

NORD/LB Luxembourg S.A. Covered Bond Bank

Public Sector Covered Bonds

Full Rating Report

Ratings/Outlook

Lettres de Gages Publiques	AAA/Stable
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Rating Rationale

IDR/Outlook	A-/Stable
D-Cap	3 notches (‘Moderate High’ risk)
IDR Uplift	1 notch
Tested rating on a PD Basis	AA
Recovery given default uplift (notches)	2
Covered Bond Rating	AAA
OC Fitch considers in analysis (%)	25.7
‘AAA’ Breakeven OC (%)	19.0
DR – Long-Term Issuer Default Rating	
PD – Probability of default	
OC – Overcollateralisation	

Discontinuity Risk (D-Cap of 3 notches)

Asset segregation	Very low
Liquidity gap and systemic risk	Moderate high
Systemic alternative management	Low
Cover pool-specific alternative management	Low
Privileged derivatives	Moderate
Asset segregation	Very low

Key Data

	Dec 15
Asset type	Public sector
Cover assets (EURbn)	4.0
Lettres de Gage (EURbn)	3.2
Calculated weighted-average life assets (years)	7.1
Stressed weighted-average life assets (years)	6.7
Weighted-average life LdGPs (years)	6.7

Related Research

[Fitch: No Rating Impact from NORD/LB CFB Covered Bonds Transfer \(June 2015\)](#)

[Fitch Rates NORD/LB Luxembourg Covered Bond Bank; Withdraws NORD/LB COVERED FINANCE BANK \(June 2015\)](#)

[Fitch Affirms NORD/LB Luxembourg S.A. Covered Bond Bank's Lettres de Gages Publiques at 'AAA' \(February 2016\)](#)

[2016 Outlook: Covered Bonds \(December 2015\)](#)

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Key Rating Drivers

Rating Rationale: The ‘AAA’ rating with Stable outlook of NORD/LB Luxembourg S.A. Covered Bond Bank’s (NORD/LB CBB) Lettres de Gage Publiques (LdGPs) is based on NORD/LB CBB’s Long-Term Issuer Default Rating (IDR) of ‘A-’, the unchanged Discontinuity Cap (D-Cap) of three notches (“moderate high” risk), an IDR uplift of one notch and the 25.7% overcollateralisation (OC) that Fitch Ratings takes into account in its analysis, which provides more protection than the 19% ‘AAA’ breakeven OC.

D-Cap Unchanged: The D-Cap remains unchanged at three notches, driven by the “moderate high” risk assessment for the Liquidity Gap and Systemic Risk component. Fitch has revised the Systemic Alternative Cover-Pool Management component to “low” from “very low”, reflecting the agency’s view that an alternative manager would face more complex insolvency procedures for programmes embedded in an integrated template as opposed to a special-purpose vehicle (SPV) template.

Credit Loss Remains OC Driver: The decreased credit loss component of 17.1% remains the main constituent of the breakeven OC. For the first time, Fitch has credit linked the programme’s rating to Germany (AAA/Stable/F1+). The German exposure has continuously increased over the past three years, in line with the issuer’s strategy to focus its asset origination on Germany and other European countries.

Programme Highlights

Benchmark Triggers More Sales: The asset-disposal loss component increased to 4.4% from 2.6%, mainly triggered by the issuance of the second benchmark issued in 2015. In our modelling, cash inflows are used to redeem earlier US dollar liabilities, therefore more forced asset sales are necessary for the timely repayment of the benchmark maturing in 2018. In addition, slightly higher refinancing spreads have been applied.

Sensitivity Towards Issuer Default Timing: The increased cash flow valuation component of 2.2% (-0.6% previously) mainly reflects the sensitivity towards later dates at which the recourse against the cover pool is enforced. NORD/LB CBB issued two benchmarks in 2015, consequently more funds are required at later periods of the programme’s life to ensure the timely repayment of these benchmarks. The application of foreign-exchange stresses as per the ‘Covered Bond Rating Criteria’ dated 11 March 2016 further contributed to the increase.

Internationally Diversified Pool: The cover pool remains geographically diversified with concentrations to Germany (43% of cover assets) and the US (26%). The share of German assets increased by 8%, while US assets declined in local currency (but remained stable in euro). The share of UK assets increased to 4% from 1%, underpinning the issuer’s new focus on European countries. The cover pool volume remained fairly stable at EUR4.0bn.

Privileged Derivatives in Place: NORD/LB CBB has hedges in place to mitigate interest-rate and foreign-currency risks, which Fitch considered in its analysis. Fitch stressed the remaining open-interest-rate position and open-foreign-currency position by modelling cash flows under appropriate stresses.

Sovereign Impact

The covered bond rating does not include any adjustments due to the sovereign ratings of Germany and Luxembourg, which are both rated 'AAA'/Stable/'F1+'. For countries rated above 'A+' Fitch applies its standard liquidity gap analysis, which forms part of the D-Cap, focusing on asset liquidity following an idiosyncratic stress of an issuer, while the banking sector as a whole is expected to remain stable and not suffer from a systemic crisis. Therefore, Fitch's view on liquidity and systemic risk is unlikely to change unless either Luxembourg or Germany was downgraded four notches to 'A+' or below.

Exposure to countries with lower country ceilings than the 'AAA' covered bond rating is limited and amounts to about 9% (exposure to Japan, Korea, Italy, Poland and the Czech Republic). For these exposures, Fitch adjusted the calculated recovery rates for higher rating scenarios, which are applied in its cash flow analysis.

