Moody's
INVESTORS SERVICE

Credit Opinion: Landesbank Hessen-Thüringen GZ

Global Credit Research - 17 Jul 2015

Frankfurt am Main, Germany

Ratings

Category	Moody's Rating
Outlook	Positive(m)
Bank Deposits	A1/P-1
Bkd Bank Deposits	Aa1/P-1
Baseline Credit Assessment	baa3
Adjusted Baseline Credit Assessment	baa1
Bkd Issuer Rating	Aa1
Senior Unsecured	A1
Subordinate -Dom Curr	Baa2
Jr Subordinate -Dom Curr	Baa3 (hyb)
Commercial Paper -Dom Curr	P-1
Main Capital Funding II Limited Partnership	
Pref. Stock Non-cumulative	Ba1 (hyb)
Main Capital Funding Limited Partnership	
Pref. Stock Non-cumulative	Ba1 (hyb)

Contacts

Analyst	Phone
Michael Rohr/Frankfurt am Main	49.69.707.30.700
Bernhard Held/Frankfurt am Main	
Carola Schuler/Frankfurt am Main	
Mira Carey/Frankfurt am Main	

Key Indicators

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

	[2]**12-14**	[3]**12-13**	[3]**12-12**	[3]**12-11**	[3]**12-10**	**Avg.**
Total Assets (EUR billion)	**169.7**	**170.5**	**199.3**	**164.0**	**166.2**	[4]**0.5**
Total Assets (USD billion)	**205.4**	**235.0**	**262.8**	**212.9**	**223.0**	[4]**-2.0**
Tangible Common Equity (EUR billion)	**7.0**	**7.0**	**6.5**	**5.5**	**3.2**	[4]**21.2**
Tangible Common Equity (USD billion)	**8.4**	**9.6**	**8.5**	**7.1**	**4.3**	[4]**18.1**
Problem Loans / Gross Loans (%)	**2.2**	**3.2**	**3.0**	**2.7**	**3.0**	[5]**2.8**
Tangible Common Equity / Risk Weighted Assets (%)	**12.9**	**12.9**	**10.6**	**9.6**	**5.6**	[6]**12.9**
Problem Loans / (Tangible Common Equity + Loan Loss Reserve) (%)	**25.6**	**36.1**	**35.1**	**34.1**	**58.9**	[5]**37.9**
Net Interest Margin (%)	**0.8**	**0.7**	**0.7**	**0.7**	**0.6**	[5]**0.7**
PPI / Average RWA (%)	**1.4**	**1.5**	**1.7**	**1.5**	**1.2**	[6]**1.4**
Net Income / Tangible Assets (%)	**0.2**	**0.2**	**0.2**	**0.2**	**0.2**	[5]**0.2**
Cost / Income Ratio (%)	**65.4**	**63.0**	**56.5**	**58.8**	**63.4**	[5]**61.4**
Market Funds / Tangible Banking Assets (%)	**58.5**	**61.2**	**65.0**	**63.9**	**65.5**	[5]**62.8**
Liquid Banking Assets / Tangible Banking Assets (%)	**39.1**	**41.5**	**42.4**	**38.3**	**38.7**	[5]**40.0**
Gross Loans / Total Deposits (%)	**112.6**	**116.6**	**104.5**	**114.4**	**120.8**	[5]**113.8**

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 19 June, we upgraded Landesbank Hessen-Thueringen GZ's (Helaba) long-term debt and deposit ratings to A1 from A2. The bank's baa3 baseline credit assessment (BCA) as well as its Prime-1 short-term debt and deposit ratings were affirmed. Further, we affirmed the bank's Baa2 rating on senior subordinated debt, its Baa3(hyb) rating on junior subordinated debt and upgraded its non-cumulative preferred securities ratings (Main Capital Funding) by one notch to Ba1(hyb). The bank's Aa1 rating for debt qualifying qualifying for 'grandfathering' was either not affected or affirmed (for subordinated debt).

We further assigned a Counterparty Risk Assessment of Aa3(cr)/Prime-1(cr) to Helaba.

The one-notch upgrade of Helaba's long-term deposit and senior unsecured debt ratings to A1 incorporates (1) the affirmation of the bank's baa3 BCA; (2) the affirmation of its baa1 adjusted BCA, as our assessment of a high probability of Helaba receiving affiliate support from the Sparkassen-Finanzgruppe (S-Group; Corporate Family Rating Aa2 stable) continues to result in two notches of rating uplift; (3) the results of our Loss Given Failure (LGF) Analysis; partially offset by (4) our reduced "moderate" government support assumptions, resulting in one notch of rating uplift from two notches previously.

For Helaba, our LGF analysis indicates a very low loss-given-failure for senior unsecured debt and deposits, leading to a two-notch uplift on Helaba's wholesale deposits as well as its senior unsecured debt from its baa1 adjusted BCA.

The affirmation of the bank's baa3 BCA reflects (1) the group's improved capital and leverage ratios; (2) its moderate asset risk profile, displaying a sound long-run loan-loss performance; and (3) its comfortable funding profile. At the same time, the standalone BCA is constrained by the bank's substantial exposure to international commercial real-estate (CRE) markets and the bank's modest, yet improving and solid, financial performance.

