

Landeskreditbank Baden-Württemberg – Förderbank - (L-Bank) Rating Report



Credit strengths

- Explicit guarantee from the federal state of Baden-Württemberg
- Very supportive legal set-up with additional support mechanisms
- Strategic importance as the federal state's sole development bank
- Strong liquidity and funding profile
- High quality of assets

Credit weaknesses

- Modest, but stable profitability
- Limited loan portfolio diversification

Ratings & Outlook

Foreign currency

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

Local currency

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

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Related ratings

Scope affirms and publishes Baden-Württemberg's credit rating of AAA and Stable Outlook

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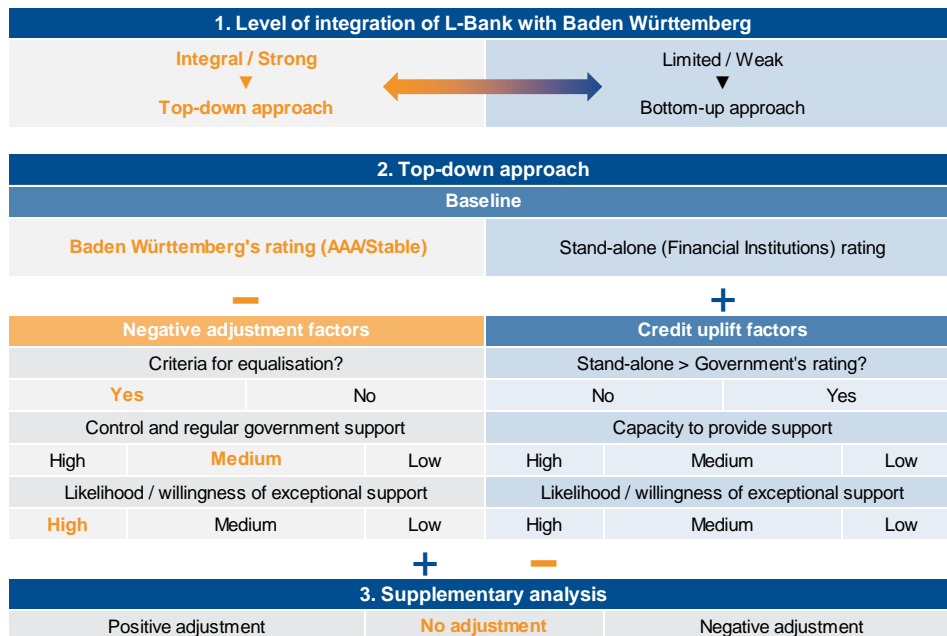
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Rating rationale and Outlook: The AAA rating of L-Bank reflects: i) the explicit, direct, unconditional, irrevocable and statutory guarantee of the federal state of Baden-Württemberg (AAA/Stable) for L-Bank's obligations; ii) the mature and supportive legal framework with additional liability support mechanisms provided by the federal state; iii) its high strategic importance as a key government-related entity (GRE) implementing economic policy for the federal state; iv) its strong liquidity and funding profile with excellent capital market access; and iv) its strong capital position and high asset quality. L-Bank's modest, but stable profitability and a limited loan portfolio diversification, both foreseen by L-Bank's public policy mandate, are challenges. The Stable Outlook reflects our assessment that the risks L-Bank faces are manageable and remain balanced.

Figure 1. Scope's approach to rating L-Bank



N.B. The orange colouring indicates the outcome of the analysis

Source: Scope Ratings GmbH

Positive rating-change drivers

- Not applicable

Negative rating-change drivers

- Downgrade of the federal state of Baden-Württemberg
- Changes to the guarantee framework, leading to weaker government support

Strong level of integration with the Land's economic development activities

Top-down approach is followed for the rating analysis

Level of integration with government

Landeskreditbank Baden-Württemberg – Förderbank - (L-Bank) is a GRE as defined¹ in Scope's GRE methodology. L-Bank is commissioned by the federal state of Baden-Württemberg to support it in performing its public functions, in areas such as structural, economic and social policies as well as development measures including the promotion of home ownership and the provision of support to small and medium sized enterprises (SME) in accordance with the state aid regulations of the European Community. Key area of promotion is the regional economy.