Sensitivity Analysis

NORD/LB CBB's Long-Term IDR of 'A-' has a Stable outlook and reflects the likely support from its parent Norddeutsche Landesbank Girozentrale (NORD/LB GZ), which provides a letter of comfort to NORD/LB CBB. With the IDR uplift of one notch and D-Cap of three notches in place, NORD/LB CBB's covered bond rating is likely to be vulnerable to downward IDR changes of one notch or more.

If NORD/LB CBB's IDR remained at 'A-', the covered bond rating would be unlikely to changed due to IDR uplift and D-Cap impact, unless the combination of the single-notch IDR uplift and D-Cap of three notches (equivalent to a total of four notches currently) fell to three notches. Please refer to Appendix 2 for further details on the Discontinuity risk assessment.

There is a significant cushion between the breakeven OC and the level of OC that Fitch gives credit to in its analysis, which equals 25.7% OC, making the programme less vulnerable to changes in the breakeven OC.

Related Criteria

[Asset Analysis Criteria for Covered Bonds and CDOs of European Public Entities \(January 2016\)](#)

[Counterparty Criteria for Structured Finance and Covered Bonds \(May 2014\)](#)

[Counterparty Criteria for Structured Finance and Covered Bonds: Derivative Addendum \(May 2014\)](#)

[Covered Bonds Rating Criteria \(March 2016\)](#)

[Covered Bonds Rating Criteria - Public Sector Liquidity and Refinancing Stress Addendum \(Jan 2015\)](#)

[Criteria for Interest Rate Stresses in Structured Finance Transactions and Covered Bonds \(May 2016\)](#)

[Rating of Public-Sector Entities - Outside the United States \(Feb 2016\)](#)

[State Revolving Fund and Leveraged Municipal Loan Pool Criteria \(October 2015\)](#)

[Exposure Draft: Counterparty Criteria for Structured Finance and Covered Bonds \(April 2016\)](#)

[Exposure Draft: Counterparty Criteria for Structured Finance and Covered Bonds - Derivative Addendum \(April 2016\)](#)

Abbreviations

D-Cap: Discontinuity Cap
IDR: Issuer Default Rating
OC: Overcollateralisation
PD: Probability of default
WAL: Weighted average life
RDR: Rating default rate
RRR: Rating recovery rate
RLR: Rating loss rate

The Issuer

NORD/LB Luxembourg S.A. Covered Bond Bank (CBB) (A-/F1/Stable) was established in 2015 as a legal successor of NORD/LB Luxembourg S.A. after NORD/LB Luxembourg S.A.'s merger with its fully owned subsidiary NORD/LB Covered Finance Bank S.A.

NORD/LB CBB is wholly owned by Norddeutsche Landesbank Girozentrale (NORD/LB GZ, A-/F1/Stable), which guarantees fulfilment of the CBB's obligations with a letter of comfort. Please refer to the most recent reports on NORD/LB GZ and the integration of NORD/LB CBB within the group: [Full rating report](#) (November 2015), [Update](#) (November 2015) and [Ratings Navigator](#) (June 2015).

NORD/LB CBB operates as a specialised covered bond bank with the task of generating additional covered refinancing for the core business of the NORD/LB group by issuing covered bonds in accordance with Luxembourg law (Lettres des Gage).

The covered bond holders benefit from a dual recourse against NORD/LB CBB, which is secured by the cover assets, and an unsecured, unsubordinated recourse against NORD/LB CBB (see Appendix 1 for a programme summary).

IDR Uplift of One Notch

In bank resolution frameworks where covered bonds are favourably treated, such as under the Bank Recovery and Resolution Directive for EU countries, Fitch's analysis starts with an uplift over the IDR of up to two notches for programmes of issuers rated in the 'BB' category and above. A two-notch uplift is granted if at least two of the following three factors are present in Fitch's view or one notch if one of the factors is present.

Figure 1

IDR Uplift of 1 for NORD/LB CBB's Covered Bonds

IDR uplift factors	Fitch assessment
Relative ease/motivation for alternative resolution methods to liquidation	No. NORD/LB CBB is not a global or domestic systemically important bank that would be more likely to be supported by resolution tools other than liquidation if insolvent.
Covered-bond-intensive country	No
Sufficient protection through senior unsecured debt	Yes. NORD/LB CBB's level of senior unsecured debt is higher than the 5% threshold (relative to the total balance sheet, adjusted for insurance assets and derivatives) that Fitch considers.

Source: Fitch

Combined with a reference IDR of 'A-' for NORD/LB CBB, the one-notch IDR Uplift leads to a floor for the LdGP rating at 'A', subject to the legal minimum OC.

D-Cap of Three Notches ('Moderate High')

The potential risk that a covered bond could default if recourse shifts to the cover pool from an issuer is captured via Fitch's D-Caps, which determine the maximum uplift from the IDR (adjusted by any IDR uplift) to the tested rating on a probability of default (PD) basis. It reflects the highest risk assessment of the five components ranging from '8' for minimal discontinuity to '0' for full discontinuity.

Fitch has assigned this programme a D-Cap of three notches ("moderate high" risk). Liquidity gap and systemic risk is assessed as moderate high risk and thus constitutes the weak link in the analysis.

Figure 2

Summary of NORD/LB CBB's Covered Bonds Discontinuity Risk Assessment

Overall assessment	3 notches (moderate risk)
Asset segregation	Very low
Liquidity gap and systemic risk	Moderate high
Systemic alternative management	Low
Cover-pool-specific alternative management	Low
Privileged derivatives	Moderate

Source: Fitch

Details on the assessment for each D-Cap component can be found in Appendix 2.

