MOODY'S
INVESTORS SERVICE

# Credit Opinion: Sparkassen-Finanzgruppe

Global Credit Research - 13 Jan 2016

*Germany*

## Ratings

| Category | Moody's Rating |
|---|---|
| Outlook | Stable |
| Baseline Credit Assessment | a2 |
| Adjusted Baseline Credit Assessment | a2 |
| Corporate Family Rating -Dom Curr | Aa2 |

## Contacts



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## Key Indicators

**Sparkassen-Finanzgruppe (Consolidated Financials)[1]**

| | [2]12-14 | [3]12-13 | [3]12-12 | [3]12-11 | [3]12-10 | Avg. |
|---|---|---|---|---|---|---|
| Total Assets (EUR billion) | 2,251.9 | 2,264.3 | 2,426.8 | 2,453.5 | 2,601.7 | [4]-3.5 |
| Total Assets (USD billion) | 2,724.9 | 3,120.1 | 3,199.4 | 3,184.9 | 3,490.3 | [4]-6.0 |
| Net Interest Margin (%) | 1.5 | 1.4 | 1.4 | 1.4 | 1.4 | [5]1.4 |
| PPI / Average RWA (%) | 1.4 | 1.4 | 1.5 | 1.5 | 1.5 | [6]1.4 |
| Net Income / Tangible Assets (%) | 0.0 | 0.1 | 0.1 | 0.1 | 0.1 | [5]0.1 |
| Cost / Income Ratio (%) | 67.6 | 66.1 | 62.4 | 61.2 | 60.5 | [5]63.6 |
| Market Funds / Tangible Banking Assets (%) | 31.1 | 33.2 | 33.6 | 35.7 | 38.5 | [5]34.4 |
| Liquid Banking Assets / Tangible Banking Assets (%) | 16.2 | 17.4 | 18.5 | 20.0 | 22.0 | [5]18.8 |
| Gross loans / Due to customers (%) | -- | -- | -- | -- | 104.3 | [5]104.3 |

Source: Moody's

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

## Opinion

### SUMMARY RATING RATIONALE

We assign a Aa2 corporate family rating (CFR) to S-Finanzgruppe, with a stable outlook; we also assign an a2 baseline credit assessment (BCA). In assigning the BCA and CFR to S-Finanzgruppe, we assess the group as though 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. However, the members of this group do not constitute a single economic entity that functions with centralised management and control at the group level. The BCA and CFR apply only to the creditworthiness of the group as a whole rather than to individual members of the group.

S-Finanzgruppe's Aa2 CFR and the stable outlook reflect (1) the group's a2 BCA; (2) the results of our Advanced Loss Given Failure (LGF) analysis; and (3) our moderate government support assumptions resulting in one notch of uplift.

S-Finanzgruppe's BCA of a2 reflects the savings banks' low-risk profiles, overall improving capitalisation and strong funding situation. However, the BCA also captures the weaker business profiles of the Landesbanken (regional public-sector banks), and concentration risk from these banks with a combined share in total assets of 47% of S-Finanzgruppe.

The major members of this group of public-sector banks are the 414 German regional savings banks (as of 15 June 2015) through their regional associations, the Landesbanken and DekaBank Deutsche Girozentrale (DekaBank, deposits Aa3 positive/ senior unsecured Aa3 negative, BCA baa2). The members of S-Finanzgruppe are organised in the German Savings Banks Association (Deutscher Sparkassen-und Giroverband or DSGV).

RATING DRIVERS

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

- Capitalisation is solid

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

- S-Finanzgruppe's liquidity profile benefits from strong access to the German depositor base

- The characteristics of S-Finanzgruppe's balance sheet as a single class of debt

- Moderate probability of government support

**Rating Outlook**

The outlook on the Aa2 CFR is stable.

WHAT COULD CHANGE THE RATING - UP

Upward pressure on S-Finanzgruppe's CFR could arise from upward pressure on its BCA following, for instance, a significant and sustained improvement in profitability of the sector.

