FitchRatings

RATING ACTION COMMENTARY

Fitch Upgrades LBBW's IDR to 'A+'/Stable; Affirms VR at 'bbb+'

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Fitch Ratings - Frankfurt am Main - 08 Jul 2024: Fitch Ratings has upgraded Landesbank Baden-Wuerttemberg's (LBBW) Long-Term Issuer Default Rating (IDR) to 'A+' from 'A-' and Shareholder Support Rating (SSR) to 'a+' from 'a-'. The Outlook on the Long-Term IDR is Stable. Fitch affirmed LBBW's Viability Rating (VR) at 'bbb+'. The bank's Short-Term IDR, debt and deposit ratings have also been upgraded. A full list of rating actions is below.

The upgrade of the IDRs and SSR reflects our view that the likelihood of support for LBBW from its owners has increased as a result of the recent reform of the institutional protection scheme (IPS) of the German savings bank sector. We believe the revised IPS statutes significantly increase the probability of timely support for LBBW, and the creation of an additional fund also improves the IPS's ability to support a larger number of members requiring capital support at the same time, in a reasonable downside scenario.

KEY RATING DRIVERS

Support Drives IDRs: LBBW's IDRs and SSR are aligned with the IDRs of Sparkassen-Finanzgruppe (Sparkassen) (SFG, A+/Stable/F1+), the German savings bank network. This reflects Fitch's view that there is a very high probability that SFG, which owns 40.5% of LBBW, would provide support if needed. Fitch believes that the revised statutes of SFG's IPS, which include clear rules for addressing weaknesses at member banks, including the Landesbanken, have resulted in an increased propensity for SFG to provide timely support. The Stable Outlook on LBBW's Long-Term IDR mirrors that on SFG.

We believe that support would also be available from its other owners, the state of Baden-Wuerttemberg and the City of Stuttgart, but LBBW's SSR does not factor in support from its public sector owners as it is based on the lowest of the owners' ratings. Fitch uses SFG's Long-Term IDR as the anchor rating because support would need to be forthcoming from both SFG and its public owners to avoid triggering state-aid considerations and resolution under the German Recovery and Resolution Act if LBBW fails.

LBBW's Short-Term IDR is the higher of two ratings mapping to its Long-Term IDR and is equalised with SFG's Short-Term IDR to reflect our view that propensity to support is more certain in the short term.

Large German Corporate Bank: LBBW's VR reflects the bank's wholesale-driven business model with focus on corporate clients, with high sector concentrations and moderate earnings-generation capacity compared with international peers. This is balanced by its good asset quality, adequate capitalisation and access to the savings banks' excess liquidity.

High Sector Concentrations: LBBW's strong regional corporate-banking franchise benefits from Baden Wuerttemberg's large economy. However, this regional focus leads to concentrations on cyclical industries and, to some extent, on large borrowers, in particular in the commercial real estate (CRE) and automotive sectors. Stiff competition in most of LBBW's business lines limits the bank's pricing power and weighs on its profitability.

Good Asset Quality: LBBW's impaired loans ratio deteriorated modestly in 2023 as a result of the economic downturn, rising rates and inflation. We expect loan impairment charges (LICs) and impaired loans to rise in 2024 from their previously exceptionally low levels, but for the four-year average gross impaired loans ratio to remain below 2% in the medium term. Pressure on asset quality could arise from LBBW's exposure to cyclical industries, which are also sensitive to global supply chain disruptions, input price shocks and structural changes, particularly in its large CRE portfolio. Large buffers of precautionary loan loss allowances should absorb a large portion of LICs.

Moderate Profitability: We expect LBBW's operating profits/risk-weighted assets (RWAs) to have peaked in 2023 and to decline slightly in 2024 due to tighter net interest margins in line with further expected policy rate cuts in the eurozone, slightly rising LICs and cost inflation. We believe LBBW's revenue will gradually improve in the medium term as the bank executes its growth strategy, compensating for regulatory RWAs inflation. We expect the bank's four-year average operating profit to remain above 1.0% of RWAs. LBBW's average profitability remains weaker than that of higher rated international peers, burdened by high costs and low margins in German corporate banking.

Adequate Capitalisation: LBBW's common equity Tier 1 (CET1) ratio increased to 14.9% at end-2023, due to profit retention as well as a decline in RWAs due to methodological changes and capital relief transactions. We view this level as adequate, but not strong, for the bank's business model, which exposes LBBW to potential cyclical performance swings. Profit retention will be key in offsetting higher RWAs from the execution of the bank's growth strategy and the phasing-in of Basel III. We expect LBBW's CET1 ratio to remain above 14% in the medium term.

Sound Funding and Liquidity: LBBW is primarily wholesale funded, which is reflected in a moderately higher loans/deposits ratio than commercial bank peers. However, the bank benefits from moderate capital market funding requirements, due to the bank's reliable placement capacity within the savings bank sector. Its liquidity position is sound, underpinned by a large portfolio of cash and liquid securities.

RATING SENSITIVITIES

Factors that Could, Individually or Collectively, Lead to Negative Rating Action/Downgrade

A downgrade of SFG's IDRs would likely lead to a downgrade of LBBW's IDRs and SSR.

