FITCH AFFIRMS LANDESBANK BADEN-WUERTTEMBERG'S IDR AT 'A-'/STABLE, VR AT 'BBB+'

Fitch Ratings-Frankfurt/London-11 April 2019: Fitch Ratings has affirmed Landesbank Baden-Wuerttemberg's (LBBW) Long-Term Issuer Default Rating (IDR) at 'A-' with a Stable Outlook, Viability Rating (VR) at 'bbb+', Short-Term IDR at 'F1' and Support Rating (SR) at '1'. A full list of rating actions is at the end of this rating action commentary. The rating actions have been taken in conjunction with Fitch's periodic review of three Landesbanken based in southern Germany.

KEY RATING DRIVERS

IDRS, SR, SENIOR UNSECURED

LBBW's IDRs, SR and senior debt ratings are driven by Fitch's view of strong likelihood of support from its owners, the State of Baden-Wuerttemberg (BW), the City of Stuttgart, the regional savings banks and the Sparkassen-Finanzgruppe (SFG, A+/Stable).

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

Fitch uses the lower Long-Term IDR of LBBW's owners', SFG's Long-Term IDR, as an anchor for determining LBBW's support-driven ratings. In Fitch's view, support would need to be forthcoming from SFG as well as the State of BW and the City of Stuttgart to avoid triggering state aid considerations and resolution under the German Recovery and Resolution Act if LBBW fails. Our assessment of the State of BW's creditworthiness is underpinned by the stability of Germany's solidarity and financial equalisation system, which links the State of BW's creditworthiness to that of the German sovereign (AAA/Stable). SFG's support ability, as expressed by its 'A+' Long-Term IDR, is strong, despite recent commitments from SFG's institutional protection scheme to recapitalise one of its member's Landesbanken, Norddeutsche Landesbank Girozentrale (NORD/LB).

We notch down LBBW's Long-Term IDR twice from SFG's 'A+' because we consider LBBW's role for its owners strategic, but not key and integral, and due to potential legal and regulatory barriers related to state aid considerations and to the provisions of German resolution legislation. The Stable Outlook reflects our stable support assumptions and the Stable Outlook on SFG's Long-Term IDR.

LBBW's senior unsecured debt ratings are equalised with its IDRs. The bank's 'F1' Short-Term IDR is at the higher of the two Short-Term IDRs that map to a 'A-' Long-Term IDR on Fitch's rating scale. This reflects LBBW's strong links with SFG and privileged access to SFG's ample liquidity and funding resources.

VR

LBBW's VR reflects the bank's stable company profile and market position in its home region both in corporate and retail markets, and its solid capitalisation. LBBW's asset quality is strong but concentration risks in cyclical industries, primarily corporates and real estate, highlight vulnerability to an economic downturn. Our assessment of LBBW's earnings and profitability remains a relative weakness, although LBBW reported a satisfactory financial performance at end-2018. We consider its funding and liquidity profile adequate, reflecting access to retail deposits but also inherent dependency on capital market funding due to its business model.

LBBW reported an increase in its pre-tax profit of 8% to EUR558 million in 2018. A key driver of its financial performance has been a reduction in administrative expenses including termination of guarantee fees related to loans provided to an SPV (Sealink). However, on a group level both net interest and fee income still moderately declined. This is largely due to the weak capital market business, which in line with other banks suffered from widening spreads and notable investor reluctance. More importantly, LBBW's corporate segment, its most important revenue source, remained only on an even pre-tax profit y-o-y despite well above average growth. This highlights banks' difficulties in achieving risk-adjusted margin improvements in Germany's competitive environment and structurally undermines LBBW's revenue dynamics. This makes it challenging for LBBW to meet its strategic long-term financial targets.

LBBW's asset quality indicators, including its non-performing loans ratio of below 1%, remained strong but are at a cyclical peak, in our view. LBBW's asset growth did not significantly increase the overall risk in the bank's portfolio but we believe it to be increasingly challenging to maintain current underwriting standards.

LBBW is well capitalised, but the bank's common equity Tier 1 ratio (CET1) has started to drift moderately lower, primarily reflecting LBBW's growth strategy. LBBW's reported CET1 ratio slightly decreased to 15.1% at end-2018 from 15.7% at end-2017. It still comfortably exceeds the bank's 2019 supervisory review and evaluation process (SREP) ratio requirement of 9.75% and the bank's long-term planning target. We believe the current level allows for a continuation of LBBW's strategic objectives and accommodates an expected regulatory driven medium-term upward trend on risk weighted assets from the implementation of an output floor and other measures under the revised Basel rules. We view LBBW's leverage ratio of 4.7% at end-2018 as adequate.

