MOODY'S
INVESTORS SERVICE

Credit Opinion: Sparkassen-Finanzgruppe

Global Credit Research - 24 Mar 2015

Germany

Ratings

Category	Moody's Rating
Outlook	Stable
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]**12-13**	[2]**12-12**	[2]**12-11**	[2]**12-10**	[2]**12-09**	**Avg.**
Total Assets (EUR million)	**2,264,317.0**	**2,426,756.0**	**2,453,461.0**	**2,601,695.0**	**2,582,783.0**	[3]**-3.2**
Total Assets (USD million)	**3,120,097.3**	**3,199,414.6**	**3,184,948.0**	**3,490,287.2**	**3,705,624.2**	[3]**-4.2**
Tangible Common Equity (EUR million)	**146,398.0**	**140,371.0**	**123,323.0**	**122,240.0**	**126,678.0**	[3]**3.7**
Tangible Common Equity (USD million)	**201,727.9**	**185,063.9**	**160,091.1**	**163,990.3**	**181,750.1**	[3]**2.6**
Tangible Common Equity / Risk Weighted Assets (%)	**15.4**	**13.9**	**11.8**	**11.6**	**10.8**	[4]**12.7**
Net Interest Margin (%)	**1.4**	**1.4**	**1.4**	**1.4**	**1.3**	[5]**1.4**
PPI / Average RWA (%)	**1.5**	**1.5**	**1.5**	**1.5**	**1.4**	[4]**1.5**
Net Income / Tangible Assets (%)	**0.1**	**0.1**	**0.1**	**0.1**	**-0.2**	[5]**0.0**
Cost / Income Ratio (%)	**64.5**	**63.6**	**61.2**	**60.5**	**61.6**	[5]**62.3**
Market Funds / Tangible Banking Assets (%)	**33.2**	**33.6**	**35.7**	**38.5**	**42.9**	[5]**36.8**
Liquid Banking Assets / Tangible Banking Assets (%)	**17.4**	**18.5**	**20.0**	**22.0**	**25.1**	[5]**20.6**
Gross Loans / Total Deposits (%)	**102.4**	**103.3**	**105.3**	**104.3**	**106.3**	[5]**104.3**

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] Basel II & LOCAL GAAP reporting periods have been used for average calculation [5] LOCAL GAAP reporting periods have been used for average calculation

Opinion

SUMMARY RATING RATIONALE

On 17 March, we affirmed the corporate family rating (CFR) of Aa2 to Sparkassen-Finanzgruppe (S-Finanzgruppe), Germany's Savings Banks Finance Group, and changed the outlook to stable from negative. The bank's standalone baseline credit assessment (BCA) of a2 was not affected by this rating action and remained unchanged.

The affirmation was prompted by the expected effects on S-Finanzgruppe's CFR resulting from the implementation of our new methodology for rating banks globally, as well as considerations on government support, deemed lower in an environment with an operational resolution regime.

For S-Finanzgruppe, the combined effects of moderate government support and the special characteristics of the CFR have a neutralising effect. A CFR is assigned to a corporate family as if the entity had a single class of debt., This has positive effects stemming from the introduction of our Loss Given Failure (LGF) analysis, which takes into account the severity of loss faced by the different liability classes across the liability structure Under the CFR assumption of a single class of debt a simulated LGF analysis indicates a very low loss-given-failure, which compensates for an expected reduction in our government support assumption.

We assign a standalone baseline credit assessment (BCA) of a2 to S-Finanzgruppe. The BCA is supported by the savings banks' very strong footprint 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).

In assigning the BCA 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. 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.

The major members of this group of public-sector banks are the 416 (as of year-end 2014) German regional savings banks ("savings banks") through their regional associations, the Landesbanken and DekaBank Deutsche Girozentrale (DekaBank, deposits A1 under review for upgrade). The majority of the members of S-Finanzgruppe are organised in the German Savings Banks Association (Deutscher Sparkassen-und Giroverband or DSGV).

S-FINANZGRUPPE IS SUPPORTED BY A VERY STRONG- MARCO PROFILE

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.

Rating Drivers

- Key risk drivers for asset quality reflect the medium-term challenges of the German economy, while some risk from international exposures of Landesbanken 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 CFR assigned to S-Finanzgruppe reflects the characteristics of its balance sheet as a single class of debt. The pure volume effects result in a very low expected loss rate, providing two notches of uplift from the BCA

- Moderate probability of government support provides a one-notch uplift to the CFR from the BCA.

Rating Outlook

The outlook on the Aa2 CFR is stable.

What Could Change the Rating - Up

Upward pressure on S-Finanzgruppe's CFR could primarily originate from upward pressure on its BCA, for instance by a significant improved profitability of the sector.

