MOODY'S INVESTORS SERVICE

Credit Opinion: Sparkassen-Finanzgruppe

Global Credit Research - 20 Feb 2014

Germany

Ratings

Category	**Moody's Rating**
Outlook	Stable
Bank Financial Strength	C+
Baseline Credit Assessment	a2
Adjusted Baseline Credit Assessment	a2
Corporate Family Rating -Dom Curr	Aa2

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Key Indicators

Sparkassen-Finanzgruppe (Consolidated Financials)[1]

	[2]**12-12**	[2]**12-11**	[2]**12-10**	[2]**12-09**	[2]**12-08**	**Avg.**
Total Assets (EUR million)	**2,426,756.0**	**2,453,461.0**	**2,601,695.0**	**2,582,783.0**	**2,684,968.0**	[3]**-2.5**
Total Assets (USD million)	**3,199,414.6**	**3,184,948.0**	**3,490,287.2**	**3,705,624.2**	**3,732,232.4**	[3]**-3.8**
Tangible Common Equity (EUR million)	**140,371.0**	**123,323.0**	**122,240.0**	**126,678.0**	**115,307.0**	[3]**5.0**
Tangible Common Equity (USD million)	**185,063.9**	**160,091.1**	**163,990.3**	**181,750.1**	**160,282.2**	[3]**3.7**
Net Interest Margin (%)	**1.4**	**1.4**	**1.4**	**1.3**	**1.3**	[4]**1.3**
PPI / Average RWA (%)	**1.5**	**1.5**	**1.5**	**1.4**	**1.2**	[5]**1.4**
Net Income / Average RWA (%)	**0.2**	**0.2**	**0.3**	**-0.4**	**-0.4**	[5]**0.0**
(Market Funds - Liquid Assets) / Total Assets (%)	**16.5**	**17.3**	**18.2**	**19.7**	**19.5**	[4]**18.2**
Core Deposits / Average Gross Loans (%)	**97.4**	**94.5**	**95.2**	**93.8**	**94.2**	[4]**95.0**
Tier 1 Ratio (%)	**13.3**	**11.5**	**10.9**	**10.1**	**8.8**	[5]**10.9**
Tangible Common Equity / RWA (%)	**13.9**	**11.8**	**11.6**	**10.8**	**9.2**	[5]**11.5**
Cost / Income Ratio (%)	**62.4**	**61.2**	**60.5**	**61.6**	**64.2**	[4]**62.0**

Source: Moody's

[1] All figures and ratios are adjusted using Moody's standard adjustments [2] Basel II; LOCAL GAAP [3] Compound Annual Growth Rate based on LOCAL GAAP reporting periods [4] LOCAL GAAP reporting periods have been used for average calculation [5] Basel II & LOCAL GAAP reporting periods have been used for average calculation

Opinion

SUMMARY RATING RATIONALE

We assign a corporate family rating (CFR) of Aa2 to Sparkassen-Finanzgruppe (S-Finanzgruppe), Germany's

Savings Banks Finance Group, which benefits from a three-notch uplift from its a2 baseline credit assessment (BCA) as a result of our assumption of a very high probability of external support by (1) regional and local governments ; and (2) systemic support from the German government.

We assign a standalone bank financial strength rating (BFSR) of C+ to S-Finanzgruppe, which is equivalent to a BCA of a2 and exceeds the asset-weighted average BCA of rated German banks by five notches. The BFSR is supported by the savings banks' very strong and deeply entrenched franchises in their regional retail banking markets in Germany, demonstrated by high and well-defended market shares as well as their strong brand value and low risk profiles. The rating also captures the weaker business profiles of the Landesbanken (regional public-sector banks) which continue to benefit from the cross-sector joint liability scheme (Haftungsverbund).

The major members of this group of public-sector banks are the 422 (as of year-end 2012) German regional savings banks ("savings banks") through their regional associations, the Landesbanken and DekaBank Deutsche Girozentrale (DekaBank, deposits A1 stable/Prime-1 BFSR C-/BCA baa2 stable). The majority of the members of S-Finanzgruppe are organised in the German Savings Banks Association (Deutscher Sparkassen-und Giroverband or DSGV).

