FitchRatings

# Fitch Affirms NORD/LB at 'A-'; Outlook Negative

Fitch Ratings-Frankfurt/London-19 March 2018: Fitch Ratings has affirmed Norddeutsche Landesbank Girozentrale's (NORD/LB) Long- and Short-Term Issuer Default Ratings (IDRs) at 'A-'/'F1' and Viability Rating (VR) at 'bb'. The Outlook on the Long-Term IDR is Negative. A full list of rating actions is at the end of this rating action commentary.

KEY RATING DRIVERS

IDRS, SUPPORT (SR), SENIOR DEBT, DERIVATIVE COUNTERPARTY (DCR) AND DEPOSIT RATINGS

NORD/LB's IDRs and SR are driven by the strong institutional support from its owners, the 'AAA'/Stable rated German federal states of Lower Saxony and Saxony-Anhalt (combined 64.7% share), the savings banks associations of Lower Saxony, Saxony-Anhalt and Mecklenburg-Western Pomerania and ultimately the German savings banks group, Sparkassen Finanzgruppe (SFG, A+/Stable).

Fitch's institutional support considerations are based on the view that NORD/LB's owners consider their investment in NORD/LB long-term and strategic, as reflected by the bank's Support Rating of '1'. The owners' strong support propensity is underpinned by NORD/LB's focus on its statutory roles, which include supporting the regional economy as well as acting as the regional savings banks' central clearing institution and the regional states' house bank.

Fitch uses the lowest rating of NORD/LB's parents, SFG's Long-Term IDR, as anchor and starting point for determining the bank's support-driven ratings. In Fitch's view, support would need to be forthcoming from SFG as well as the states of Lower Saxony and Saxony-Anhalt to avoid triggering state aid considerations and resolution under the German Recovery and Resolution Act (Sanierungs- und Abwicklungsgesetz, SAG) if NORD/LB fails.

Our assessment of Lower Saxony and Saxony-Anhalt's creditworthiness is underpinned by the stability of Germany's solidarity and financial equalisation system, which links the regional states' creditworthiness to that of Germany (AAA/Stable). SFG's ability to support, as expressed by its Long-Term IDR of 'A+' is very strong but weaker than that of the regional states.

We notch down NORD/LB's Long-Term IDR twice from SFG's 'A+'. The notching reflects NORD/LB's role for its owners, which we consider strategic, but not key and integral, as well as uncertainties over potential legal and regulatory barriers related to state aid considerations and provisions of German resolution legislation.

The Negative Outlook on NORD/LB's Long-Term IDR reflects our view that the likelihood of extraordinary solvency support from NORD/LB's owners could weaken if the sustainability of the bank's business model weakens further over the next one to two years.

NORD/LB's Short-Term IDR of 'F1' is at the higher of two Short-Term IDRs that map to a 'A-' Long-Term IDR on Fitch's rating scale, reflecting strong links to SFG and privileged access to SFG's ample excess liquidity and funding resources.

NORD/LB's senior unsecured debt ratings, DCR and Deposit Ratings are equalised with its IDRs. We believe the bank's buffer of junior and non-preferred senior unsecured debt does not afford any obvious incremental probability of default benefit over and above the multi-notch support benefit already factored into its IDRs.

VR
NORD/LB's VR reflects the bank's intrinsic weaknesses arising from its outsized exposure to poorly performing ship lending, which burden its asset quality, earnings and capitalisation, and limit its managerial and strategic flexibility. NORD/LB's exposure is fairly diversified across mainly wholesale specialised financing areas such as commercial real estate, aviation, agriculture, energy and infrastructure. However, the prolonged crisis in the shipping industry has had an overwhelming impact on the bank's financials. This was particularly evident in 2016, when a net loss of EUR2 billion significantly reduced the bank's fully-loaded CET1 capital ratio.

To safeguard the threatened viability of its subsidiary Bremer Landesbank, which generated part of the losses, NORD/LB acquired full ownership of Bremer Landesbank and fully merged it into its own operations on 31 August 2017.

NORD/LB has had some success in reducing its shipping exposure to around 12% of loans and advances to customers in 9M17 (9M16: 13%), already achieving its 2018 reduction target of EUR12 billion-EUR14 billion exposure at default through outright sales, maturities, securitisation and a beneficial foreign currency effect.

However, negative rating migration in the non-performing loan (NPL) portfolio has limited the net reduction in shipping NPLs to just EUR300 million in excess of new NPL formation, to EUR9.1 billion at end-9M17. NORD/LB's non-shipping credit risk exposure is performing well, helped by Germany's benign economic environment and the bank's moderate risk appetite. The bank's overall non-performing loans ratio increased slightly to 10.2%, because the customer loan portfolio declined more than NPLs.

NORD/LB's earnings are weakened by revenue pressure owing to a shrinking and lower yielding asset base, margin pressure from low interest rates and competition, upfront restructuring costs and lagging cost reductions. We expect high credit impairment charges to continue to erode a large share of NORD/LB's pre-provision income, albeit not to the same extent as in 2016. Management expects cost benefits from Bremer Landesbank's integration, but cost-cutting measures are unlikely to benefit the group in the near term, given the lengthy processes and associated up-front charges. Consequently, we expect the bank's cost-income ratio to remain above management's target of 50% over the next years.

The high loss in 2016 weakened NORD/LB's fully-loaded CET1 ratio to 9.9%. It had recovered to 11.2% by end-3Q17, driven by a significant reduction in risk weighted assets. However, its leverage ratio of 3.4% remains tight and offers only limited buffer above regulatory requirements. Weak and volatile internal capital generation prospects and rising capital requirements limit NORD/LB's flexibility to manage its capital. The bank is evaluating potential business disposals and other options to strengthen its capitalisation as its public ownership restricts the provision of external capital. We understand that the sale of its small asset management activities announced in February 2018 will bring little capital relief.

