LfA Förderbank Bayern
Rating Report

AAA STABLE OUTLOOK

Credit strengths

- Explicit guarantee from the Free State of Bavaria
- Supportive legal framework
- High strategic importance to the Free State of Bavaria
- Sound asset quality and capitalisation
- Strong liquidity and funding profile

Credit weaknesses

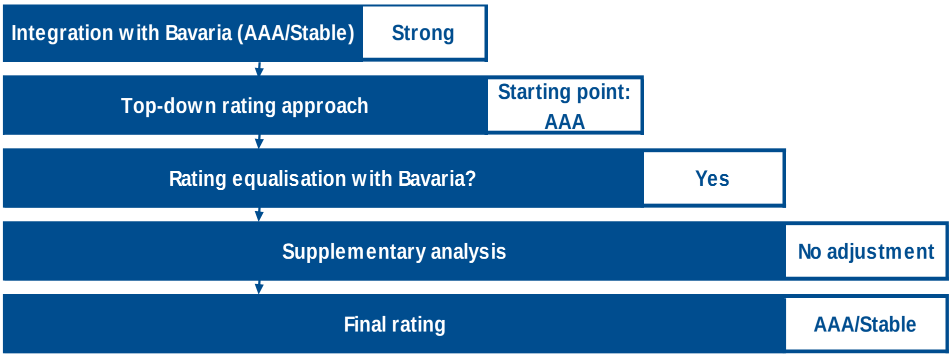
- Modest profitability, driven by non-profit-maximising development mandate
- Limited loan portfolio diversification

Rating rationale and Outlook

The AAA rating of LfA Förderbank Bayern (LfA) is equalised with the AAA/Stable rating of the Free State of Bavaria, given the German federal state's explicit, unconditional, unlimited, statutory, direct and irrevocable guarantee for LfA's obligations.

Scope acknowledges i) a mature and very supportive legal set-up, which makes changes to LfA's business model or guarantee structure unlikely; ii) the bank's high strategic importance to the federal state as a key government-related entity (GRE) with a counter-cyclical role, supported by the stability of its resources; iii) high capitalisation and asset quality; and iv) a strong liquidity and funding profile with strong capital market access. Challenges are LfA's modest but stable profitability and limited loan portfolio diversification, both foreseen by the bank's public policy mandate.

Figure 1: Our approach to rating LfA



Source: Scope Ratings

The Stable Outlook reflects our assessment that the risks LfA faces are balanced.

Positive rating-change drivers

- Not applicable

Negative rating-change drivers

- Downgrade of the Free State of Bavaria
- Changes to guarantee framework, leading to weaker government support

Ratings & Outlook

Local and foreign currency

Long-term issuer rating	AAA/Stable
Senior unsecured debt	AAA/Stable
Short-term issuer rating	S-1+/Stable

Lead analyst

Jakob Suwalski
+49 69 6677389 45
j.suwalski@scoperatings.com

Team leader

Dr Giacomo Barisone
+49 69 6677389 22
g.barisone@scoperatings.com

Related ratings

Scope affirms the Free State of Bavaria at AAA with Stable Outlook
8 April 2022

Scope Ratings GmbH

Neue Mainzer Straße 66-68
60311 Frankfurt am Main

Phone +49 69 6677389 0

Headquarters

Lennéstraße 5
10785 Berlin

Phone +49 30 27891 0
Fax +49 30 27891 100

info@scoperatings.com
www.scoperatings.com

Bloomberg: RESP SCOP

Level of integration with government: top-down approach

Strong integration with Bavaria's economic development activities

LfA is a promotional bank that is wholly owned by the Free State of Bavaria (AAA/Stable), with total assets amounting to EUR 23.6bn at YE 2021. It operates out of its headquarters in Munich and two offices in Bavaria with a staff of 370, or 326 full-time equivalents.