In assigning the BFSR and CFR to S-Finanzgruppe, we assess the group as if it operated as a single entity. This approach takes into consideration the cohesion and solidarity within S-Finanzgruppe - particularly between the savings banks - as well as the high level of co-operation amongst the members. The recent confirmation of zero risk-weightings for mutualist intra-group exposures by German regulator BaFin further underpins this view. However, the members of this group do not constitute a single economic entity with centralised management and control at the group level. The BFSR and CFR do not apply to individual members of the group, but only to the creditworthiness of the group as a whole.

Rating Drivers

- Well-entrenched and diversified franchise of the savings banks contrasts with the fragility of several Landesbanken

- Profitability is under pressure from low interest rates and rising costs

- Liquidity profile benefits from strong access to the German depositor base

- Capitalisation is solid with public sector banks on track to comply with Basel III regulation

- Key risk drivers for asset quality reflect the medium term challenges of the German economy, while some risk from international exposures of Landesbanken remains

Rating Outlook

The outlook on the ratings is stable

What Could Change the Rating - Up

There is currently no upside pressure on the ratings, given the vulnerability of several of the Landesbanken and uncertainties regarding their future performance.

What Could Change the Rating - Down

Downward pressure on S-Finanzgruppe's BFSR could mainly originate from a negative trend in its market positions in retail banking that might be triggered by failure to keep pace with market developments in IT infrastructure or with the relative cost positions of key competitors

A weakening in the cohesion of the group and solidarity amongst the members could also have negative implications for the long-term rating. Any further support actions that become necessary for the group's larger members could critically test the group's commitment to the existing mutual-support mechanisms.

DETAILED RATING CONSIDERATIONS

WELL-ENTRENCHED AND DIVERSIFIED FRANCHISE OF THE SAVINGS BANKS CONTRASTS WITH THE FRAGILITY OF SEVERAL LANDESBANKEN

S-Finanzgruppe's franchise is one of the strongest in the German market, driven largely by the positioning of the local savings banks. With around 50 million customers and leading market shares of approximately 39% for deposits and 34% for residential mortgage lending, the savings banks benefit from their very solid and deeply entrenched franchises in their regional retail and SME banking markets and a strong brand value. Our assessment also reflects major challenges for some of the Landesbanken franchises, which account for approximately 50% of the assets of the total group.

Whilst S-Finanzgruppe maintained its market share in lending at 36% (loans to domestic non-banks, Bundesbank data), it recorded a relative reduction in deposits to 34% in 2012 from 37% in 2009, mainly driven by a lower market share in corporate deposits. Since 2007, large support measures have been necessary in order to either stabilise or unwind four of the (formerly) eight Landesbanken groups. The affected banks remain under the scrutiny of the EC to adapt their business models and unwind or divest major portions of their assets, implying significant challenges.

PROFITABILITY IS UNDER PRESSURE FROM LOW INTEREST RATE ENVIRONMENT AND RISING COSTS

During 2013-14, we expect persistent pressure on interest income driven by the low interest environment to offset any progress in cost reduction. As savings banks continue to operate through an extensive branch network - and as their organisational structure remains fragmented - the potential for achieving economies of scale is limited.

The sector has continued to post strong aggregate results with pre-tax profits at EUR5.5 billion in 2012 after EUR5.7 billion 2011 under local GAAP. Pre-provision income was at EUR15.7 billion after EUR16.1 billion the year before. We note in particular that the sector has continued to build EUR6.1 billion capital reserves according to section 340g of the German Commercial Code (HGB).

However, while loans to customers grew by 1.2%, net interest income fell by 4.5% in 2012, illustrating the pressure on the net interest margin (calculated as net interest income divided by loans and advances to non-banks) which fell to 2.7% from 2.9% the year before. The decline is partly driven by the large share of deposits which account for 51% of the group's balance sheet. The other factor is the deleveraging at the Landesbanken which run off major parts of their non-core but higher-yielding portfolios (as required from three Landesbanken by the EC in compensation for state aid). S-Finanzgruppe efficiency metrics compare less favourably with its international peers and were under pressure in 2012 as total costs rose 3.2% year-on-year.

