

# Revised Support Assumptions for German Landesbanken

## Special Report

**Institutional Support:** The EU Bank Recovery and Resolution Directive (BRRD) and the Single Resolution Mechanism (SRM) significantly reduce the likelihood of sovereign support for German banks' senior unsecured creditors. Fitch Ratings has revised its support assumptions for German Landesbanken IDRs from sovereign systemic to institutional support.

**IDRs Remain High:** We believe that strong support likelihood from the combination of German federal states (Laender; if rated, 'AAA'), the Sparkassen-Finanzgruppe (Sparkassen) (SFG, 'A+') and the Sparkassen (savings banks) and Landesbanken institutional protection fund (Haftungsverbund) underpins very high support-driven IDRs for most Landesbanken.

**Strong and Committed Owners:** Our institutional support considerations are based on our assessment that the owners of the Landesbanken, the respective Laender and regional savings banks, consider their investment as long-term and strategic. The strong propensity to support Landesbanken reflects the banks' increased focus on their statutory roles, supporting the regional economies, acting as the states' house bank, and working with the savings banks.

### Related Research

[Fitch Downgrades 6 German Landesbanken on Support Revision \(May 2015\)](#)

[German Laender Budgetary Performance Update February 2015\)](#)

[Peer Review: German Landesbanken \(December 2014\)](#)

[Landesbank Saar \(September 2014\)](#)

[Norddeutsche Landesbank Girozentrale \(October 2014\)](#)

[HSH Nordbank AG \(October 2014\)](#)

[Bremer Landesbank Kreditanstalt Oldenburg - Girozentrale \(August 2014\)](#)

[Bayerische Landesbank \(September 2014\)](#)

[Landesbank Baden-Wuerttemberg \(August 2014\)](#)

### Rating Navigators

[Landesbank Baden-Wuerttemberg \(June 2015\)](#)

[Bayerische Landesbank \(June 2015\)](#)

[Landesbank Saar \(June 2015\)](#)

[HSH Nordbank AG \(June 2015\)](#)

[Bremer Landesbank Kreditanstalt Oldenburg - Girozentrale \(June 2015\)](#)

[Norddeutsche Landesbank Girozentrale \(June 2015\)](#)

[Sparkassen-Finanzgruppe \(Sparkassen\) \(February 2015\)](#)

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**Lower IDR as Anchor:** We believe that support would need to be forthcoming from both the Laender and the Sparkassen to avoid triggering state aid considerations and resolution under the BRRD if a Landesbank becomes insolvent. Therefore, we take the lower of the two parents' ratings as the anchor rating for our support assessment.

**Notched Twice From SFG:** Potential prevention of state owners being able to provide support ahead of senior creditors under the BRRD results in an additional notch added to the one notch down from the owners we generally apply to strategic subsidiaries. We, therefore, notch twice from the 'A+' anchor rating to arrive at IDRs of 'A-' for Landesbanken. We apply wider notching when we consider the lack of a sustainable business model makes a long-term investment strategy questionable and therefore introduces more risk that the BRRD would restrict support.

**Institutional Support Fund Critical:** Pre-emptive support measures by the owners as part of recovery plans reduce the risk of unexpected failures. If owners' support fails the private investor test, the participation of the Haftungsverbund in the support measures could still result in avoidance of resolution, as long as the viability of the failed Landesbank can be restored.

**Sustainable Business Model Needed:** Fitch widens the notching by a full rating category if we doubt the long term sustainability of a Landesbank's business. The extra notching reflects increased uncertainty of whether state support would be allowed, and the savings banks propensity to support, increasing the risk of a potential orderly wind down. We use a Viability Rating (VR) of 'bb-' or below as an initial indicator to assess whether a Landesbank's business model is sustainable.

**Short-Term IDRs at F1:** The ample liquidity of the Sparkassen and their strong links to Landesbanken results in 'F1' Short-Term IDRs for the Landesbanken rated 'A-', the higher of the two mapping options from a Long-Term IDR of 'A-'.

**Rating Sensitivities:** Landesbanken IDRs are primarily sensitive to changes to SFG's IDR, but also to deterioration in the sustainability of a bank's business mode, likely indicated initially by downgrades of its VR. The IDRs are also sensitive to changes to our assessment of the risks of triggering a resolution process ahead of support for a Landesbank and to any changes in the owners' strategic commitment and importance of the banks for their home regions.

Figure 1

### Ratings of German Landesbanken End-May 2015

|  | IDR             |         | Short-term IDR | Viability Rating | Support Rating | Guaranteed obligations <sup>a</sup> |
|--|-----------------|---------|----------------|------------------|----------------|-------------------------------------|
|  | Long-term IDR   | Outlook |                |                  |                |                                     |
| Bayerische Landesbank                                    | A-              | Stable  | F1             | bb+              | 1              | AAA                                 |
| Landesbank Baden-Wuerttemberg                            | A-              | Stable  | F1             | bbb              | 1              | AAA                                 |
| Landesbank Saar  | A-              | Stable  | F1             | bb+              | 1              | AAA                                 |
| Norddeutsche Landesbank Girozentrale                     | A-              | Stable  | F1             | bb+              | 1              | AAA                                 |
| Bremer Landesbank Kreditanstalt Oldenburg - Girozentrale | A-              | Stable  | F1             | bb               | 1              | AAA                                 |
| HSH Nordbank AG  | BBB-            | Stable  | F3             | b/RWE            | 2              | AAA                                 |
| Landesbank Hessen-Thueringen Girozentrale                | A+ <sup>b</sup> | Stable  | F1+            | NR               | WD             | AAA                                 |

<sup>a</sup> Based on grandfathered guarantees by owners in the form of "Gewährträgerhaftung" (guarantor liability)

<sup>b</sup> The IDRs assigned to Helaba reflect its integration into S-Finanzgruppe Hessen-Thueringen. All group members – 50 savings banks plus Helaba – have the same ratings, which are driven by mutual support for each other and the VR of the group as a whole.