We consider L-Bank to have a 'strong' level of integration with its sole public owner, the federal state of Baden-Württemberg (see Figure 2), indicating a top-down approach for deriving the rating assignment. L-Bank's public legal status as an *Anstalt des öffentlichen Rechts* (public law institution) implies that it would not be subject to insolvency procedures (insolvency is excluded by law) and is exempt from corporate income tax. Any changes to the entity's legal form or resolution are permissible only via an Act of the federal state. As Baden-Württemberg's development agency, L-Bank's operating activities are performed on behalf of the federal state, with the purpose of providing key services in the public interest to support regional economic and social objectives.

Figure 2: Level of integration with government (Qualitative Scorecard 1)

Criteria	Level of integration with government	
	High/ Strong	Limited/ Weak
Legal Status & Resolution Framework	<input checked="" type="radio"/> Public; Insolvency, bankruptcy and resolution laws unlikely to apply	<input type="radio"/> Private; Insolvency, bankruptcy and resolution laws do apply
Purpose/ Activities	<input checked="" type="radio"/> Good/ service is backed by constitution or in the public interest	<input type="radio"/> Good/ service has mostly a commercial purpose
Shareholder Structure	<input checked="" type="radio"/> Significant public ownership	<input type="radio"/> Mostly private ownership
Approach*	Top-down	

* Two of the three parameters indicate the chosen approach for most instances.

Source: Scope Ratings GmbH

Explicit government support

We view the explicit, direct, unconditional, irrevocable and statutory guarantee for L-Bank's liabilities, provided by the federal state of Baden-Württemberg (AAA/Stable), as the key factor for equalising L-Bank's ratings with the ratings of the federal state. As the guarantee is laid down in the relevant laws (since 1998), it can only be amended through a parliamentary decision of the federal state to amend the legislation.

In addition, L-Bank benefits from further liability support mechanisms provided by the federal state of Baden-Württemberg:

- i) *an Anstaltslast* (maintenance obligation) that requires the federal state to settle any financial shortfalls on a timely basis and provide L-Bank with the necessary resources to ensure solvency; and
- ii) *a Gewährträgerhaftung* (guarantee obligation) that comprises the guarantor's unlimited legal liability for L-Bank's obligations in case of liquidation or if creditor claims cannot be satisfied out of L-Bank's assets.

Rating equalisation factor is applicable: explicit guarantee

Additional liability support mechanisms: maintenance & guarantor obligation

¹ Under Scope's GRE rating methodology, a GRE is defined as an issuer that fulfils both of the following conditions: i) it is directly or indirectly majority owned and/or sufficiently controlled by a government; and ii) its activities fulfil a public-sector mandate by implementing government policies or delivering essential public services.

Strong oversight with a support framework in place but not used**Government control and regular government support**

Overall, we assign a 'medium' level of government control and regular government support for L-Bank (see Qualitative Scorecard 2 on page 4).

- We view the federal state's ability to control L-Bank as 'high', reflecting L-Bank's organisational structure as Baden-Württemberg's development agency. The scope and content of its business activities are defined and regulated by law² (L-Bank Act).
- We assess regular financial support for L-Bank as 'limited' despite our expectation that timely financial support would be given prior to any potential call on the guarantees for L-Bank. Our evaluation reflects L-Bank's positive and stable operating performance, as well as its excellent access to capital markets, which implies limited intervention by the government.

Guided by L-Bank's statutes, government exercises operational, management and financial control

Baden-Württemberg's control over L-Bank includes the federal state's ability to: i) alter L-Bank's strategy or mandate which is defined and regulated by public law; ii) appoint and dismiss key personnel, including members of governing and oversight bodies, with the supervisory board mainly consisting of representatives from the federal state; and iii) intervene in decision-making processes including the distribution of profits. As guided by L-Bank statutes, at least half of its annual profits must be retained.

Self-supporting GRE

L-Bank receives no additional funds from the federal budget and finances its investment programme via market funds. There is no track record of direct financial support for L-Bank and any regular financial support is neither needed nor expected in our view.

