

## ISSUER IN-DEPTH

2 May 2018

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### RATINGS

#### Sparkassen-Finanzgruppe

Baseline Credit Assessment	a2
Adjusted Baseline Credit Assessment	a2
LT Corporate Family Rating	Aa2 Stable

Source: Moody's Investors Service

### KEY METRICS

#### Sparkassen-Finanzgruppe

	2016	2015	2014
Total Assets (in € billion)	2,119	2,158	2,252
Tier 1 Capital Ratio	15.6%	15.1%	14.6%
Net Income / Tangible Assets	0.3%	0.3%	0.2%

Source: Moody's Investors Service

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## Sparkassen-Finanzgruppe

Ample capital permits loan growth, offsetting revenue pressure from low rates

### Summary

The combined 2017 annual results of the 390 savings banks<sup>1</sup> that make up the primary level of Germany's Sparkassen-Finanzgruppe (S-Finanzgruppe; Aa2 stable, a2)<sup>2</sup>, published in March 2018, suggest that the banks' sizeable capital reserves will allow them to pursue continued loan growth without compromising their solvency. This will help offset revenue pressure from persistently low interest rates, which lowered their net interest margin during 2017. The German savings banks' profitability nonetheless remained stable during the year, helped by a continued lack of credit provisions, nice increase in fee and commission income, and reasonably sound cost controls.

» **Good credit quality supports profitability.** The Sparkassen Finanzgruppe's savings banks reported aggregate return on assets (ROA) of around 19 basis points in 2017, a level unchanged since 2012. Their stable performance primarily reflected an absence of credit risk charges thanks to solid economic growth and low unemployment in Germany. This, combined with the benefits of price increases for fee-based products, counterbalanced continued pressure on the banks' net interest income (NII) from low interest rates. NII accounted for 73% of their total revenues in 2017.

» **Revenue pressure will intensify.** We expect further declines in NII over the next two to three years as old, higher yielding loans mature and are replaced with new loans that carry lower interest rates while the room for deposit funding reduction shrinks. This process is weighing on the banks' net interest margin (NIM), which we estimate to have declined to about 1.9% in 2017 from 1.96% the previous year.

» **Solid capital provides scope for incremental loan growth.** The Sparkassen Finanzgruppe's savings banks have ample capital, with their aggregate Tier 1 capital ratio improving to 15.9% at end-2017 from 15.2% in 2016 (2014: 14.5%). We believe this will allow them to expand their loan book without weakening their solvency, partly offsetting the negative revenue effect of a narrowing net interest margin. We estimate that adding around €25 billion of new loans annually would contribute about €300-500 million to net interest income. However, growth in new lending comes at the risk of future credit losses, as current benign credit conditions are likely to deteriorate.

## Good credit quality supports profitability

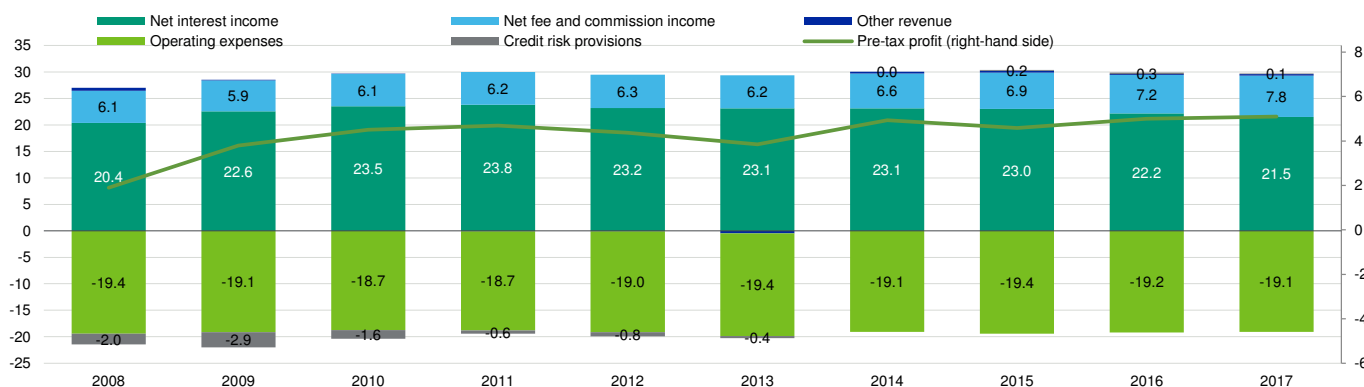
The German savings banks<sup>3</sup> reported aggregate return on assets (ROA) of around 19 basis points in 2017, a level unchanged since 2012. Good credit quality was the key driver behind this stable performance. The banks were able to release around €100 million of provisions in 2017, compared with €300 million and €200 million in 2016 and 2015 respectively. Over the next 12 to 18 months, we expect a further decline in problem loans for rated banks in Germany, helped by the country's solid economic performance and low unemployment rate.<sup>4</sup>

