MOODY'S
INVESTORS SERVICE

Credit Opinion: Landesbank Hessen-Thüringen GZ

Global Credit Research - 24 Mar 2015

Frankfurt am Main, Germany

Ratings

Category	Moody's Rating
Outlook	Rating(s) Under Review
Bank Deposits	*A2/P-1
Bkd Bank Deposits	Aa1/P-1
Baseline Credit Assessment	baa3
Adjusted Baseline Credit Assessment	baa1
Bkd Issuer Rating	Aa1
Senior Unsecured	**A2
Subordinate -Dom Curr	Baa2
Jr Subordinate -Dom Curr	Baa3 (hyb)
Commercial Paper -Dom Curr	P-1
Main Capital Funding II Limited Partnership	
Outlook	Stable
Pref. Stock Non-cumulative	Ba2 (hyb)
Main Capital Funding Limited Partnership	
Outlook	Stable
Pref. Stock Non-cumulative	Ba2 (hyb)

* Rating(s) within this class was/were placed on review on March 17, 2015
** Placed under review for possible upgrade on March 17, 2015

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Key Indicators

Landesbank Hessen-Thueringen GZ (Consolidated Financials)[1]

	[2]**6-14**	[3]**12-13**	[3]**12-12**	[3]**12-11**	[3]**12-10**	**Avg.**
Total Assets (EUR million)	**176,508.0**	**170,339.0**	**199,301.0**	**163,985.0**	**166,244.0**	[4]**1.5**
Total Assets (USD million)	**241,666.0**	**234,717.2**	**262,756.8**	**212,876.3**	**223,023.6**	[4]**2.0**
Tangible Common Equity (EUR million)	**6,954.0**	**6,793.0**	**6,464.7**	**5,483.4**	**3,221.2**	[4]**21.2**
Tangible Common Equity (USD million)	**9,521.1**	**9,360.4**	**8,523.0**	**7,118.2**	**4,321.4**	[4]**21.8**
Problem Loans / Gross Loans (%)	**--**	**3.5**	**3.0**	**2.7**	**3.0**	[5]**3.0**
Tangible Common Equity / Risk Weighted Assets (%)	**12.6**	**12.6**	**10.6**	**9.6**	**5.6**	[6]**12.6**
Problem Loans / (Tangible Common Equity + Loan Loss Reserve) (%)	**--**	**39.3**	**35.1**	**34.1**	**58.9**	[5]**41.8**
Net Interest Margin (%)	**0.8**	**0.7**	**0.7**	**0.7**	**0.6**	[5]**0.7**

PPI / Average RWA (%)	**1.6**	**1.6**	**1.7**	**1.5**	**1.3**	[6]**1.6**
Net Income / Tangible Assets (%)	**0.3**	**0.2**	**0.2**	**0.3**	**0.2**	[5]**0.2**
Cost / Income Ratio (%)	**64.1**	**61.9**	**55.9**	**58.1**	**62.2**	[5]**60.4**
Market Funds / Tangible Banking Assets (%)	**61.4**	**61.2**	**65.0**	**63.9**	**65.5**	[5]**63.4**
Liquid Banking Assets / Tangible Banking Assets (%)	**37.2**	**41.5**	**42.4**	**38.3**	**38.7**	[5]**39.6**
Gross Loans / Total Deposits (%)	**119.1**	**116.3**	**104.5**	**114.4**	**120.8**	[5]**115.0**

Source: Moody's

[1] All figures and ratios are adjusted using Moody's standard adjustments [2] Basel III - fully-loaded or transitional phase-in; IFRS [3] Basel II; IFRS [4] Compound Annual Growth Rate based on IFRS reporting periods [5] IFRS reporting periods have been used for average calculation [6] Basel III - fully-loaded or transitional phase-in & IFRS reporting periods have been used for average calculation

Opinion

SUMMARY RATING RATIONALE

On 17 March, we placed on review for upgrade Landesbank Hessen-Thueringen GZ's (Helaba) A2 long-term debt and deposit ratings.

The bank's baa3 standalone baseline credit assessment (BCA) as well as its Prime-1 short-term debt and deposit ratings were unaffected by our rating action. Further, the bank's Baa2 rating on senior subordinated debt, Baa3 (hyb) rating on junior subordinated debt as well as its Ba2 (hyb) non-cumulative preferred securities ratings (Main Capital Funding) were unaffected. The bank's Aa1 rating for debt qualifying for 'grandfathering' was also not affected.

