

## CREDIT OPINION

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Update

✓ Rate this Research

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# Sparkassen-Finanzgruppe

## Update to credit analysis

### Summary

[Sparkassen-Finanzgruppe's](#) (S-Finanzgruppe) Corporate Family Rating (CFR) is Aa2(stable). We furthermore assign a Baseline Credit Assessment (BCA) and Adjusted BCA of a2 to Germany's largest banking group.

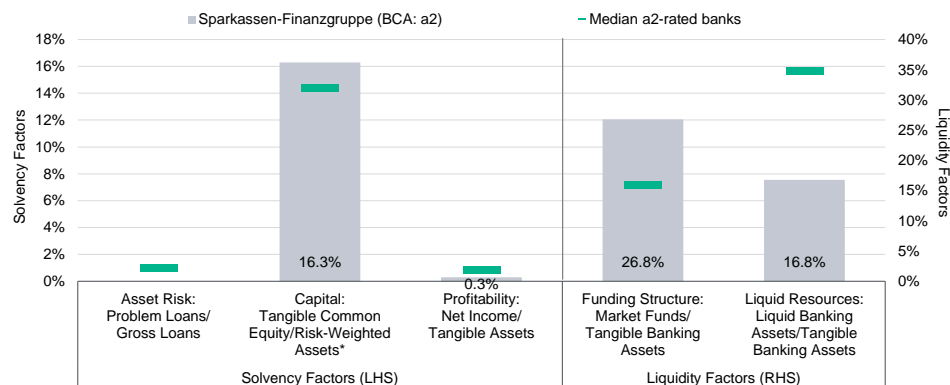
S-Finanzgruppe's Aa2 CFR reflects (1) its a2 BCA; (2) the results of our Advanced Loss Given Failure (LGF) analysis, providing two notches of rating uplift; and (3) our moderate government support assumptions that result in one notch of rating uplift.

S-Finanzgruppe's BCA reflects our expectation of sustained moderate economic growth in Germany which should keep credit risk at benign levels and allows for moderately increasing capitalization from already strong levels. At the same time, it reflects sustained challenges from the low interest rate environment, mostly pressuring the group's smaller member banks' profitability.

In assigning the BCA and CFR to S-Finanzgruppe, we assess the group as if it operates 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 among the members. However, the members of S-Finanzgruppe 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.

Exhibit 1

### Rating Scorecard - Key financial ratios



Note: \*The capital ratio shown is S-Finanzgruppe's Tier 1 ratio at the end of 2017 (latest available figure) as a proxy for its TCE/CET ratio, which is not disclosed.

Source: Moody's Financial Metrics

## Credit strengths

- » S-Finanzgruppe's strong capital provides an ample cushion for unexpected shocks.
- » The group's liquidity benefits from prime access to the German depositors and a balanced loan-to-deposit ratio of around 100%.
- » S-Finanzgruppe's capital support for NORD/LB underpins the reliability of the group's close cohesion, codified in institutional protection schemes (IPS)

## Credit challenges

- » S-Finanzgruppe's profitability is under pressure from low interest rates, with cost controls a key issue.
- » Despite the group's balanced risk profile, tail risks from German Landesbanks' international exposures persists, including international lending to commercial real estate.

## Outlook

- » The outlook on the Aa2 CFR is stable, based on our expectation of a stable fundamental credit profile.

## Factors that could lead to an upgrade

- » Upward pressure on S-Finanzgruppe's CFR could arise from upward pressure on its BCA driven by a significantly and sustainably higher profitability of the sector together with improvements of its asset risk profile through reduced concentration risks.

## Factors that could lead to a downgrade

- » Downward pressure on S-Finanzgruppe's CFR could originate from pressure on its BCA, in particular if the funding and liquidity situation of the S-Finanzgruppe weakens.
- » A support scenario for a number of member banks, in which necessary funds significantly compress the sector's overall capitalisation, could exert downward pressure on the rating.
- » Additionally, a deterioration in Germany's Macro Profile could lead to downward rating pressure.