The savings banks' stable profits also reflected ongoing cost controls. Their cost-to-income ratio fell to 64.6% in 2017 from 65.0% the previous year thanks to a moderate reduction in operating expenses to €19.1 billion from €19.2 billion. During 2017, the combination of strong credit quality and cost discipline offset continued pressure on the savings banks' net interest income (NII) from low interest rates. NII is the banks' primary source of income (see Exhibit 1).

Further, an important contributor to the protection of the bottom line for the savings banks was their ability to grow net fee and commission income. Exhibit 1 shows the revenue and cost development of the savings banks since 2008. Whereas fee and commission income remained broadly flat in the first five years of this period, fee and commission income growth started in 2013 and accelerated in 2017. In fact, while net interest income fell by about €1.6 billion since 2013, net fee and commission income increased by about the same amount. Not only has this resulted in a sideways development of revenues, it has over time reduced the savings banks' reliance on interest income as the main revenue source.

Exhibit 1

**The savings banks' revenues, operating expenses, and pre-tax profits show little volatility**  
in €billion



Source: Sparkassen-Finanzgruppe, Moody's Investors Service

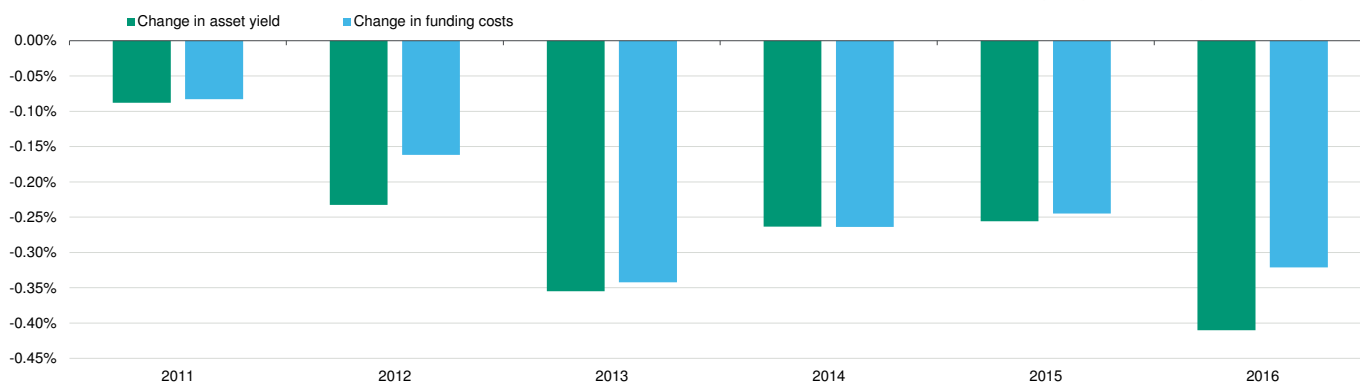
## Revenue pressure will intensify

Over the next two to three years, we expect the pressure on the savings banks' NII to intensify. This is because as their older, higher yielding loans mature, they are replaced with new loans that carry lower interest rates. The banks also have less flexibility to cut interest rates on sight deposits, their main source of funding, as the rate on these instruments is already at or close to zero (see Exhibit 2). Sight deposits accounted for around 62% of total customer deposits at end-2017.

We do not expect the savings banks to introduce negative interest rates for retail customers due to concerns about potential deposit outflows. We note however that the selective introduction of negative rates for corporate customers at some savings banks has not triggered meaningful deposit outflows.

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.moody's.com](http://www.moody's.com) for the most updated credit rating action information and rating history.