LfA is an institution under public law and delivers essential, competition-neutral services, making it a GRE as defined[1] by our GRE methodology. Its key area of promotion is the regional economy, to which it provides a wide range of funding instruments including promotional loans, equity participations and municipal infrastructure financing. Further details on LfA's business and financial profile are provided in the section on LfA's **stand-alone fundamentals**.

Top-down approach for rating analysis

We have used a 'top-down' approach to assign LfA's ratings, with Bavaria's AAA rating as the starting point. This is driven by our assessment of LfA's 'strong' integration with the Free State of Bavaria (see **Qualitative Scorecard 1** in **Appendix I**) based on the following considerations:

- LfA's public legal status as an 'Anstalt des öffentlichen Rechts' (public law institution) legally exempts it from insolvency procedures and German income tax, in line with most other German federal state development banks. Any changes to the bank's legal form are only permissible via a legal act of the Free State of Bavaria which we deem an unlikely scenario.
- LfA's operating activities are performed on behalf of Bavaria and are governed and regulated by the LfA law[2].

  The bank's activities have a 'high' strategic importance for its public sponsor. It plays a central role in key regional economic objectives, primarily by financing medium-sized corporations, freelancers, start-up enterprises and municipalities in Bavaria to promote Bavaria as a business location. LfA's strategic position and ability to adapt to crises was highlighted during the Covid-19 pandemic, when LfA adjusted its existing products and originated new ones to support, which in turn benefitted from a dedicated guarantee from the federal state.

  Risks to LfA's position as one of two of the federal state's development banks and its provision of competition-neutral activities (underpinned by a stable and supportive legal framework on national and European levels[3]) are remote.
- Bavaria is LfA's sole owner and exerts comprehensive operational and financial control. Heightened coordination needs during the Covid-19 pandemic made interactions between the bank and federate state more frequent, which we view positively.

Rating equalisation with the Free State of Bavaria

Equalisation with Bavaria's ratings given explicit guarantee

LfA's rating is equalised with Bavaria's AAA/Stable rating. This is because the federal state provides an explicit, unconditional, unlimited, statutory, direct and irrevocable guarantee for obligations related to money borrowed, bonds issued and derivative transactions entered into by the bank. As the guarantee is set in public law, it can only be

[1] See point 1.1 of our Government Related Entities Rating Methodology for the definition of a GRE.
[2] LfA law (a specific law governing LfA).
[3] An agreement called 'Verständigung II' in 2002 between the European Commission and the German federal government defines regulations for legally independent development banks engaging in competition-neutral infrastructure and development business. This ensures that German development banks will continue to benefit from state support. We therefore do not expect changes in the bank's ownership status, business model, policy role or guarantee structure that would be subject to amendments in the respective laws.

amended, revoked or restricted through a parliamentary act of Bavaria. Any such change is unlikely.

Extensive guarantee framework provided by the federal state

As is the case with other German regional development banks, LfA benefits from two additional ownership liability support mechanisms:

- an 'Anstaltslast' (institutional liability), which enables the bank to assert a claim against Bavaria, upon which the federal state must settle any financial shortfall on an unlimited and timely basis, thus providing LfA with the necessary resources to carry out required functions (i.e. creditors have no right to claim against the federal state); and
- a 'Gewährträgerhaftung' (guarantor liability), which comprises the guarantor's unlimited legal liability to step in for LfA's liabilities in case of the bank's liquidation. The guarantor liability is only relevant in certain and unlikely circumstances as LfA is exempt from insolvency procedures as it is chartered under public law.

Stand-alone fundamentals

Business profile determined by public policy mandate

LfA is a credit institution subject to the German Banking Act as well as prudential regulation and supervision by German financial supervisor BaFin and the German Bundesbank. Its public policy mandate and non-profit status are reflected in its modest profitability and earnings, which mostly comprise net interest income.

LfA is self-supporting and finances its investments via capital markets and credit facilities from other development banks, predominantly Germany's KfW, as it does not take private-sector retail deposits. The bank's funding costs are low, underpinned by the extensive guarantee framework. LfA has never required financial support and we do not consider that financial support will be needed.