LIQUIDITY PROFILE BENEFITS FROM STRONG ACCESS TO THE GERMAN DEPOSITOR BASE

The solid funding profile of the savings banks benefits strongly from their prime access to German deposits and is a key strength of the sector. Nonetheless, the Landesbanken may face refinancing risk during the period 2014-15 when the bulk of their legacy `grandfathered' debt (which was EUR243 billion at year-end 2012) will mature. At the same time, we note significant potential for the savings banks to use their substantial mortgage books for secured funding in the capital market.

Savings banks' deposits amounted to EUR799 billion as of year-end 2012, which compares with EUR696 billion in loans. The majority of the EUR103 billion excess funding is lent on to the Landesbanken, thereby helping to close their EUR144 billion funding gap (i.e., the difference between EUR350 billion in deposits and EUR494 billion in loans, as of December 2012). The Landesbanken continue to show a degree of wholesale funding dependence.

At the same time, the Landesbanken deleveraging has resulted in a reduced dependence on interbank borrowings (EUR317 billion at year-end 2012, down from EUR542 billion in 2008) and securitised liabilities (EUR305 billion, down from EUR440 billion). S-Finanzgruppe's Market Funds Ratio (MFR) - defined as market funds minus liquid assets as a percentage of total assets - has gradually declined to 16.5% at year-end 2012 (2009: 19.7%), illustrating the progress at the Landesbanken.

CAPITALISATION IS SOLID WITH PUBLIC-SECTOR BANKS ON TRACK TO COMPLY WITH BASEL III REGULATION

The aggregate financial fundamentals of the savings banks are underpinned by strong total capitalisation (15.9%, as of year-end 2012) and limited leverage (7.0%, according to Bundesbank data). We expect the savings banks to be able to absorb considerable shocks, partly owing to the sizeable undisclosed, fully taxed reserves that they put aside (and include in Tier 2 capital) under local GAAP (section 340f of the German Commercial Code (HGB). In our view, Tier 2 treatment of such reserves is conservative, as they are of similar quality to that of common equity. Due to the high quality of their Tier 1 capital and limited trading activities, we believe that the savings banks have sufficient capital buffer to manage the transition to Basel III.

Despite our rating assignment to the entire S-Finanzgruppe, it is important to note that capital cannot be freely allocated to single members within S-Finanzgruppe, and that the risk of renewed cases of distress due to capital shortfalls cannot be ruled out. Also, we consider that there is limited political appetite for further capital injections. The Landesbanken have also improved regulatory and economic capitalisation, but display a riskier business profile and higher leverage, which renders them more vulnerable to event risk or any renewed market disruption.

At year-end 2012, the savings banks' Tier 1 ratio was at 12.5% (up from 10.5% at year-end 2011). At year-end 2012, the savings banks had EUR20.2 billion of Tier 2 capital, part of which we consider constitutes undisclosed reserves as discussed above. Significant strengthening of the Landesbanken quality of capital was achieved during 2012 as several banks addressed the previously high content of hybrid capital in order to comply with raised core Tier 1 targets set by the European Banking Authority (EBA). With a Tier 1 ratio of 14% at year-end 2012, the reported regulatory capitalisation of the Landesbanken nearly doubled since 2007, also accounting for risk shields. We consider such shields to be low-quality (capital-substituting) instruments given (1) their costs, which need to be paid regardless of a bank's profitability; and (2) the fact that these instruments cannot be reallocated towards new business.

Most German savings banks do not use the Internal Ratings Based Approach which would allow them to report a lower risk-weighted asset (RWA) base.

KEY RISK DRIVERS FOR ASSET QUALITY REFLECT THE MEDIUM TERM CHALLENGES OF THE GERMAN ECONOMY, WHILE SOME RISK FROM INTERNATIONAL EXPOSURES OF LANDESBANKEN REMAINS

The group remains vulnerable in the context of its sizeable commercial real estate and ship-financing exposures; the latter may cause elevated credit losses during 2014-15. The Landesbanken are also exposed to diverse international lending and asset-based finance activities as well as large investment portfolios, which have led to major valuation and credit losses during the global financial crisis, even if exposures have been reduced significantly since the onset of the crisis.

S-Finanzgruppe's risk profile primarily reflects that of the German economy. Risk concentrations in export-driven industries, such as the automotive sector, as well as to the cyclical construction sector, are a function of Germany's economic structure. On the positive side, credit conditions currently remain relatively benign. In addition, a high proportion of the loan book of the savings banks is backed by conservatively valued residential property, particularly in retail business, where most loans have loan-to-value ratios below 80%, partly due to the relatively stable conditions in the German residential property market to date.

