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Fitch Upgrades LBBW's Viability Rating to 'bbb+'; Affirms IDR at 'A-/Stable

Fitch Ratings - Frankfurt am Main - 07 Mar 2023: Fitch Ratings has upgraded Landesbank Baden-Wuerttemberg's (LBBW) Viability Rating (VR) and subordinated debt rating to 'bbb+' from 'bbb' and to 'BBB-' from 'BB+', respectively. Its Long-Term Issuer Default Rating (IDR) has been affirmed at 'A-' with a Stable Outlook. A full list of rating actions is below.

The upgrade of the VR reflects Fitch's expectation that the bank's operating profit will average close to 1% of risk-weighted assets (RWAs) going forward. Performance was resilient through the pandemic, and we expect that the economic slowdown in Germany will only lead to a moderate increase of the bank's impaired loans ratio and that precautionary loan loss allowances should absorb a large portion of loan impairment charges.

Key Rating Drivers

Owners' Support Drives IDRs: LBBW's Long-Term IDR is driven by its 'a-' Shareholder Support Rating (SSR), which reflects a strong likelihood of support from the bank's owners, the regional members of Germany's savings banks group Sparkassen-Finanzgruppe (Sparkassen) (SFG; A+/Stable), the federal states of Baden-Wuerttemberg and the City of Stuttgart.

Fitch uses SFG's Long-Term IDR as the anchor rating for determining LBBW's support-driven ratings, as we believe support would need to be forthcoming from both SFG and Baden Wuerttemberg to avoid triggering state-aid considerations and resolution under the German Recovery and Resolution Act if LBBW fails. The Stable Outlook on LBBW's Long-Term IDR reflects that of SFG.

Fitch believes the federal states of Baden Wuerttemberg will participate in support measures for the bank, but LBBW's SSR does not factor in support from the federal state as it is based on the lowest of the owners' ratings, ie that of SFG. We notch LBBW's SSR down twice from SFG's 'A+' to reflect regulatory restrictions on support, due to the requirement for state-aid examination under EU competition rules. The two-notch difference also reflects LBBW's strategic, but not key and integral role, for SFG.

Large German Corporate Bank: LBBW's VR reflects the bank's focus on corporate clients, with high sector concentrations, and subdued profitability compared with international peers'. This is balanced by strong asset-quality metrics, adequate capitalisation and access to the saving banks' excess liquidity.

High Sector Concentrations: LBBW's strong regional corporate-banking franchise benefits from Baden Wuerttemberg's large economy. However, this regional focus leads to concentrations on cyclical

industries and, to some extent, on large borrowers, in particular in commercial real estate and automotive. Stiff competition in most of LBBW's business lines limits the bank's pricing power and weighs on its profitability.

Low Impaired Loans: The bank's exposure to cyclical industries is higher than that of peers, and its asset quality is sensitive to global supply chain disruptions, input price shocks and structural changes. We expect loan impairment charges (LICs) and impaired loans to rise from their exceptionally low levels at end-1H22, but the four-year average impaired loans ratio should remain below 2% in the next two years, a level we view as commensurate with LBBW's VR.

Large buffers of precautionary loan loss allowances should also absorb a large portion of loan impairment charges.

Subdued Profitability: LBBW's profitability is burdened by its high costs and low margins. We expect operating profits/RWAs to remain broadly stable in the next two years, as the positive effect from higher interest rates should be offset by higher costs. We believe that LBBW's revenue will gradually improve in the long term as the bank executes on its growth strategy, compensating for regulatory RWA inflation.

Adequate Capitalisation: We expect LBBW's common equity Tier 1 (CET1) ratio to remain comfortably above its 13% strategic target after the consolidation of Berlin Hyp AG (A-/Stable/bbb+). We view this level as adequate, but not strong, for the bank's business model, which exposes LBBW to potential cyclical performance swings. Stronger profit retention will be key in offsetting higher RWAs from the execution of the bank's growth strategy and the phasing-in of Basel III.

IPS Membership Underpins Funding: LBBW's predominantly wholesale funding benefits from its membership in SFG's Institutional Protection Scheme (IPS). The bank's liquidity is underpinned by a large portfolio of liquid securities and should remain sound following the repayment of central bank tender funding (TLTRO).

Rating Sensitivities

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

A downgrade of SFG's IDRs, or an adverse change in the ownership structure or in SFG's strategic commitment to the bank could lead to a downgrade of LBBW's IDRs and SSR.

The VR would likely be downgraded if we expect the bank's impaired loans ratio to rise to and remain above 3%; if the CET1 ratio falls below 13% on a sustained basis; or if operating profit declines durably below 0.7% of RWAs without clear recovery prospects.