Exhibit 2

**Since 2016 the reduction in asset yield has surpassed saving banks' ability to lower their funding costs**

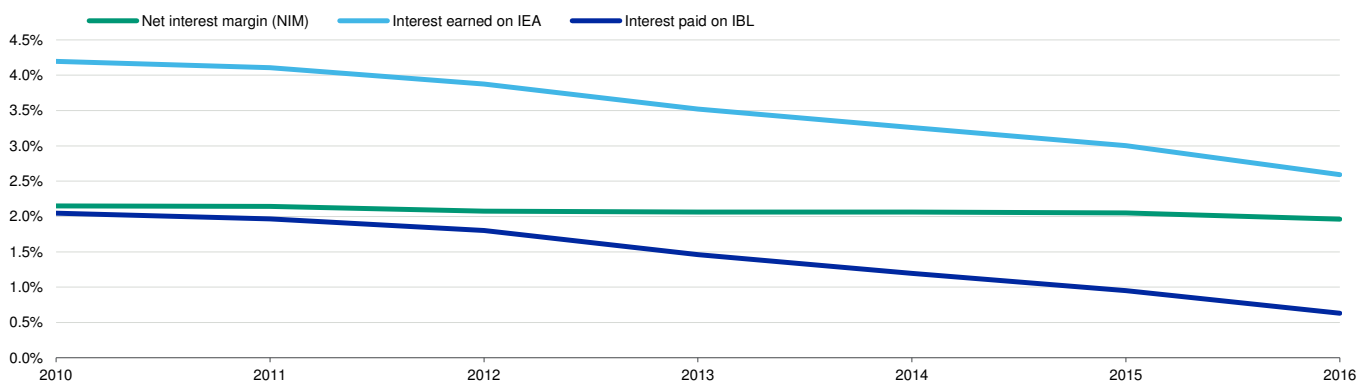
Source: Sparkassen-Finanzgruppe, Moody's Investors Service

For 2017, we expect a reduction in the savings banks' net interest margin (NIM) to around 1.90%, compared with 1.96% in 2016 (see Exhibit 3).<sup>5</sup> For the years 2012 to 2015, the banks' NIM was broadly stable at around 2.05%, which helped to protect their revenue.

Exhibit 3

**Savings banks' net interest margin was stable until 2015 but has started to decline**

Margins in %



Note: \* Interest-earning assets (IEA); \*\* Interest-bearing liabilities (IBL)

Source: Sparkassen-Finanzgruppe, Moody's Investors Service

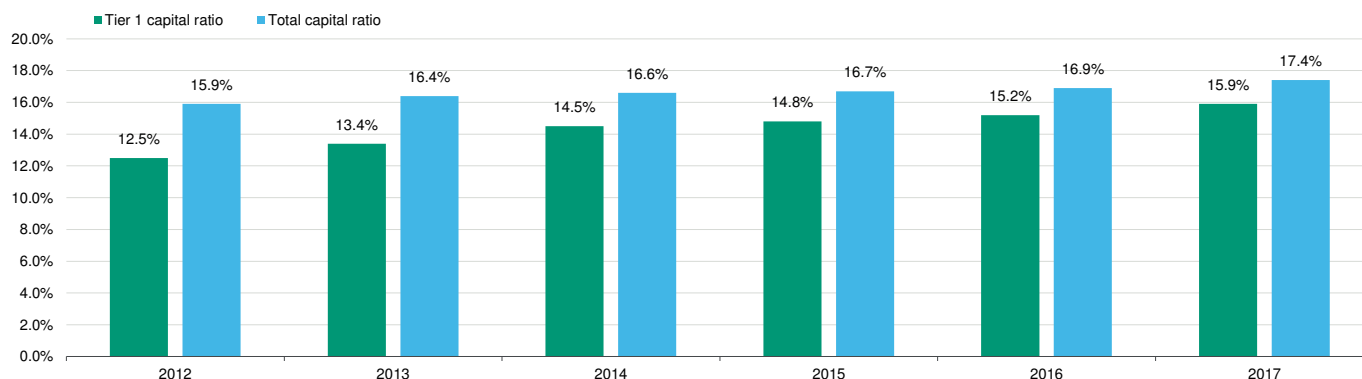
Downward pressure on NII weighs particularly heavily on the savings banks, as NII accounted for 73% of their total revenue in 2017. The banks have started to explore alternative income sources, including fees for payment transactions, securities trading commissions, and brokerage services (including the sale of building savings and insurance contracts). During 2017, this helped reduce the revenue contribution from NII compared with 77% in 2016, a credit positive. Developing some of these alternative revenue sources will require charging for services that customers have until now expected to be free, or increase prices, a process which will take time, but 2017 in particular was a promising development.