Global Local Currency Deposit Rating (Joint Default Analysis)

S-Finanzgruppe's Aa2 CFR is based on its a2 BCA (equivalent to the C+ standalone BFSR), and our view that the probability of support in the event of need is very high, both from (1) the group's governing public-sector bodies (amongst them the various German federal states and local municipalities); and (2) the government of the Federal Republic of Germany (Aaa, negative). In our opinion, the levels of support are closely interlinked for public-sector banks, and therefore we use a unified approach of applying support uplift from multiple sources, anticipating concerted support solutions in case of need.

Our assessment of a very high probability of support for S-Finanzgruppe from the regional and local governments is based on our view that the individual members of the group will benefit from support from the relevant public-sector bodies (mostly federal states and municipalities) in the event of need. In addition to the ownership considerations, the support assessment is also based on the following two additional factors:

(1) The vast majority of the group's members are of vital importance to their respective local retail and SME markets, particularly the savings banks that have leading market positions and strong links to their local economies.

(2) The often significant contribution of the members to the tax revenues of their respective regional and local governments.

Our assessment of a very high probability of systemic support for S-Finanzgruppe is based on the group's significant role in the national payments system and its high importance to the national economy. In addition, we take into account the group's strong deposit and loan market shares in the German market.

ABOUT MOODY'S BANK RATINGS

Bank Financial Strength Rating

Moody's Bank Financial Strength Ratings (BFSRs) represent Moody's opinion of a bank's intrinsic safety and soundness and, as such, exclude certain external credit risks and credit support elements that are addressed by Moody's Bank Deposit Ratings. BFSRs do not take into account the probability that the bank will receive such external support, nor do they address risks arising from sovereign actions that may interfere with a bank's ability to honor its domestic or foreign currency obligations. Factors considered in the assignment of BFSRs include bank-specific elements such as financial fundamentals, franchise value, and business and asset diversification. Although BFSRs exclude the external factors specified above, they do take into account other risk factors in the bank's operating environment, including the strength and prospective performance of the economy, as well as the structure and relative fragility of the financial system, and the quality of banking regulation and supervision.

Corporate Family Rating

Moody's Corporate Family Rating (CFR) for banking groups (public sector, mutualist or cooperative) is an opinion of a banking group's or association's ability to honour its financial obligations, and is assigned to a banking group as if it had a single class of debt and a single, consolidated, legal-entity structure. A CFR does not reference an obligation or class of debt and thus does not reflect priority of claim. The CFR does not apply to individual members of the group, but only to the creditworthiness of the group as a whole.

According to Moody's joint default analysis (JDA) methodology, the Corporate Family Rating of a banking group is determined by the incorporation of external elements of support into the bank's Baseline Credit Assessment. In calculating the Corporate Family Rating for a banking group, the JDA methodology also factors in the rating of the support provider, in the form of the local currency deposit ceiling for a country, Moody's assessment of the probability of systemic support for the bank in the event of a stress situation and the degree of dependence between the issuer rating and the Local Currency Deposit Ceiling.

Global Local Currency Deposit Rating

A deposit rating, as an opinion of relative credit risk, incorporates the BFSR as well as Moody's opinion of any external support. Specifically, Moody's Bank Deposit Ratings are opinions of a bank's ability to repay punctually its deposit obligations. As such, they are intended to incorporate those aspects of credit risk relevant to the prospective payment performance of rated banks with respect to deposit obligations, which includes: intrinsic financial strength, sovereign transfer risk (in the case of foreign currency deposit ratings), and both implicit and explicit external support elements. Moody's Bank Deposit Ratings do not take into account the benefit of deposit insurance schemes which make payments to depositors, but they do recognize the potential support from schemes that may provide assistance to banks directly.

According to Moody's joint default analysis (JDA) methodology, the global local currency deposit rating of a bank is determined by the incorporation of external elements of support into the bank's Baseline Credit Assessment. In calculating the Global Local Currency Deposit rating for a bank, the JDA methodology also factors in the rating of the support provider, in the form of the local currency deposit ceiling for a country, Moody's assessment of the probability of systemic support for the bank in the event of a stress situation and the degree of dependence between the issuer rating and the Local Currency Deposit Ceiling.

