FitchRatings

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Fitch Affirms LBBW at 'A-'; Outlook Stable

Fitch Ratings - Frankfurt am Main - 17 Mar 2022: Fitch Ratings has affirmed Landesbank Baden-Wuerttemberg's (LBBW) support-driven Long-Term Issuer Default Rating (IDR) at 'A-' with a Stable Outlook and Viability Rating (VR) at 'bbb'. A full list of rating actions is detailed below.

Fitch has withdrawn the bank's Support Rating following the update of the agency's Bank Rating Criteria on 12 November 2021 as it is no relevant to the agency's coverage. In line with the updated criteria, we have assigned LBBW a Shareholder Support Rating (SSR) of 'a-'.

Key Rating Drivers

LBBW's Long-Term IDR is driven by its SSR, which reflects a strong likelihood of support from the bank's owners, the regional members of Germany's savings banks group Sparkassen-Finanzgruppe (SFG; A+/Stable), the State of Baden-Wuerttemberg and the City of Stuttgart.

LBBW's VR is one notch below the implied 'bbb+' rating, due to the bank's subdued average profitability, which we score at 'bbb-'. The VR also reflects the bank's exposure to cyclical corporate sectors, strong asset- quality metrics and adequate capitalisation. LBBW's announced acquisition of Berlin Hyp AG (A+/RWN) is neutral to our assessment of LBBW's standalone credit strength.

High Likelihood of Support: Fitch's support assumptions are underpinned by LBBW's focus on its statutory roles, which include supporting the regional economy as well as acting as the central institution for regional savings banks and as house bank for its federal state owners, and by provisions contained in the statutes of the institutional protection scheme (IPS) of SFG and the Landesbanken.

Fitch uses SFG's Long-Term IDR as the anchor rating for determining LBBW's support-driven ratings. Fitch believes support would need to be forthcoming from both SFG and the State of Baden Wuerttemberg to avoid triggering state-aid considerations and resolution under the German Recovery and Resolution Act if LBBW fails.

We notch LBBW's SSR down twice from SFG's 'A+' to reflect regulatory restrictions to support, due to the requirement for state-aid examination under EU competition rules. The two-notch difference also reflects LBBW's strategic, but not key and integral role, for its owners. The Short-Term IDR of 'F1' is the higher of two possible ratings that map to a 'A-' Long-Term IDR, because LBBW has privileged access to SFG's ample liquidity and funding, and propensity of support by its owners is more certain in the near term.

High Sector Concentrations: LBBW's strong regional corporate-banking franchise benefits from Baden Wuerttemberg's large economy. However, this regional focus leads to concentrations on cyclical industries and, to some extent, on large borrowers, in particular in commercial real-estate and automotive, the latter being reduced. Stiff competition in most of LBBW's business lines limits the bank's pricing power and weighs on profitability.

Low Impaired Loans: The bank's exposure to cyclical industries is higher than that of peers, and asset quality is sensitive to global supply chain disruptions, input price shocks and structural changes. We expect loan impairment charges (LICs) and Stage 3 loans to rise in 2022 from their exceptionally low level at end-2021, but its four-year average Stage 3 ratio should remain below 2% in the next two years, a level we view as commensurate with LBBW's VR.

Subdued Profitability: LBBW's profitability is burdened by its high costs and low margins. We expect operating profits/risk-weighted assets (RWAs) to decline in 2022 from their exceptional high level in 2021 due to weaker market conditions, muted loan growth and potentially higher LICs. We believe that LBBW's revenue will gradually improve in the long term as the bank executes on its growth strategy and interest-rate pressure eases, compensating for regulatory RWA inflation.

Adequate Capitalisation: We expect LBBW's common equity Tier 1 (CET1) ratio to remain comfortably above its 13% strategic target after the acquisition of Berlin Hyp is finalised. We view this level as adequate, but not strong, because of the bank's business model, which exposes LBBW to potential cyclical performance swings. Stronger profit retention will be key in offsetting higher RWAs from the execution of the bank's growth strategy and the phasing-in of the Basel output floor starting in 2025.

Rating Sensitivities

Factors that could, individually or collectively, lead to negative rating action/ downgrade:

A downgrade of SFG's IDRs, or a change in the ownership structure or in the owners' strategic commitment to the bank could lead to a downgrade of LBBW's IDRs and SSR.

We believe that LBBW's VR has sufficient headroom at the current level to absorb moderate deterioration of asset quality and capitalisation. The VR would likely be downgraded if we expect the bank's Stage 3 loans ratio to rise to and remain above 3%, or if the CET1 ratio falls durably below 12.5%.

Factors that could, individually or collectively, lead to positive rating action/upgrade:

An upgrade of the IDRs and SSR would require an upgrade of SFG's ratings. An upgrade of LBBW's VR would require a limited impact from the economic fallout of the Ukraine-Russia conflict on the bank's asset quality and capitalisation. An upgrade would also be contingent on an improvement in LBBW's profitability, with an average operating profit/RWAs close to 1%, without a material increase in risk appetite.

OTHER DEBT AND ISSUER RATINGS: KEY RATING DRIVERS

LBBW's long-term deposit rating, senior preferred debt rating and Derivative Counterparty Rating

(DCR) are rated one notch above the Long-Term IDR because of the protection provided by resolution buffers to these preferred creditors. LBBW's senior non-preferred debt rating is in line with its Long-Term IDR.