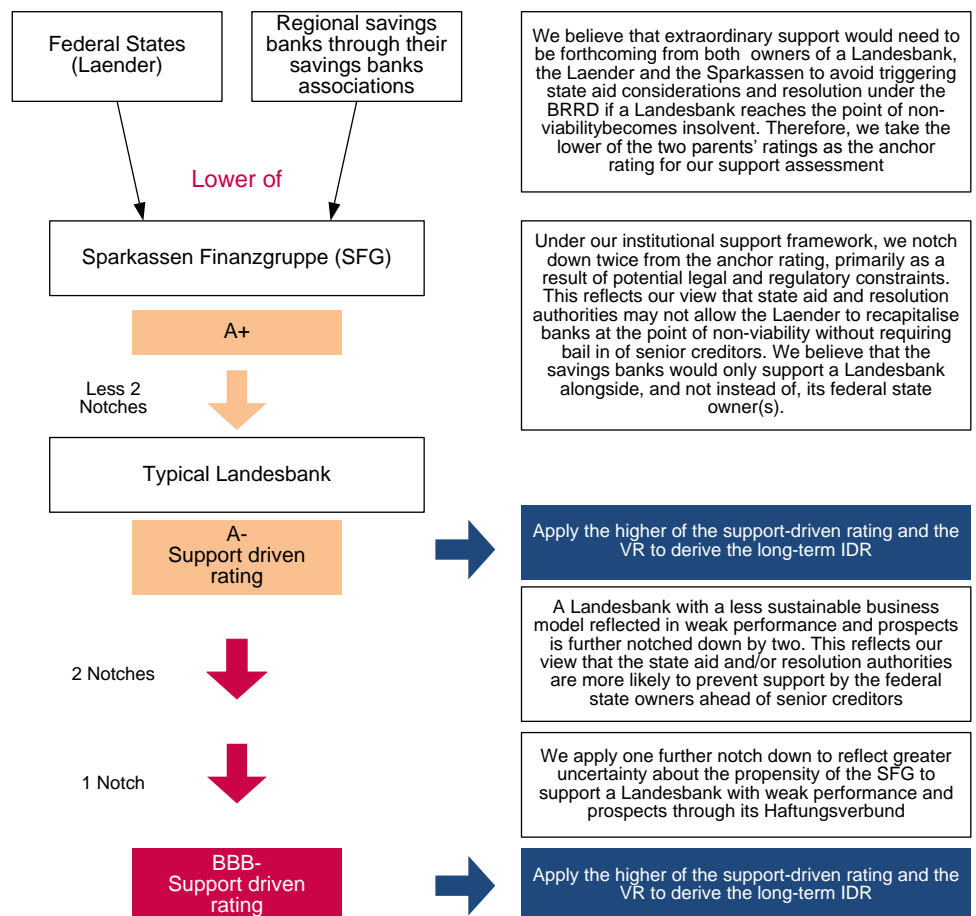
<sup>c</sup> Helaba and the savings banks are not assigned VRs separately, as their viability depends on the strength of the group as a whole.

Source: Fitch

With the exception of Helaba, whose Long-Term IDR is driven by its membership of a mutual support group rated 'A+', IDRs of Landesbanken are driven by the ability and propensity of their owners to provide extraordinary support should this be required.

Figure 2

### Deriving German Landesbank Ratings



Source: Fitch

- Institutional framework to deal with banks that fail or a likely to fail
- BRRD and SRM became effective in Germany on 1 January 2015
- Participation of shareholders and creditors in banks' losses and in the costs for resolution
- Dilution of national influence over resolution decisions

## BRRD and SRM Are Changing Dynamics of Support

The BRRD provides an institutional framework with harmonised rules regarding the resolution of banks that are failing or likely to fail. These rules have been implemented into German Law (German Act on the Recovery and Resolution of Credit Institutions (Gesetz zur Sanierung und Abwicklung von Kreditinstituten – SAG) on 1 January 2015. Key provisions are the participation of shareholders and creditors in banks' losses and in the related costs for resolution to avoid an injection of taxpayers' money. SAG includes early application of the bail-in tool in Germany.

Decisions on whether and how a Landesbank will be resolved will be made under the SRM. The SRM will be effective from 1 January 2016 and forms the second main pillar of banking union, complementing the Single Supervisory Mechanism which started in November 2014. All but one Landesbanken are also subject to direct supervision by the ECB. Due its smaller size, Landesbank Saar (SaarLB; A-/Stable/bb+) is not directly supervised by the ECB<sup>1</sup>, but as a eurozone bank also falls under banking union.

Under SRM transfers the resolution process will be governed by the new Single Resolution Board (SRB). SRM will ensure centralised management of the resolution of 'significant banks' that fail or are likely to fail. The powers of the SRB are wide ranging but yet untested. As a result there will be a dilution of national influence over resolution decisions and sovereign and sub-sovereign owners will have less leeway to take autonomous support measures when a bank falls under resolution.

- High probability of support from owners despite BRRD/SRM provisions and limitations

We believe that due to this regulation sovereign support in Germany, despite its strong financial resources, can no longer be relied upon to protect senior creditors in full. However the specific ownership of the Landesbanken by their federal states and regional savings banks and the important role these banks play in their region in our view supports a continued high probability of protection for senior creditors within the provisions and limitations of BRRD and SRM. We consequently revised our support drivers for German Landesbanken IDRs from sovereign to institutional support and incorporated the potential constraints for owners' ability to support under the German SAG.

## Institutional Support from Landesbanken Owners

### Solid Support from Strategic Owners Underpins IDR

We believe that strong support likelihood from the combination of German Laender, SFG and the Sparkassen (savings banks) and Landesbanken institutional protection fund (Haftungsverbund) underpins solid support-driven IDRs for Landesbanken with sustainable business models.

Our institutional support considerations are based on our assessment that the owners of the Landesbanken, the respective Laender and regional savings banks, consider their investment as long-term and strategic.

The strong propensity to support Landesbanken reflects the banks' increased focus on their statutory roles defined in specific laws or statutes governing the banks ('Landesbankengesetzen' or 'Staatsvertraegen'), the role they play in supporting their regional economies and their link to and mandatory role to work with the local Sparkassen and their customers. Landesbanken also play a role as a house bank to their relevant states and other related municipal entities and central banks to the savings banks.

