MOODY'S
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Credit Opinion: Landesbank Hessen-Thüringen GZ

Global Credit Research - 12 Jan 2016

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
Counterparty Risk Assessment	Aa3(cr)/P-1(cr)
Bkd Issuer Rating	Aa1
Senior Unsecured -Dom Curr	A1
Subordinate -Dom Curr	Baa2
Jr Subordinate -Dom Curr	Baa3
Commercial Paper -Dom Curr	P-1
Main Capital Funding II Limited Partnership	
Pref. Stock Non-cumulative	Ba1
Main Capital Funding Limited Partnership	
Pref. Stock Non-cumulative	Ba1

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Key Indicators

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

	[2]6-15	[2]12-14	[3]12-13	[3]12-12	[3]12-11	Avg.
Total Assets (EUR billion)	172.2	169.7	170.5	199.3	164.0	[4]1.2
Total Assets (USD billion)	191.8	205.4	235.0	262.8	212.9	[4]-2.6
Tangible Common Equity (EUR billion)	7.1	7.0	7.0	6.5	5.5	[4]6.7
Tangible Common Equity (USD billion)	7.9	8.4	9.6	8.5	7.1	[4]2.7
Problem Loans / Gross Loans (%)	--	2.2	3.2	3.0	2.7	[5]2.8
Tangible Common Equity / Risk Weighted Assets (%)	12.8	12.9	12.9	10.6	9.6	[6]12.9
Problem Loans / (Tangible Common Equity + Loan Loss Reserve) (%)	--	25.6	36.1	35.1	34.1	[5]32.7
Net Interest Margin (%)	0.8	0.8	0.7	0.7	0.7	[5]0.7
PPI / Average RWA (%)	1.6	1.4	1.5	1.7	1.5	[6]1.5
Net Income / Tangible Assets (%)	0.3	0.2	0.2	0.2	0.2	[5]0.2
Cost / Income Ratio (%)	62.6	65.4	63.0	56.5	58.8	[5]61.3
Market Funds / Tangible Banking Assets (%)	55.7	58.5	61.2	65.0	63.9	[5]60.9

Liquid Banking Assets / Tangible Banking Assets (%)	**37.4**	**39.1**	**41.5**	**42.4**	**38.3**	[5]**39.8**
Gross loans / Due to customers (%)	**190.4**	**201.0**	**207.3**	**190.8**	**200.5**	[5]**198.0**

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

We assign A1/P-1 long- and short-term debt and deposit ratings to Landesbank Hessen-Thueringen GZ (Helaba), as well as a subordinated debt rating of Baa2, a junior subordinated debt rating of Baa3(hyb) and non-cumulative preferred securities ratings (Main Capital Funding) of Ba1(hyb). We further assign a baa3 baseline credit assessment (BCA) and a baa1 adjusted BCA to Helaba, as well as a Counterparty Risk Assessment of Aa3(cr)/P-1(cr). Ratings for senior and subordinated debt qualifying for 'grandfathering', i.e. instruments backed by the State of Hesse (unrated), have been assigned at Aa1.

Helaba's A1/P-1 long- and short-term debt and deposit ratings reflect (1) the bank's baa3 BCA; (2) its baa1 adjusted BCA incorporating two notches of affiliate support from Sparkassen-Finanzgruppe (S-Group; Corporate Family Rating Aa2 stable, BCA a2); (3) the result of our Advanced Loss Given Failure (LGF) analysis, which takes into account the severity of loss faced by the different liability classes in resolution and which provides two notches of rating uplift to Helaba's debt and deposit ratings; and (3) a moderate likelihood of Helaba receiving government support, resulting in one additional notch of rating uplift.

Helaba'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.

Rating Drivers

- Helaba's domestic and international exposures determine its Strong+ Macro Profile

- 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 and further improvement of the bank's underlying profitability 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) a deterioration of the bank's Macro Profile; (2) deterioration of the bank's financial strength, especially if followed by an unexpected and sustained weakening of its capital adequacy metrics; (3) material deterioration in asset quality; and/or (4) heightened turbulence in the European debt markets leading to widening credit spreads negatively affecting Helaba's profitability metrics.

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

HELABA's DOMESTIC AND INTERNATIONAL EXPOSURES DETERMINE ITS STRONG+ MACRO PROFILE

Helaba is predominantly active in Germany. The very high economic, institutional and government financial strength and very low susceptibility to event risk thus support the bank's BCA. 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. Overall, 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. A deterioration of the bank's Macro Profile may negatively affect its financial profile, all things being equal.

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, as evidenced by strong results during the first nine months of 2015.

The bank benefits from sound capital buffers, as displayed by its further strengthened fully-loaded Basel III common equity Tier 1 (CET1) and total capital ratios of 12.0% and 18.3%, respectively, as of 30 September 2015 (30 September 2014: 11.8% and 18.5%, respectively).

Notwithstanding the bank's solid loss-absorption capacity, Helaba'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 CET1 capital of approximately EUR7.3 billion as of end-September 2015. 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 (3.9% as of 30 September 2015) 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.

During the first nine months of 2015, Helaba reported a pre-tax profit of EUR485 million, down 4% year-over-year. The results were marked by a solid performance in net interest income which stood at EUR983 million as of 30 September 2015, virtually unchanged year-over-year. This was offset by higher loan loss provisions of EUR114 million as of end-September 2015, up from EUR62 million over the same period in 2014. Moreover, volatility in hedge accounting and lower gains from financial investments were offset by higher other operating revenues, overall supporting the solid 9M 2015 results.

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 (end-September 2015: EUR11.6 billion), 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 reduces the probability of default, as such support would be available to stabilise a distressed member bank, and not just compensate for losses in resolution. The "high" support assumption assigned to Helaba reflects its prominent service function for the sector, the majority ownership by S-Group members and the bank's cross-liability scheme. As a result, cross-sector support provides 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 Advanced 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, according to 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

Given its size on a consolidated basis, we consider S-Group as domestically systemically relevant. We 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. For Helaba, this results in one notch of additional government support uplift for its senior debt and deposit ratings.

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	12.8%	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	
Dated subordinated bank debt	-1	0	baa2	0	Baa2	
Junior subordinated bank debt	-1	-1	baa3	0	Baa3(hyb)	

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