Fitch revised the assessment of the 'Systemic Alternative Management' component to "low" from "very low". This reflects the agency's view that the role of an alternative manager for covered bond programmes embedded in an integrated template would be challenged by complexity of insolvency procedures upon the transition from the issuer to the cover pool as the source of covered bond payments. The altered assessment is in line with the updated assessment of German Pfandbriefe programmes having a comparable legal programme structure.

Cover Pool

As of 31 December 2015, the cover pool contained 285 assets forming a cover pool volume of EUR4.0bn.

Figure 3

NORD/LB CBB Public-Sector Pool and Lettres de Gage Stratifications

Cover assets (EURm)	4,017	Interest type after swaps (%)		
Lettres de Gage (EURm)	3,197		Assets	Liabilities
		Fixed rate	58	68
Number of assets	285	Floating rate	42	32
Number of obligors*	117			
		Denomination after swaps (%)		
Instrument type (%)			Assets	Liabilities
Bonds	63	CHF	2.1	0
Promissory notes	7	EUR	65.8	67.8
Loans	30	GBP	1.2	0
		JPY	0.4	0
Redemption type (%)		USD	30.5	31.9
Bullet	64	NOK	0	0.3
Annuity	3			
Instalments	33			

Source: Fitch/NORD/LB CBB

*Fitch aggregation

The programme mainly contains bonds (63% of cover assets), including covered bonds. The cover pool is denominated in six different currencies, the outstanding LdGP in three different currencies. The geographical breakdown is outlined below:

Figure 4

NORD/LB CBB Public-Sector Pool Geographical Distribution

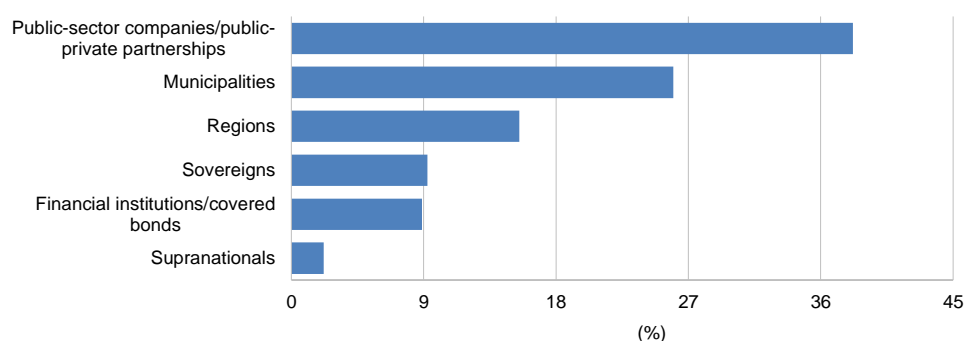
Country of assets	Nominal (EURm)	Weight (%)
Germany	1,732	43.1
USA	1,037	25.8
Canada	256	6.4
UK	170	4.2
Poland	138	3.4
Italy	107	2.7
Netherlands	99	2.5
Supranationals	88	2.2
Austria	87	2.2
Luxembourg	70	1.7
South Korea	55	1.4
Denmark	40	1.0
France	38	1.0
Czech Republic	30	0.8
Norway	20	0.5
Finland	20	0.5
Japan	16	0.4
Ireland	15	0.4

Source: Fitch/NORD/LB CBB

The programme is internationally diversified with concentrations to Germany (43% of cover assets) and the US (26%). An overview over the different asset classes is provided below:

Figure 5

Classification of Cover Assets



Source: Fitch

Figure 6

Default Model Output (%)

Rating level	AAA	AA+	AA
RDR	21.3	19.3	18.1
RRR	31.5	38.3	38.7

Source: Fitch

Cover Pool Credit Analysis

Fitch analysed the public-sector portfolio using its applicable *Asset Analysis Criteria for Covered Bonds of European Public Entities* dated 20 January 2016.

The majority of cover assets either carries a public rating or an internal credit opinion from Fitch's International Public Finance (IPF) team (about 80% of the cover pool). For the remaining assets, assumptions were made. The specific asset model assumptions are outlined in more detail below.

Credit Link to Germany

For the first time, Fitch has credit linked NORD/LB CBB's LdGP programme rating to Germany (AAA/Stable/F1+). This is based on the continuous increase of German assets over recent years to 43% of the cover pool, reflecting NORD/LB CBB's strategy to focus its asset origination in Germany and other European countries.

Rating Assumptions for German Municipalities

Fitch divided German municipalities into two groups in this analysis. For the first group, Fitch assigned internal credit opinions provided by Fitch's IPF team. For the second group, no individual credit assessment has been conducted. Instead, a 'BBB-' assumption has been applied, which reflects a conservative average credit quality of these municipal obligors on a portfolio basis.

Public-Sector Entities

Exposure to public-sector entities accounts for about 32% of the cover pool.

When a public rating for the PSE itself was available, this rating was applied. Otherwise, the rating assumption was derived from the approach outlined in Fitch's criteria report *'Rating of Public-Sector Entities - Outside the United States'* dated 22 February 2016. The criteria report distinguishes between a top-down approach (based on the controlling municipal sponsor) and a bottom-up approach (based on the standalone creditworthiness of the PSE). As Luxembourg's covered bond law requires a controlling public owner, the top-down approach was applied for most PSEs. The rating of this controlling stakeholder was then either equalised or notched down (by up to three notches), depending on the compounded share of public ownership. In line with the criteria report, more conservative rating assumptions were formed for exposures with a fragmented ownership structure.