<sup>1</sup> Bremer Landesbank Kreditanstalt Oldenburg - Girozentrale (BremerLB; A-/Stable/bb) is indirectly supervised by the ECB through its integration into Norddeutsche Landesbank Girozentrale (NORD/LB; A-/Stable/bb+) group

### Historic Evidence of Support

Landesbanken owners have demonstrated their willingness to support on various occasions through the financial crises either by direct capital injections or provision of state guarantees as was the case for Bayerische Landesbank (Bayern LB; A-/Stable/bb+), Landesbank Baden-Wuerttemberg (LBBW; A-/Stable/bbb), HSH Nordbank AG (HSH; BBB-/Stable/b RWE) and NORD/LB. Only SaarLB, BremerLB and Landesbank Hessen-Thuringen (Helaba; A+/Stable) did not require direct support through the crisis.

Importantly, even the orderly wind-down rather than liquidation of the former WestLB in December 2011 would not have been possible without the support from the owners and the sector's mutual support fund.

- Propensity to support varies between the Laender
- But is ultimately backed by the solidarity mechanism between the Laender

### Support From the Laender: Strong Ability and Propensity

The fundamental factors of each of Germany's federal state owners of Landesbanken vary substantially (see Figure 3). In terms of ability to provide support to the Landesbanken, differences in each Land's economic and financial performance are mitigated by all Laender being equally entitled to mutual financial support in the event of financial distress.

Our view of the creditworthiness of Germany's federal states is driven by the stability of the solidarity system; the ratings for Laender covered by Fitch are equalised with those of Germany. The solidarity system is enshrined in the German constitution and reflects the institutional framework of the Laender. According to the German constitution, all Laender are jointly responsible for supporting a federal state (Land) in financial distress. If a Land experiences "extreme budgetary hardship", it is entitled to financial assistance from all other Laender. As a result Fitch's ratings for the German Laender it rates are 'AAA'.

In terms of propensity, we believe that each Landesbank has a manageable size relative to the size of the respective Land to ensure that the Land owner would be able to support in its own right – absent state aid or BRRD restrictions. Figure 1 demonstrates that each Land has sufficient resources to recapitalise even following a substantial shortfall arising in the relevant Landesbank given the size of the banks' balance sheets and their capital in relation to the federal states' GDP or revenues.

Figure 3

#### Key Figures Laender end-2014 (EURm)

|                           | Adjusted<br>revenues<br>(EURm) | Adjusted<br>expenses<br>(EURm) | Balance<br>(EURm) | Tax<br>revenues<br>(EURm) | Interest<br>expenses<br>(EURm) | Debt<br>EUR bn | GDP real<br>growth<br>1H14 (%) | GDP<br>(1H14)<br>(EURm) | Debt/<br>GDP<br>(%) | GDP per<br>inhabitant | Debt/<br>Inhabitant | Unemploy-<br>ment rate |
|---------------------------|--------------------------------|--------------------------------|-------------------|---------------------------|--------------------------------|----------------|--------------------------------|-------------------------|---------------------|-----------------------|---------------------|------------------------|
| Bayern                    | 51,785.8                       | 50,117.9                       | 1,667.9           | 39,659.2                  | 885.4                          | 26,111.2       | 2.3                            | 499.210                 | 5.23                | 39,313                | 2,056               | 4.2                    |
| Baden-Wuerttemberg        | 42,951.7                       | 42,254.3                       | 697.4             | 31,830.5                  | 1,581.0                        | 47,299.3       | 2.2                            | 416.203                 | 11.36               | 38,296                | 4,352               | 4.1                    |
| Hessen                    | 23,011.3                       | 23,677.3                       | -666.0            | 18,536.3                  | 1,191.2                        | 41,437.3       | 1.7                            | 239.691                 | 17.29               | 39,144                | 6,767               | 5.8                    |
| Thuringen                 | 9,142.9                        | 8,957.0                        | 185.9             | 5,525.8                   | 549.3                          | 15,699.3       | 1.8                            | 51.952                  | 30.22               | 23,584                | 7,127               | 8.4                    |
| Saarland                  | 3,590.0                        | 3,890.7                        | -300.7            | 2,621.5                   | 470.4                          | 13,981.2       | 2.1                            | 32.729                  | 42.72               | 32,502                | 13,884              | 7.5                    |
| Niedersachsen             | 27,140.2                       | 27,345.5                       | -205.3            | 20,130.7                  | 1,522.1                        | 57,803.1       | 1.3                            | 242.087                 | 23.88               | 30,541                | 7,292               | 6.7                    |
| Sachsen-Anhalt            | 9,986.1                        | 9,916.0                        | 70.1              | 5,666.8                   | 594.1                          | 20,520.0       | 1.1                            | 53.587                  | 38.29               | 23,451                | 8,980               | 11.3                   |
| Bremen                    | 4,657.7                        | 5,097.3                        | -439.6            | 2,565.0                   | 560.9                          | 19,744.0       | 0.8                            | 28.806                  | 68.54               | 43,428                | 29,766              | 11.2                   |
| Hamburg                   | 12,297.3                       | 11,873.1                       | 424.2             | 9,889.4                   | 685.3                          | 23,227.3       | 0.7                            | 98.415                  | 23.60               | 53,985                | 12,741              | 7.8                    |
| Schleswig-Holstein        | 9,621.2                        | 9,865.3                        | -244.1            | 7,176.0                   | 773.5                          | 27,105.9       | 3.0                            | 81.063                  | 33.44               | 28,514                | 9,535               | 7.1                    |
| Berlin                    | 23,798.7                       | 22,961.2                       | 837.5             | 13,126.8                  | 1,753.4                        | 60,561.3       | 1.2                            | 110.496                 | 54.81               | 31,010                | 16,996              | 11.2                   |
| Brandenburg               | 10,537.3                       | 10,210.4                       | 326.9             | 6,142.5                   | 427.9                          | 16,717.5       | 1.6                            | 60.071                  | 27.83               | 24,132                | 6,716               | 9.8                    |
| Mecklenburg<br>Vorpommern | 7,393.5                        | 7,130.9                        | 262.6             | 4,210.7                   | 316.5                          | 9,371.6        | 2.3                            | 37.913                  | 24.72               | 23,341                | 5,770               | 12.2                   |
| Nordrhein-Westfalen       | 59,880.7                       | 61,874.1                       | -1,993.4          | 46,388.6                  | 3,564.6                        | 140,076.8      | 1.0                            | 605.750                 | 23.12               | 33,958                | 7,853               | 8.3                    |
| Rheinland-Pfalz           | 14,578.0                       | 15,192.3                       | -614.3            | 10,558.4                  | 945.7                          | 37,031.0       | 1.2                            | 123.038                 | 30.10               | 30,785                | 9,265               | 5.7                    |
| Sachsen                   | 17,318.2                       | 16,655.1                       | 663.1             | 4,909.3                   | 255.4                          | 6,890.4        | 2.9                            | 102.791                 | 6.70                | 24,929                | 1,671               | 9.4                    |

Source: Fitch



We believe that failure to provide support to a failing Landesbank would likely result in considerable damage to the relevant Land's own reputation and funding costs and would negatively affect the regional economy. A bail-in of senior unsecured debt at a Landesbank could affect the regional savings banks' ability to provide financing to the regional small businesses and corporates, especially in lesser developed and smaller states.

