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CREDIT OPINION
11 July 2018

Update

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RATINGS

NORD/LB Luxembourg S.A. Covered Bond Bank

Domicile	Luxembourg
Long Term Debt	(P)Baa3
Type	Senior Unsecured MTN - Dom Curr
Outlook	Not Assigned
Long Term Deposit	Baa2
Type	LT Bank Deposits - Fgn Curr
Outlook	Negative

Please see the ratings section at the end of this report for more information. The ratings and outlook shown reflect information as of the publication date.

Contacts

Katharina Barten +49.69.70730.765
Senior Vice President
katharina.barten@moodys.com

Alexander Hendricks, CFA +49.69.70730.779
Associate Managing Director
alexander.hendricks@moodys.com

Carola Schuler +49.69.7073.0766
MD-Banking
carola.schuler@moodys.com

» Contacts continued on last page

NORD/LB Luxembourg S.A. Covered Bond Bank

Update to credit analysis

Summary

We assign a Baa3 long-term issuer rating to Norddeutsche Landesbank Luxembourg S.A. Covered Bond Bank (NORD/LB CBB) with a negative outlook. Furthermore, we assign Baa2/ P-2 deposit ratings, a (P)Baa3 senior unsecured programme rating, Baa2/P-2 Counterparty Risk Ratings and a Baa2(cr)/P-2(cr) Counterparty Risk (CR) Assessment. The bank's Baseline Credit Assessment (BCA) is b2 and its Adjusted BCA is ba3. All the ratings and rating inputs are aligned with those of the bank's parent Norddeutsche Landesbank GZ (NORD/LB, Baa2 negative/Baa3 negative, b2)[1].

NORD/LB CBB's ratings reflect (1) the bank's b2 BCA; (2) its ba3 Adjusted BCA, incorporating two notches of affiliate support uplift from its parent, NORD/LB, and Sparkassen-Finanzgruppe (S-Finanzgruppe, Aa2 stable, a2)[2]; (3) the result of our Advanced Loss Given Failure (LGF) analysis, which takes into account the severity of loss faced by the different liability classes in resolution and provides three notches of rating uplift to NORD/LB CBB's deposit ratings and two notches of rating uplift to the senior unsecured programme ratings; and (4) a moderate probability of NORD/LB CBB receiving support from the Government of Germany (Aaa stable) in case of need, resulting in a one-notch rating uplift.

NORD/LB CBB's b2 BCA is aligned with that of its owner, NORD/LB, because we consider NORD/LB CBB to be a highly integrated and harmonised subsidiary.

Credit strengths

» NORD/LB CBB's asset quality is sound, characterised by its low share of nonperforming loans and the credit protection granted by its parent.

» The bank has a cost-efficient covered bond funding franchise.

» In resolution, senior creditors would face an extremely low loss given failure because they would benefit from the loss absorbing buffers implied by NORD/LB Group's subordinated instruments and its large volume of outstanding senior debt.

Credit challenges

» Tight integration into NORD/LB, which bears downside potential for NORD/LB CBB's ratings

» Strong emphasis on market funding

» Moderate return on assets after credit protection fee payments to the parent

Outlook

» NORD/LB CBB's long-term ratings carry a negative outlook.

» This mirrors the negative outlook on the ratings of its parent NORD/LB. As part of our 12 December rating action, we maintained a negative outlook on NORD/LB CBB's long-term issuer rating. The negative outlook therefore reflects our view that once the pending Bank Recovery and Resolution Directive amendments are transposed into German law, unsecured bonds that meet the definition of Article 46f of the German Banking Act (§46f KWG) could rank pari passu with future junior senior bonds. This may call into question the moderate probability of government support we currently consider warranted for senior unsecured debt instruments.

Factors that could lead to an upgrade

» There is currently limited upward pressure on NORD/LB CBB's ratings, as indicated by the negative outlook.

» Upward rating pressure on NORD/LB CBB's issuer, senior unsecured programme and deposit ratings would be subject to respective rating upgrades for its parent.

Factors that could lead to a downgrade

» As indicated by the negative outlook, we may downgrade the ratings of NORD/LB and of its subsidiary NORD/LB CBB if their BCAs are downgraded.

» We would consider downgrading the BCA of NORD/LB if (1) its pre-provision income proves insufficient to absorb additional loan-loss provisioning needs, specifically in the bank's high-risk ship finance portfolio, thereby hurting capitalisation; or (2) the bank faces extended difficulties in accessing debt markets for its medium- and long-term senior funding requirements.

» Furthermore, the long-term issuer and deposit ratings of NORD/LB and NORD/LB CBB may be downgraded if, at the group level, the amount of equal-ranking or subordinated debt for an individual debt class were to decline beyond our current expectations, leading to a less favourable outcome under our Advanced LGF analysis.