## Key indicators

Exhibit 2

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

	12-17 <sup>2</sup>	12-16 <sup>2</sup>	12-15 <sup>2</sup>	12-14 <sup>2</sup>	12-13 <sup>3</sup>	CAGR/Avg. <sup>4</sup>
Total Assets (EUR billion)	2,129	2,119	2,158	2,252	2,264	-1.5 <sup>5</sup>
Total Assets (USD billion)	2,557	2,235	2,344	2,725	3,120	-4.9 <sup>5</sup>
Net Interest Margin (%)	-	-	1.5	1.5	1.4	1.5 <sup>6</sup>
PPI / Average RWA (%)	1.3	1.4	1.3	1.3	1.4	1.3 <sup>7</sup>
Net Income / Tangible Assets (%)	0.4	0.3	0.3	0.2	0.1	0.3 <sup>6</sup>
Cost / Income Ratio (%)	68.8	66.8	69.2	69.7	66.1	68.1 <sup>6</sup>
Market Funds / Tangible Banking Assets (%)	26.8	27.1	28.4	31.1	33.2	29.3 <sup>6</sup>
Liquid Banking Assets / Tangible Banking Assets (%)	16.8	14.9	15.1	16.2	17.4	16.1 <sup>6</sup>

[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] May include rounding differences due to scale of reported amounts. [5] Compound Annual Growth Rate (%) based on time period presented for the latest accounting regime. [6] Simple average of periods presented for the latest accounting regime. [7] Simple average of Basel III periods presented.

Source: Moody's Financial Metrics

This publication does not announce a credit rating action. For any credit ratings referenced in this publication, please see the ratings tab on the issuer/entity page on [www.moodys.com](http://www.moodys.com) for the most updated credit rating action information and rating history.

## Profile

S-Finanzgruppe is a German banking group that consists of around 540 independent enterprises, including 385<sup>1</sup> savings banks, six Landesbank groups, the asset manager [DekaBank Deutsche Girozentrale](#) (DekaBank, Aa2 stable, Aa2 stable, baa2)<sup>2</sup>, eight Landesbausparkassen (regional building societies) and 11 primary insurance groups and a number of other financial service companies as of year-end 2017 (latest available figure). S-Finanzgruppe, Germany's largest banking group, held domestic market shares of 28.6% in terms of business volume (excluding derivative financial instruments in the trading portfolio and own bond issues repurchased), 41.9% in terms of corporate lending, 36.9% in terms of private housing construction loans, 21.6% in terms of consumer lending, 39.2% in terms of deposits from private individuals (excluding term deposits for a period of over two years) and 28.2% in terms of deposits from domestic enterprises at YE2017. As of 31 December 2017, S-Finanzgruppe reported total aggregated assets of €2.1 trillion.

The German Savings Banks Association (DSGV) is the umbrella organisation of S-Finanzgruppe. Entities of S-Finanzgruppe are independent and managed on a decentralised basis. Most of the group's savings banks are institutions incorporated under public law and operated under municipal trusteeship.<sup>3</sup>

## Recent developments

On 2 February 2019, Norddeutsche Landesbank GZ (NORD/LB, Baa2/Baa2 review for upgrade, b2 review for upgrade)<sup>4</sup> announced the decisions of its owners to strengthen the bank's capital and re-focus its activities and not to proceed with an alternative option of a joint bid received from two private financial investors. Sparkassen Finanzgruppe's announcement to support NORD/LB underpins the reliability of its IPS and also our current assumptions of a very high probability of affiliate support for savings banks, as well as a high probability of affiliate support for Landesbanks that are not fully owned by Sparkassen Finanzgruppe, such as NORD/LB. For further details please refer to "[Capital injections for NORD/LB are credit positive](#)", published on 4 February 2019.

Hamburg Commercial Bank AG (HCB, Baa2/Baa2 stable, ba2)<sup>5</sup>, former HSH Nordbank AG, is the first former Landesbank, which has been privatized. Since 28 November 2018, the bank is owned by a consortium of private equity funds led by Cerberus Capital Management L.P. and J.C. Flowers & Co. HCB will remain a member of S-Finanzgruppe's institutional protection scheme (IPS) during the three-year transition period until HCB will become a full member of the voluntary deposit guarantee fund for Germany's private banks, subject to a positive assessment of its financial strength at that point by the Bundesverband deutscher Banken (BdB).