Figure 4

**Federal States Propensity to Support**

|          | Total assets<br>(EURbn) | Laender                          | GDP (1H14)<br>(EURbn) | GDP/LB assets<br>(%) | Total revenues<br>(EURbn) | Total revenues /FCC (%) | Tax revenues<br>(EURbn) | Tax revenues /FCC (%) |
|----------|-------------------------|----------------------------------|-----------------------|----------------------|---------------------------|-------------------------|-------------------------|-----------------------|
| BayernLB | 232.1                   | Bayern                           | 499.2                 | 215.1                | 51.8                      | 460.8                   | 39.7                    | 352.9                 |
| LBBW     | 266.2                   | Baden-Wuerttemberg               | 416.2                 | 156.3                | 42.9                      | 355.6                   | 31.83                   | 263.6                 |
| SaarLB   | 15.9                    | Saarland                         | 32.7                  | 205.8                | 3.6                       | 685.0                   | 2.6                     | 500.1                 |
| NORD/LB  | 197.6                   | Niedersachsen and Sachsen-Anhalt | 295.7                 | 149.6                | 37.1                      | 450.3                   | 25.8                    | 312.9                 |
| BremerLB | 31.6                    | Bremen                           | 28.8                  | 91.2 <sup>a</sup>    | 4.7                       | 285.2                   | 2.6                     | 157.1                 |
| HSH      | 100.1                   | Hamburg and Schleswig Holstein   | 179.5                 | 179.3                | 21.9                      | 495.3                   | 17.1                    | 385.6                 |
| Helaba   | 179.5                   | Hessen and Thuringen             | 291.6                 | 162.5                | 32.2                      | 449.5                   | 24.1                    | 336.5                 |

<sup>a</sup> BremerLB is purely based on Bremen; but indirectly NORD/LB's state ownership is also relevant  
Source: Fitch

**Strong Support Also Likely From the Savings Banks**

The savings banks' propensity to support their respective Landesbanken is similarly strong to support from the Laender. Given their close operational and financial links we believe that the investment in Landesbanken is equally strategic for savings banks. Landesbanken function as the central banks for their savings banks, balance liquidity flows between the savings banks and provide capital markets products for the larger savings banks. Regional savings banks' or their clients' investments in Landesbanken debt could be at risk of a bail-in alongside third party investors.

Figure 5:

**Savings Banks Association Propensity to Support**

|           | No. of regional banks | Total Assets<br>(EURbn) | Assets /LB assets | Net Profit<br>(EURm) | Net Profit /LB FCC |
|-----------|-----------------------|-------------------------|-------------------|----------------------|--------------------|
| BayernLB  | 71                    | 186.0                   | 80.1%             | 835.1                | 9.1%               |
| LBBW      | 53                    | 178.8                   | 67.2%             | 1.600.               | 13.2%              |
| SaarLB    | 7                     | 16.1**                  | 97.5%             | 170.0**              | 25.9%              |
| NORD/LB*  | 68                    | n.a.                    | n.a.              | n.a.                 | n.a.               |
| BremerLB* | 46                    | 94.6**                  | n.a.              | n.a.                 | n.a.               |
| HSH       | 13                    | n.a.                    | n.a.              | n.a.                 | n.a.               |
| Helaba    | 50                    | 113.0**                 |                   | 538.0**              | 7.8%               |

\* NORD/LB comprises the savings bank associations of Lower Saxony (46); Saxony Anhalt (13), and Mecklenburg Pomerania (9) are grouped under the Eastern German savings bank association.

\*\* end-2013

Source: Fitch

Some regional saving banks are too small or financially too weak to support their Landesbanken on their own. For example the savings bank association in Schleswig-Holstein comprises only 13 member banks and their total balance sheet volume of EUR36.3bn are small compared to HSH's balance sheet. They have faced problems in recent years, and we would not expect them to be able to provide support to HSH even proportionately to their small stake (5.3%). However, we would expect that the savings banks' share in a support scenario for HSH would not be limited to the resources of the regional savings banks themselves but could come from other regions as well.

Failure to provide support for one troubled Landesbank from other regions' savings banks would raise concerns about the future viability of the Haftungsverbund, the institutional support

fund of the SFG, and the cohesion among its members. Ultimately, this could undermine the entire fabric of the largest pillar of the German banking system.<sup>2</sup> Today the German regulator views members of the Sparkassen Finanzgruppe as one risk unit and allows members to assign a zero per cent risk weighting to intragroup exposures.

In addition, savings banks' exposure to Landesbanken is not limited to their regional Landesbank and is not limited to their equity stakes. Landesbanken typically generate 40% to 60% of their unsecured funding through Sparkassen and their customers, not limited to their own region. This contingent liability of the savings banks towards the Landesbanken is reflected in our analysis of the SFG, where, in our capital assessment, we deduct around EUR28.2bn of SFG's aggregated capital for contingent liabilities to the Landesbanken sector.

### Haftungsverbund's Purpose Is To Support Banks In Need

The Haftungsverbund is a combination of mutual support schemes for Germany's public sector financial institutions that can be applied to any of the public sector institutions and which further underpins the savings banks propensity to support Landesbanken. It comprises 11 institutional funds of the regional savings banks, a dedicated fund for the Landesbanken and a dedicated fund for the Landesbausparkassen. The funds safeguard their members' liquidity and solvency. They can also be used for different institutions that are members of other public sector funds. They provide liquidity and capital support to prevent the institution from entering insolvency rather than providing guarantees directly to investors or depositors. However, the Haftungsverbund has limited cash resources and members have no legal claim to specific support from the group.