Other strengths are its high capitalisation, prudent risk management, conservative risk profile and strong asset quality supported by double-recourse loan protection via the bank's on-lending practice[4].

Business model and earnings

LfA's business focused on regional SMEs and start-ups

LfA's promotional banking focuses on small- and medium-sized enterprises (SMEs[5]) and start-up companies and on developing the regional economy through infrastructure investments in Bavaria. Activities must directly or indirectly benefit businesses in Bavaria. In addition to development banking, LfA holds a treasury portfolio that it conservatively manages.

Development activities across six main areas

LfA's development banking targets six pillars: i) the financing of start-ups; ii) the financing of growth-enhancing business investments; iii) technology; iv) energy and environmental impact; v) liquidity support; and vi) municipal infrastructure. To this end, the bank provides on-lending to commercial banks for their loans to SMEs and start-ups; direct lending to municipalities; guarantees; risk-mitigation products; and equity participations via its holding companies.

2021 business volume of EUR 3.2bn

In 2021, the bank's overall banking activities amounted to EUR 3.2bn (EUR 2.6bn in loans and EUR 0.6bn of risk-participation products), down from EUR 4.3bn in 2020 (see **Figure 2**, next page). In 2020, volumes were particularly elevated due to the pandemic, with EUR 1.5bn of loans disbursed and guarantees granted to support businesses, which

[4] In this lending practice that is common to German regional development banks, LfA benefits from both the direct claim against the ultimate borrower as well as the intermediary bank to whom it provided the initial loan.
[5] The bank definition of SMEs is in line with the European Commission's definition, i.e. companies with fewer than 250 employees with either an annual turnover of up to EUR 50m or with a total balance sheet size of up to EUR 43m.

the Bavarian state also counter-guaranteed. In 2021, pandemic-related products declined to EUR 488m. The volume of traditional products (excluding Covid-19 programmes) has been broadly stable over the last three years, averaging EUR 2.7bn.

2022 business volume should be moderately higher than in 2021

For 2022, we expect a moderately higher business volume. In the nine months to September 2022, loan volumes increased 17% against the same period in 2021. This shows the continued demand for the bank's core products, as the bank already discontinued Covid-19 programmes in June 2022. The bank has continued to display an ability to adapt its products to current needs: It expanded its guarantee products to businesses affected by the inflationary shock and the war in Ukraine in July 2022, and is in the process of setting up a dedicated loan to help bridge liquidity for businesses affected by the shock. For 2023, these dedicated programmes will continue to benefit from a counter-guarantee from Bavaria.

Net interest is main income source

LfA's earnings are stable but undiversified, a reflection of its mandate. Net interest income is the primary source of revenue, representing around 80% of total operating income on average. It was around EUR 100m in 2021 and largely stable over the last three years. Net interest income relative to total assets over the past five years has been around 0.5%, in line with the national peer[6] average. The bank benefits from modestly rising credit volumes, but net interest margins on loans are low.

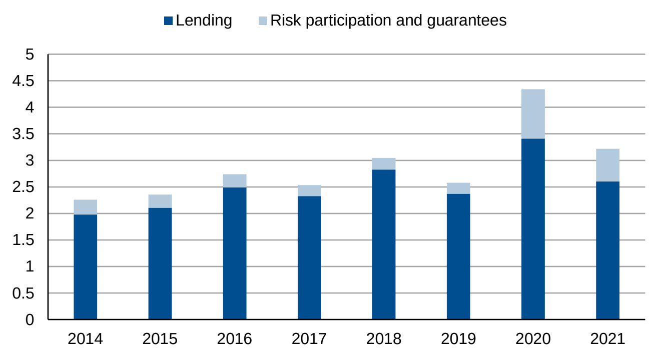
Main lever for continued profitability is cost containment

Net commission income totalled EUR 28m in 2021, which is mainly compensation for the bank's guarantee programmes. Other net operating income amounted to EUR 1.1m. LfA's administrative expenses declined by 6% to EUR 61.4m in 2021 (**Figure 3**), largely driven by lower depreciation charges. The bank's cost-to-income ratio declined to 47.9% below the bank's 55% target, which compares favourably with national peers. We expect some cost pressures amid the inflationary environment, such as on staff and other administrative expenses. At the same time, the continued digitising of processes, including automated loan approvals within certain programmes, should lead to moderate longer-term cost savings.