Funding remains a relative rating strength as NORD/LB can rely on its placement capacity with the savings banks and it typically taps capital markets only for regular issuance of benchmark secured debt issues. However, in our view the bank's funding costs and access to SFG's liquidity are sensitive to a deterioration of the bank's credit profile. Liquidity is adequate, as reflected by a liquidity coverage ratio of 186% at end-3Q17 and a liquid securities portfolio of EUR34 billion, of which 83% are eligible for central bank refinancing.

SUBSIDIARY AND AFFILIATED COMPANY
The IDRs and senior debt ratings of NORD/LB Luxembourg S.A. Covered Bond Bank's (NORD/LB CBB) are equalised with those of its parent NORD/LB, reflecting NORD/LB's strong propensity to provide support given NORD/LB CBB's strategic role within the group. This expectation is underpinned by a declaration of backing from NORD/LB. Operating as a specialised covered bond issuer, NORD/LB CBB's role is to fund NORD/LB's core businesses by issuing covered bonds in accordance with Luxembourg law (Lettres de Gage).

SUBORDINATED DEBT
NORD/LB's Tier 2 subordinated notes DE000NLB8K69 is notched once from the

bank's VR to reflect our assessment of the notes' relative loss severity.

GRANDFATHERED STATE-GUARANTEED SECURITIES
The ratings of NORD/LB's grandfathered state-guaranteed market-linked and Tier 2 notes are equalised with the Long-Term IDRs of their guarantors, the states of Lower Saxony and Saxony-Anhalt. This reflects our opinion that the states' ability and propensity to honour their guarantees are very strong.

RATING SENSITIVITIES
IDRS, SR, DCR, SENIOR DEBT AND DEPOSIT RATINGS
NORD/LB's support-driven ratings are sensitive to changes in our assumptions around the propensity or ability of its owners to provide timely support. This could result from a change to SFG's IDRs or changes to the owners' strategic commitment to NORD/LB. A change to our assessment of the risks of triggering a resolution process ahead of support for a Landesbank more generally could also negatively affect these ratings.

The strategic commitment could weaken if NORD/LB's credit profile deteriorates to an extent that would ultimately put the sustainability of its business model at risk. This could be indicated by a further downgrade of the bank's VR, in which case we could apply a wider notching to its IDR and senior unsecured debt rating from SFG's anchor rating.

The DCR and Deposit Ratings are primarily sensitive to changes in the bank's IDRs.

VR
NORD/LB's VR is primarily sensitive to further deterioration in its asset quality, which could lead to outsized loan losses and threaten its internal capital generation. This could be triggered by a renewed deterioration in shipping markets despite NORD/LB's reduced exposure in 2017.

Upside potential for the VR is unlikely in the short term as it would notably require a significant structural improvement of the bank's balance sheet, strengthening of its regulatory capital ratios well beyond our expectations and a lasting recovery of the shipping sector. NORD/LB's plan to reduce its shipping exposure could benefit its VR in the longer term. However, a worsening of the retained shipping exposure potentially arising from this reduction amid the shipping sector's volatile dynamics carries significant short-term risk.

GRANDFATHERED STATE-GUARANTEED SECURITIES
The ratings of NORD/LB's grandfathered state-guaranteed marked-linked securities and Tier 2 notes are sensitive to changes in Fitch's view of the

guarantors' creditworthiness.

SUBORDINATED DEBT
The rating of NORD/LB's Tier 2 subordinated note DE000NLB8K69 is sensitive to the same considerations that might affect the bank's VR.

SUBSIDIARIES
Rating actions on NORD/LB CBB's IDRs and senior unsecured debt rating would most likely mirror similar actions on NORD/LB's IDRs. A downgrade of NORD/LB's Long-Term IDR would also trigger a downgrade of NORD/LB CBB's SR. In addition, NORD/LB CBB's IDRs, SR and senior unsecured debt ratings are sensitive to changes in our view of NORD/LB's propensity to support.

Norddeutsche Landesbank Girozentrale
Long-Term IDR: affirmed at 'A-'; Outlook Negative
Short-Term IDR: affirmed at 'F1'
Support Rating: affirmed at '1'
Viability Rating: affirmed at 'bb'
Derivative Counterparty Rating: affirmed at 'A-'(dcr)
Deposit Ratings: affirmed at 'A-'/'F1'
Senior unsecured debt and programme ratings: affirmed at 'A-'/ 'F1'
Non-guaranteed Tier 2 subordinated debt ( DE000NLB8K69): affirmed at 'BB-'
Grandfathered state-guaranteed market-linked and Tier 2 subordinated notes: affirmed at 'AAA'

NORD/LB Luxembourg S.A. Covered Bond Bank
Long-Term IDR: affirmed at 'A-'; Outlook Negative
Short-Term IDR: affirmed at 'F1'
Support Rating: affirmed at '1'
Senior unsecured debt rating: affirmed at 'A-'

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Summary of Financial Statement Adjustments - Fitch reclassified loans reported by the bank as "assets held for sale" to "loans".

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Additional information is available on www.fitchratings.com

**Applicable Criteria**
Global Bank Rating Criteria (pub. 25 Nov 2016)
(https://www.fitchratings.com/site/re/891051)

**Additional Disclosures**
Dodd-Frank Rating Information Disclosure Form
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