The review on the bank's long-term ratings was prompted by the expected effects on Helaba's debt and deposit ratings resulting from the implementation of our new global bank rating methodology as well as considerations regarding government support. For Helaba, the rating impact from the new methodology is positive for its debt and deposit ratings. This positive effect stems from the introduction of Loss Given Failure (LGF), which takes into account the impact that a potential failure of the bank may have on its various debt classes across the liability structure. We anticipate that the uplift on Helaba's long-term ratings from our LGF analysis will overcompensate for the adverse effect from anticipated restrictions to government support.

HELABA's BCA IS SUPPORTED BY ITS STRONG+ MACRO PROFILE

The bank's BCA benefits from its Strong+ Macro Profile, largely determined by the German environment with very high economic, institutional and government financial strength and very low susceptibility to event risk. Operating conditions for the German banking system are, however, constrained by high fragmentation in an over-saturated market, low fee income generation and intensifying competition for domestic business. Helaba's Strong+ Macro Profile also captures exposures to international corporate as well as commercial real estate (CRE) lending activities in countries with weaker Macro Profiles than Germany.

The BCA also reflects (1) the group's relatively strong client franchise; (2) its conservative approach to risk-taking; and (3) its comfortable funding profile. At the same time, the standalone BCA is constrained by the bank's modest, yet improving, financial performance and the bank's substantial exposure to international CRE markets.

Rating Drivers

- Improved capitalisation and sound risk management partly mitigate high sector concentrations to cyclical commercial real estate

- Level of risk-weighted profitability in terms of global comparison is low yet stable core earnings improve

- Improving liquidity metrics and funding from the savings banks sector mitigate remaining wholesale dependence

- Senior creditors benefit from Helaba's strong position within the mutually supportive Sparkassen-Finanzgruppe and a large volume of outstanding debt as well as subordinated instruments in the unlikely event of resolution (LGF analysis)

Rating Outlook

Helaba's A2 long-term debt and deposit ratings are on review for upgrade. After the review process, and with reduced government support factored into these ratings, Helaba's long-term ratings will likely have stable outlooks.

The upward pressure on the long-term ratings, as indicated by the review, is due to the positive effects from our LGF analysis, which may provide up to two notches of rating uplift. This upward pressure could more than offset pressure on the bank's long-term ratings from weakening government support. We expect Helaba's debt and deposit ratings to be one notch higher, at A1, following conclusion of the review.

What Could Change the Rating - Up

Upward rating pressure on Helaba's baa3 BCA would arise from (1) a meaningful lowering of the bank's concentration risk, specifically with regards to CRE exposures; (2) a sustained improvement in the bank's underlying performance, resulting in higher net income levels versus total banking assets; and (3) a further reduction in Helaba's dependence on debt capital markets, resulting from higher funds available from and cooperation with a larger number of savings banks.

An upward movement in Helaba's BCA would likely result in upgrades to all other rating classes.

What Could Change the Rating - Down

We do not expect negative pressure on the bank's A2 long-term ratings from the new methodology, as indicated by the review for upgrade. We recognise stability in the bank's ownership structure, the implied creditworthiness of its owners as well as existing cross-sector support mechanisms.

Challenges for the bank's BCA may arise from (1) heightened turbulence in the European debt markets leading to widening credit spreads negatively affecting Helaba's profitability metrics; (2) a sustained weakening of its recurring earnings power and levels of operating efficiency; and (3) a material deterioration in asset quality beyond levels that are consistent with the bank's risk-absorption capacity.

DETAILED RATING CONSIDERATIONS

The below considerations partly reflect comments on items and specifically numbers that will only be reflected in our new scorecard during the review period. The bank will report full-year 2014 financials on 25 March 2014 and we expect to update our Credit Opinion shortly thereafter.

IMPROVED CAPITALISATION AND SOUND RISK MANAGEMENT PARTLY MITIGATE HIGH SECTOR CONCENTRATIONS TO CYCLICAL COMMERCIAL REAL ESTATE

We anticipate that Helaba will be able to further grow its capital base over the next two years. This view is underpinned by our expectations of solid core earnings, albeit at a slightly lower level than during the very strong 2014.

The bank benefits from sound capital buffers, as displayed by its further strengthened Basel III Tier 1 and total capital ratios of 14.0 % and 18.1%, respectively, as of 30 September 2014 (31 December 2013: 12.8% and 17.4%, respectively). The bank's fully loaded common equity Tier 1 (CET1) stood at a solid 11.8%. To further strengthen its Tier 2 capital, Helaba issued EUR534 million of subordinated capital in 2014.

This solid capitalisation allowed the bank to successfully pass the European Central Bank's asset quality review and subsequent European Banking Authority's stress test with a 2016 baseline scenario CET1 ratio of 11.6% and an adverse scenario CET1 ratio of 8.2%, both well above the minimum requirements of 8.0% and 5.5% for the two scenarios, respectively.