Risk provisions led to a decline in net profits in 2021

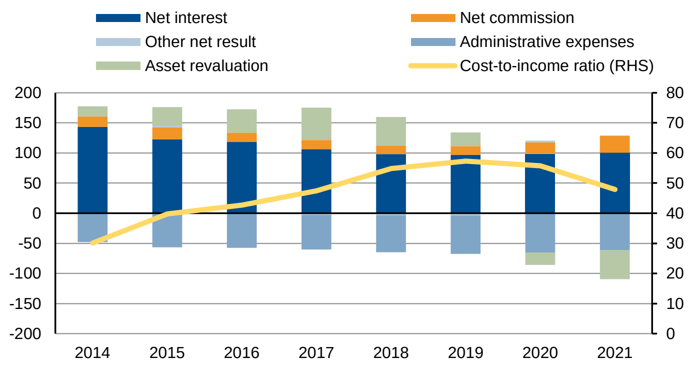
Net income in 2021 declined to EUR 20m from EUR 25m a year earlier, a result of EUR 48.1m in risk provisions.

Figure 2: Business volume
EUR bn



Source: LfA, Scope Ratings

Figure 3: Operating result breakdown
EUR m (LHS); % (RHS)



Source: LfA, Scope Ratings

Profitability and capitalisation

Modest profitability due to mandate and low interest rates

LfA's profitability is modest, reflecting its public mandate. Return on equity over the past five years averaged around 2%, which is broadly in line with the national peer average. Profitability benefits from LfA's excellent access to capital markets, itself underpinned by

[6] National peers refer to the 12 largest German regional development banks excluding LfA.

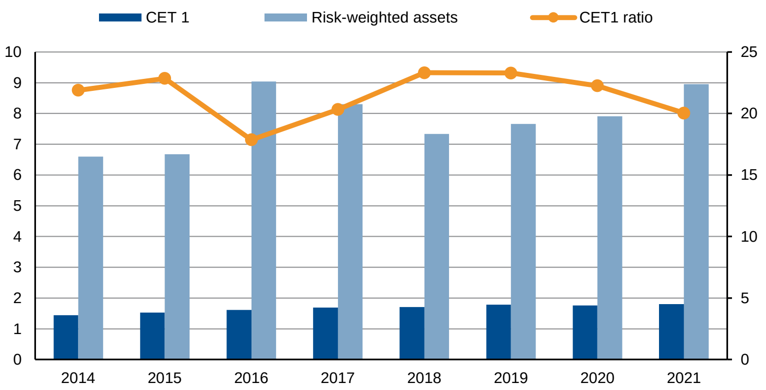
the explicit state guarantee. In past years, net profits have been retained or distributed to the Free State of Bavaria, which then channelled the proceeds back to the bank, in line with provisions of article 18 of the LfA law, strengthening capitalisation.

Adequate and rising regulatory capitalisation

Earnings retention supports LfA's capitalisation, which is well above regulatory requirements. Its Common Equity Tier 1 (CET1) capital of EUR 1.8bn against risk-weighted assets of EUR 9bn results in a 20% CET1 capital ratio as of end-2021 (**Figure 4**). Between 2016 and 2021, risk-weighted assets were broadly stable while the CET1 ratio increased from around 18% to 20%, underpinned by earnings retention. LfA's average risk weight (risk-weighted assets over total assets) is relatively high at 36% over the last three years. We expect capital buffers to rise moderately as LfA continues to retain profits.