On this basis, we therefore capture the benefit of the guarantee framework, which allows L-Bank to operate without regular financial support from the federal state of Baden-Württemberg.

Likelihood of exceptional support**High likelihood of government support due to ...**

The extensive three-fold guarantee framework provided by the federal state of Baden-Württemberg (AAA/Stable) ensures an almost certain likelihood that timely financial support will be provided to L-Bank if needed.

... high strategic importance given L-Bank's important role as the federal state's development bank, ...

We assign L-Bank a 'high' strategic importance. This reflects its central role in i) meeting key economic and political objectives; ii) providing important public services in areas such as economic development including the provision of loans, subsidies or other financial assistance especially to SMEs and for housing developments, and iii) financing infrastructure projects, which are essential business activities for the federal state.

... low substitution risk, given the stable operating performance and mature legal framework, ...

We assess substitution risk for L-Bank as 'low'. Potential risks to L-Bank's strong position as the federal state's sole development bank and its provision of competition-neutral business activities, which are underpinned by a stable and supportive legal framework, are deemed remote. L-Bank's stable track record in operating performance also makes it difficult to replace with other players. We do not expect a change in L-Bank's ownership status or guarantee structure that would be subject to changes in the respective laws.

... and high economic importance of Baden-Württemberg.

Our assessment of a 'high' likelihood that government support would be provided to L-Bank is underpinned by Baden-Württemberg's economic importance, with the federal state contributing 15% to national GDP in 2018 and L-Bank's prominent public policy role in supporting Germany's economy (as the country's second largest regional development bank).

² L-Bank Act (a specific law governing L-Bank): <https://www.l-bank.info/en/for-investors/investor-relations/l-bank-act.html>

Figure 3: Qualitative scorecard overview (QS 2)

Top-down approach	Analytical considerations	Assessment			Outcome & indicative notching		
		High	Medium	Limited			
	Equalisation Factor	Statutory guarantee or laws to similar effect <input checked="" type="radio"/> Yes <input type="radio"/> No			Equalisation		
Control and regular government support	Organisational Structure	Legal Status	<input type="radio"/> N/A <input checked="" type="radio"/> Government department or similar	<input type="radio"/> Legal structure with significant government involvement	<input type="radio"/> Legal structure with limited government involvement	Medium	High
		Ownership of & rights to GRE's assets	<input type="radio"/> N/A <input checked="" type="radio"/> Mostly government	<input type="radio"/> Somewhat government	<input type="radio"/> Public and private		
	Government Control	Mission, mandate and strategy	<input type="radio"/> N/A <input checked="" type="radio"/> Mostly directed by government	<input type="radio"/> Government-influenced	<input type="radio"/> Possible, but mostly independent		
		Financial, operating and investment policies	<input type="radio"/> N/A <input checked="" type="radio"/> Mostly directed by government	<input type="radio"/> Government-influenced	<input type="radio"/> Possible, but mostly independent		
		Key personnel and oversight bodies	<input type="radio"/> N/A <input checked="" type="radio"/> Mostly directed by government	<input type="radio"/> Government-influenced	<input type="radio"/> Possible, but mostly independent		
	Financial Support	Funding options	<input type="radio"/> N/A <input type="radio"/> Mostly via government	<input type="radio"/> Mix of government and market funds	<input checked="" type="radio"/> Mostly market funds		
		Support agreements	<input type="radio"/> N/A <input type="radio"/> Regular cash or capital injections	<input type="radio"/> Active/open credit lines or similar	<input checked="" type="radio"/> Support framework in place but rarely used		
	Track record	<input type="radio"/> N/A <input type="radio"/> History of timely support under all circumstances	<input type="radio"/> History of support under select circumstances	<input checked="" type="radio"/> Support expected but not yet required			
Likelihood of exceptional support	Strategic importance to government	<input type="radio"/> N/A <input checked="" type="radio"/> Good/ service protected by the constitution	<input type="radio"/> Disruption of good/ service likely damaging to government; expected political costs	<input type="radio"/> Disruption of good/ service unlikely damaging to government; limited political costs	High		
	Ease of substitution	<input type="radio"/> N/A <input checked="" type="radio"/> Good/ service is difficult to replace	<input type="radio"/> Prospects of private players entering the market	<input type="radio"/> Private sector operators provide same good/ service			
	Default implications	<input type="radio"/> N/A <input checked="" type="radio"/> Large; default likely to affect government's creditworthiness	<input type="radio"/> Some financial inter-dependence (eg. Dividends)	<input type="radio"/> Limited, not a major concern			