WHAT COULD CHANGE THE RATING - DOWN

Downward pressure on S-Finanzgruppe's CFR could originate from pressure on its BCA, driven, for instance, by a deterioration in profitability stemming from the persistently low-yield environment resulting in declining capitalisation. A support scenario for individual member banks, in which necessary funds significantly compress the sector's overall capitalization, could exert downward pressure on the rating.

**DETAILED RATING CONSIDERATIONS**

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

The group's BCA benefits from its `Very 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.

S-Finanzgruppe's Asset Risk score of a3 primarily reflects the average risk profile of the German households and corporate sector throughout the economic cycle. Risk concentrations in export-driven industries, such as the automotive sector, as well as the cyclical construction sector, are a function of Germany's economic structure, with the overall size and diversification of the loan book providing a positive effect.

Credit conditions currently remain relatively benign. In addition, a high proportion of the savings banks' loan book is backed by conservatively valued residential property, particularly in retail business, where most loans have loan-to-value ratios below 80%, partly because of the relatively stable conditions in the German residential property market to date.

The group remains vulnerable in the context of its sizeable commercial real estate and ship-financing exposures; the latter may continue to cause elevated credit losses during 2015-16. The Landesbanken are also exposed to diverse international lending and asset-based finance activities as well as large, though declining investment portfolios, which 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.

CAPITALISATION IS SOLID

The aggregate financial fundamentals of the savings banks are underpinned by strong total capitalisation (16.6% as of year-end 2014) and limited leverage (8% according to Bundesbank data). We expect that the savings banks will be able to absorb considerable shocks, owing partly to the sizeable undisclosed, fully taxed reserves that they put aside (and include in Tier 2 capital) under local GAAP. Tier 2 treatment of such reserves is conservative, as they are of similar quality to that of common equity.

At year-end 2014, the savings banks' Tier 1 ratio was at 14.5% (up from 13.4% at year-end 2013 and 12.5% at year-end 2012), based on the respective regulatory standards valid. Significant strengthening of the Landesbanken quality of capital was achieved in 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. With a Tier 1 ratio of 14.7% at year-end 2014 (2013: 16.9%), the reported regulatory capitalisation of the Landesbanken doubled since 2007, also accounting for risk shields. We consider such shields to be low-quality (capital-substituting) instruments given (1) their significant 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.

Despite the Capital score of aa3 assigned to the entire S-Finanzgruppe capital cannot be freely allocated to single members within S-Finanzgruppe, and the risk of renewed cases of distress as a result of capital shortfalls cannot be ruled out. 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

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

During 2015-16, we expect that persistent pressure on interest income, driven by the low interest environment, will offset any progress in cost reduction. As the 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.

Nevertheless, the sector has continued to post strong, but declining, aggregate results, with pre-tax profits at EUR3.7 billion in 2014 after EUR4.8 billion 2013 under local GAAP. Over the same period, the group reported pre-provision income of EUR13.0 billion (2013: EUR13.9 billion), reflecting the high quality of capital generation. We note, in particular, that the sector has continued to build EUR5.1 billion capital reserves. This build-up of reserves supports our adjustment for net income, as those reserves are booked as other expenses, with a negative impact on net income, thereby underestimating the capital generation capacity of the sector, which is reflected in the upward adjustment to the group's Profitability score to ba3.

In 2014, net interest income was stable at EUR32.5 billion and the volume of loans granted to customers was flat at EUR1.2 billion. The net interest margin (calculated as net interest income as a proportion of loans and advances to non-banks) remained stable at 2.7%. S-Finanzgruppe's efficiency metrics compare less favourably with those of its international peers, although total costs recorded a modest 1.4% increase year-over-year.