US Municipal Exposure

US municipal exposure accounts for about 26% of NORD/LB CBB's cover pool. Most US municipal bonds are publicly rated (23% of cover assets), for the remainder rating assumptions in line with the *'State Revolving Fund and Leveraged Municipal Loan Pool Criteria'* dated 29 October 2015 criteria were formed. Mostly 'BB' assumptions were applied.

Fitch models all sub-national obligors jointly with their sovereign to account for the increased default risk upon sovereign default, which is higher than indicated by the credit opinion or rating assumption assigned to the sub-national obligor. Fitch's PCM therefore assumes that a high share of sub-national assets defaults upon the default of the sovereign and recovers with the sovereign recovery rate. For US municipalities, a conditional default probability assumption of 40% was assumed, which is lower than the 80% used for European sub-nationals. This mirrors the more federal framework of US municipalities compared with European municipalities, corresponding to a lower correlation between US municipalities and the US sovereign.

The recovery assumptions for US assets were based on the type of bond and vary between 15% and 70% in a 'AAA' scenario.

Private-Public Partnerships

NORD/LB CBB's programme also comprises loans to private-public partnerships (PPP), which account for about 6% of the cover pool. The assets mainly comprise healthcare and infrastructure projects from European countries (the UK, the Netherlands and Luxembourg). A conservative 'CCC' assumption was applied as Fitch did not conduct a detailed analysis of these assets. This contributed about one percentage point to the credit analysis results shown in Figure 6.

Covered Bonds

NORD/LB CBB's LdGP cover pool also comprises covered bonds (about 4% of the cover pool). To separate the positive effect from recoveries inherent in covered bond ratings from the genuine default probability, ratings on a probability of default basis were assigned, if available. Otherwise the rating assumption was lowered by two notches. In the absence of a public rating, the IDR from the underlying issuer was assigned.

Fitch has high recovery expectations for covered bonds, which was reflected in this analysis by assigning recovery rate assumptions of 40% in a 'AAA' scenario.

Obligor and Country Concentrations

To capture the risk posed by large obligor exposures, Fitch stresses the pair-wise correlation of all obligors exceeding 2% of the cover pool by 50% and reduces the assumed recovery rates by 25%. This stress was applied to about 18% of the cover pool assets irrespective of any correlation uplifts applied for countries or regions.

The stress is not applied to artificially aggregated exposures, such as an artificially created eurozone sovereign exposure, as the linking of such exposures already forms an additional stress under Fitch's PCM analysis. Eurozone sovereign exposure is aggregated as Fitch is of the opinion that a high contagion risk exists between the eurozone sovereigns in scenarios of high stress.

Cash Flow Analysis

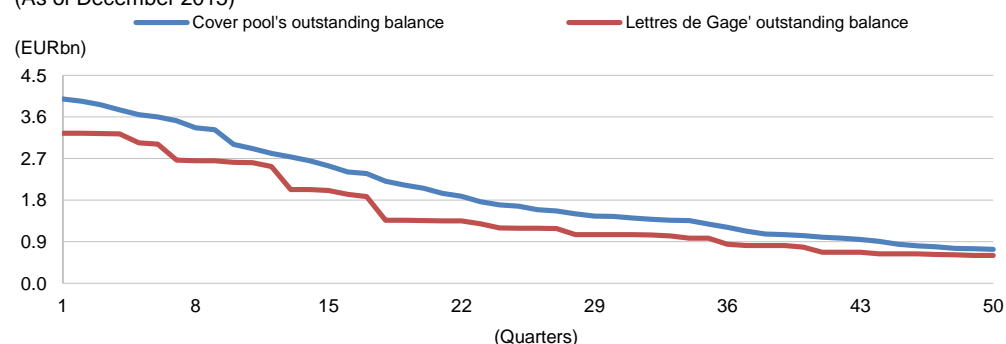
Fitch's cash flow model simulates the asset cash flows to reflect prepayment, servicing costs, delinquencies, defaults and recoveries in multiple stress scenarios under various issuer default timings.

Fitch assumes that an alternative manager would sell part of the portfolio to ensure the timely payment of outstanding covered bonds in case of a liquidity shortfall. A price cap was applied on loan sales within the first 12 months of the enforcement of the recourse against the cover pool. Fitch calculated a stressed price of 87% of par on average for the programme's assets sold to bridge maturity mismatches. However, there is no guarantee that a portfolio could be realised in any prevailing economic environment.

Fitch identified a low-interest-rate scenario as the worst case for NORD/LB CBB's covered bond programme. NORD/LB CBB's 'AAA' LdGP rating is based on a 'AA' tested rating on a PD basis and two notches of recovery uplift.

Figure 7

Amortisation Profile (Post Swap) (As of December 2015)



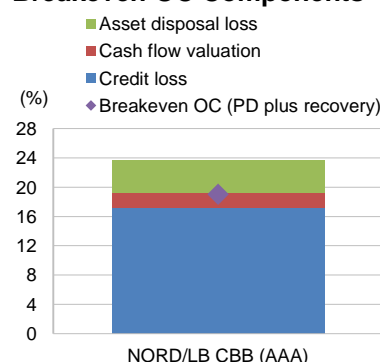
Source: Fitch/NORD/LB CBB

Some of NORD/LB CBB's LdGP incorporate call rights enabling the issuer to redeem these bonds earlier than the final maturity date. Fitch assumed that an alternative manager would use this additional flexibility if it is beneficial for the programme, which is the case in the identified worst case scenario in the current analysis.