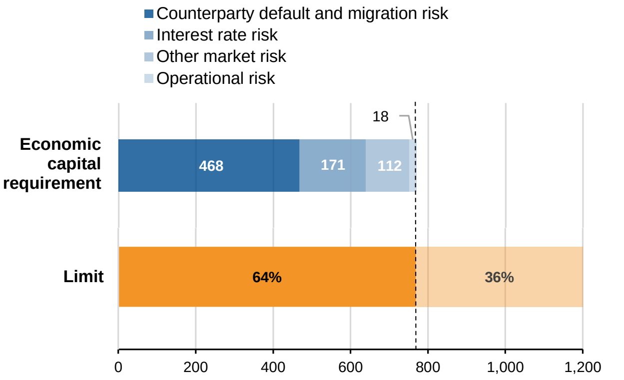
Finally, the leverage ratio increased to 12.4% in 2021 from 6.9% in 2020 due to changes in the Capital Requirements Regulation 2 in view of LfA's exposure to promotional loans.

Figure 4: CET1 development
EUR bn, % (Basel 3 fully phased-in, RHS)



Source: LfA, SNL Financial, Scope Ratings

Figure 5: LfA's risk-bearing capacity
EUR m, %



Source: LfA, Scope Ratings

Prudent risk management ensures capital adequacy…

The bank's risk management follows national prudential regulation, including BaFin's MaRisk requirements. LfA manages its capital according to the Internal Capital Adequacy Assessment Process, which is equivalent to the risk-bearing concept as defined in Article 25a of the German Banking Act. To this end, management defines the bank's total risk appetite by setting value-at-risk limits by risk type, i.e. credit risk, interest rate risk, other market risks and operational risks.

… and significant capital buffers of internal capital

Under the economic capital requirement approach, the bank ensures that, in a stressed scenario, internal capital would be sufficient to meet risks stemming from activities (e.g. credit, market and operational risks) that may entail economic losses (value at risk). At end-2021, the bank identified EUR 769m of value at risk, comprised mostly of credit and interest rate risks. The bank's internal limit is EUR 1.2bn, of which 36% remains unused, indicating a significant buffer of unused internal capital (**Figure 5**).

Portfolio risks and asset quality

Most of LfA's loans are to financial institutions

Most of LfA's activities are composed of exposures to the financial sector (86% of total exposure), including loans for on-lending. LfA's double-recourse loan protection further reduces capital requirements, mitigates concentration risks and shields the bank's sound asset quality from the pandemic's and energy shock's impact on certain corporate segments.

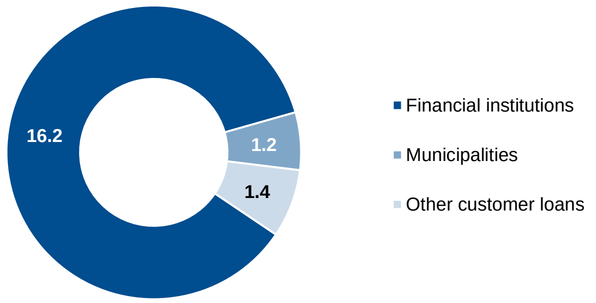
Loans to municipalities and guarantees are provided at bank's own risk

LfA also conducts business at its own risk, including direct lending to municipalities in Bavaria. This activity amounted to around EUR 1.2bn in 2021. In addition, its guarantee and risk mitigation products support commercial banks in financing businesses that would otherwise not have access to bank credit, e.g. start-ups lacking sufficient collateral. Here, LfA either issues guarantees of usually up to 80% of credit risk or relieves the commercial bank of its liability in case of losses.

In the context of the Covid-19 crisis, the bank's guarantee coverage ratio increased to 90% and up to 100% for certain loan programmes. The bank's guarantee and risk participation products amounted to around EUR 2bn at the end of 2021, double its 2019 level due to the bank's response to Covid-19 as mandated by the Free State of Bavaria.

For Covid-19-related guarantees and risk mitigation, discontinued since June 2022, the federal state equipped the bank with a EUR 12bn counter-guarantee.