## Detailed credit considerations

### Strong capital complemented by additional buffers

Our assigned aa2 Capital score for S-Finanzgruppe reflects the group's solid capitalization which provides substantial buffer against a severe economic downturn. Our assessment takes into account additional capital-equivalent reserves and limitations around capital fungibility within members of the group. At end-2017, S-Finanzgruppe's reported Tier 1 ratio was 16.3%, compared with 15.6% in 2016. The positive development reflects improvements for savings banks, as well as Landesbanks.

We estimate that, at end-2018, German savings banks accounted for around 55% of S-Finanzgruppe's aggregate assets (2017: 56%, 2016: 55%). Over the same time, the banks reported somewhat improved capital, as demonstrated by Tier 1 and Total Capital ratios of 16.2% and 17.6%, compared with 15.9% and 17.4% in 2017. Based on its aggregate 2018 financials, these institutions' leverage, defined as equity compared to assets, was 8.5% at end-2018, compared with 9.0% in 2017 (2016: 8.6%). German savings banks are able to absorb considerable adverse market developments because of sizeable and fully taxed reserves. These reserves are undisclosed and exist in accordance with local accounting rules (Handelgesetzbuch, HGB).

At end-2017 (latest available figure), German Landesbanks (excluding DekaBank) represented 43% of the group's aggregate assets (2016: 44%), and reported solid capital, as demonstrated by a Tier 1 ratio of 17.5%, compared with 16.5% in 2016. The improvement reflects retained earnings and a moderate decline in assets.

Our favorable capital assessment for S-Finanzgruppe considers certain privileges which arise from the group's institutional protection scheme (IPS).<sup>6</sup> These privileges reduce regulatory capital requirements because intragroup exposures benefit from a zero percent risk weight. A loss of these sector privileges, for example triggered by the absence of support for a troubled member bank, may have negative repercussions for S-Finanzgruppe's overall regulatory capital levels. Although we regard such a scenario unlikely, the impact would be credit negative.

However, capital cannot be freely allocated to single members within S-Finanzgruppe, and the risk of new cases of distress as a result of capital shortfalls cannot be ruled out. Although the Landesbanks have improved their regulatory and economic capitalisation, they exhibit riskier business profiles and higher leverage, rendering them more vulnerable to event risk or to renewed market disruption.

### **Moderate profitability which is challenged by low interest rates and cost pressures**

S-Finanzgruppe's assigned ba2 Profitability score is positioned in-line with its Macro-Adjusted score. Our assessment reflects the group's moderate but stable profits, and its good ability to build capital reserves. For 2019 and beyond, we expect persistent pressure on interest income, driven by the low interest-rate environment. As the savings banks continue to operate through an extensive branch network, and as their organizational structure remains fragmented, the potential for achieving economies of scale is somewhat limited in the absence of decisive moves at local levels.

S-Finanzgruppe reported almost unchanged pre-tax profits at €5.7 billion in 2017 (latest available figure), compared with €5.6 billion in 2016 (2015: €6.6 billion; 2014: €3.6 billion), according to local accounting rules (HGB). Stable pre-provision income at €12.4 billion, compared with €12.6 billion in 2016 underpins the group's ability to absorb loan-loss provisions. As in 2016, the sector continued to build €5.0 billion capital reserves (\$340g reserves; 2016: €4.5 billion).

In 2017 (latest available figure), S-Finanzgruppe's net interest income declined by 5.4% to €29.5 billion, and the net interest margin (calculated as net interest income as a proportion of loans and advances to non-banks) declined slightly to 2.4% from 2.6%. The sector's efficiency metrics compare less favorably with those of its international peers; however, administrative expenses recorded a marginally 0.6% increase from the year earlier, with cost containment a key challenge for the group on back of the low interest-rate environment.