» We may downgrade by one notch the senior unsecured debt instrument ratings that currently incorporate one notch of government support if German legislative changes rank outstanding senior unsecured debt instruments pari passu with future issuance of junior senior debt. For additional information, please refer to Moody's affirms 22 German banks' senior unsecured debt ratings; changes 16 outlooks to negative, FAQ on credit impact of changes to EU insolvency hierarchy on German bank debt and Proposed Update to the Banks Rating Methodology – Issuer Ratings and German Registered Bonds.

Key indicators

Exhibit 1
NORD/LB Luxembourg S.A. Covered Bond Bank (Consolidated Financials) [1]

	12-17[2]	12-16[2]	12-15[2]	12-14[2]	12-13[3]	CAGR/Avg.[4]
Total Assets (EUR million)	14,634	15,134	15,048	15,480	15,873	-2.0[5]
Total Assets (USD million)	17,573	15,963	16,346	18,732	21,872	-5.3[5]
Tangible Common Equity (EUR million)	664	667	671	702	703	-1.4[5]
Tangible Common Equity (USD million)	798	704	729	849	968	-4.7[5]
Problem Loans / Gross Loans (%)	0.3	0.8	2.1	1.9	3.4	1.7[6]
Tangible Common Equity / Risk Weighted Assets (%)	15.7	15.8	16.2	15.1	15.9	15.7[7]
Problem Loans / (Tangible Common Equity + Loan Loss Reserve) (%)	4.3	9.1	19.8	15.9	23.4	14.5[6]
Net Interest Margin (%)	0.7	0.6	0.6	0.6	0.6	0.6[6]
PPI / Average RWA (%)	1.0	0.9	1.0	0.7	0.5	0.9[7]
Net Income / Tangible Assets (%)	0.2	0.2	0.2	0.2	0.1	0.2[6]
Cost / Income Ratio (%)	55.9	52.6	53.5	62.3	66.0	58.1[6]
Market Funds / Tangible Banking Assets (%)	66.5	66.2	66.8	70.0	89.4	71.8[6]
Liquid Banking Assets / Tangible Banking Assets (%)	30.3	33.6	39.8	33.5	49.6	37.3[6]
Gross Loans / Due to Customers (%)	268.9	241.5	210.1	197.5	614.3	306.4[6]

[1] All figures and ratios are adjusted using Moody's standard adjustments [2] Basel III - fully-loaded or transitional phase-in; IFRS [3] Basel II; IFRS [4] May include rounding differences due to scale of reported amounts [5] Compound Annual Growth Rate (%) based on time period presented for the latest accounting regime [6] Simple average of periods presented for the latest accounting regime. [7] Simple average of Basel III periods presented
Source: Moody's Financial Metrics

Profile

NORD/LB Luxembourg S.A. Covered Bond Bank (NORD/LB CBB) is a specialised issuer of public-sector covered bonds (lettres de gage publiques), thereby contributing to the diversified funding structure and funding sources of the Germany-based NORD/LB, its 100% owner. This issuance tool allows NORD/LB Group to increase the scope of assets eligible for refinancing through covered bonds by transferring specific assets eligible for cover pool inclusion under Luxembourg's covered bond framework to the Luxembourg-based subsidiary.

NORD/LB CBB's business model as a specialised issuer of lettres de gage may face challenges in 2018-19, considering the targeted harmonisation of the legal framework for covered bonds in the EU. At the same time, the bank sees opportunities as a specialised issuer of other debt products, including secured green bonds (lettres de gage énergies renouvelables).

NORD/LB CBB reported total assets of €15.4 billion as of December 2017 and total outstanding covered bonds of €4.0 billion. NORD/LB has pledged to support its subsidiary based on a letter of comfort (*Patronatserklärung*).

Detailed credit considerations

Tight integration into NORD/LB bears downside potential for NORD/LB CBB's ratings

NORD/LB CBB's credit profile is tightly interlinked with that of its parent NORD/LB. Considering the subsidiary's name identity with its parent bank, its role of a specialised financier within NORD/LB Group and its high proportion of intragroup liabilities, we consider the bank to be a highly integrated and harmonised subsidiary, with a limited proprietary franchise. The respective factors that lead to this categorisation imply a high correlation of risk between the parent and the subsidiary.

The close integration of NORD/LB CBB into NORD/LB Group therefore also limits the significance of a standalone analysis of the subsidiary's financials. Although the bank itself holds an insignificant amount of high-risk assets and is adequately capitalised, the vulnerabilities at the group level — specifically related to its parent's asset risk and therefore its solvency — drive our assessment of NORD/LB CBB's default risk and therefore limit its BCA and ratings.