LBBW's VR would likely be downgraded if we expect the bank's impaired loans ratio to rise to and remain above 3%, or if the CET1 ratio falls durably below 13%.

Factors that Could, Individually or Collectively, Lead to Positive Rating Action/Upgrade

An upgrade of SFG's IDRs would likely lead to an upgrade of LBBW's IDRs.

An upgrade of the bank's VR would require a stronger franchise with a more diversified revenue base and significantly lower sector and single-name concentrations. An upgrade would also be contingent on a structural improvement of LBBW's profitability, with average operating profit above 2% of RWAs, without material increase in risk appetite.

OTHER DEBT AND ISSUER RATINGS: KEY RATING DRIVERS

LBBW's Derivative Counterparty Rating (DCR), long-term deposit rating and senior preferred debt ratings have been upgraded to 'AA-' from 'A' and are one notch above its Long-Term IDR. This reflects the protection of preferred creditors arising from the bank's large resolution buffers, including senior non-preferred and more junior debt. For the same reason, the senior non-preferred debt rating is in line with the bank's Long-Term IDR.

LBBW's short-term deposit and senior preferred debt ratings are the only short-term ratings mapping to the long-term deposit and senior preferred ratings, respectively.

The 'AAA' ratings of LBBW's grandfathered state-guaranteed senior unsecured and Tier 2 subordinated notes reflect our view of the creditworthiness of the state of Baden-Wuerttemberg, which is closely linked to that of Germany (AAA/Stable), and our expectation that Baden-Wuerttemberg will honour its guarantee.

The rating of LBBW's non-guaranteed Tier 2 subordinated debt has been upgraded to 'A-' from 'BBB-' and is now notched down twice from LBBW's Long-Term IDR to reflect poor recoveries in case of non-performance. Fitch now uses LBBW's Long-Term IDR rather than its VR as the anchor rating because we expect shareholder support from SFG to be extended to the bank's Tier 2 instruments under the revised statutes, which we believe has reduced the likelihood of regulatory resolution measures at LBBW.

OTHER DEBT AND ISSUER RATINGS: RATING SENSITIVITIES

LBBW's DCR, deposit, senior preferred and non-preferred debt ratings are sensitive to changes in its IDRs. We could also downgrade these ratings if we expect its junior and senior preferred debt buffer to fall below 10% of its RWAs on a sustained basis.

LBBW's subordinated debt is primarily sensitive to changes in SFG's IDR. The subordinated debt could also be downgraded if Fitch no longer believes that shareholder support would be extended to subordinated creditors, or that such support is moderately less likely for subordinated creditors than for senior creditors.

Adverse changes in Fitch's view of Baden-Wuerttemberg's creditworthiness, which is closely linked to that of Germany, would lead to a downgrade of LBBW's grandfathered state-guaranteed senior unsecured and Tier 2 subordinated debt ratings.

VR ADJUSTMENTS

The business profile score of 'bbb' has been assigned below the 'a' implied category score, due to the following adjustment reason: business model (negative).

The asset quality score of 'bbb+' has been assigned below the 'aa' implied category score, due to the following adjustment reason: concentrations (negative).

The capitalisation and leverage score of 'bbb+' has been assigned below the 'a' implied category score, due to the following adjustment reason: internal capital generation and growth (negative).

The funding and liquidity score of 'bbb+' has been assigned below the 'a' implied category score, due to the following adjustment reason: deposit structure (negative).

REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING

The principal sources of information used in the analysis are described in the Applicable Criteria.

PUBLIC RATINGS WITH CREDIT LINKAGE TO OTHER RATINGS

LBBW's ratings are driven by potential support from SFG.

ESG CONSIDERATIONS

The highest level of ESG credit relevance is a score of '3', unless otherwise disclosed in this section. A score of '3' means ESG issues are credit-neutral or have only a minimal credit impact on the entity, either due to their nature or the way in which they are being managed by the entity. Fitch's ESG Relevance Scores are not inputs in the rating process; they are an observation on the relevance and materiality of ESG factors in the rating decision. For more information on Fitch's ESG Relevance Scores, visit https://www.fitchratings.com/topics/esg/products#esg-relevance-scores.

RATING ACTIONS

ENTITY / DEBT	RATING			PRIOR
Landesbank Baden-Wuerttemberg	LT IDR	A+ Rating Outlook Stable	Upgrade	A- Rating Outlook Stable
	ST IDR	F1+	Upgrade	F1
	Viability	bbb+	Affirmed	bbb+
	DCR	AA-(dcr)	Upgrade	A(dcr)
	Shareholder Support	a+	Upgrade	a-
senior unsecured	LT	AAA	Affirmed	AAA

subordinated	LT	AAA	Affirmed	AAA
Senior non-preferred	LT	A+	Upgrade	A-
long-term deposits	LT	AA-	Upgrade	A
Senior preferred	LT	AA-	Upgrade	A

VIEW ADDITIONAL RATING DETAILS

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APPLICABLE CRITERIA

Bank Rating Criteria (pub. 15 Mar 2024) (including rating assumption sensitivity)

ADDITIONAL DISCLOSURES

Dodd-Frank Rating Information Disclosure Form

Solicitation Status

Endorsement Policy

ENDORSEMENT STATUS

Landesbank Baden-Wuerttemberg	EU Issued, UK Endorsed

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