In 2018, the German savings banks reported pre-tax profits at €5.0 billion, unchanged to 2017. The stable profits were driven by a moderate 3.3% decline in net interest income to €20.8 billion, compensated by a small increase of 2.6% in fee and commission income to €7.8 billion. Lower credit provisions, which declined to €4.1 billion in 2018 from €4.7 billion in 2017, as well as stable operating expenses at €18.9 billion further helped Germany's largest banking group to weather the challenges from the low rate environment.

In 2018, and except for NORD/LB, Germany's Landesbanks's profits were in line with our expectations and, in some instances, even higher than their 2017 net income.

### **Asset risks reflect the medium-term challenges to Germany's economy**

S-Finanzgruppe's Asset Risk score of a3 primarily reflects the average risk profile of German households and the 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, supported by expectations of robust economic growth in 2019 and beyond, accompanied with low unemployment rates, supporting the retail and corporate clients capacity to service its debts.

In addition, a high proportion of the savings banks' loan book is backed by conservatively valued residential properties. However, German residential real estate prices continue to accelerate, with indications of price growth outpacing fundamentals, particularly in large metropolitan areas. The savings banks' high and increasing exposure to residential property finance could impose future risks to asset quality and profitability. Significant price corrections, if paired with a higher share of above 100% loan/value mortgages, would significantly increase loan-loss charges in case of problem loan additions.

S-Finanzgruppe is vulnerable because of its sizeable commercial real estate exposures at some Landesbanks which may cause earnings volatility because of fluctuating credit losses. Landesbanks are exposed to international lending and asset-based finance activities, as well as investment portfolios, which may lead to valuation and credit losses during the global uncertainties, even if exposures have been reduced significantly in the meantime.

Further, we identify a rising importance of interest rate risks — which are catching regulatory attention as reflected by the introduction of separate capital buffers (see also our publication [New Interest Rate-Related Capital Buffers are Credit Positive](#)) — that may hurt more than half of the savings banks.

### Strong funding profile due to sizeable deposits

S-Finanzgruppe's credit strength is strongly supported by its sizeable and well diversified deposits. This view is reflected in our assigned a1 Funding Structure score which is four notches above the group's baa2 Macro-Adjusted score. The positive adjustments take into account (1) S-Finanzgruppe's high deposits granularity, reflecting its market leadership across Germany; and (2) the significant potential of savings banks to use their substantial mortgage books for secured funding in the capital market, if needed. However, our assessment also reflects a moderate degree of wholesale funding dependence for German Landesbanks.

At end-2018, savings banks reported aggregate deposits of €950 billion (2017: €902 billion), compared with aggregate loans of €823 billion (2017: €794 billion), resulting in an unchanged loan-to-deposit ratio of 87%, compared with 2017 (2016: 86%).

German Landesbanks deleveraging efforts have helped to reduce their dependence on wholesale funding. This trend is supported by declining interbank exposures, which declined to €238 billion as of year-end 2017 (latest available figure), compared with €542 billion in 2008. Over the same time, securitised liabilities declined to €187 billion from €440 billion. Excess funds from the savings banks are shared within the group, supporting the Landesbanks' funding profile. At end-2017, about 26% of savings banks' €118 billion excess funds are transferred to Landesbanks (2016: 21%, €121 billion). This helps to the Landesbanks' €108 billion funding gap (2016: €134 billion), which we define as the difference between €282 billion in deposits and €390 billion in loans (2016: €273 billion, €408 billion).

### Liquidity benefits from prime access to German depositors

S-Finanzgruppe's assigned Liquid Resources score of a2 is four notches above the group's baa2 Macro-Adjusted score. Our assessment considers (1) the high quality of liquid assets available; (2) additional, ECB eligible securities held in savings banks' held-to-maturity portfolios; and (3) asset encumbrance, which arises for example from intra-group exposures.

S-Finanzgruppe maintains ample liquid assets within the sector to balance the market funding dependence of Landesbanks and enjoys a strong covered bond franchise. At end-2017 (latest available figure), liquid assets were €688 billion and included €86 billion in cash, €271 billion due from banks and a €331 billion securities portfolio (2016: combined €671 billion).