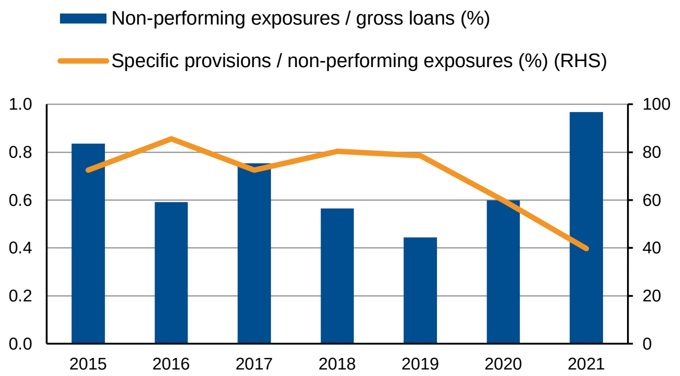
Figure 6: Exposure* by sector
EUR bn



*Note: Exposures include interbank assets and net loans to customers.

Source: LfA, Scope Ratings

Figure 7: LfA's asset quality*
%



*Note: Non-performing exposures as reported by LfA. Gross loans are net customer loans and interbank assets. Specific provisions include individual asset revaluations for customers and provisions for specific positions.

Source: LfA, Scope Ratings

LfA's lending mostly to banks, benefitting Bavarian companies

LfA's exposure is concentrated on the financial sector with a total exposure of EUR 16.2bn at YE 2021, or 86% of overall exposure, and including EUR 4.7bn in investments in financial sector securities, followed by a roughly even split of around 7% each for loans to municipalities and other loans in 2021, respectively (**Figure 6**). The underlying loan portfolio of end-customers of on-lent funds is diversified across sectors and within Bavaria. Both sectoral and geographical concentration is a consequence of the bank's mandate. Longer-term risks relate to transition risks in the automotive sector, to which Bavaria's export-oriented economy is particularly exposed.

Strong asset quality with low non-performing loans

LfA's loan book benefits from strong asset quality and a low share of non-performing exposures. Non-performing exposures relative to interbank assets and customers was 1% in 2021, up from 0.6% in 2021, or EUR 182m. The bank's non-performing loans ratio under the BaFin's definition was 0.87% at YE 2021.

LfA resilient to lingering pandemic effects

The bank's asset quality was resilient to the Covid-19 crisis over 2020-21. Its on-lending portfolio benefits from double-recourse loan protection. In addition, measures during the Covid-19 pandemic such as federal and state grants to businesses and short-time work schemes supported both the Bavarian economy. We expect some increases in risk provisions and non-performing exposures in the near term due to the gradual withdrawal of Covid-19 support and the impacts of the energy shock, but to remain low overall.

Conservative investment strategy; limited market risks

LfA's investment strategy continues to be conservative. It has a portfolio of fixed-income securities worth EUR 3.9bn (17% of total assets). Investments are usually held until maturity and derivative use is limited. Around EUR 2.8bn of assets, or 71% of the total, qualify as collateral for use of central bank refinancing facilities.

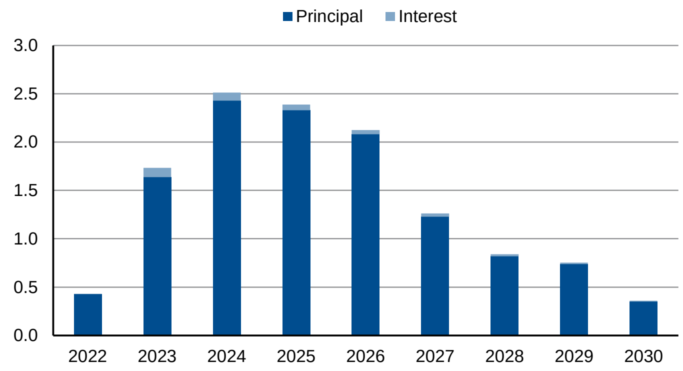
Funding and liquidity

Favourable refinancing conditions

Equipped with the explicit liability support from the Free State of Bavaria, LfA benefits from strong market access and the preferential regulatory treatment of its debt obligations.