Prepayment Assumptions

Prepayment assumptions are applied as constant annualised rates on the performing portfolio. According to Fitch's 'Asset Analysis Criteria for Covered Bonds and CDOs of European Public Entities' dated 20 January 2016, the agency tests for high and low prepayment rate scenarios ranging between 0% and 10%. As the majority of cover assets consists of bonds and Schuldscheindarlehen (promissory notes) that cannot prepay, Fitch only tested for 0% and 1% in the current analysis.

Figure 8
Breakeven OC Components



Source: Fitch

Recovery Timing

The recovery timing is the length of time it will take to receive the recovery proceeds. Fitch calculated a weighted average recovery time of five years for the programme, mirroring the internationally diverse composition of NORD/LB CBB's cover pool.

Privileged Derivatives

NORD/LB CBB has entered into different swap agreements to hedge against adverse interest-rate and currency movements. Fitch has modelled the post-swap cash flows in its analysis. Fitch applied the foreign-exchange-rate stress assumptions outlined in Fitch's 'Covered Bonds Rating Criteria' dated 11 March 2016 on the remaining open foreign-currency positions after taking into account the currency swaps.

Refinancing Spread Assumptions

Fitch calculates refinancing spread levels (RSLs) which are added to the stressed interest rates to derive the stressed net present value of future cash flows. RSLs represent the discount on the sales price of cover assets once recourse against the cover pool has been enforced. The calculation of RSLs is based on four steps, starting with the classification of the countries into six groups, depending on the historically observed sovereign spread levels and the sovereign ratings. Fitch classified South Korea (AA-/Stable) into country 'Group C', which corresponds to an assumed 'AAA' RSL of 300bp. Please refer to 'Covered Bond Rating Criteria – Public Sector Liquidity and Refinancing Stress Addendum', dated 29 January 2015 for the classification of the remaining countries.

This first step is followed by the classification of the instrument type (e.g. bond or loan), the classification of the debtor (e.g. sovereign or municipal) and a term adjustment for portfolios with a weighted average life exceeding five years. For covered bonds, a classification one category below a sovereign debtor was applied to reflect the low spread levels in times of stress and the preferential regulatory treatment of covered bonds. PPPs were allocated to the category 'other'.

Breakeven OC for the Rating

Fitch calculated a 'AAA' breakeven OC of 19%, which is higher than the 'AAA' OC of 15% determined in the 2015 review. This is mainly driven by the cash outflows triggered by US dollar redemptions and the benchmark maturing in 2018, increasing both cash flow valuation component (2.2%) and the asset-disposal loss (4.4%). The 'AAA' breakeven OC relates to a 'AA' tested rating on a PD basis and recoveries given default in excess of 91% in a 'AAA' scenario, which supports a two-notch uplift to the 'AAA' covered bond rating.

The decreased credit loss component of 17.1% (18.5% previously) continues to be the main driver of the 'AAA' breakeven OC. The decrease mainly reflects the credit link to Germany (AAA/Stable/F1+), which was set by the agency for the first time.

The asset disposal loss component increased to 4.4% (2.6% previously), mainly reflecting the altered LdGP profile resulting from the two euro benchmarks issued in 2015. In our analysis, the programme exhibits cash outflows due to maturing US dollar LdGP and the first euro benchmark due in 2018. This doubled the volume of forced asset sales to ensure timely payment on outstanding LdGP. Additionally Fitch also applied slightly higher refinancing spreads.

The cash flow valuation component also increased to 2.2% from -0.6%, showing the programme's sensitivity towards later points in time at which recourse against the cover pool is enforced. Fitch tested for up to six quarters after the pool cut-off date, plus at the benchmark maturity, rather than up to four quarters previously, to incorporate the first benchmark due in 2018. The application of stresses applied on open foreign exchange positions as outlined in Fitch's 'Covered Bonds Rating Criteria' dated 11 March 2016 further increased this component.

For this rating that considers both an uplift on a probability of default basis and for recoveries given default, the asset disposal loss component is in line with the 'AA' tested rating on a PD basis, while the other breakeven OC components represent 'AAA' stresses. This, plus Fitch's testing for at least 91% recoveries rather than 100% to assign two notches credit for recoveries given default, is why the sum of the breakeven OC drivers is higher than the 'AAA' breakeven OC. See [Breaking Down Breakeven Overcollateralisation](#) (July 2014) for Fitch's approach on determining breakeven OC components.

In the future, the breakeven OC for the rating will be affected, among other things, by the credit quality of the cover pool and the profile of the cover assets relative to the outstanding LdGP, which can change over time.

OC Fitch Relies On

Fitch bases its analysis on the lowest OC of the previous 12 months, which is 25.7% as of December 2015.

Programme Review

Fitch will periodically review the credit quality of the cover pool and perform a cash flow analysis to assess whether the OC taken into account by the agency provides protection against identified risks commensurate with the rating of the covered bonds issued by NORD/LB CBB under this programme. Cover pool and covered bonds information will be updated regularly and displayed on Fitch's covered bond surveillance tool (available at www.fitchratings.com) and in the quarterly [Covered Bonds Surveillance Snapshot](#) (April 2016).