Overall Assessment	Indicative notches	Indicative notching	
Equalisation	0		
High	0-1		
Medium	1-2		
Limited	2-3		
		Indicative notching	0-1
		Additional adjustment	0
		Final indicative notching	0-1

Source: Scope Ratings GmbH

Business profile and risk positioning are determined by the public policy mandate

Business performance affected by persistently low interest rates

Improving net interest income in 2018

Supplementary analysis

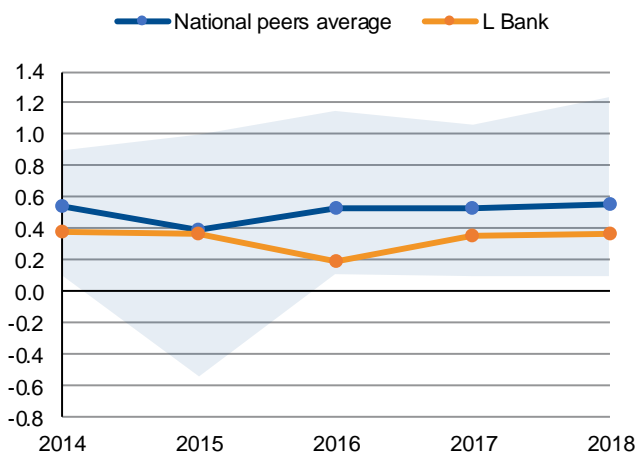
L-Bank's business structure and risk positioning is determined by its public policy mandate to support the federal state of Baden-Württemberg in fulfilling key public services. L-Bank is not considered to be a CRR credit institution. The provisions of the Single Supervisory Mechanism therefore do not apply to L-Bank and oversight competences fall under the remit of the German Federal Financial Supervisory Authority, in cooperation with Deutsche Bundesbank.

Business performance and earnings

While complying with its public policy mandate and non-profit status, reflected by modest profitability and stable although undiversified earnings, L-Bank benefits from excellent capital market access for conducting its business. In recent years, the low interest rate environment has affected L-Bank's activities: supporting private investments and robust demand for housing loans in Baden-Württemberg and thereby resulting in high credit volume, while weighing on interest income.

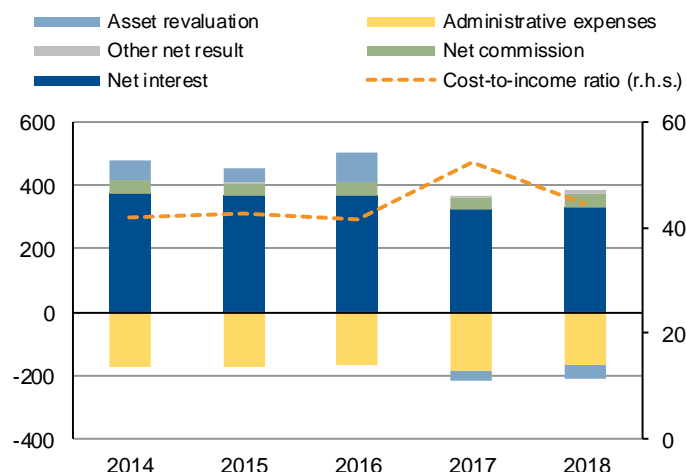
L-Bank's earnings are relatively stable although undiversified. Net interest income, L-Bank's primary source of revenue, improved by 2.5% to EUR 331.4m in 2018, supported by lower funding costs. Net commission income, which mainly comprises payments by Baden-Württemberg for the distribution of family benefits and financial aid, totaled EUR 41.4m. Other net operating income amounted to EUR 16.1m. L-Bank's net interest income as a share of total assets has been relatively stable over the past five years at around 0.5%, below the national peer³ average of 0.6% (**Figure 4**).