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

The bank's BCA further 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 CRE lending activities in countries with weaker Macro Profiles than Germany.

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 S-Group and a large volume of outstanding debt as well as subordinated instruments in the unlikely event of resolution (LGF analysis)

Rating Outlook

The outlook on the bank's A1 long-term deposit ratings is positive and the outlook on the A1 long-term senior unsecured debt ratings is stable, indicating that a modified insolvency order in Germany would place positive pressure on Helaba's long-term deposit ratings.

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. In addition, Helaba's debt and/or deposit ratings could be upgraded if the volume of subordinated instruments increases relative to the bank's tangible banking assets. This could result in additional notches of uplift resulting from our LGF analysis.

What Could Change the Rating - Down

We do not expect negative pressure on the bank's A1 long-term ratings at present as indicated by our outlooks. This assessment also reflects our anticipation of 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.

In addition, Helaba's debt and/or deposit ratings could be downgraded if their volume or that of its subordinated instruments decreases significantly relative to the bank's tangible banking assets. This could result in fewer notches of uplift resulting from our LGF analysis.

DETAILED RATING CONSIDERATIONS

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 14.3 % and 18.5%, respectively, as of 31 December 2014 (2013: 12.8% and 17.4%, respectively). The bank's fully loaded common equity Tier 1 (CET1) stood at a solid 11.8%, up from 10.7% in 2013.

Notwithstanding the loss-absorption capacity, the bank's total loan exposure to the commercial real-estate sector amounted to EUR32.9 billion as of end-2014, resulting in considerable concentration risk especially when compared to the group's reported Tier 1 capital of EUR7.7 billion. We take account of the relating risks and the bank's exposure to market risk by adjusting our Asset Risk score down by four 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, the bank reported a non-performing loan ratio of 2.4% as of 31 December 2014 and risk-related charges declined further to very low levels during 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 31 December 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 31 December 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 statutory obligation to perform 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 31 December 2014, Helaba reported a record pre-tax profit of EUR607 million (IFRS), up 25.7% year-over-year. The result was driven by strong net interest income growing 6.3% year-over-year to EUR1.3 billion and significantly lower loan loss charges of EUR80 million (2013: EUR240 million).

Negative effects stemmed from a normalisation in trading income to EUR126 million from overly high levels of EUR344 million during 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 prudent strategy of managing new business as well as its total balance sheet. 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 four notches to ba2. Our consideration of encumbered assets in our Liquid Banking Assets ratio results in a two-notch downward adjustment of the Liquid Resources score to a3.

Notching Considerations

AFFILIATE SUPPORT

Helaba benefits from cross-sector support from S-Group. 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.

The ownership structures of the individual banks or banking groups determine the assigned level of support -- either "high" or "very high" -- with full S-Group ownership or affiliation combined with the membership in the cross liability scheme constituting "very high" support. The "high" support, assigned to most Landesbanks, reflects cross-liability scheme membership and only partial ownership by S-Group members.

We currently consider the readiness of the sector to support Helaba to be high, given its prominent service function for the sector. Cross-sector support thus 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. We have thus assigned an a2 Preliminary Rating Assessment (PRA) to Helaba's wholesale deposits as well as its senior unsecured debt, two notches above the bank's baa1 adjusted BCA.

SUBORDINATED AND HYBRID INSTRUMENTS

Our LGF analysis indicates a high loss-given-failure for subordinated debt classes, leading us to position their PRAs one notch below the bank's baa1 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 Ba1(hyb), three notches below the bank's Adjusted BCA, reflective of the instruments' net loss triggers.

GOVERNMENT SUPPORT

Following the introduction of the BRRD, we have lowered our expectations about the degree of support that the government might provide to a bank in Germany in the event of need. Because of its size on a consolidated basis, we consider S-Group as systemically relevant and therefore attribute a "moderate" probability of German government support for all members of the sector, in line with support assumptions for other systemically relevant banking groups in Europe. We therefore still include one notch of government support uplift in the senior debt and deposits ratings of S-Group member banks that are incorporated in Germany, including Helaba.

Output of the Baseline Credit Assessment 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 Loans	2.8%	a2	←→	baa3	Sector concentration	Market risk
Capital						
TCE / RWA	12.9%	a3	←→	baa2	Nominal leverage	
Profitability						
Net Income / Tangible Assets	0.2%	b1	←→	ba3	Earnings quality	

Combined Solvency Score		baa1		baa3		
Liquidity						
Funding Structure						
Market Funds / Tangible Banking Assets	58.5%	b3	←→	ba2	Market funding quality	Market access
Liquid Resources						
Liquid Banking Assets / Tangible Banking Assets	39.1%	a1	←→	a3	Quality of liquid assets	Intragroup restrictions
Combined Liquidity Score		ba1		baa3		

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	2	0	a2	1	A1	A1
Senior unsecured bank debt	2	0	a2	1	A1	A1
Dated subordinated bank debt	-1	0	baa2	0	Baa2	
Junior subordinated bank debt	-1	-1	baa3	0	Baa3(hyb)	

This publication does not announce a credit rating action. For any credit ratings referenced in this publication, please see the ratings tab on the issuer/entity page on http://www.moodys.com for the most updated credit rating action information and rating history.

Moody's
INVESTORS SERVICE