S-Finanzgruppe's market share 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 40% for deposits and 37% for residential mortgage lending, the group benefits from their very strong footprint in their regional retail and small and medium-sized enterprise banking markets, as well as a strong brand value. Our assessment also reflects challenges for some of the Landesbanken franchises, which account for 47% of the assets of the total group.

S-FINANZGRUPPE'S 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. The Landesbanken refinancing risk in 2015 (i.e., when the bulk of their legacy grandfathered debt will mature or has already matured) is contained, given their progress in matching asset maturities for most of the group members. 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.

The savings banks' deposits amounted to EUR837 billion as of year-end 2014, as compared to EUR721 billion in loans. The majority of the EUR116 billion excess funding is lent on to the Landesbanken, thereby helping to close their funding gap (EUR150 billion, as of Dec 2014 when defined as the difference between EUR289 billion in deposits and EUR438 billion in loans). The Landesbanken continue to show a degree of wholesale funding dependence, while at the same time the Landesbanken's deleveraging has resulted in a reduced dependence on interbank borrowings (EUR301 billion at year-end 2014, down from EUR542 billion in 2008) and securitised liabilities (EUR234 billion, down from EUR440 billion). S-Finanzgruppe's Funding Structure score of a1 reflects these positive factors, as well our view that the group benefits from its strong covered bond franchise.

The group's Liquid Resources score of a2 is based on its significant securities portfolio and liquid banking assets.

NOTCHING CONSIDERATIONS

NOTCHING FOR CFR

S-Finanzgruppe represents a conglomerate of diverse financial institutions in Germany. As such, it is not considered a banking group in the context of the European Capital Requirement Regulation. S-Finanzgruppe is therefore not a regulated group, but all of its affiliated institutions are subject to applicable regulation for banks or other financial institutions. As a result, the EU's Bank Resolution and Recovery Directive, which we consider to be an Operational Resolution Regime, does not apply to S-Finanzgruppe but only to its member banking institutions individually. Thus, our CFR on S-Finanzgruppe represents the risk characteristics of a notional single class of debt assumed to fund its aggregate balance sheet. Our Advanced LGF analysis suggests that this notional instrument would face very low losses in resolution. This results in two notches of uplift to the CFR relative to S-Finanzgruppe's BCA of a2, and hence a Preliminary Rating Assessment of aa3.

GOVERNMENT SUPPORT

The implementation of the Bank Resolution and Recovery Directive has caused us to reconsider the potential for government support to benefit certain creditors. We now expect a moderate probability of government support, resulting in a one-notch uplift to the Preliminary Rating Assessment for the assigned CFR of Aa2. Our revised government support assumption reflect the size and high systemic relevance at the domestic level of S-Finanzgruppe.

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

**Sparkassen-Finanzgruppe**

| **Macro Factors** | |
|---|---|
| **Weighted Macro Profile** | **Very 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* | -- | -- | ←→ | a3 | Quality of assets | |
| **Capital** | | | | | | |
| *TCE / RWA* | -- | -- | ←→ | aa3 | | |
| **Profitability** | | | | | | |
| *Net Income / Tangible Assets* | 0.0% | b2 | ↑ | ba3 | Loan loss charge coverage | Earnings quality |
| **Combined Solvency Score** | | ba2 | | a3 | | |
| **Liquidity** | | | | | | |
| **Funding Structure** | | | | | | |
| *Market Funds / Tangible Banking Assets* | 31.1% | baa3 | ←→ | a1 | Market funding quality | Deposit quality |
| **Liquid Resources** | | | | | | |
| *Liquid Banking Assets / Tangible Banking Assets* | 16.2% | baa2 | ←→ | a2 | Quality of liquid assets | |
| **Combined Liquidity Score** | | baa3 | | a1 | | |

| | |
|---|---|
| **Financial Profile** | **a2** |

| **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 | **a1 - a3** |
| **Assigned BCA** | **a2** |
| Affiliate Support notching | **0** |
| **Adjusted BCA** | **a2** |

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