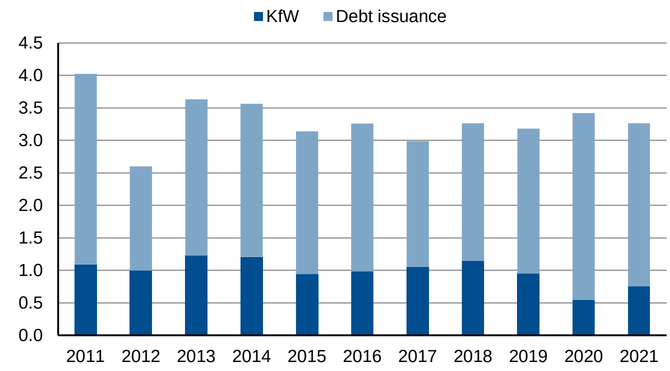
The bank predominantly funds its operations via medium and long-term debt securities with maturities of 3-10 years. The bank's redemption profile is smooth and will peak in 2024 at EUR 2.5bn (**Figure 8**). Annual refinancing volumes are around EUR 2bn to EUR 2.5bn. Total funding activity in 2021 amounted to EUR 2.5bn. In addition, roughly 30% of refinancing is typically via KfW facilities (**Figure 9**). In line with other German development banks, refinancing conditions are very favourable.

Figure 8: Redemption profile up to 2030
EUR bn, as of 26 October 2022



Source: Bloomberg, Scope Ratings

Figure 9: Annual refinancing
EUR bn



Source: LfA, Scope Ratings

LfA's debt securities carry a 0% regulatory risk weight, are recognised as Level 1 high-quality liquid assets for liquidity coverage ratio requirements and are eligible for preferential treatment under Solvency II. The bank's bonds are also eligible for the ECB's monetary policy operations including asset purchase programmes. We expect LfA to continue to tap capital markets at very favourable rates.

Assured liquidity; access to central bank facilities

The bank's established capital market access, access to central bank facilities (around EUR 2.8bn of securities available as collateral for central bank refinancing operations), and its treasury portfolio ensure sufficient liquidity. The bank's detailed reporting and liquidity coverage ratios help to ensure liquidity remains adequate. As at end-2021, LfA's liquidity coverage ratio was 326%, in line with levels in previous years.

Appendix I. Qualitative scorecard

Qualitative Scorecard 1: Level of integration with the government

Analytical component	Weight	Assessments			
		Limited (1)	Medium (50)	High (100)	Not applicable
Legal status	40%	○	○	◉	○
Purpose & activities	20%	○	○	◉	○
Shareholder structure	20%	○	○	◉	○
Financial interdependencies	20%	○	○	○	◉

Integration score		100		
Indicative approach	***Score***	1 ≤ x < 33.3	33.3 ≤ x ≤ 66.7	**66.7 < x ≤ 100**
	Approach	Bottom-Up	Top-Down or Bottom-Up	**Top-Down**
Approach adopted				