What Could Change the Rating - Down

Future downward pressure on S-Finanzgruppe's CFR could mainly originate from pressure on its BCA, driven, for instance, by a deterioration in profitability stemming from the persistently low yield environment. A support scenario for individual member banks in which necessary funds significantly compress the sector's overall capitalisation, 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 INTERNATIONAL EXPOSURES OF LANDESBANKEN PERSIST

S-Finanzgruppe's Asset Risk score of a3 primarily reflects the average risk profile of the German households and corporate sector. 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, 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 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 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 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 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.

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 with a remit to adapt their business models and unwind or divest major portions of their assets, implying significant challenges, though we note major progress.

CAPITALISATION IS SOLID

The aggregate financial fundamentals of the savings banks are underpinned by strong total capitalisation (16.4%, as of year-end 2013) and limited leverage (7.6%, 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. Given 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.

At year-end 2013, the savings banks' Tier 1 ratio was at 13.4% (up from 12.5% at year-end 2012). At year-end 2013, the savings banks had EUR18.2 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 16.9% at year-end 2013, the reported regulatory capitalisation of the Landesbanken more than 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.

Despite the Capital score of aa3 assigned to the entire S-Finanzgruppe - based on a tangible comment equity ratio (TCE) of 15.2% - 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 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. However, we note that all sector members that were reviewed in the ECB's comprehensive assessment in 2014 did pass, with no additional capital needs signalled.

The use of the Internal Ratings Based (IRB) approach would enable the savings banks to report a lower risk-weighted asset (RWA) base, but most of these banks do not use the IRB approach for measuring credit risk.

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

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 38% for deposits and 35% for residential mortgage lending, the savings banks benefit from their very strong footprint in their regional retail and SME banking markets and a strong brand value. Our assessment also reflects challenges for some of the Landesbanken franchises, which account for 48% of the assets of the total group.

During 2015-16, 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.

Nevertheless, the sector has continued to post strong aggregate results, with pre-tax profits at EUR4.9 billion in 2013 after EUR5.5 billion 2012 under local GAAP. Over the same period the group reported pre-provision income of EUR14.7 billion (2012: EUR15.1 billion), reflecting the quality of capital generation. We note, in particular, that the sector has continued to build EUR3.7 billion capital reserves according to section 340g of the HGB. This build-up of reserves supports our adjustment for loan loss coverage, as those reserves are booked as loan loss reserves, 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 by 3 notches to ba2.

In 2013, however, the volume of loans granted to customers fell by 3%, and net interest income declined by 2.7%. The net interest margin (calculated as net interest income as a proportion of loans and advances to non-banks) remained stable at 2.8%. S-Finanzgruppe efficiency metrics compare less favourably with its international peers, though total costs recorded a modest 1% increase year-on-year. Factors contributing to this increase are the large share of deposits which account for 51% of the group's balance sheet and the sustained deleveraging at the Landesbanken which run off major parts of their non-core but higher-yielding portfolios (as required in the case of three Landesbanken by the EC in compensation for state aid).

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. In our view, the Landesbanken refinancing risk in 2015 (i.e., when the bulk of their legacy `grandfathered' debt will mature) - 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.

Savings banks' deposits amounted to EUR817 billion as of year-end 2013, which compares with EUR708 billion in loans. The majority of the EUR109 billion excess funding is lent on to the Landesbanken, thereby helping to close their EUR143 billion funding gap (i.e., the difference between EUR301 billion in deposits and EUR445 billion in loans, as of December 2013). The Landesbanken continue to show a degree of wholesale funding dependence, while the overall market funding ratio of the group is at around 30%.

At the same time, the Landesbanken deleveraging has resulted in a reduced dependence on interbank borrowings (EUR315 billion at year-end 2013, down from EUR542 billion in 2008) and securitised liabilities (EUR260 billion, down from EUR440 billion). S-Finanzgruppe's Funding Structure score of a1 reflects these 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 (CRR). 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 (BRRD), which we consider to be an Operational Resolution Regime does not apply to S-Finanzgruppe but only to its member banking institutions individually. Given this, 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, because of its large size relative to our assumed loss rate of 8% of tangible banking assets together with assumed residual tangible common equity at failure of 3%. This results in two notches of uplift to the CFR relative to S-Finanzgruppe's BCA of a2, and hence a PRA of aa3.

GOVERNMENT SUPPORT

The implementation of the BRRD 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 PRA 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	15.4%	aa3	←→	aa3		
Profitability						
Net Income / Tangible Assets	0.1%	b2	↑	ba2	Loan loss charge coverage	Earnings quality
Combined Solvency Score		-		a3		
Liquidity						
Funding Structure						
Market Funds / Tangible Banking Assets	33.2%	baa3	←→	a1	Market funding quality	Deposit quality
Liquid Resources						
Liquid Banking Assets / Tangible Banking Assets	17.4%	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**

Instrument Class	Loss Given Failure notching	Additional notching	Preliminary Rating Assessment	Government Support notching	Local Currency rating	Foreign Currency rating

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