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

An upgrade of the IDRs and SSR would require an upgrade of SFG's ratings. An upgrade of LBBW's VR is unlikely unless its franchise strengthens with more diversified revenue and significantly lower sector

and single-name concentrations. An upgrade would also be contingent on a structural improvement of LBBW's profitability, with average operating profit above 2% of RWAs, without a material increase in risk appetite.

OTHER DEBT AND ISSUER RATINGS: KEY RATING DRIVERS

LBBW's Short-Term IDR is the higher of two possible levels that map to a 'A-' Long-Term IDR on Fitch's rating scale, because propensity to support by its institutional owners is likely more certain in the near term and also because the bank shares strong links to SFG and privileged access to SFG's ample liquidity and funding resources.

LBBW's long-term deposit rating, senior preferred debt rating and Derivative Counterparty Rating (DCR) are rated one notch above the Long-Term IDR because of the protection provided by resolution buffers to these preferred creditors. LBBW's senior non-preferred debt rating is in line with its Long-Term IDR.

LBBW's short-term senior preferred and deposit ratings are the lower of two ratings that map to an 'A' long-term deposit rating. This is because we believe that, despite the owners' very high propensity to provide support to LBBW, we see potential impediments to the prompt flow of funds, given the lengthy process required to support a Landesbank, which are not commensurate with an 'F1+' short-term rating.

The 'AAA' ratings of LBBW's grandfathered state-guaranteed senior unsecured and Tier 2 subordinated notes reflect our view of the creditworthiness of the State of Baden Wuerttemberg, which is closely linked to that of Germany (AAA/Stable), and our expectation that Baden Wuerttemberg will 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.

LBBW's subordinated debt is rated two notches below the VR to reflect loss severity that is in line with Fitch's baseline approach.

OTHER DEBT AND ISSUER RATINGS: RATING SENSITIVITIES

A change in LBBW's short-term ratings would require a change in LBBW's Long-Term IDR of more than one notch.

LBBW's DCR, long term senior preferred and non-preferred debt and deposit ratings are sensitive to a change in LBBW's Long-Term IDR. We could also downgrade these ratings if the sum of senior non-preferred and more junior debt falls below 10% of RWAs.

The rating of LBBW's non-guaranteed Tier 2 subordinated notes is sensitive to a change in the bank's VR. The ratings of the grandfathered state-guaranteed senior unsecured and Tier 2 subordinated notes are sensitive to adverse changes in Fitch's view of Baden Wuerttemberg's creditworthiness, which is closely linked to that of Germany.

VR ADJUSTMENTS

The business profile score of 'bbb' is below the 'a' implied category score, due to the following adjustment reason: business model (negative)

The asset quality score of 'bbb+' is below the 'aa' implied category score, due to the following adjustment reason: concentrations (negative)

The capitalisation and leverage score of 'bbb+' is below the 'a' implied category score, due to the following adjustment reason: internal capital generation and growth (negative)

The funding and liquidity score of 'bbb+' is below the 'a' implied category score, due to the following adjustment reason: deposit structure (negative)

Best/Worst Case Rating Scenario

International scale credit ratings of Financial Institutions and Covered Bond 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, visit <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 ratings are driven by potential support from SFG.

LBBW's grandfathered state-guaranteed senior unsecured and Tier 2 subordinated notes are linked to Fitch's assessment of Baden Wuerttemberg's creditworthiness and, by extension, to Germany's ratings.

ESG Considerations

Unless otherwise disclosed in this section, the highest level of ESG credit relevance is a score of '3'. This means ESG issues are credit-neutral or have only a minimal credit impact on the entity, either due to their nature or the way in which they are being managed by the entity. For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com/esg

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Rating Actions

ENTITY/DEBT	RATING		RECOVERY	PRIOR
Landesbank Baden- Wuerttemberg	LT IDR	A- 	Affirmed	A- 
	ST IDR	F1	Affirmed	F1
	Viability	bbb+	Upgrade	bbb
	DCR	A(dcr)	Affirmed	A(dcr)
	Shareholder Support	a-	Affirmed	a-

ENTITY/DEBT	RATING		RECOVERY	PRIOR
• senior unsecured ^{LT}	AAA		Affirmed	AAA
• subordinated	AAA		Affirmed	AAA
• Senior non-preferred ^{LT}	A-		Affirmed	A-
• subordinated	BBB-		Upgrade	BB+
• long-term deposits ^{LT}	A		Affirmed	A
• Senior preferred ^{LT}	A		Affirmed	A
• short-term deposits ST	F1		Affirmed	F1
• Senior preferred ST	F1		Affirmed	F1

RATINGS KEY OUTLOOK WATCH

POSITIVE



RATINGS KEY OUTLOOK WATCH

NEGATIVE	●	◊
EVOLVING	◊	◆
STABLE	○	

Applicable Criteria

[Bank Rating Criteria \(pub.07 Sep 2022\) \(including rating assumption sensitivity\)](#)

Additional Disclosures

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