Appendix 1: Programme Summary

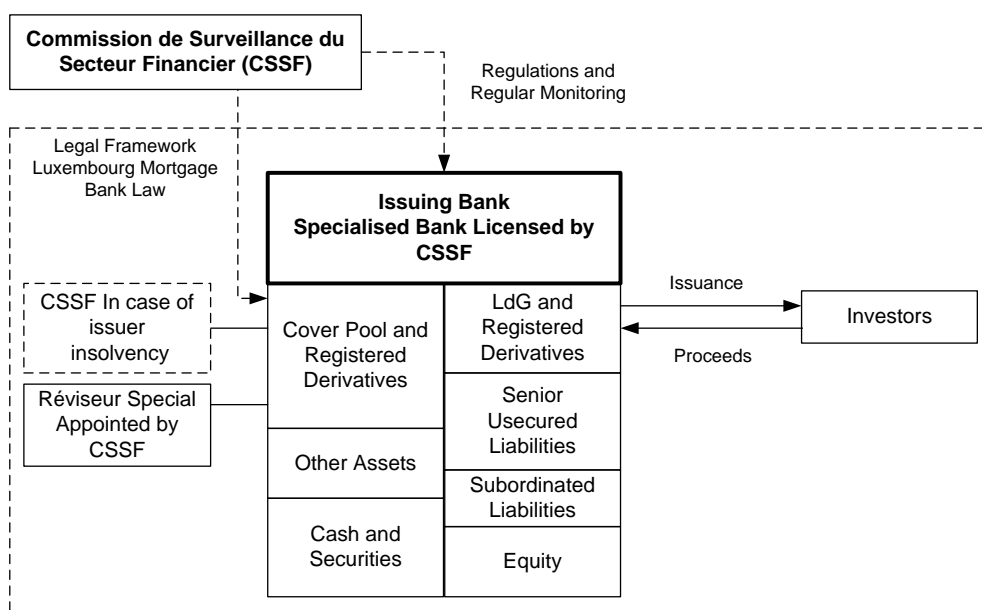
Under this programme, NORD/LB CBB can issue LdGPs, which are governed by dedicated articles 12-1 to 12-12 in the Luxembourgian Financial Sector act and supplementary circulars issued by the Luxembourgian regulator Commission de Surveillance du Secteur Financier (CSSF). The public-sector covered bonds are secured by a dynamic pool of public-sector assets, predominantly stemming from Germany (43%), the US (26%) and other European countries (23%). The cover assets remain on NORD/LB CBB's balance sheet and are serviced by the issuer. All cover assets are recorded on a dedicated cover register.

The covered bonds rank pari passu among themselves and represent direct, unsecured and unconditional obligations of NORD/LB CBB. The programme is regulated by CSSF which is also responsible to appoint an alternative manager upon the opening of insolvency proceedings on NORD/LB CBB.

The cover assets would not be affected by the opening of insolvency proceedings, as they would be separated from NORD/LB CBB's general insolvency estate. This separated estate would form a covered bond bank with limited business activity, similar to the Pfandbriefbank with limited business activity concept stipulated in the German Pfandbrief act. The entity would solely fulfil the purpose of managing the cover assets to repay LdGP in a timely manner and in full. Therefore it carries a banking licence and the alternative manager is provided with extended rights to manage the cover pool assets, including the right to sell assets and to receive cash flows from the assets.

Figure 9

Simplified Group Structure Diagram



Source: Fitch, Transaction documents. As at date

Appendix 2: D-Cap Assessment for NORD/LB CBB's Covered Bonds

Asset Segregation: Very Low Risk

Fitch expects that ring-fencing of the cover pool will be effective when applying any D-Cap assessment other than full discontinuity, given the “all or nothing” nature of this risk. The differentiation between the D-Cap categories is based on whether any portion of the cash flow or assets might still be lost (and if so, to what extent), which would lower the cover pool amount available for bondholders.

The agency also notes the explicit preferential rights of LdGP holders, which rank higher than any other legal claim. As a result, Fitch regards risks such as claw back and commingling risk as remote as cash flows from assets are separated through the registration of cover assets in a cover register and the preferential claim excludes other enforcements besides the claims by LdGP holders.

Figure 10

Asset Segregation: Very Low Risk

Component driver	Fitch assessment
Segregation of cover pool from other creditors of issuer	Yes, all cover assets are recorded on a dedicated cover register.
Asset and liability claw back risk	Remote risk of asset and liability claw back due to the general preferential right of LdGP holders which rank higher than any other claim or enforcement by law.
Commingling risk	Remote risk due to the preferential right of LdGP holders (see above).
Set-off risk for deposits	In general excluded in loan contracts, additional protection by the preferential right of LdGP holders.

Source: Fitch

Liquidity Gap and Systemic Risk: Moderate High Risk

The analysis of the liquidity gap and systemic risk component considers liquidity risks, principal payment risk and systemic risks. The Luxembourgian covered bond legislation does not require a liquidity provision and only allows covered bonds with hard-bullet redemption profiles. As NORD/LB CBB's portfolio contains a high portion of highly liquid assets (bonds, covered bonds and Schuldscheindarlehen) deemed to be sufficient to cover the liquidity needs for any 12-month period over the life of the programme, Fitch would generally assign a “moderate” assessment.

Some comfort can also be drawn from the self-imposed liquidity commitment that the issuer provides on its homepage. NORD/LB CBB voluntarily complies with a liquidity rule similar to the 180-day liquidity provision stipulated in the German Pfandbrief act as the Luxembourgian covered bond legislation does not require a mandatory liquidity mechanism. NORD/LB CBB covers the largest aggregated daily difference between assets and LdGP over the next 180 days. However, the issuer can change or remove this voluntary liquidity protection at any time. Changes will come into force one month after the republication of commitment.

NORD/LB CBB solely relies on an intra-group swap counterparty. Fitch assumes that both entities would default together. As termination payments rank pari passu with covered bonds in Luxembourg, they could cause a potential strain on liquidity. Fitch's “moderate high” risk assessment reflects this conditional risk of termination payments arising in the immediate aftermath of the issuer defaulting from derivatives concluded with a simultaneously defaulting internal counterparty.