Figure 4. Net interest income/average assets
%



N.B. The light blue area shows the range for national peers.
Source: SNL, Scope Ratings GmbH

Figure 5. Operating result breakdown
EUR m (l.h.s.); % (r.h.s.)



Source: L-Bank, Scope Ratings GmbH

Relatively stable earnings centred on interest income

Supporting L-Bank's efficiency is the reduction in administrative expenses, which decreased by 9.1% to EUR 167.9m in 2018 due to lower IT costs and building-related expenditure (**Figure 5**). L-Bank's cost-to-income ratio improved from 52.4% to 44.5% in 2018, which is lower than those of national peers. Net income – after accounting for taxes, subsidies and L-Bank's contributions to the development fund – totalled EUR 50.2m in 2018, a slight decrease from EUR 50.6m in 2017, which was due to the depreciation of receivables and securities as well as higher provisions in the lending business.

³ National peers refer to the 10 largest German regional development banks excluding L-Bank.

Going forward, management expects the volume of new business and financial performance to remain broadly stable. The exemption from the Single Supervisory Mechanism may reduce the administrative burden linked to regulatory procedures. We note however that a weakening of growth in Baden-Württemberg’s export-oriented economy could negatively impact business performance.

Profitability and capital

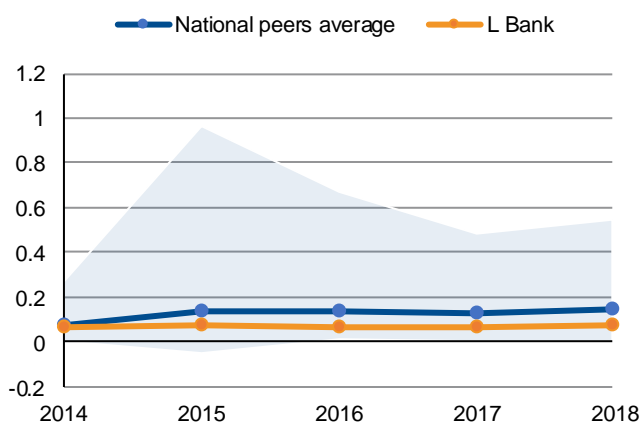
Modest profitability owing to public policy mandate and low interest rate environment

L-Bank’s profitability is modest but stable, reflecting its lending book determined by the non-profit maximising character of its business and low interest rate environment. Return on average assets has remained broadly stable over the past five years at 0.07%, below the national peer average of 0.16% (**Figure 6**). Profitability has been supported by the L-Bank’s excellent access to capital markets, underpinned by the ownership guarantee. We expect profitability to remain subdued in view of the low interest rate environment.

As of year-end 2018, L-Bank reported a total capital ratio of 20.6%, composed almost entirely of Common Equity Tier 1 (CET 1) capital (18.6% of risk-weighted assets). L-Bank adopts a prudent approach to the management of its regulatory capital, having increased the internally-required minimum total capital ratio by 0.5pps and applying a bank-specific countercyclical buffer of 1%, the latter of which is above current regulatory requirements. L-Bank’s capitalisation levels have been increasing steadily in recent years as its board has consistently opted to retain net profits. The CET1 ratio increased from around 12% in 2013 to around 19% in 2017-18. We expect it to rise further in 2019 given L-Bank’s decision to retain EUR 50m of net profits.

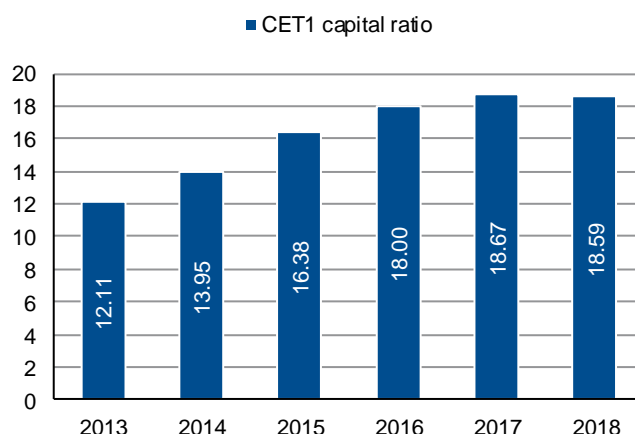
Adequate and rising capitalisation levels supported by earnings retention

Figure 6. Return on average assets
%



N.B. The light blue area shows the range for national peers.
Source: L-Bank, SNL, Scope Ratings GmbH

Figure 7. CET1 capital development
% (Basel III fully phased-in)



Source: L-Bank, Scope Ratings GmbH

Portfolio risks and asset quality

Concentrated exposures due to development business model...