NORD/LB CBB does not have to adhere to any regulatory limits for intragroup lending exposures because it is exempt from respective compliance requirements, based on a waiver from the Luxembourg regulator.

Moderate profitability reflects low asset-risk profile

NORD/LB CBB has consistently made positive contributions to group profit in the five years to 2017. Its cost-to-income ratio has moved within a narrow range of 53%-56% since 2015. The bank's broadly resilient revenue and pre-provision income reflect its stable net interest income from long-dated assets and very low risk provisions, owing to its low-risk lending exposures.

The bank's consistently low risk provisions benefit from the credit protection sourced selectively from the parent bank. The respective guarantees provided by NORD/LB stood at €3.8 billion as of 31 December 2017, representing over 44% of the bank's €8.6 billion loan book.

NORD/LB CBB reported a €40.3 million pretax profit in 2017. With a 0.2% return on assets during 2015-17, the bank's profitability is moderate. NORD/LB CBB's profitability is constrained by its low net interest margin, which was 0.7% in 2017, reflective of the good-quality, and therefore low-yielding, asset portfolio. In addition, the bank has high fee and commission expenses that it pays to its parent for the retention of credit risks on transferred assets. That said, the important role of low-cost market funds in NORD/LB CBB's funding mix has helped the bank withstand the margin pressures that deposit-funded institutions are increasingly exposed to in the low interest rate environment.

Given its low-risk asset base, NORD/LB CBB is adequately capitalised

As of 31 December 2017, NORD/LB CBB reported an adequate Common Equity Tier 1 (CET1) capital ratio of 14.7% (December 2016: 14.8%) and a relatively modest regulatory leverage ratio of 3.8%. The comparatively low leverage ratio primarily reflects the high degree of effective credit risk transfers to its parent bank through individually guaranteed loan exposures. This allows the bank to operate with a low risk-weighted assets (RWA) density. NORD/LB CBB's €4.2 billion in RWA as of year-end 2017 represented 28% of its reported total assets of €15.4 billion.

The low RWA density is a function of not only the considerable guaranteed portion of its loan book but also the low-risk nature of its unguaranteed exposures. Almost 49% of its €17.2 billion total exposure as of December 2017 was to financial institutions and public-sector clients. The bank's defaulted exposure amounted to a low €25 million.

NORD/LB CBB's covered bond franchise and access to parental funding mitigate its high dependence on market funds

NORD/LB CBB sources the vast majority of its funding through debt issuance and interbank borrowings. Moreover, the bank participated in the TLTRO II programme of the ECB in March 2017. However, we do not expect this setup to result in undue liquidity risk that differs from that of its parent, NORD/LB, given the high integration of the subsidiary in the parent's treasury management and the parent's role as the provider of medium- and long-term senior unsecured funding.

NORD/LB generally provides the senior unsecured funding with initial maturities greater than two years for its subsidiary, which covered more than 25% of NORD/LB CBB's €15.4 billion total assets as of December 2017. NORD/LB's significant contribution to the subsidiary's funding needs underscores the importance of the group's funding support for NORD/LB CBB's funding structure.

Support and structural considerations

Affiliate support

We align NORD/LB CBB's Adjusted BCA with the ba3 Adjusted BCA of NORD/LB, which results in a two-notch affiliate support rating uplift. NORD/LB CBB's Adjusted BCA incorporates the high likelihood of support being available to NORD/LB Group from the cross-sector support mechanism of S-Finanzgruppe, from which we expect the Luxembourg-based subsidiary would equally benefit.

NORD/LB provides a letter of comfort for the benefit of its subsidiary and has proven its ability and willingness to support its subsidiaries in case of need, as demonstrated in 2017 when NORD/LB supported (and subsequently merged with) its former subsidiary Bremer Landesbank Kreditanstalt Oldenburg GZ.

Loss Given Failure (LGF) analysis

NORD/LB CBB is subject to the EU Bank Recovery and Resolution Directive, which we consider an operational resolution regime. Notwithstanding the current differences in Luxembourg's and Germany's insolvency hierarchies, we expect NORD/LB CBB to be included in the resolution perimeter of its parent entity NORD/LB and therefore apply our LGF analysis of NORD/LB, which takes into consideration the risks faced by the different debt and deposit classes across the liability structure at failure at the group level.

In our LGF analysis for NORD/LB Group, we assume residual tangible common equity of 3% and losses post-failure of 8% of tangible banking assets, a 25% run-off in junior wholesale deposits, and a 5% run-off in preferred deposits for NORD/LB. These are in line with our standard assumptions. In line with the new German insolvency legislation that effectively subordinates senior bonds and notes to deposits in resolution since January 2017, we base our calculation on the assumption that deposits are preferred to most senior unsecured debt instruments.

