Fitch Revises LBBW's Outlook to Negative, Affirms IDR at 'A-'

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Fitch Ratings - Frankfurt am Main - 03 Apr 2020: Fitch Ratings has revised the Outlook on Landesbank Baden Wuerttemberg's (LBBW) Long-Term Issuer Default Rating (IDR) to Negative from Stable and affirmed the IDR at 'A-'. At the same time, LBBW's Viability Rating (VR) was downgraded to 'bbb' from 'bbb+'.

The revision of the Outlook follows the revision of the Outlook on Sparkassen-Finanzgruppe (SFG, A+/Negative) as LBBW's IDR is driven by institutional support from SFG.

Fitch has upgraded LBBW's long-term deposit rating and long-term senior preferred rating to 'A' from 'A-' and Derivative Counterparty Rating (DCR) to 'A(dcr)' from 'A-(dcr)' because of the protection that could accrue to depositors, derivative counterparties and senior preferred creditors from LBBW's more junior bank resolution debt and equity buffers.

A full list of rating actions is at the end of this rating action commentary.
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**KEY RATING DRIVERS**

LBBW's IDR, senior unsecured and senior non-preferred debt ratings and Support Rating are driven by Fitch's view of a strong likelihood of support from the bank’s owners.

Fitch's institutional support assumptions are underpinned by provisions contained in the statutes of the institutional protection fund of the SFG and the Landesbanken. Our support considerations are also based on the view that the owners view their investment in LBBW as long-term and strategic. This is underpinned by LBBW’s focus on the bank’s statutory roles, which include supporting the regional economy as well as acting as the central institution for the regional savings banks and as house bank for the State of Baden Wuerttemberg.

Fitch uses SFG's Long-Term IDR as the anchor rating for determining the bank'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 Long-Term IDR down twice from SFG’s 'A+', to reflect regulatory restrictions to support due to the requirement for state aid examination under the EU competition rules despite the short-term exception communicated by the European Commission in March 2020 that allows for state aid.
aid to compensate for losses that are directly related to the COVID-19 outbreak, which we expect to be only temporary. The two-notch difference in the ratings also reflects LBBW's strategic but not key and integral role for its owners.

LBBW's Short-Term IDR is the higher of two possible ratings that map to a 'A-'. Long-Term IDR on Fitch's rating scale, because propensity of support by its institutional owners is likely more certain in the near term.

VR

We have downgraded LBBW's VR because we believe that the bank's wholesale business model is relatively more exposed to the economic disruption in Germany than more retail-focused peers. At the same time, the economic downturn poses material execution risk for the implementation of the bank's selective growth plan, which will negatively affect revenue generation. The bank enters the expected economic fallout from the coronavirus crisis from a position of relative weakness given its below-average earnings and profitability, which is of high importance to its VR.

We believe that there is additional downside risk to our assessment of the bank's asset quality, despite Stage 3 loans being at cyclical lows. Our view reflects LBBW's role as key financer of SMEs in Baden Wurttemberg, which has historically shown higher GDP volatility compared with the rest of the country. It also reflects concentration risks in LBBW's corporate portfolio, including large exposures to the automotive, industrials and consumer industries (EUR11.9 billion, EUR9.9 billion and EUR12.8 billion net exposure, respectively, at end-2019). Despite government programmes to support the economy, there is a heightened probability that corporate risks will drive up loan impairment charges, considering also that the bank's share of Stage 2 loans was already higher than the German average at end-2019.

We therefore expect increased pressure on the bank's earnings, which is a relative rating weakness for LBBW. Pressure on the bank's profitability could be compounded by lower business volumes and even lower interest rates, which LBBW's business model is sensitive to. We also expect pressure on LBBW's capitalisation, which with a 14.6% CET1 ratio at end-2019 was above European peers, due to negative rating migration that could inflate risk-weighted assets. We expect LBBW's funding and liquidity to remain sound, because in our view access to savings banks and central bank liquidity will be sufficient to compensate increased liquidity demand from corporates.
LBBW's long-term deposit rating, senior preferred debt rating and DCR are rated one notch above its Long-Term IDR because of the protection provided by resolution buffers to these preferred creditors.