Most of L-Bank’s activities are composed of direct loans to customers (32% of total assets in 2018) and loans to the financial sector mostly for on-lending purposes (34%) with commercial banks assuming the credit risk on the ultimate borrower (i.e. the ‘house-bank principle’). L-Bank’s double-recourse loan protection, that is, its direct claim against the ultimate borrower as well as the intermediary bank to whom it provided the initial loan, further reduces its capital requirements and mitigates its credit risks.

... with the quality of the loan book affected by the regional economy...

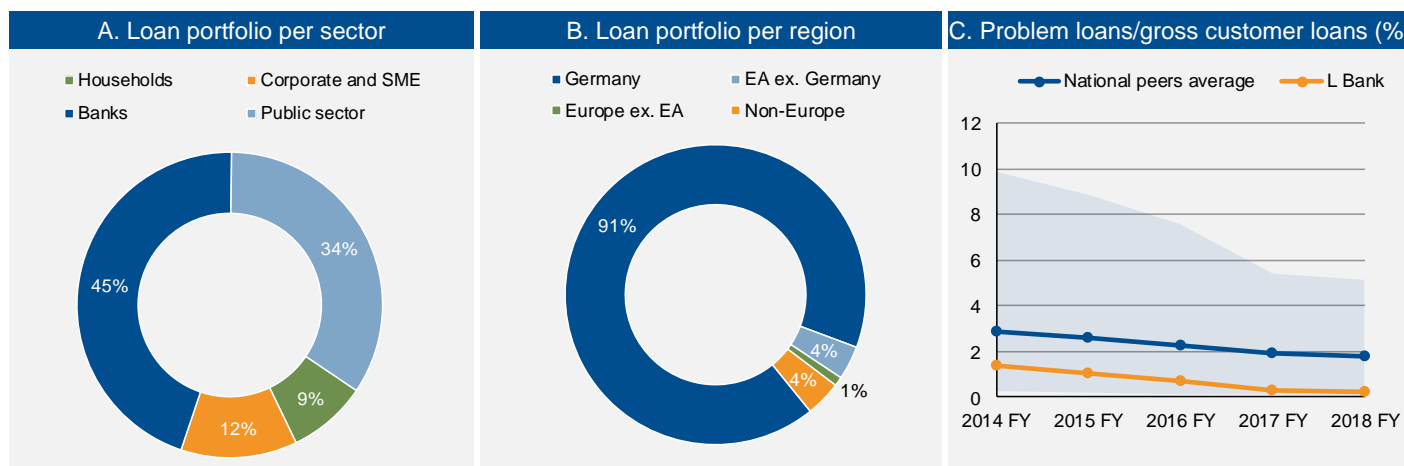
L-Bank’s loan portfolio is characterised by exposure concentration to financial and public sectors, at 45% and 34% of counterparty risks respectively in 2018 (**Figure 8-A**). The quality of L-Bank’s loan book is exposed to regional concentration risks with 91% of the

...and mitigated by strong asset quality

portfolio attributable to Germany (of which 68.5% in Baden-Württemberg, **Figure 8-B**).

L-Bank benefits from its strong asset quality with very low non-performing exposures. Its share of problem loans relative to gross customer loans has been steadily decreasing and reached 0.22% in 2018, the second lowest among national peers whose average problems loans stood at 2% of customer loans (**Figure 8-C**). The low non-performing exposures reflect L-Bank's conservative lending strategy focused on low-risk borrowers with strong credit fundamentals. More than half of the loan portfolio is internally rated AA- and above and only 1.1% had a non-investment grade rating at the end of 2018.