» For deposits, our LGF analysis indicates an extremely low loss given failure, leading to a three-notch uplift from the bank's ba3 Adjusted BCA.

» For senior unsecured debt and the issuer rating, our LGF analysis indicates a very low loss given failure, leading to a two-notch uplift from the bank's ba3 Adjusted BCA.

Government support

As a result of the Luxembourg-based bank's close integration into NORD/LB Group, we expect any potential support from the German government — which would be made available through S-Finanzgruppe — to be available to both NORD/LB and NORD/LB CBB. We therefore include one notch of government support from Germany in the deposit, issuer and Counterparty Risk Ratings and the CR Assessment of NORD/LB CBB.

Counterparty Risk Ratings (CRRs)

CRRs are opinions of the ability of entities to honour the uncollateralised portion of non-debt counterparty financial liabilities (CRR liabilities) and also reflect the expected financial losses in the event such liabilities are not honoured. CRRs are distinct from ratings assigned to senior unsecured debt instruments and from issuer ratings because they reflect that, in a resolution, CRR liabilities might benefit from preferential treatment compared with senior unsecured debt. Examples of CRR liabilities include the uncollateralised portion of payables arising from derivatives transactions and the uncollateralised portion of liabilities under sale and repurchase agreements.

NORD/LB CBB's CRRs are positioned at Baa2/P-2

The CRRs, prior to government support, are positioned three notches above the Adjusted BCA of ba3, reflecting the extremely low loss given failure from the high volume of instruments that are subordinated to CRR liabilities. NORD/LB CBB's CRRs benefit from one notch of rating uplift based on government support, in line with our support assumptions on deposits and senior unsecured debt.

Counterparty Risk (CR) Assessment

CR Assessments are opinions of how counterparty obligations are likely to be treated if a bank fails and are distinct from debt and deposit ratings in that they (1) consider only the risk of default rather than both the likelihood of default and the expected financial loss suffered in the event of default, and (2) apply to counterparty obligations and contractual commitments rather than debt or deposit instruments. The CR Assessment is an opinion of the counterparty risk related to a bank's covered bonds, contractual performance obligations (servicing), derivatives (for example, swaps), letters of credit, guarantees and liquidity facilities.

NORD/LB CBB's CR Assessments are positioned at Baa2(cr)/P-2(cr)

The CR Assessment, prior to government support, is positioned three notches above the Adjusted BCA of ba3 based on the buffer against default provided to the senior obligations represented by the CR Assessment by more subordinated instruments, including junior deposits and senior unsecured debt, within the context of the group liability structure of NORD/LB.

NORD/LB CBB's CR Assessment benefits from one notch of rating uplift based on government support, in line with our support assumptions on deposits and senior unsecured debt.

Rating methodology and scorecard factors

The principal methodology we used in rating NORD/LB CBB was the Banks rating methodology published in June 2018.

We do not apply our banking scorecard for the positioning of NORD/LB CBB's BCA, given the alignment of the bank's BCA with that of its parent.

Ratings

Exhibit 2

Category	Moody's Rating
NORD/LB LUXEMBOURG S.A. COVERED BOND BANK	
Outlook	Negative
Counterparty Risk Rating	Baa2/P-2
Bank Deposits	Baa2/P-2
Baseline Credit Assessment	b2
Adjusted Baseline Credit Assessment	ba3
Counterparty Risk Assessment	Baa2(cr)/P-2(cr)
Issuer Rating	Baa3
Senior Unsecured MTN -Dom Curr	(P)Baa3
ST Issuer Rating	P-2
PARENT: NORDDEUTSCHE LANDESBANK GZ	
Outlook	Negative
Counterparty Risk Rating	Baa2/P-2
Bank Deposits	Baa2/P-2
Baseline Credit Assessment	b2
Adjusted Baseline Credit Assessment	ba3
Counterparty Risk Assessment	Baa2(cr)/P-2(cr)
Issuer Rating	Baa3
Senior Senior Unsecured -Dom Curr	Baa2
Senior Unsecured	Baa3
Subordinate	B1
Commercial Paper	P-2
Other Short Term -Dom Curr	(P)P-2

Source: Moody's Investors Service

Endnotes

1 The ratings shown are NORD/LB's deposit rating and outlook, its senior unsecured rating and outlook, and its Baseline Credit Assessment.

2 The ratings shown are S-Finanzgruppe's corporate family rating and outlook, and its BCA.

REPORT NUMBER 1126033

Contacts

Katharina Barten
Senior Vice President
katharina.barten@moodys.com

Christina Holthaus
Analyst
christina.holthaus@moodys.com

CLIENT SERVICES

Americas	1-212-553-1653
Asia Pacific	852-3551-3077
Japan	81-3-5408-4100
EMEA	44-20-7772-5454

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