Notwithstanding the loss absorption capacity, the bank's total exposure to the commercial real-estate sector amounted to EUR32.6 billion as of end-June 2014, resulting in considerable concentration risk especially when compared to the group's reported Tier 1 capital of EUR7.5 billion. As a result, the bank's non-performing loan ratio of 2.6% as of 30 June 2014 does not adequately gauge inherent risks. We take account of the relating risks and the bank's exposure to market risk by adjusting our Asset Risk score down by three notches to baa3.

Despite this adjustment for the sizeable concentration risks, Helaba's total CRE portfolio has a sound history of low credit losses compared with peers, owing to Helaba's focus on prime locations and properties with a high level of pre-arranged rental agreements. Furthermore, risk-related charges declined further to very low levels during the first half of 2014. Moreover, the group's corporate finance loan book is well diversified, and includes equally sized lending activities with multinational corporates, asset-based lending focused on aircraft and (to a lesser degree) ship finance, structured and project finance and leasing. In this context, we note Helaba's comparatively low exposure to shipping finance loans of EUR1.5 billion as of 30 September 2014, which forms part of the bank's total transportation finance exposure of approximately EUR5.0 billion.

We also take account of the bank's still high, albeit improving, balance sheet leverage ratio (4.0% as of 30 September 2014) by adjusting our Capital score down by two notches to baa2.

LEVEL OF RISK-WEIGHTED PROFITABILITY IN TERMS OF GLOBAL COMPARISON IS LOW YET STABLE CORE EARNINGS IMPROVE

We expect that Helaba will continue to show fairly stable operating performance and profitability levels on the back of rising core business margins and positive effects from the integration of the Verbundbank. However, regulation-related expenses will continue to burden the operating costs of Helaba. At the same time, the group's revenues will likely remain subject to market volatility and thus remain difficult to predict. Helaba's performance metrics will therefore remain slightly below those of its international peers, largely as a result of the group's promotional banking activities, which are run on a cost-coverage basis rather than on return targets.

Notwithstanding the low profitability of the group's savings banks business and promotional banking activities, we view earnings stability at the group level as sound, taking into account the relative stability of pre-provision income over the past five years, improving earnings diversification and increasingly steady contributions from retail banking and asset management. An upward adjustment of one notch to ba3 has therefore been assigned to the bank's Profitability score based on Helaba's resilient, stable and relatively high quality earnings over the past several years.

As of 30 September 2014, Helaba reported a pre-tax profit of EUR507 million (IFRS), up 14.7% year-over-year. The result was driven by strong net interest income growing 9.5% year-over-year to EUR978 million and significantly lower loan loss charges of EUR62 million (9M 2013: EUR202 million).

Negative effects stemmed from a normalisation in trading income to EUR121 million from overly high levels of EUR298 million during the first nine months of 2013 that benefitted from narrowing of own credit spreads at that time.

IMPROVING LIQUIDITY METRICS AND FUNDING FROM THE SAVINGS BANKS SECTOR MITIGATE REMAINING WHOLESALE DEPENDENCE

Helaba is partially depending on wholesale funding for a part of its lending business and is presently a net lender in the interbank market. However, we consider Helaba's liquidity profile to be sound. This view reflects the bank's proven and recurring access to considerable excess liquidity of the regional savings banks and good access to debt capital markets, even in times of stress.

Notably, funding requirements will remain modest over the foreseeable future, given the group's strategy of actively reducing its current liability overhang and re-allocating longer-term funds to higher-margin business areas over time. This approach results in a broadly matched funding profile for its medium- and long-term lending business. The bank typically issues approximately EUR12 billion-EUR15 billion in medium- and long-term debt instruments per year, placed with a broad and diversified investor base. A growing portion of Helaba's unsecured wholesale debt issued is placed with savings banks and their retail clients.

To capture these benefits, we have positively adjusted our Funding Structure score by five notches to ba2. Our consideration of encumbered assets in our liquid resources ratio results in a two-notch downward adjustment of the Liquid Resources score to a2.

Notching Considerations

AFFILIATE SUPPORT

Helaba benefits from cross-sector support from Sparkassen-Finanzgruppe (Corporate Family Rating Aa2 stable). Cross-sector support materially reduces the probability of default, as it would be available to stabilise a distressed member bank, and not just compensate for losses in resolution.

We continue to consider the readiness of the sector to support its members to be very high. This particularly applies to Helaba given its prominent service function for the sector. Cross-sector support continues to provide two notches of rating uplift to Helaba's debt, deposit and subordinated instrument ratings.