LBBW's short-term deposit rating is the lower of the two ratings that map to a 'A' long-term deposit rating because our assessment of LBBW's funding and liquidity score is not sufficiently high to achieve a higher short-term rating.

GRANDFATHERED STATE-GUARANTEED SECURITIES

The ratings of LBBW's grandfathered state-guaranteed senior unsecured and Tier 2 subordinated notes are equalised with the State of Baden Wuerttemberg's Long-Term IDR because we expect Baden Wuerttemberg to 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.

NON-GUARANTEED TIER 2 SUBORDINATED DEBT

LBBW's subordinated debt is rated two notches below its VR. This reflects the change in LBBW's VR and the change in our baseline notching for loss-severity to two notches (from one previously) since the bank does not meet the specific conditions under our criteria for applying a reduced notching.

RATING SENSITIVITIES

IDRS, SR, SENIOR UNSECURED AND SENIOR NON-PREFERRED DEBT

The IDRs, SR, senior unsecured debt and senior non-preferred debt ratings are primarily sensitive to changes in our assumptions around the propensity or ability of LBBW's owners to provide timely support. This could result from a change to SFG's IDRs, to the owners' strategic commitment to LBBW, or to the bank's importance for its home region or for the savings bank sector.

Factors that could, individually or collectively, lead to positive rating action/upgrade:
An upgrade of SFG’s IDRs or a loosening of European state support regulation, which we do not expect, could lead to an upgrade of the above ratings.

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

A downgrade of SFG’s IDRs, a change in the ownership structure or a change in the owners' strategic commitment to the bank could lead to a downgrade of the above ratings.

VR

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

An upgrade of LBBW's VR would require the economic shock from the pandemic to be short, followed by a swift recovery, resulting in a limited impact on the bank's financial metrics, and a structural improvement in LBBW's profitability, which in our view is unlikely in the near term.

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

LBBW has headroom to emerge with its VR intact, but this outcome will depend on the ultimate depth and duration of the coronavirus shock to the domestic economy. The VR would likely be downgraded if the economic and financial market disruption arising from the coronavirus outbreak is likely to reach a level that places sustained pressure on asset quality or earnings that ultimately make the bank's business model less sustainable. Further deterioration in the bank's profitability, which is a relative rating weakness, could indicate pressure on the business model.

GRANDFATHERED STATE-GUARANTEED SECURITIES

The ratings of the grandfathered state-guaranteed senior unsecured and Tier 2 subordinated notes are sensitive to 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:
The ratings are 'AAA', which is the highest level on Fitch's scale. The ratings cannot be upgraded.

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

A downgrade of the IDRs of the federal state of Baden Wuerttemberg would lead to a downgrade of the ratings.

NON-GUARANTEED TIER 2 SUBORDINATED DEBT

The ratings of the Tier 2 subordinated notes are primarily sensitive to changes in the bank's VR, from which they are notched.

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

An upgrade of LBBW's VR or a buffer of Tier 1 and Tier 2 debt sustainably exceeding 10% of RWAs.

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

A downgrade of LBBW's VR

DCR, DEPOSIT AND SENIOR-PREFERRED RATINGS

The DCR, senior-preferred debt and Deposit Ratings are primarily sensitive to changes in the bank's IDRs.

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

An upgrade of LBBW's IDRs

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

A downgrade of LBBW's IDRs or if we expect LBBW to include senior preferred debt in its resolution buffer or if the sum of SNP and more junior debt buffers falls below 10% of RWA.
BEST/WORST CASE RATING SCENARIO

Ratings of Financial Institutions 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 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.

PUBLIC RATINGS WITH CREDIT LINKAGE TO OTHER RATINGS

LBBW's IDRs are driven by institutional support from Sparkassen FinanzGruppe (A+/Negative)

ESG CONSIDERATIONS

ESG issues are credit neutral or have only a minimal credit impact on the entity(ies), either due to their nature or the way in which they are being managed by the entity(ies). For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com/esg.

Additional information is available on www.fitchratings.com

APPLICABLE CRITERIA

Bank Rating Criteria (pub. 28 Feb 2020) (including rating assumption sensitivity)

ADDITIONAL DISCLOSURES
Dodd-Frank Rating Information Disclosure Form

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Endorsement Policy

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Landesbank Baden-Wuerttemberg EU Issued

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