If a Landesbank applies for funds from the Sparkassen's support scheme a 75% majority is required from the decision making committee at the Sparkassen's national central coordination body, Deutscher Sparkassen – and Giroverband (DSGV). The DSGV's decision making committee ("Gemeinsamer Ausschuss") consists entirely of savings banks representatives including the president of DSGV.

### Savings Banks Rating Anchor

- Savings Banks Rating Anchor
- Applying a two-notch differential to reflect BRRD-related uncertainties
- Institutional support fund recognised as 'alternative means' to prevent resolution

We take the lower of the two parents' ratings as the anchor rating for our assessment of the appropriate support-based IDR for the Landesbanken. We believe that support would need to be forthcoming from both the Laender and the Sparkassen owners to avoid triggering state aid considerations and, therefore, resolution under SAG if a Landesbank.

The ability to support by the savings banks associations, as expressed by the SFG's 'A+' IDR, while very strong, is weaker than the 'AAA' ability we consider for the Laender's, so becomes a constraining factor in the ability of both parents to support. This means that the SFG's IDR of A+ best reflects the anchor point for notching in the SAG environment.

In addition, the Haftungsverbund with its pivotal role in a sudden rescue situation (see below diagram of support) would ultimately need the resources and willingness of the savings banks, especially if a large Landesbank need support or support is needed by more than one Landesbank.

As a result the rating of Landesbanken will be sensitive to the rating of the SFG, developments in the framework of the Haftungsverbund and the strength of the operational and financial links between Landesbanken and Sparkassen. In this context, the potential for regional groups of savings banks to opt out of the national group would likely be negative for savings banks' ratings (which are based on national mutual support arrangements remaining solid) and for Landesbanken, whose IDRs are anchored to the SFG's IDRs. However, we think it likely that a

<sup>2</sup> Group of public law and publicly owned financial institutions, comprising seven Landesbanken, 416 Sparkassen, ten regional Landesbausparkassen (building societies) and 11 insurance companies, with combined assets of around EUR 2.9trn. .

compromise will be reached and all savings banks in Germany will remain part of the national mutual support scheme.

### **Notched Twice Down From the Anchor**

We apply Fitch's institutional support framework to determine the appropriate level of notching from SFG's Long-Term IDR. We apply one notch from the anchor rating in line with our criteria to reflect the role of the Landesbanken as strategic (but not core) subsidiaries. However, we apply two notches because of the legal and regulatory barriers to support we believe are presented by state aid considerations and BRRD.

### **One Notch Down For Strategic But Not Core Role For the Sparkassen**

The Landesbanken provide wholesale and central liquidity management functions for savings banks, which are important support functions. They enable the Sparkassen to focus on their core function of providing financial services to retail and small and medium-sized business (Mittelstand) clients.

### **Two Notches Down From Anchor Rating Because of Potential Constraints to Providing Support Under SAG**

We believe that the savings banks would only support a Landesbank alongside, and not instead of, its federal state owner(s). The uncertainty of whether state aid and resolution authorities will allow the Laender to recapitalise banks at the point of non-viability without requiring bail in of senior creditors given the potential legal and regulatory constraints results in IDRs two notches below the anchor rating.

Fitch's support-based ratings express our view of the likelihood that the owners would provide extraordinary support in the event that the bank reaches the point of non-viability and would be put into resolution if support was not forthcoming. The EU's new resolution framework and the introduction of SRM in the eurozone impose obstacles that make it more difficult for the public sector owners (especially the Laender) to support the Landesbanken, in Fitch's view. We believe the owners have the propensity to overcome these obstacles if they are able to, but their ability to do so remains untested in the new framework.

### *Complex Decision Making Process*

One area of uncertainty under the new framework is around how quickly a decision can be reached between the Landesbank's owners. Decision-making processes at the Laender and savings banks remain lengthy. At the Laender, a potentially lengthy political process is likely, and we expect that intense negotiations between the Laender and the savings banks would be required in a support-scenario, especially if the support measures needed are higher than expected or described in the recovery plans.

### *Higher Uncertainty in a Gone Concern Scenario*

Compared to ordinary support measures that can be enacted more simply we see higher uncertainties to initiate support when Landesbanken face failure. Our rating approach is therefore based on a scenario where a Landesbank requires extraordinary support, which would most likely be caused by large scale losses that threaten solvency and viability without substantial capital injections. Such scenarios could stem from single name or sector concentration risks in Landesbanken's portfolios or a significant deterioration of asset quality in wind down units.

In determining whether support from a public sector owner is state aid, precedent suggests that the EC would be likely to consider whether a private investor would have made the same decision in similar circumstances (the 'private investor test'). We believe that in a gone concern scenario passing the private investor test could be considerably more complicated. A private investor, even a strategic one, might not invest further funds in a bank that is facing a large unexpected loss and is at risk of becoming non-viable.