LOSS GIVEN FAILURE (LGF) ANALYSIS

Helaba is subject to the EU Bank Resolution and Recovery Directive, which we consider to be an Operational Resolution Regime. We therefore apply our LGF analysis, considering the risks faced by the different debt and deposit classes across the liability structure at failure. We assume residual tangible common equity of 3% and losses post-failure of 8% of tangible banking assets, a 25% run-off in "junior" wholesale deposits, a 5% run-off in preferred deposits, and assign a 25% probability to deposits being preferred to senior unsecured debt. These are in line with our standard assumptions.

For Helaba, our LGF analysis indicates a very low loss-given-failure for senior unsecured debt and deposits. Following the review, we will likely assign a Preliminary Rating Assessment to Helaba's wholesale deposits as well as its senior unsecured debt two notches above the adjusted BCA.

SUBORDINATED AND HYBRID INSTRUMENTS

Further, our LGF analysis indicates a high loss-given-failure for subordinated debt classes, leading us to position their Preliminary Rating Assessments one notch below the bank's Adjusted BCA. Given that subordinated debt instruments do not benefit from any government support, their final Baa2 ratings are in-line with the assigned PRA.

One EUR300 million Genussschein (junior subordinated debt) is rated Baa3 (hyb), two notches below the bank's Adjusted BCA, reflective of its cumulative coupon-skip mechanism tied to a balance-sheet loss trigger.

Helaba's silent participations (non-cumulative preferred securities) issued by Main Capital Funding Limited Partnership and Main Capital Funding II Limited Partnership are rated Ba2 (hyb), four notches below the bank's Adjusted BCA, reflective of the instruments' net loss triggers.

GOVERNMENT SUPPORT

The implementation of the BRRD in Germany has caused us to reconsider the potential for government support to benefit certain creditors. We now expect a moderate probability of government support for Helaba's senior debt and deposits, likely resulting in a reduced one-notch uplift to the PRA. Following the review, our revised systemic support assumptions for Helaba's ratings reflect the size and high systemic relevance, at the domestic level, of the group of public sector banks.

ABOUT MOODY'S BANK RATINGS

About Moody's Bank Scorecard

Our Scorecard is designed to capture, express and explain in summary form our Rating Committee's judgment. When read in conjunction with our research, a fulsome presentation of our judgment is expressed. As a result, the output of our Scorecard may materially differ from that suggested by raw data alone (though it has been calibrated to avoid the frequent need for strong divergence). The Scorecard output and the individual scores are discussed in rating committees and may be adjusted up or down to reflect conditions specific to each rated entity.

Rating Factors

Landesbank Hessen-Thüringen GZ

Macro Factors	
Weighted Macro Profile	**Strong +**

Financial Profile						
Factor	**Historic Ratio**	**Macro Adjusted Score**	**Credit Trend**	**Assigned Score**	**Key driver #1**	**Key driver #2**
Solvency **Asset Risk** *Problem Loans / Gross*	3.5%	a3	←→	baa3	Sector	Market risk

Loans					concentration	
Capital						
TCE / RWA	12.6%	a3	←→	baa2	Nominal leverage	
Profitability						
Net Income / Tangible Assets	0.2%	b1	←→	ba3	Earnings quality	
Combined Solvency Score		baa2		baa3		
Liquidity						
Funding Structure						
Market Funds / Tangible Banking Assets	61.2%	caa1	←→	ba2	Market funding quality	Market access
Liquid Resources						
Liquid Banking Assets / Tangible Banking Assets	41.5%	aa3	←→	a2	Quality of liquid assets	Intragroup restrictions
Combined Liquidity Score		ba1		baa2		

Financial Profile	**baa3**

Qualitative Adjustments	**Adjustment**
Business Diversification	0
Opacity and Complexity	0
Corporate Behavior	0
Total Qualitative Adjustments	**0**

Sovereign or Affiliate constraint	Aaa
Scorecard Calculated BCA range	**baa2 - ba1**
Assigned BCA	**baa3**
Affiliate Support notching	**2**
Adjusted BCA	**baa1**

Instrument Class	**Loss Given Failure notching**	**Additional notching**	**Preliminary Rating Assessment**	**Government Support notching**	**Local Currency rating**	**Foreign Currency rating**
Deposits	--	--	--	--	A2 RUR Possible Upgrade	A2 RUR Possible Upgrade
Senior unsecured bank debt	--	--	--	--	A2 RUR Possible Upgrade	A2 RUR Possible Upgrade
Dated subordinated bank debt	-1	0	baa2	0	Baa2	
Junior subordinated bank debt	-1	-1	baa3	0	Baa3(hyb)	