LBBW's short-term senior preferred and deposit ratings are the lower of the two ratings that map to an 'A' long-term deposit rating. This is because we believe that, despite the owners' very high propensity to provide support to LBBW, we see potential impediments to the prompt flow of funds that are not commensurate with an 'F1+' short-term rating, given the lengthy process required to support a Landesbank.

The 'AAA' ratings of LBBW's grandfathered state-guaranteed senior unsecured and Tier 2 subordinated notes reflect our view of the creditworthiness of the State of Baden Wuerttemberg, which is closely linked to that of Germany (AAA/Stable), and our expectation that Baden Wuerttemberg will honour its guarantee. Fitch believes that the protection provided by the grandfathered guarantee is similar between senior and subordinated debt instruments because the statutory guarantor's liability (Gewaehrtraegerhaftung) does not differentiate the seniority among liabilities. In our view regulatory and EU state-aid frameworks do not constrain the level of support for grandfathered debt.

LBBW's subordinated debt is rated two notches below the VR to reflect loss severity that is in line with Fitch's baseline approach.

OTHER DEBT AND ISSUER RATINGS: RATING SENSITIVITIES

Factors that could, individually or collectively, lead to negative rating action/ downgrade:

We would downgrade LBBW's DCR, senior debt and deposit ratings if LBBW's Long-Term IDR is downgraded or if the sum of senior non-preferred and more junior debt falls below 10% of RWAs. A downgrade of LBBW's VR would result in a downgrade of the non-guaranteed Tier 2 subordinated notes. The ratings of the grandfathered state-guaranteed senior unsecured and Tier 2 subordinated notes are sensitive to adverse changes in Fitch's view of Baden Wuerttemberg's creditworthiness, which is closely linked to that of Germany.

Factors that could, individually or collectively, lead to positive rating action/upgrade:

An upgrade of LBBW's DCR, senior debt and deposit ratings would require an upgrade of LBBW's Long-Term IDR. An upgrade of LBBW's VR would result in an upgrade of the non-guaranteed Tier 2 subordinated notes. The guaranteed notes cannot be upgraded because the ratings are 'AAA', which is the highest level on Fitch's scale.

VR ADJUSTMENTS

The business profile score of 'bbb' has been assigned below the 'a' category implied score, due to the following adjustment reason: business model (negative)

The asset quality score of 'bbb+' has been assigned below the 'aa' category implied score, due to the following adjustment reason: concentrations (negative)

The capitalisation and leverage score of 'bbb+' has been assigned below the 'a' category implied score, due to the following adjustment reason: internal capital generation and growth (negative)

The funding and liquidity score of 'bbb+' has been assigned below the 'a' category implied score, due to the following adjustment reason: deposit structure (negative)

Best/Worst Case Rating Scenario

International scale credit ratings of Financial Institutions and Covered Bond issuers have a best-case rating upgrade scenario (defined as the 99th percentile of rating transitions, measured in a positive direction) of three notches over a three-year rating horizon; and a worst-case rating downgrade scenario (defined as the 99th percentile of rating transitions, measured in a negative direction) of four notches over three years. The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Best- and worst-case scenario credit ratings are based on historical performance. For more information about the methodology used to determine sector-specific best- and worst-case scenario credit ratings, visit https://www.fitchratings.com/site/re/10111579

REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING

The principal sources of information used in the analysis are described in the Applicable Criteria.

ESG Considerations

Unless otherwise disclosed in this section, the highest level of ESG credit relevance is a score of '3'. This means ESG issues are credit-neutral or have only a minimal credit impact on the entity, either due to their nature or the way in which they are being managed by the entity. For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com/esg

Fitch Ratings Analysts

Patrick Rioual
Senior Director
Primary Rating Analyst
+49 69 768076 123
Fitch Ratings – a branch of Fitch Ratings Ireland Limited Neue Mainzer Strasse 46 - 50 Frankfurt am Main D-60311

Marco Diamantini
Associate Director
Secondary Rating Analyst
+49 69 768076 114

Olivia Perney

Managing Director
Committee Chairperson
+33 1 44 29 91 74

Media Contacts

Louisa Williams
London
+44 20 3530 2452
louisa.williams@thefitchgroup.com

Rating Actions

ENTITY/DEBT	RATING			RECOVERY	PRIOR
Landesbank Baden-Wuerttemberg	LT IDR	A-	Affirmed		A-
	ST IDR	F1	Affirmed		F1
	Viability	bbb	Affirmed		bbb
	Support	WD	Withdrawn		1
	DCR	A(dcr)	Affirmed		A(dcr)
	Shareholder Support	a-	New Rating		
• senior unsecured	LT	AAA	Affirmed		AAA
• subordinated	LT	AAA	Affirmed		AAA
• Senior	LT	A-	Affirmed		A-

ENTITY/DEBT	RATING			RECOVERY	PRIOR
non-preferred					
• subordinated	LT	BB+	Affirmed		BB+
• long-term deposits	LT	A	Affirmed		A
• Senior preferred	LT	A	Affirmed		A
• short-term deposits	ST	F1	Affirmed		F1
• Senior preferred	ST	F1	Affirmed		F1

RATINGS KEY	OUTLOOK	WATCH
POSITIVE		
NEGATIVE		
EVOLVING		
STABLE		

Applicable Criteria

Bank Rating Criteria (pub.12 Nov 2021) (including rating assumption sensitivity)

Additional Disclosures

Solicitation Status

Endorsement Status

Landesbank Baden-Wuerttemberg	EU Issued, UK Endorsed

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