- Private investor test uncertain in gone concern scenario

## Haftungsverbund Limits Extra Notches for BRRD Support Restrictions to One

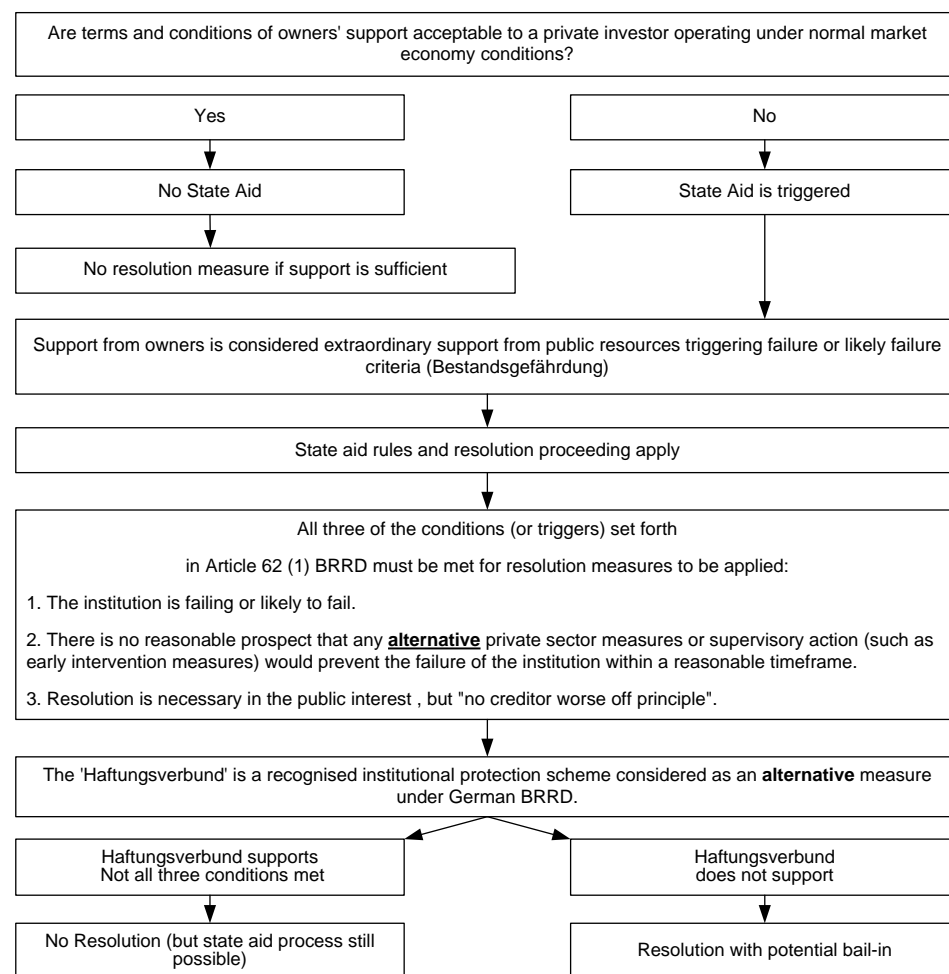
The existence of the Haftungsverbund could facilitate a capital injection of federal state capital into a non-viable bank because SAG specifically mentions institutional support funds as a potential way to resolve a bank before requiring bail in of creditors.

Article 62 of SAG requires two conditions to be met before putting a bank into resolution. Firstly, the resolution needs to be suited to accomplish the objectives of the resolution (i.e. as compared to proceeding under German insolvency law to respect the “no creditor worse off than under normal insolvency proceedings” principle), and secondly there should be no reasonable prospect that any alternative private sector measures (including measures from mutual support schemes) or supervisory action (such as early intervention) would prevent the failure of the institution within a reasonable timeframe.

Therefore, we consider the risk that the resolution authorities would prevent capital support for a Landesbank to be small (equivalent to one notch only), even when support is considered to be state aid, because support from the Haftungsverbund alongside both the federal state and savings bank owners would fulfil the BRRD’s requirements.

Figure 6

### Principle of Privat Market Investor Test



Source: Fitch



- Focus on pre-emptive measures on going-concern basis
- Landesbanken owners considered to be attributable to the state
- Authorities can trigger early intervention

## Pre-emptive Measures Are Important To Reduce Risk Of State Aid Strengthened Governance and Recovery Planning

The German SAG and the minimum requirements for a recovery plan (MaSAN) require eligible institutions to draft and maintain distinct recovery plans that outline expected measures to ensure or rebuild financial stability if financial metrics and capitalisation deteriorate and start to threaten viability.

In addition to the banks' discretionary measures, the SAG also gives the competent authorities a broad range of additional powers to intervene. Namely they can demand activation of the recovery plan or elements of it, demand changes to underlying business strategies and even appoint a temporary administrator. We expect that the ECB and European Banking Authority will develop regular and robust stress testing during the next few years. We also expect increased and more consistent regulatory data reporting to assist management and the supervisory board as well as the regulator in identifying early when remedial action is needed..

Recovery plans are not public, but we expect Landesbanken plans will include capital injections by the owners. Any capital injection from public sector owners gives rise to the risk that these would be considered state aid, but we believe that pre-emptive measures would be more likely to meet the private investor test than capital support when a bank becomes non-viable, especially as these measures will be approved in advance by the ECB as supervisor.

## Landesbanken Corporate Governance Improved

Both the Laender and the savings banks, are represented on Landesbanken's supervisory boards as well as the owners' representative assembly (Traegerversammlung). The governance framework includes additional advisory committees with representatives from the savings banks, corporates and municipalities.

The governance structure in combination with recovery planning and monitoring in regular consultation with the regulators should help to ensure owners react to warning signs more quickly than in the past. The corporate governance track record at some of the Landesbanken running up to the financial crisis was weak, which made large scale rescue operations necessary within a short period of time.

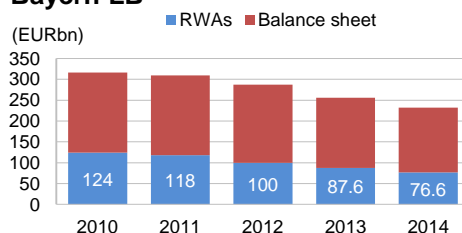
The enhanced information provided to the owners should enable them to take pre-emptive decisions.

## Deleveraging Has Strengthened Balance Sheets

The four Landesbanken that needed state aid during the financial crisis to restore them to viability are all now targeted more streamlined business models. They have substantially lowered their risk profiles while at the same time benefiting from various capital strengthening measures.

Figure 7

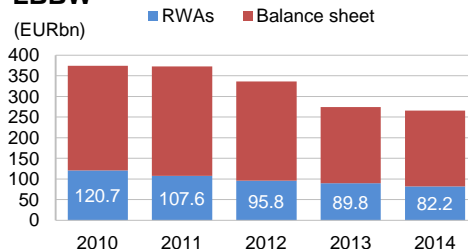
### Bayern LB



Source: Annual reports

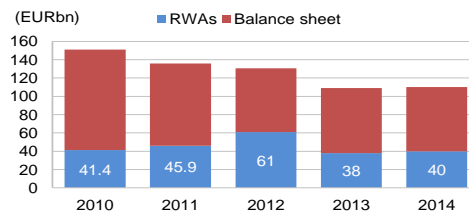
Figure 8

### LBBW



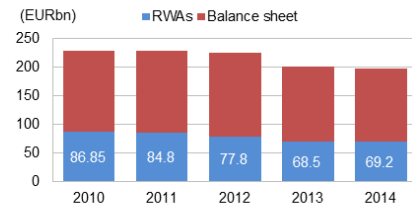
Source: Annual reports

Figure 9

**HSH Nordbank**

Source: Annual reports

Figure 10

**NORD/LB**

Source: Annual reports

- Performance and prospects critical
- HSH's IDR three notches below other Landesbanken
- Reflects concerns about sustainability of its business model
- Sustainability is reviewed when VRs fall below 'bb' i