Source: Scope Ratings

Appendix II. Statistics

	2014	2015	2016	2017	2018	2019	2020	2021
Balance sheet summary (EUR m)								
Assets								
Cash and balances with central banks	19.4	41.8	14.3	84.2	1.6	7.7	0.6	9.4
Interbank assets	14,618.6	14,229.8	14,143.1	13,535.2	13,329.7	13,720.2	15,195.9	16,207.7
Total net customer loans	2,022.1	2,254.2	2,390.4	2,301.2	2,306.2	2,454.8	2,696.3	2,606.6
Total securities	4,830.4	4,848.8	4,864.4	4,869.1	4,734.8	4,972.9	4,521.8	3,902.9
Other assets	647.5	641.8	684.3	685.6	696.4	678.1	731.6	842.5
Total assets	***22,138.1***	***22,016.4***	***22,096.5***	***21,475.4***	***21,068.7***	***21,833.7***	***23,146.3***	***23,569.1***
Liabilities								
Deposits from banks	8,965.6	8,527.1	8,507.0	8,028.0	7,859.5	7,980.2	7,862.5	7,597.0
Deposits from customers	2,958.6	3,000.5	2,686.3	2,506.3	1,880.9	1,723.6	1,622.2	1,486.2
Total debt	8,083.2	8,307.6	8,632.9	8,590.9	8,916.5	9,672.8	11,094.0	11,863.6
thereof: senior debt	7,982.7	8,207.0	8,632.9	8,590.9	8,916.5	9,672.8	11,094.0	11,863.6
Other liabilities	667.2	642.4	654.0	652.6	652.9	665.4	758.6	806.8
Total liabilities	***20,674.6***	***20,477.6***	***20,480.3***	***19,777.8***	***19,309.8***	***20,042.0***	***21,337.3***	***21,753.6***
Equity								
Fund for general banking risk	400.0	470.0	540.0	610.0	660.0	690.0	700.0	700.0
Common equity	1,063.4	1,068.8	1,076.2	1,087.6	1,098.9	1,101.7	1,109.0	1,115.6
Share capital	368.1	368.1	368.1	368.1	368.1	368.1	368.1	368.1
Other common equity	695.3	700.7	708.1	719.4	730.8	733.6	740.8	747.4
Total liabilities and equity	***22,138.1***	***22,016.4***	***22,096.5***	***21,475.4***	***21,068.7***	***21,833.7***	***23,146.3***	***23,569.1***
Common Equity Tier 1 capital	*1,445.4*	*1,525.3*	*1,614.3*	*1,688.2*	*1,709.7*	*1,783.4*	*1,759.7*	*1,794.0*
Income statement summary (EUR m)								
Net interest income	143.2	122.7	118.0	106.1	97.9	96.9	98.7	100.3
Net fee and commission income	17.4	19.7	15.7	15.4	14.4	14.7	18.9	27.9
Net result from other income/expenses	0.5	2.2	-0.9	-2.5	-3.1	-3.7	3.1	1.1
Administrative expenses	48.1	56.4	56.7	57.6	61.5	63.9	65.5	61.4
Operating result before risk provisions	***112.9***	***88.2***	***76.1***	***61.4***	***47.6***	***44.0***	***55.1***	***68.0***
Net income from asset revaluation	16.4	31.6	38.9	53.5	47.3	22.4	-20.2	-48.1
Operating result	***129.3***	***119.7***	***115.0***	***114.9***	***94.9***	***66.4***	***35.0***	***19.9***
Tax expenses	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Addition to general banking risk fund	70.0	70.0	70.0	70.0	50.0	30.0	10.0	0.0
Net income	***59.2***	***49.6***	***44.9***	***44.8***	***44.8***	***36.3***	***24.9***	***19.8***
Profit carried forward	0.2	0.3	0.0	0.1	0.1	0.1	0.0	0.1
Net profit	***59.5***	***49.9***	***44.9***	***44.9***	***44.9***	***36.4***	***24.9***	***19.9***

Source: LfA, SNL Financial, Scope Ratings

Scope Ratings GmbH

Headquarters Berlin

Lennéstraße 5
D-10785 Berlin

Phone +49 30 27891 0

Frankfurt am Main

Neue Mainzer Straße 66-68
D-60311 Frankfurt am Main

Phone +49 69 66 77 389 0

Paris

10 avenue de Messine
FR-75008 Paris

Phone +33 6 6289 3512

Oslo

Karenslyst allé 53
N-0279 Oslo

Phone +47 21 09 38 35

Madrid

Paseo de la Castellana 141
E-28046 Madrid

Phone +34 91 572 67 11

Milan

Via Nino Bixio, 31
20129 Milano MI

Phone +39 02 30315 814

Scope Ratings UK Limited

London

52 Grosvenor Gardens
London SW1W 0AU

Phone +44 20 7824 5180

info@scoperatings.com
www.scoperatings.com

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