LBBW's funding and liquidity is adequate. It reflects a broad mix of deposit based, bank and capital market funding. Deposit funding stems from its role as a savings bank in the Stuttgart area and institutional investors, as well as strong and reliable funding links to highly liquid savings banks. Consequently, LBBW is in a good position to accomplish its non-deposit funding based on a diversified pool of capital market instruments including covered bonds. Due to its high level of own funds and a large amount of legacy senior unsecured bonds, LBBW meets its expected MREL requirements by a wide margin. However, its liquidity coverage ratio of about 115% at end-2018 is comparably low.

STATE-GUARANTEED/GRANDFATHERED SENIOR, AND SUBORDINATED SECURITIES
The ratings of LBBW's state-guaranteed/grandfathered senior and subordinated debt reflect the credit strength of the regional state guarantors.

NON-GUARANTEED TIER 2 SUBORDINATED DEBT
Non-guaranteed Tier 2 subordinated debt instruments are notched down once from LBBW's VR to reflect loss severity relative to average recoveries.

DCR, DEPOSIT AND SENIOR PREFERRED DEBT RATINGS
The bank's DCR and Deposit Ratings and senior preferred debt are equalised with its IDRs. We believe the bank's buffers of junior and vanilla senior debt do not afford any obvious incremental probability of default benefit over and above the support benefit already factored into its IDRs. We do not apply any uplift for above-average recovery prospects in the event of default because of the limited visibility on recovery levels in such circumstances. In the highly unlikely event that LBBW failed and was not supported by its savings banks and state owners, its balance sheet would most probably differ substantially from the current one.

COMMERCIAL PAPER PROGAMME
Fitch has withdrawn LBBW's 'F1' EUR20 billion commercial paper programme, because this rating is no longer relevant for Fitch's coverage given that the programme has become inactive. Debt issued with original maturities of less than one year has preferred status under the new German resolution regime.

RATING SENSITIVITIES
IDRS, SR, SENIOR UNSECURED RATINGS
The IDRs, SR, senior unsecured and non-preferred debt ratings are sensitive to changes in Fitch's assumptions on the propensity or ability of LBBW's owners to provide timely support. The latter may be indicated by a change to SFG's IDR.

LBBW's IDRs are also sensitive to changes to the owners' strategic commitment to LBBW and the importance of the bank to its home region or for the savings banks sector. A change to our assessment of the risks of triggering a resolution process ahead of support for a Landesbank could also affect the SR, IDRs and senior unsecured debt ratings.

VR
Upside potential for LBBW's VR is limited unless it demonstrates a sustainable and material improvement in profitability and efficiency. This would rely on sustainably higher asset margins and a significant reduction in its cost base, which Fitch believes is unlikely to be achieved in the short term.

Downward pressure on LBBW's VR could be triggered by a significantly weaker economic environment in Germany, particularly pressure in automotive manufacturing, utilities and commercial real estate if it leads to negative rating migration and write-downs.

The VR is also sensitive to significant changes to LBBW's strategic objectives. It could come under pressure if we observe a material deviation from underwriting standards, which could erode LBBW's asset quality and capitalisation.

GRANDFATHERED STATE-GUARANTEED SENIOR AND SUBORDINATED DEBT
LBBW's state-guaranteed/grandfathered senior and subordinated debt ratings are sensitive to changes to Fitch's view of the creditworthiness of the State of BW, which is linked to that of Germany.

DCR, DEPOSIT AND SENIOR PREFERRED DEBT RATINGS
The DCR, senior preferred and Deposit Ratings are sensitive to changes in LBBW's IDRs.

NON-GUARANTEED TIER 2 SUBORDINATED DEBT
LBBW's non-guaranteed Tier 2 subordinated debt rating is sensitive to changes in the bank's VR.

The rating actions are as follows:
Long-Term IDR: affirmed at 'A-'; Outlook Stable
Short-Term IDR: affirmed at 'F1'
Support Rating: affirmed at '1'
Viability Rating: affirmed at 'bbb+'
Derivative Counterparty Rating: affirmed at 'A-'(dcr)
Deposit Ratings: affirmed at 'A-'/'F1'
Long-term senior unsecured debt, including programme ratings: affirmed at 'A-'
Long-term and short-term senior preferred debt/ programme ratings: affirmed at 'A-'/'F1'
State-guaranteed/grandfathered senior and subordinated debt: affirmed at 'AAA'
Non-guaranteed Tier 2 Subordinated debt: affirmed at 'BBB'

Commercial paper programme (EUR 20 billion): withdrawn

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Applicable Criteria
Bank Rating Criteria (pub. 12 Oct 2018)
https://www.fitchratings.com/site/re/10044408