## Solid capital provides scope for incremental loan growth

The savings banks' strong and increasing capital ratios support our view that their solvency is robust overall. Their aggregate Tier 1 capital ratio improved to 15.9% at end-2017 from 15.2% in 2016. At end-2016 (latest available figure), their aggregate equity accounted for around 64% of the Sparkassen-Finanzgruppe's €157.9 billion of equity, compared with 60% at end-2014.

Exhibit 4

### The savings banks' capital ratios are improving in % of risk-weighted assets



Source: Sparkassen-Finanzgruppe, Moody's Investors Service

The savings banks' ability to retain profits, mainly by adding them to fully taxed capital reserves in accordance with local accounting rules (HGB), equips them to absorb considerable adverse market developments, a credit strength. Based on their reported equity in 2016 and the addition to capital reserves of €4.6 billion in 2017, we estimate that the savings banks' leverage (measured as equity compared to assets) improved to 8.8% in 2017 from 8.6% the previous year. We view this level of capitalisation as very solid. Our assessment also takes into account the banks' low stand-alone risk credit profiles, reflecting their focus on domestic loans and deposit funding. Loans accounted for around 66% of their assets in 2017 (2014: 64%), and were predominantly funded by deposits (2017: 76%; 2014: 74%).

The savings banks' robust capitalization gives them sufficient flexibility to grow their lending, partly offsetting the negative revenue effect of a narrowing net interest margin, without compromising their solvency. We estimate that new, incremental loans of €25 billion per year would lower the banks' aggregate Tier 1 capital ratio by around 40-50 basis points, all else equal. This would still leave them well capitalized, even when new [interest-related capital buffers](#) designed to protect them against sudden, substantial interest rate changes are taken into account.

We estimate that additional new loans of €25 billion a year would increase the banks' combined net interest income by around €300-500 million, helping to counterbalance the adverse effect on revenues of interest income erosion. Higher new business volumes could even fully eliminate the negative effect from low interest rates. However, increases in the loan book could come at the risk of future credit losses, as new loans would be extended at a very benign point in the credit cycle, and may reflect weaker underwriting criteria.

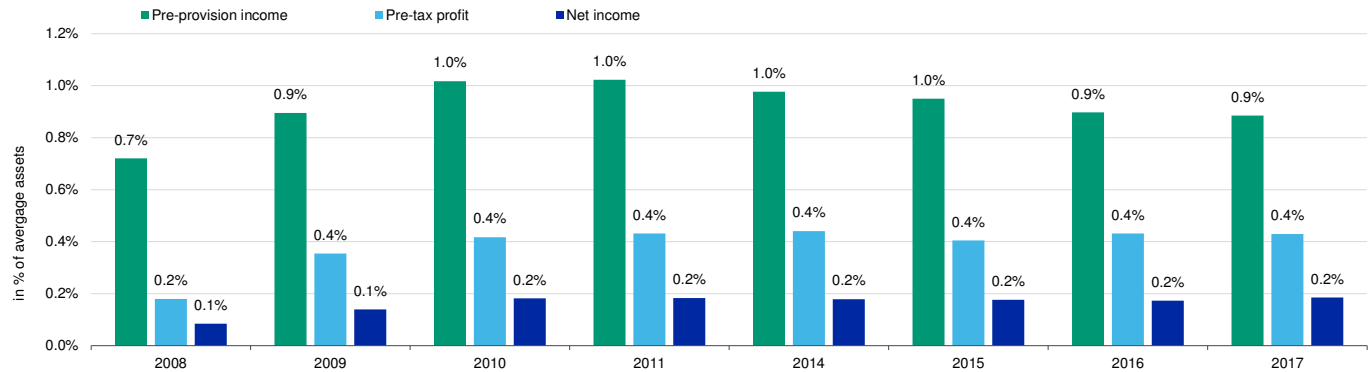
At around €150 billion annually, the savings banks' aggregate new business volume (Neugeschäftsvolumen) for the period 2015-17 was already somewhat higher than around €130 billion for the 2012-14 period. Since end-2014, the savings banks have increased their annual new business volume for corporate customers by around 21%, and for residential mortgages by around 13%.