Figure 11

Liquidity Gap and Systemic Risk: Moderate High risk

Component driver	Fitch assessment
Principal protection	Not fully sufficient. Covered bonds are issued as hard bullet. NORD/LB CBB's cover pool comprises a high share of liquid assets sufficient to cover any 12 months liquidity needs over the life of the programme. The issuer publishes a voluntary 180 days' liquidity provision ensuring to comply with the liquidity requirements stipulated in the German Pfandbrief Act (180 days rule) on a voluntary basis. This self-commitment can be withdrawn with one-month notice.
Liquidity protection	Fitch deems the share of highly liquid assets to be sufficient to cover more than three months of interest due, including a buffer to cover senior expenses. NORD/LB CBB also publishes a self-imposed 180-day liquidity rule (see above).
Access to repo transactions	Following issuer default, the cover pool is separated from the general insolvency estate and forms a covered bond bank with limited business activities which could potentially allow to repo its own covered bonds or eligible assets within the euro system.
Swap termination payments	NORD/LB CBB has registered intra-group interest rate and foreign currency derivatives. As termination payments rank pari passu with covered bonds, Fitch assumes that the issuer and the intra-group swap provider would default simultaneously. This could create a short term liquidity stress once the recourse switches from the issuer to the cover pool.
Systemic risks	No additional stress applied. Because Luxembourg (AAA/Stable/F1+) is rated above A+, Fitch focuses on asset liquidity following an idiosyncratic stress of an issuer, while the banking sector as a whole is expected to be stable.

Source: Fitch

Alternative Management

Systemic Alternative Management: Low Risk

Fitch takes into consideration the framework or contractual clauses governing the appointment of a substitute manager – together with the length of time required to appoint one – any potential conflict of interest (in cases where a single administrator in a bankruptcy takes care of covered bonds and other creditors), the manager's responsibilities in the servicing and liquidation of the cover assets to meet payments due on the covered bonds and any further protection due to oversight or potential support for regulated covered bonds.

The agency changed the assessment to "low" from "very low" as Fitch is the opinion that the role of the alternative manager would be aggravated by more complex insolvency proceedings for programmes embedded in an integrated template if the issuer defaults. The "low" assessment factors in the strong position of the alternative manager laid down in the Luxembourgian covered bond legislation and the active oversight by the Luxembourgian regulator CSSF.

Figure 12

Systemic Alternative Management: Moderate Risk

Component driver	Fitch assessment
Administrator takes exclusive care of covered bondholders? When are they appointed?	An alternative administrator is appointed by court upon the insolvency of the issuer.
Importance of timeliness of payments in the legal provisions	The special estate corresponding to a covered bond bank with limited business activity solely pursues the goal to pay back all LdGP timely and in full.
Substitute manager able to sell cover assets or borrow to make timely payments	The alternative administrator can issue new LdGP.
Conflicts of interest in cover pool management	The special administrator is solely responsible for the administration of the LdGP programme after the insolvency of the issuer.

Source: Fitch

Cover-Pool-Specific Alternative Management: Low Risk

Fitch focuses on the likely ease of the transferability of relevant data and IT systems to an alternative manager and buyer, with such quality and ease also judged on the quality and quantity of data provided to Fitch.

Fitch has assigned a “low” assessment, reflecting that the majority of cover assets comprises marketable assets and the low number of cover assets (285 assets as of December 2015). This also reflects the high quality and timeliness of NORD/LB CBB’s data delivery and the IT systems used, which are market standard for German peers.

The role of an alternative manager, however, could be complicated by the specific knowledge required due to the international diversification and the inclusion of more complex asset types, such as PPPs, in NORD/LB CBB’s cover pool.

Figure 13

Cover Pool Alternative Management for NORD/LB CBB’s Covered Bonds

Component drivers	Fitch assessment
Cover assets, debtors’ accounts and privileged swaps clearly identified within IT systems	Market standard systems are in place that ensures identification of registered assets.
Standardised or custom-made IT systems used.	Fitch considers the used IT systems as standard among peers in Germany, enabling an alternative manager to easily take over his role as cover pool manager.
Automation and speed of cover pool reporting	Considered very strong. All Fitch templates provided within one month of the end of the quarter, NORD/LB CBB also provides additional information on specific assets.
Adequate filing of loan documentation, evidence of security	Loan files for public-sector loans are available in paper based form.
Disaster recovery plan and back-up IT systems in place	NORD/LB CBB has one data centre, split on two different sites. Backups are created on a daily basis. Additionally the business continuity plan is tested annually.

Source: Fitch

Privileged Derivatives: Moderate Risk

Fitch considers programmes encompassing privileged hedging agreements to be more vulnerable to a potential insolvency of the issuer. Privileged derivatives are swap contracts designed to continue hedging the cover assets or outstanding covered bonds once recourse against the cover pool is enforced. In Luxembourg, registered derivatives rank pari passu with covered bonds.

The documentation of the privileged derivatives in the programme will be amended to introduce rating replacement triggers, remedial action periods and collateral account banks in line with Fitch’s counterparty criteria. Fitch expects these changes to be implemented until mid-June 2016. The collateral formula is different to the calculation as per Fitch’s criteria, but the calculated amounts meet the requirements outlined in Fitch’s counterparty criteria.

The agency draws comfort from the operational and contractual provisions in place, as collateral is earmarked and posted to separate accounts, irrespective of rating triggers. Should Fitch become aware of the issuer no longer intending to make the respective changes to the documentation, or should the changes not be conducted within the agreed timeline, Fitch will take rating action.

