



Fitch Affirms NORD/LB Luxembourg S.A. Covered Bond Bank's Lettres de Gages Publiques at 'AAA'

Fitch Ratings-Frankfurt/London-12 February 2016: Fitch Ratings has affirmed NORD/LB Luxembourg S.A. Covered Bond Bank's (NORD/LB CBB, A-/Stable/F1) Lettres de Gage Publiques (LdGPs) at 'AAA' with a Stable Outlook, following a periodic review of the programme.

KEY RATING DRIVERS

The rating is based on NORD/LB CBB's Long-term Issuer Default Rating (IDR) of 'A-', an unchanged IDR uplift of one notch, an unchanged Discontinuity Cap (D-Cap) of 3 notches (moderate high risk) and the 25.7% over-collateralisation (OC) that Fitch takes into account, which provides more protection than the 19% 'AAA' breakeven OC.

The main constituent of the breakeven OC remains the credit loss component of 17.1% (18.5% previously). For the first time, Fitch has credit linked the programme's rating to the Federal Republic of Germany (AAA/Stable/F1+), given the high share of German assets (43%). The German exposure has continuously increased over the past three years, in line with the issuer's strategy to focus its asset origination on Germany and other core European countries.

The asset disposal loss and the cash flow valuation components increased compared with the previous analysis and therefore explain the increase in breakeven OC (19% vs 15% previously). The asset disposal loss component increased to 4.4% (2.6% previously), reflecting slightly higher refinancing costs and a resulting higher amount of forced asset sales to ensure timely payment on outstanding LdGP.

The cash flow valuation component amounts to 2.2% (-0.6% previously). In its current cash flow analysis, Fitch tested the point at which recourse against the cover pool is enforced at up to six quarters after the pool cut-off date plus at the first benchmark maturity, rather than up to four quarters previously. In addition, Fitch applied foreign exchange rate stresses as per the 'Exposure Draft: Treatment of Residual Foreign Exchange Exposures in Covered Bonds' dated 17 November 2015. The additional flexibility provided by callable LdGP to manage mismatches was taken into account when modelling the cash flows.

We derived our rating assumptions for German public sector entities (PSE; about 26% of the cover pool) in line with the criteria report 'Rating of Public-Sector Entities - Outside the United States' dated 26 February 2015 at www.fitchratings.com. Under this approach, the rating assumption for the respective PSE is credit-linked to the rating of the largest public sector shareholder and the assumption can be equalised or notched down by up to three notches depending on the aggregate share of public ownership. We applied a conservative rating assumption for PSEs with fragmented ownership structure.

US municipal exposure accounts for about 25% of NORD/LB CBB's cover pool. The default assumptions are based on public ratings or, where not available, on floor assumptions. In line with Fitch's 'State Revolving Fund and Leveraged Municipal Loan Pool Criteria' dated 29 October 2015, a floor assumption of 'BB' was used for 2.2% of the cover pool.

Fitch believes that the default risk for municipal assets conditional on the default of the corresponding sovereign is significantly higher than the default risk indicated by the respective rating. To reflect this, for the US municipal assets, Fitch has associated the higher municipal conditional default risk with a default probability assumption of 40%. This assumption is lower than the 80% used for European municipalities taking into account the more federal framework in the US. The recovery rate assumptions for the US municipal assets range from 15% to 70% in an 'AAA' scenario, depending on the type of bond.

Loans to Public Private Partnerships, eligible as cover assets under Luxembourgian law, constitute around 6% of NORD/LB CBB's cover pool. As Fitch did not conduct a detailed analysis of these assets, a conservative 'CCC' assumption was applied. This assumption contributes approximately one percentage point to the credit loss component.

The current documentation for the privileged derivatives in the programme will be changed to introduce rating replacement triggers, remedial action periods and collateral account banks in line with Fitch's criteria. These changes are expected to be made by mid June 2016. The collateral formula is different to the calculation as per Fitch's criteria, but no changes are proposed. The calculated amounts meet the expectations outlined in Fitch's counterparty criteria.

Until the changes are implemented, Fitch draws comfort from the operational and contractual provisions already in place, stipulating collateral posting irrespective of rating triggers. The collateral is earmarked and posted to separate accounts. Should Fitch become aware of the issuer no longer intending to make the respective changes to the documentation, or should the changes not be conducted within the agreed timeline, Fitch will take rating action.

RATING SENSITIVITIES

The 'AAA' LdGP rating would be vulnerable to downgrade if any of the following occurs: (i) the IDR is downgraded by one or more notches to 'BBB+' or below; or (ii) the combined number of notches represented by the IDR uplift and D-Cap is reduced to 3 notches or lower; or (iii) the OC that Fitch considers in its analysis decreases below Fitch's 'AAA' breakeven level of 19.0%.

If the OC that Fitch considers in its analysis drops to the legal requirement of 2%, it would not be sufficient to allow for timely payment of the covered bonds following an issuer default. As a result, the covered bond rating would likely be downgraded to 'A+', because this level of OC would limit the covered bond rating to two notches above the 'A-' IDR as adjusted by the IDR uplift.

The Fitch breakeven OC for the LdGP's rating will be affected, amongst others, by the profile of the cover assets relative to outstanding covered bonds, which can change over time, even in the absence of new issuances. Therefore the breakeven OC to maintain the covered bond rating cannot be assumed to remain stable over time.

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Applicable Criteria

