of Sparkassen-Finanzgruppe.

Rating Methodology and Scorecard Factors

Exhibit 3

HSH Nordbank AG

Macro Factors							
Weighted Macro Profile	**Strong**	**100%**					
Factor		**Historic Ratio**	**Macro Adjusted Score**	**Credit Trend**	**Assigned Score**	**Key driver #1**	**Key driver #2**
Solvency							
Asset Risk							
Problem Loans / Gross Loans		23.9%	caa1	←→	b3	Collateral and provisioning coverage	Sector concentration
Capital							
TCE / RWA		15.7%	a1	←→	b1	Capital fungibility	Access to capital
Profitability							
Net Income / Tangible Assets		0.1%	b3	←→	b1	Expected trend	
Combined Solvency Score			ba2		b2		
Liquidity							
Funding Structure							
Market Funds / Tangible Banking Assets		36.1%	ba3	←→	ba3	Market funding quality	
Liquid Resources							
Liquid Banking Assets / Tangible Banking Assets		25.4%	baa1	←→	baa3	Asset encumbrance	
Combined Liquidity Score			ba1		ba2		
Financial Profile					b1		
Business Diversification					-1		
Opacity and Complexity					-1		
Corporate Behavior					0		
Total Qualitative Adjustments					-2		
Sovereign or Affiliate constraint:					Aaa		
Scorecard Calculated BCA range					b2-caa1		
Assigned BCA					b3		
Affiliate Support notching					2		
Adjusted BCA					b1		

null

Debt class	De Jure waterfall		De Facto waterfall		Notching		LGF Notching Guidance vs. Adjusted BCA	Assigned LGF notching	Additional notching	Preliminary Rating Assessment
	Instrument volume + subordination	Sub-ordination	Instrument volume + subordination	Sub-ordination	De Jure	De Facto				
Counterparty Risk Assessment	--	--	--	--	--	--	--	3	0	ba1 (cr)
Deposits	--	--	--	--	--	--	--	3	0	ba1
Senior senior unsecured bank debt	--	--	--	--	--	--	--	3	0	ba1
Senior unsecured bank debt	--	--	--	--	--	--	--	3	0	ba1
Dated subordinated bank debt	--	--	--	--	--	--	--	-1	0	b2

Instrument class	Loss Given Failure notching	Additional Notching	Preliminary Rating Assessment	Government Support notching	Local Currency Rating	Foreign Currency Rating
Counterparty Risk Assessment	3	0	ba1 (cr)	1	Baa3 (cr)	--
Deposits	3	0	ba1	1	Baa3	Baa3
Senior senior unsecured bank debt	3	0	ba1	1	Baa3	Baa3
Senior unsecured bank debt	3	0	ba1	1	Baa3	Baa3
Dated subordinated bank debt	-1	0	b2	0	(P)B2	--

Source: Moody's Financial Metrics

About Moody's Bank Scorecard

Our Scorecard is designed to capture, express and explain in summary form our Rating Committee's judgment. When read in conjunction with our research, a fulsome presentation of our judgment is expressed. As a result, the output of our Scorecard may materially differ from that suggested by raw data alone (though it has been calibrated to avoid the frequent need for strong divergence). The Scorecard output and the individual scores are discussed in rating committees and may be adjusted up or down to reflect conditions specific to each rated entity.

Ratings

Exhibit 4

Category	Moody's Rating
HSH NORDBANK AG	
Outlook	Developing
Bank Deposits	Baa3/P-3
Baseline Credit Assessment	b3
Adjusted Baseline Credit Assessment	b1
Counterparty Risk Assessment	Baa3(cr)/P-3(cr)
Issuer Rating	Baa3
Senior Unsecured	Baa3
Subordinate MTN -Dom Curr	(P)B2
ST Issuer Rating	P-3
Other Short Term -Dom Curr	(P)P-3
HSH N FUNDING I	
BACKED Pref. Stock Non-cumulative	Ca (hyb)
HSH N FUNDING II	
Jr Subordinate	Ca

Source: Moody's Investors Service

Endnotes

1 The rating for Sparkassen Finanzgruppe shown is the corporate family rating and outlook, and the baseline credit assessment.

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