## Appendix

Exhibit 5

### German Savings banks' earnings performance

Ratios in % of average assets

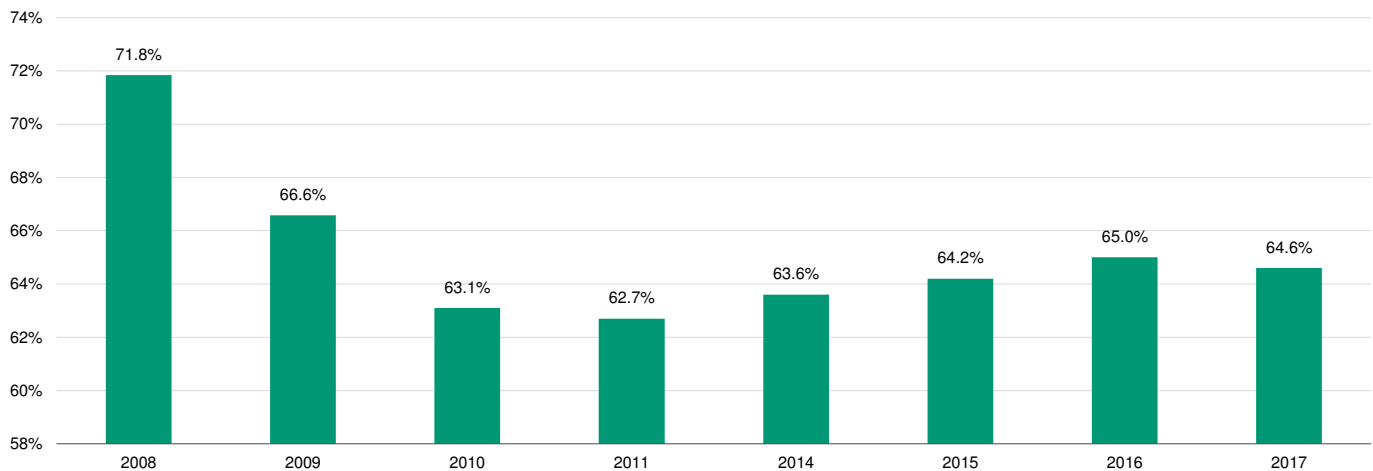


Source: Sparkassen-Finanzgruppe, Moody's Investors Service

Exhibit 6

### German Savings banks' cost-to-income ratios

Operating expenses as % of revenues



Source: Sparkassen-Finanzgruppe, Moody's Investors Service

## Moody's Related Research

- » Credit Opinion: [Sparkassen-Finanzgruppe - Update to credit analysis following rating affirmation](#), 16 November 2017
- » Rating Action: [Moody's affirms Sparkassen-Finanzgruppe's Aa2 Corporate Family Rating](#), 1 November 2017
- » Issuer Profile: [Sparkassen-Finanzgruppe - Key facts and statistics](#), 6 October 2017
- » Issuer In-Depth: [Low interest rates reveal the regional savings banks' profitability challenges](#), 30 June 2017
- » Issuer Comment: [Sparkassen-Finanzgruppe: Preliminary 2016 Results Reveal Rising Earnings Pressures at German Savings Banks](#), 20 March 2017
- » Issuer Comment: [Sparkassen-Finanzgruppe: Lower net interest income more than balanced by higher fees](#), 21 March 2016

To access any of these reports, click on the entry above. Note that these references are current as of the date of publication of this report and that more recent reports may be available. All research may not be available to all clients.

## Endnotes

- [1](#) By end-March 2018, the total number of German savings has further declined to 386.
- [2](#) The ratings shown are S-Finanzgruppe's Corporate Family Rating and outlook, and its BCA.
- [3](#) In addition to 390 savings banks at end-2017, the S-Finanzgruppe also includes six Landesbank groups, DekaBank Deutsche Girozentrale (Deka, deposits Aa2 stable, senior unsecured debt Aa3 stable, baseline credit assessment baa2), and 8 building societies.
- [4](#) In Germany, problem loans have been declining steadily, falling to around 3% of gross loans in 2016 from 3.3% in 2015 and 3.9% in 2014.
- [5](#) Based on Bundesbank data, the savings banks' net interest margin is comparable to those of co-operative banks, Germany's second largest banking sector.

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