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Research Update:

Liechtenstein-Based VP Bank Outlook Revised To Negative On Risk Management And Strategic Challenges

July 17, 2020

Overview

- VP Bank's CHF20 million Lombard loss in March 2020, during extreme market volatility, revealed weaknesses in risk management and governance, and triggered management and organizational changes.
- Although we believe a new management and governance structure, alongside a clear remediation path, should lift VP Bank's risk governance to a level in line with peers, the upgrades will likely be gradual.
- We are therefore revising our outlook on VP Bank to negative from stable, and affirming the ratings at 'A/A-1'.
- The negative outlook reflects the possibility of a downgrade should deficiencies persist or if the competitive environment constrains VP Bank's profitability.

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Rating Action

On July 17, 2020, S&P Global Ratings revised the outlook on VP Bank to negative from stable. At the same time, we affirmed our 'A' long-term and 'A-1' short-term issuer credit ratings on the bank. We also affirmed the issue ratings on VP Bank's senior unsecured note at 'A' and on the senior subordinated notes at 'A-'.

Rationale

The outlook revision to negative follows VP Bank's loss of Swiss franc (CHF) 20 million in its Lombard book and related shifts in management. We also consider that the bank is likely to face strategic challenges over the coming years.

On March 30, 2020, VP Bank announced a CHF20 million loss in its Lombard book amid the the onset of COVID-19-related capital market disruptions. Because we had assessed this portfolio as being generally very low risk, given its granularity and conservative collateralization, the loss was very unexpected. We believe that it didn't stem from higher risk appetite, but rather from weaknesses in the bank's risk governance.

The loss also triggered management and organizational changes that underscore the severity of the incident and internal deficiencies. Both the chief financial officer and the chief risk officer left the bank in June as a result of a thorough review conducted to examine the circumstances that led to the loss. Nevertheless, we acknowledge that this review and the resulting management and organizational developments point to the bank's swift reaction. Furthermore, the bank conducted a portfolio review and regular stress test of the existing Lombard book that should prevent future loss events of similar magnitude.

However, we think that VP Bank's risk position could remain relatively weaker than peers' if there are delays in needed upgrades to its internal risk governance and processes. These enhancements will likely be gradual, indicating that the bank could be vulnerable to a higher likelihood of further loss incidents.

In our view, the latest reshuffling of senior leaders, considering the management changes before the loss incident, could lead to a less sustainable business model that harms the bank's reputation. The newly composed management team has now to constitute itself and prove its ability to deliver on the ambitious targets of the bank's strategy 2025. While we largely expect the bank will continue to pursue its profitable growth strategy, reinforced with further cost optimization and efforts to improve revenue streams, we also anticipate persisting intense competitive pressure that could result in gradually weakening revenue margins and deteriorating profitability. In our view, maintaining the current profitability hinges on additional revenue streams from existing and new clients.

We maintain a cautious stance toward VP Bank's future buffer of bail-in-able instruments and do not assign any rating uplift for additional loss-absorbing capacity that would protect senior unsecured creditors. The bank so far has issued only one instrument that will likely count toward its minimum requirement for own funds and eligible liabilities (MREL). In addition, we expect the communication of bank-specific requirements only toward the second half of 2021.

Our 'A' long-term issuer credit rating on VP Bank continues to be materially supported by the bank's very strong capitalization and very solid funding position. That said, the bank's relatively small size and niche position in the global private banking market are rating constraints.

Environmental, social, and governance (ESG) credit factors for this credit rating change:

- Risk management and internal controls

Outlook

The negative outlook on VP Bank reflects uncertainty about the speed and success of its remediation package to improve its risk management and governance over the coming 12-24 months. It also considers the challenge of achieving the ambitious goals of the bank's strategy 2025, weighing in the current market environment.

Downside scenario

We could lower the rating should we observe delays in the improvements to its risk governance or further loss incidents. A downgrade could also occur if the bank's growth strategy or search for additional revenue streams were not as successful as planned, questioning the stability of the bank's business strengths. A sizable acquisition could also constrain the rating should it materially erode the capital buffer, as reflected by our risk-adjusted capital (RAC) ratio dropping below 15%.

Upside scenario

We could revise the outlook to stable if VP Bank successfully implements measures to eradicate the weaknesses in the risk management of its Lombard book, since this would prevent any material losses amid heightened market volatility.

An outlook revision to stable would also hinge on positive outcomes of its growth strategy, leading to continuing net new money inflows that would result in stable to improving profitability, despite persisting strong competition.

We could also consider a positive rating action if we believed that VP Bank had built a material buffer of bail-in-able capital that protects senior unsecured creditors should the bank become nonviable, however its MREL requirements will likely only communicated toward mid-2021.

Ratings Score Snapshot

	To	From
Issuer Credit Rating	A/Negative/A-1	A/Stable/A-1
SACP	a	a
Anchor	a-	a-
Business position	Moderate (-1)	Moderate (-1)
Capital and earnings	Very Strong (+2)	Very Strong (+2)
Risk position	Adequate (0)	Adequate (0)
Funding and	Average and	Average and
Liquidity	Adequate (0)	Adequate (0)
Support	0	0
ALAC support	0	0
GRE support	0	0
Group support	0	0
Sovereign support	0	0
Additional Factors	0	0

Related Criteria

- General Criteria: Group Rating Methodology, July 1, 2019
- Criteria | Financial Institutions | General: Methodology For Assigning Financial Institution Resolution Counterparty Ratings, April 19, 2018
- Criteria | Financial Institutions | General: Risk-Adjusted Capital Framework Methodology, July 20, 2017

- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings, April 7, 2017
- Criteria | Financial Institutions | Banks: Bank Rating Methodology And Assumptions: Additional Loss-Absorbing Capacity, April 27, 2015
- Criteria | Financial Institutions | Banks: Quantitative Metrics For Rating Banks Globally: Methodology And Assumptions, July 17, 2013
- Criteria | Financial Institutions | Banks: Banks: Rating Methodology And Assumptions, Nov. 9, 2011
- Criteria | Financial Institutions | Banks: Banking Industry Country Risk Assessment Methodology And Assumptions, Nov. 9, 2011
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Related Research

- Liechtenstein-Based VP Bank's Proposed First Issuance Of Senior Nonpreferred Notes Rated 'A-', Nov. 4, 2019
- VP Bank AG, Aug. 27, 2019
- Banking Industry Country Risk Assessment: Liechtenstein, Feb. 18, 2019

Ratings List

Ratings Affirmed		
VP Bank AG		
Local Currency	a	
Resolution Counterparty Rating	A+/--/A-1	
Senior Unsecured	A	
Senior Subordinated	A-	
Ratings Affirmed; Outlook Action		
	To	**From**
VP Bank AG		
Issuer Credit Rating	A/Negative/A-1	A/Stable/A-1