Figure 14

Covered Bonds Privileged Derivatives for NORD/LB CBB's Covered Bonds

Component drivers	Fitch assessment
Replacement provision of swap counterparties post issuer default	Proposed amendments to be in line with Fitch criteria.
Intra-group or external counterparties	Interest rate and currency swaps for assets and liabilities hedged by an internal counterparty.
Magnitude of swap exposure. Is it standard?	All swaps are market standard swaps. Some of the currency swaps feature adjustments to the prevailing exchange rates every three to six months. The materiality of the swaps is assessed as high as the currency swaps decrease the currency materially.
Termination payments to swap counterparties ranking pari passu with covered bonds	Termination payments to swap counterparties rank pari passu to covered bonds in the Luxembourgian covered bond legislation.
Cover assets isolated in an SPV or under an integrated template	Cover assets are embedded in an integrated template.

Source: Fitch

Appendix 3: Originator and Servicer Operational Review

NORD/LB CBB is an experienced LdGP issuer. Fitch conducts regular on-site reviews, with the last review having taken place in October 2015. Fitch deems the underwriting and servicing processes of NORD/LB CBB to be in line with market standards.

Origination and Underwriting

Loan origination and customer relationship management activities for NORD/LB CBB are generally handled by NORD/LB GZ. The cooperation between the two entities is regulated through agency and various service level agreements.

With regard to new loan origination, NORD/LB CBB changed the geographical focus to mainly Germany and other Western European countries, which in the medium term is expected to further decrease the relative importance of its US exposure.

The underwriting process is generally performed in close cooperation with NORD/LB GZ, which provides the first credit analysis and assigns internal ratings. As a separate step, NORD/LB CBB representatives need to support the application and a further credit approval is sought within NORD/LB CBB. Upon approval, the loan amount is then disbursed by NORD/LB CBB, which acts as legal lender on all of its loan contracts.

Servicing

Credit exposures are reviewed at least annually on the basis of credit documentation prepared by NORD/LB CBB. NORD/LB CBB is integrated into the early warning systems of Nord/LB GZ. NORD/LB CBB's LdGP programme is managed in-house with market standard software. The integrated IT platform allows managing all loans, irrespective of their currencies and tenors, within one system.

Appendix 4: Outstanding Liabilities (Benchmarks Only)

Figure 15

List of Outstanding Benchmark Lettres de Gage

Currency	(Size/bn)	Coupon rate (%)	Interest type	Maturity	ISIN
EUR	0.5	0.25	Fixed	10 Mar 20	XS1199018398
EUR	0.5	0.13	Fixed	06 Nov 18	XS1316421137

Source: NORD/LB CBB

Appendix 5: Legal Framework

Figure 16

Main Characteristics of Luxembourgian Lettres de Gage Publiques Luxembourgian Financial Sector Act (implemented in 1997, latest amendment on 27 June 2013)

Issuers	Specialized financial institutions (banques d'émission de lettres de gage).
Supervision	All lettres de gage programmes are overviewed by the Commission de Surveillance du Secteur Financier (CSSF).
Public-sector collateral	<ul style="list-style-type: none"> Ordinary cover assets for LdGP programmes generally contain two types of assets: <ol style="list-style-type: none"> Claims against public bodies, which also comprises covered bonds backed by public sector debt; Claims against public sector entities. The public owner must have the controlling stake in the company. This comprises companies where the public owner is either the majority shareholder, has the majority of voting rights or appoints the majority of board members. Geographical scope to EU, EEA, OECD and countries with high and highest sovereign ratings from recognized rating agencies.
Substitute assets	<p>Up to 20% of the outstanding LdGP can be constituted by:</p> <ul style="list-style-type: none"> Cash; Deposits with central banks or financial institutions located in the EU, EEA, OECD or in a country with a sufficiently high rating (credit quality step 1 or 2); Obligations fulfilling the criteria laid down by article 42(3) of the law of 17 December 2010 (national implementation of UCITS directive).
Transfer of assets	The issuer can either hold the cover assets on its balance sheet or reference cover assets from a third-party bank by use of the refinancing register. The cover assets are segregated through registration in a cover register. A register can only be used for one type of lettres de gage.
Cover register	Cover register is required for the respective lettres de gage programme. Different cover registers must be used for each programme with a different collateral type.
Cover pool monitor	The issuer manages the programme, but is regularly checked by the cover pool monitor (réviseur d'entreprises agréé spécial). The cover pool monitor is an audit firm different to the auditor of annual accounts. The duties of the cover pool monitor comprise the regular monitoring of the cover pool, especially prior to new issuances, and an annual report to the Luxembourgian regulator CSSF.
Cover pool alternative manager	The alternative manager is appointed by court.
Minimum OC	2% nominal and on a net present value basis.
Protection of voluntary OC	The Luxembourgian Financial Sector act stipulates that excess assets can only be returned to the general insolvency estate of the issuer after full redemption of all outstanding lettres de gage.
Protection against mismatches	No specific hedging/ALM requirements.
Interest rate and currency stresses	None specifically prescribed by the legislation.
Treatment of swap counterparties	Registered swap counterparties benefit from the same priority of payments as covered bondholders.
Bank with limited business activity	<p>Post issuer insolvency, the cover pool is separated from the issuer's general insolvency estate and forms a covered bond bank with limited business activity which holds a banking licence.</p> <p>The alternative manager who runs the entity can issue new LdGP.</p>

Source: Fitch

The ratings above were solicited by, or on behalf of, the issuer, and therefore, Fitch has been compensated for the provision of the ratings.

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