Figure 8. Loan portfolio⁴ concentration risks and problem loans



N.B. The light blue area in the right-hand chart shows the range for national peers.
Source: L-Bank, SNL, Scope Ratings GmbH

Conservative investment strategy and limited market price risks

L-Bank continues to pursue a conservative investment strategy, holding a large investment portfolio of fixed-income securities worth EUR 22bn (32% of total assets) as well as EUR 231m in strategic equity holdings at the end of 2018.

Favourable refinancing conditions

Funding and liquidity

L-Bank funds its operations by issuing short- and long-term debt securities and has a long-term debt issuance programme including an authorised size of EUR 30bn (of which EUR 14.6bn was utilised at year-end 2018) as well as a commercial paper programme with a funding limit of EUR 15bn (utilisation at year-end 2018: EUR 10.2bn), which is used for short-term refinancing. L-Bank benefits from an excellent market access thanks to the explicit liability support by the federal state for obligations in respect of money borrowed, bonds issued, and derivative transactions entered into by L-Bank.

L-Bank'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. L-Bank's bonds are also eligible for the ECB's monetary policy operations, including its asset purchase programme as well as for GC-Pooling transactions in repo markets. L-Bank's excellent market access was again observed in July 2019 when it issued a USD 2bn five-year bond with a 2% coupon. We therefore expect L-Bank to continue to tap capital markets at very attractive rates.

Assured liquidity: L-Bank remains compliant with all regulatory capital requirements

In 2018, L-Bank issued a total volume of EUR 3.6bn of medium- and long-term debt securities. L-Bank's diversified investor base and its portfolio of highly liquid securities support its liquidity position. Over the past two years, L-Bank has maintained an average liquidity coverage ratio of 255%, far above the regulatory requirement for 2018 of 100%.

⁴ Loan portfolio includes outstanding amounts, arrears, irrevocable loan commitments and undrawn, externally approved lines of credit associated with loans.



Appendix: Consolidated financials

	2014	2015	2016	2017	2018
Balance sheet summary (EUR m)					
Assets					
Cash and interbank assets	20,809	21,097	22,501	23,995	23,508
Total net customer loans	23,475	25,670	26,894	24,168	22,645
Total securities	22,562	23,027	22,513	21,140	22,024
Other assets	3,344	3,502	3,167	1,367	1,432
Total assets	70,190	73,296	75,075	70,670	69,609
Liabilities					
Deposits from banks	21,113	23,063	24,718	25,269	25,863
Deposits from customers	7,096	8,097	7,623	8,009	9,013
Total debt	36,917	36,314	36,783	30,837	28,657
<i>thereof: Senior debt</i>	35,983	35,584	36,226	30,383	28,278
<i>thereof: Subordinated debt</i>	934	731	557	454	379
Other liabilities	1,820	2,425	2,507	3,040	2,412
Total liabilities	66,945	69,900	71,631	67,155	65,945
Equity					
Fund for general banking risks	530	630	630	650	700
Common equity	2,715	2,765	2,815	2,865	2,964
Share capital	250	250	250	250	250
Other common equity	2,995	3,145	3,195	3,265	3,414
Total liabilities and equity	70,190	73,295	75,075	70,670	69,609
<i>Common equity tier 1 capital</i>	2,986	3,232	3,384	3,438	3,556
Income statement summary (EUR m)					
Net interest income	375.5	365.4	368.9	323.4	331.4
Net fee and commission income	42.4	42.4	40.9	40.0	41.4
Net result from other income/expenses	-4.9	4.7	1.1	6.6	16.1
Administrative expenses	165.6	171.2	165.3	184.8	167.9
Operating result before risk provisions	247.4	241.3	245.6	185.2	221.0
Net income from asset revaluation	61.0	42.6	92.9	-31.7	-39.9
Operating result	308.4	283.9	338.5	153.5	181.1
Taxes on income	0.9	4.7	1.5	0.3	0.9
Net income	49.2	50.6	49.3	50.6	50.2
Profit carried forward	1.1	0.3	0.9	0.2	0.8
Net profit	50.3	50.9	50.2	50.8	51.0

Source: L-Bank, SNL



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