**Additional Notching Applied to HSH**

HSH's Long-Term IDR is three notches below other Landesbanken. Its weak performance and prospects mean that we believe there is a weaker likelihood of support than for its peers. We are doubtful that the business model is sustainable, which makes a long-term investment strategy by respective owners questionable. Two of these notches relate to our view that the state aid and/or resolution authorities are more likely to prevent support by the federal state owners ahead of senior creditors and the third notch factors in greater uncertainty about the propensity of the SFG to support through its Haftungsverbund

The sustainability of a Landesbank's business model is an important driver of our assessment of the propensity of the savings banks to continue to inject capital and allow the bank to continue to carry out new business. Similarly, we believe that the European Commission's state aid authorities and the SRB would be less likely to allow capital support from a German federal state to be injected into a bank without a sustainable business model, as this would probably not be the way a private investor would behave.

Fitch considers it likely that if owners and/or the resolution authorities consider a Landesbank's business model to be unsustainable, they may require a resolution process. We believe that this is most likely to take the form of an orderly wind-down under sponsorship of the owners, which would still imply a high likelihood that senior creditors would be protected.

Eventual limitations on the Haftungsverbund's resources and willingness is also an important consideration. The savings banks' willingness to support Landesbanken would be tested when the regional owners allowed a Landesbank to deteriorate without taking pre-emptive measures and to reach a state of non-viability. If another Landesbank's VR is downgraded to 'bb-' or below and no plausible recovery plan is in place, we will assess the weight of specific VR drivers and the reasons for these to determine whether we think the bank's business model is sustainable. If not, we will apply the further three notches down from the two we otherwise apply from the anchor rating.

**Rating Sensitivities**

The Landesbanken's IDRs are sensitive to changes in our view of the owners' ability or propensity to provide support. Therefore, the IDRs are primarily sensitive to changes to SFG's IDR. An upgrade of SFG's IDR would likely lead to an upgrade of the Landesbanken IDRs and vice versa. The IDRs are also sensitive to any changes in the owners' strategic commitment and importance of the banks for their home region

IDRs are also sensitive to any deterioration in (or in HSH's case, substantial improvement to) the sustainability of a bank's business model, indicated initially by the level of their VRs.

A Landesbank's IDR could also be upgraded if its VR was upgraded above its support-driven IDR. However, the highest VR currently assigned to a Landesbank is 'bbb', which would mean a three-notch upgrade of the VR would be required to upgrade the IDR. We do not expect Landesbanken VRs to move into the 'a' category during the next one to two years.

The evolution of the EU's new banking resolution regime -particularly as experience of handling failed banks and the role of the SRB emerge - will bring more transparency. This could lead us to review our assessment of uncertainties in the resolution process that drive the notching we apply from the anchor rating, which could be positive or negative for ratings. Again, we do not expect any significant developments in the next one to two years.

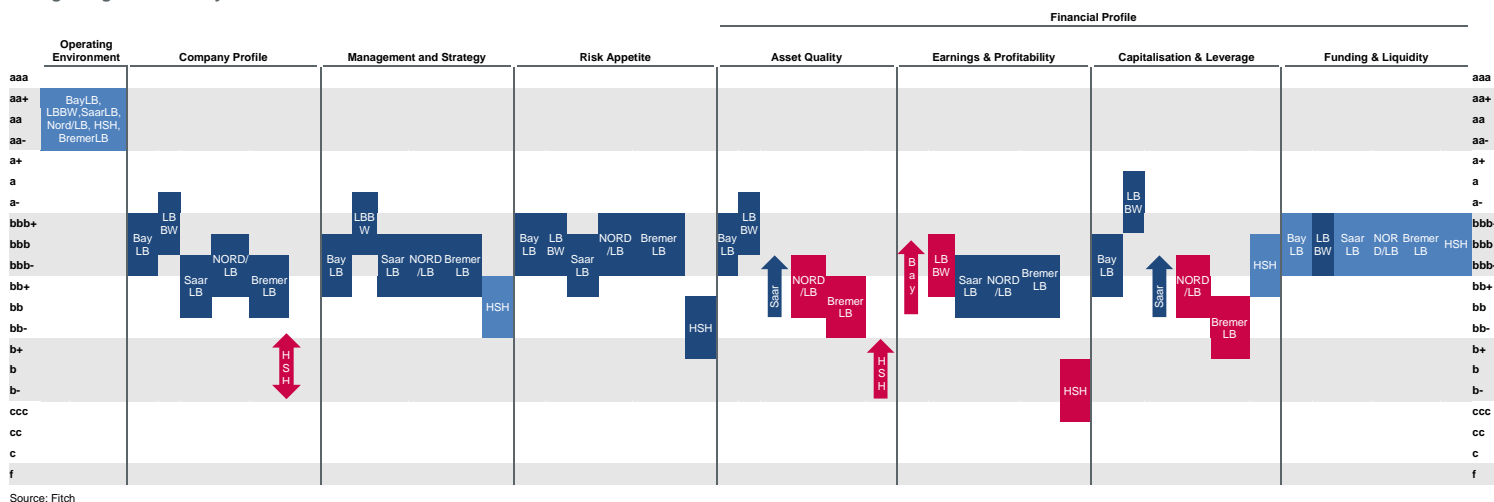
### Landesbank Hessen-Thuringen (Helaba) Rated as Part of Its Mutual Support Group

Fitch's ratings of Helaba are based on its membership of the S-Finanzgruppe Hessen Thuringen (SF-HT, rated A+/Stable). Consequently, Helaba's Long-Term IDR is primarily sensitive to changes in SF-HT's VR.

S-Verbund HT could benefit from institutional support from SFG in cooperation with Helaba's state owners Hesse and Thuringia. However, S-Verbund HT's rating is based on the combined and integrated financial strength of its members. Its members include savings banks that are also part of SFG. Given this overlap and our view that Helaba is one of the strongest Landesbanken, it is difficult to envisage a scenario where S-Verbund HT would require support from SFG and Helaba's federal state owners, without SFG itself being in a substantially weaker position than it currently is. Therefore, while possible, institutional support beyond the mutual support mechanism cannot be relied upon, in our view, which we reflect in S-Verbund HT's Support Rating of '5'.