### Macro Profile of "Very Strong -"

S-Finanzgruppe's BCA is supported by its Very Strong- macro profile, which is derived from the group's weighted average, reflecting around 78% exposure to Germany, 17% to the European Union, and 5% worldwide. S-Finanzgruppe's weighted average macro profile matches the assigned macro profile to Germany, which is largely determined by the country's very high economic, institutional and government financial strength and very low susceptibility to event risk. However, operating conditions for the German banking system are constrained by high fragmentation in an oversaturated market, low fee income generation and intensifying competition for domestic business.

## Support and structural considerations

### Notching for Corporate Family Rating (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 Recovery and Resolution 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 Loss Given Failure analysis suggests that this notional instrument would face very low losses in resolution. This results in two notches of uplift to the CFR compared with S-Finanzgruppe's BCA of a2, and hence, a Preliminary Rating Assessment of aa3.

### Government support considerations

We expect a moderate probability of government support, resulting in a one-notch rating uplift for S-Finanzgruppe. Our government support assumption reflects the size and high systemic relevance of S-Finanzgruppe to Germany's financial stability.

## Methodology and Scorecard

### Methodology

The principal methodology we use in rating S-Finanzgruppe is [Banks](#), published in August 2018.

### About Moody's Bank Scorecard

Our scorecard is designed to capture, express and explain in summary form our Rating Committee's judgement. When read in conjunction with our research, a fulsome presentation of our judgement 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 methodology and scorecard factors

Exhibit 3

### Sparkassen-Finanzgruppe

#### Macro Factors

**Weighted Macro Profile**      **Very Strong -**      **100%**

Factor	Historic Ratio	Initial Score	Expected Trend	Assigned Score	Key driver #1	Key driver #2
Solvency						
Asset Risk						
Problem Loans / Gross Loans	--	--	--	a3	Quality of assets	Sector concentration
Capital						
TCE / RWA	--	--	--	aa2	Risk-weighted capitalisation	Expected trend
Profitability						
Net Income / Tangible Assets	0.3%	ba2	← →	ba2	Loan loss charge coverage	Earnings quality
Combined Solvency Score		a2		a3		
Liquidity						
Funding Structure						
Market Funds / Tangible Banking Assets	26.8%	baa2	← →	a1	Market funding quality	Deposit quality
Liquid Resources						
Liquid Banking Assets / Tangible Banking Assets	16.8%	baa2	← →	a2	Quality of liquid assets	Additional liquidity resources
Combined Liquidity Score		baa2		a1		
Financial Profile				a2		
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		

Balance Sheet is not applicable.

Instrument class	Loss Given Failure notching	Additional Notching	Preliminary Rating Assessment	Government Support notching	Local Currency Rating	Foreign Currency Rating
Corporate Family Rating	2	0	aa3	1	Aa2	--

[1] Where dashes are shown for a particular factor (or sub-factor), the score is based on non-public information.

Source: Moody's Financial Metrics

## Ratings

Exhibit 4

**Category**      **Moody's Rating**

#### SPARKASSEN-FINANZGRUPPE

Outlook	Stable
Baseline Credit Assessment	a2
Adjusted Baseline Credit Assessment	a2
Corporate Family Rating -Dom Curr	Aa2

Source: Moody's Investors Service

## Endnotes

- <sup>1</sup> As of 15 June 2018, the total number of German savings banks has declined to 385.
- <sup>2</sup> The ratings shown are DekaBank's Long-term Deposit ratings, Long-term Senior Unsecured rating and outlook, as well as its Baseline Credit Assessment.
- <sup>3</sup> For further details, please refer to [S-Finanzgruppe's Company profile](#) and the [German Banking System Profile](#).
- <sup>4</sup> The ratings shown are NORD/LB's deposit ratings/senior unsecured ratings and outlook, as well as its Baseline Credit Assessment.
- <sup>5</sup> The ratings shown are Hamburg Commercial Bank's deposit ratings/senior unsecured ratings and outlook, as well as its Baseline Credit Assessment.
- <sup>6</sup> This scheme includes rules for mutual support within groups of banks in order to ensure the liquidity and solvency of their member institutions.



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MJKK and MSFJ also maintain policies and procedures to address Japanese regulatory requirements.

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