National Scale Rating

National scale ratings are intended primarily for use by domestic investors and are not comparable to Moody's globally applicable ratings; rather they address relative credit risk within a given country. A Aaa rating on Moody's National Scale indicates an issuer or issue with the strongest creditworthiness and the lowest likelihood of credit loss relative to other domestic issuers. National Scale Ratings, therefore, rank domestic issuers relative to each other and not relative to absolute default risks. National ratings isolate systemic risks; they do not address loss expectation associated with systemic events that could affect all issuers, even those that receive the highest ratings on the National Scale.

Foreign Currency Deposit Rating

Moody's ratings on foreign currency bank obligations derive from the bank's local currency rating for the same class of obligation. The implementation of JDA for banks can lead to high local currency ratings for certain banks, which could also produce high foreign currency ratings. Nevertheless, it should be noted that foreign currency deposit ratings are in all cases constrained by the country ceiling for foreign currency bank deposits. This may result in the assignment of a different, and typically lower, rating for the foreign currency deposits relative to the bank's rating for local currency obligations.

Foreign Currency Debt Rating

Foreign currency debt ratings are derived from the bank's local currency debt rating. In a similar way to foreign currency deposit ratings, foreign currency debt ratings may also be constrained by the country ceiling for foreign currency bonds and notes; however, in some cases the ratings on foreign currency debt obligations may be allowed to pierce the foreign currency ceiling. A particular mix of rating factors are taken into consideration in order to assess whether a foreign currency bond rating pierces the country ceiling. They include the issuer's global local currency rating, the foreign currency government bond rating, the country ceiling for bonds and the debt's eligibility to pierce that ceiling.

About Moody's Bank Financial Strength Scorecard

Moody's bank financial strength model (see scorecard below) is a strategic input in the assessment of the financial strength of a bank, used as a key tool by Moody's analysts to ensure consistency of approach across banks and regions. The model 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

Sparkassen-Finanzgruppe

Rating Factors [1]	**A**	**B**	**C**	**D**	**E**	**Total Score**	**Trend**
Qualitative Factors (50%)						**C+**	
Factor: Franchise Value						**B**	**Neutral**
Market share and sustainability	**x**						
Geographical diversification		**x**					
Earnings stability			**x**				
Earnings Diversification [2]							
Factor: Risk Positioning						**D+**	**Neutral**
Corporate Governance [2]							
- Ownership and Organizational Complexity							
- Key Man Risk							
- Insider and Related-Party Risks							
Controls and Risk Management			**x**				
- Risk Management			x				
- Controls			x				
Financial Reporting Transparency					**x**		
- Global Comparability					x		
- Frequency and Timeliness					x		
- Quality of Financial Information					x		
Credit Risk Concentration			**x**				
- Borrower Concentration			x				
- Industry Concentration			x				
Liquidity Management		**x**					
Market Risk Appetite			**x**				
Factor: Operating Environment						**B**	**Neutral**
Economic Stability			**x**				
Integrity and Corruption		**x**					
Legal System	**x**						
Financial Factors (50%)						**C**	
Factor: Profitability						**D**	**Improving**
PPI % Average RWA (Basel II)			1.53%				
Net Income % Average RWA (Basel II)					0.23%		

Factor: Liquidity						C+	Neutral
(Market Funds - Liquid Assets) % Total Assets				17.30%			
Liquidity Management		x					
Factor: Capital Adequacy						A	Neutral
Tier 1 Ratio (%) (Basel II)	11.90%						
Tangible Common Equity % RWA (Basel II)	12.46%						
Factor: Efficiency						C	Improving
Cost / Income Ratio			61.37%				
Factor: Asset Quality						D+	Neutral
Problem Loans % Gross Loans			4.81%				
Problem Loans % (Equity + LLR)				38.58%			
Lowest Combined Financial Factor Score (15%)						D+	
Economic Insolvency Override						Neutral	
Aggregate BFSR Score						C	
Aggregate BCA Score						a3	
Assigned BFSR						C+	
Assigned BCA						a2	

[1] - Where dashes are shown for a particular factor (or sub-factor), the score is based on non-public information.
[2] - A blank score under Earnings Diversification or Corporate Governance indicates the risk is neutral.

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