### Wide Range of Viability Ratings

Rating Navigator Summary



Landesbanken VRs range from 'bbb' to 'b'. The highest rated is LBBW, with a VR of 'bbb', which primarily reflects strength of its core commercial banking franchise in its home region, which has benefited from a solid performance in the automotive industry and commercial real estate markets, two of LBBW's key market sectors. LBBW's 'bbb' VR is negatively affected by continued low earnings stemming mainly from challenges to enforcing greater efficiency.

BayernLB's 'bb+' VR reflects further progress in reducing legacy risks but at the cost of a significant loss reported for 2014. In our view this poses challenges to restore capitalisation in the medium term, especially in light of its obligation to repay EUR 2.3bn of outstanding silent participations (hybrid capital) to Bavaria by end-2017.

SaarLB's 'bb+' VR benefits from the bank addressing capitalisation, previously the lowest among peers, by converting silent participations into core capital. However, capitalisation is not yet sufficiently strong to be commensurate with an investment-grade VR given single name and sector concentration in its loan portfolio. Saar LB is developing its franchise with a stronger focus on Sparkassen and municipal finance than in the past and delivering incremental improvements in a number of its structural weaknesses such as asset concentration.

NORD/LB's VR was downgraded to 'bb+' in May 2015, primarily due to weakened capital ratios and continued asset quality pressure from its large shipping exposure. Subdued earnings, low regulatory capital ratios and the lack of foreseeable material and lasting improvement in the shipping sector have reduced NORD/LB's resilience to adverse market movements. Capital ratios have been burdened by rising RWAs resulting from the strengthening of the USD. Its 'fully loaded' common equity Tier 1 ratio was a moderate 8.4% at end-2014 and could weaken further in the short-term as the USD gained another 8% against the EUR in the first four months of 2015. Furthermore, despite some profit retention NORD/LB plans to propose a dividend payment to its owners based on its 2014 results, which is not conducive to strengthening its capital-generating capacity.

BremerLB's VR was downgraded to 'bb' in May 2015. Similarly to its parent, NORD/LB, BremerLB is experiencing weakening regulatory capitalisation as a result of a materially wider expected loss shortfall, adverse effects from a stronger USD and the lack of material recovery in the shipping sector, which hampers its asset quality. Its CET1 (phased in) ratio was only 8% at end-2014, the weakest among its Landesbanken peers. BremerLB's business model is becoming increasingly constrained and is highly sensitive to developments in the shipping industry, reflecting its local economy. If BremerLB's shipping exposure is hit further, this would likely result not only in a VR downgrade but also potentially a three-notch downgrade of its Long-term IDR.

HSH 'b' VR primarily reflects its weak company profile and low legacy asset quality. In our view HSH would not be viable without the guarantee from the federal states of Hamburg and Schleswig Holstein (granted through HSH Finanzfonds). The RWE on the VR is driven by the state aid investigation into the restoration of an additional EUR3bn asset guarantee (taking the total to EUR10bn) and will be resolved once the EC has taken its decision. If the increase in state aid is finally approved, it would not be sufficient on its own for Fitch to upgrade HSH's VR. The ongoing costs of the guarantee continue to outweigh its earnings capacity despite a good level of new business reported for 2014.

HSH is seeking discussions with the EC to review not only the volume of the guarantee but also its terms and conditions. Adjustments to the terms and conditions which are supportive for HSH's capital-generating capacity - although not our base case - could improve the bank's long term viability. A transfer of the legacy assets off the bank's balance sheet or sale of the assets without depleting capital would also be beneficial for the VR. HSH's VR would be negatively affected if the EC rejects the full restoration of its guarantee. In our view, this would increase the likelihood of an orderly wind-down.

## Appendix 1: Landesbanken Ownership Structure

Figure 12

**Ownership**

| <b>Landesbank</b>                                     | <b>Stake (%)</b> | <b>Stakeholder</b>  |
|---|------------------|---|
| Bayerische Landesbank                                 | 75.0             | State of Bavaria (indirectly via BayernLB Holding AG)                                     |
|   | 25.0             | Association of the Bavarian Savings Banks (SVB)   |
| Landesbank Baden-Wuerttemberg                         | 40.5             | Savings bank Association of Baden-Wuerttemberg  |
|   | 25.0             | State of Baden-Wuerttemberg   |
|   | 18.9             | City of Stuttgart   |
|   | 13.5             | Landesbeteiligungen Baden-Wuerttemberg GmbH   |
|   | 2.0              | Landeskreditbank Baden-Wuerttemberg (L-Bank)  |
| Landesbank Saar                                       | 74.9             | State of Saarland   |
|   | 25.1             | Saar Savings Bank Association   |
| Norddeutsche Landesbank                               | 59.1             | State of Lower-Saxony   |
| Girozentrale <sup>a</sup>                             | 26.4             | Savings Banks Association of Lower-Saxony   |
|   | 5.6              | State of Saxony-Anhalt  |
|   | 5.3              | Savings Banks Holding Association in Saxony-Anhalt  |
|   | 3.7              | Special Purpose Holding Association of the Savings Banks in Mecklenburg-Western Pomerania |
| Bremer Landesbank                                     | 54.8             | Norddeutsche Landesbank Girozentrale  |
| Kreditanstalt Oldenburg                               | 41.2             | City of Bremen  |
|   | 4.0              | Sparkassen- and Giroverband Lower Saxony  |
| HSH Nordbank AG                                       | 65.0             | HSH Finanzfonds (legal entity jointly owned by Hamburg and Schleswig-Holstein)            |
|   | 10.8             | City of Hamburg   |
|   | 9.6              | State of Schleswig-Holstein   |
|   | 9.3              | 9 trusts advised by J.C. Flowers & Co. LLC  |
|   | 5.3              | Savings Banks Association of Schleswig-Holstein   |
| Landesbank Hessen-Thuringen Girozentrale <sup>a</sup> | 68.9             | Savings and Giro Association Hesse-Thuringia  |
|   | 8.1              | State of Hesse  |
|   | 4.0              | State of Thuringia  |
|   | 4.75             | Savings and Giro Association Rhineland  |
|   | 4.75             | Savings Association Westfalia-Lippe   |
|   | 4.75             | FIDES Beta GmbH   |
|   | 4.75             | FIDES Alpha GMBH  |

Source: Banks' annual reports



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