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CREDIT OPINION
22 August 2018

Update

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RATINGS

NORD/LB Luxembourg S.A. Covered Bond Bank

Domicile	Luxembourg
Long Term CRR	Baa2
Type	LT Counterparty Risk Rating - Fgn Curr
Outlook	Not Assigned
Long Term Debt	(P)Baa2
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.

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NORD/LB Luxembourg S.A. Covered Bond Bank

Update following legislative changes in Germany

Summary

On 3 August 2018, we upgraded NORD/LB Luxembourg S.A. Covered Bond Bank's (NORD/LB CBB) issuer rating to Baa2 negative from Baa3 negative and affirmed the P-2 short-term issuer rating. At the same time, we affirmed the bank's Baa2/P-2 deposit ratings. We continue to assign a b2 Baseline Credit Assessment (BCA) and a ba3 Adjusted BCA. All the ratings and rating inputs are aligned with those of the bank's parent, Norddeutsche Landesbank GZ (NORD/LB, Baa2 negative/Baa2 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 the amended application 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 the bank's deposit and senior unsecured programme ratings; and (4) a moderate probability of the bank 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 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 large volume of outstanding junior senior debt and subordinated instruments.

Credit challenges

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

» The bank strongly relies on market funding.

» Return on assets after fee payments for credit protection to the parent is moderate.

Outlook

» NORD/LB CBB's long-term ratings carry a negative outlook, which mirrors the negative outlook on the ratings of its parent, NORD/LB.

Factors that could lead to an upgrade

» Currently, there is 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 NORD/LB's BCA 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.

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*).

Recent developments

On 3 August 2018, we reclassified a range of senior debt instruments issued by German banks and took rating actions on them. The changes came in response to German legislation that took effect on 21 July 2018, transposing an amendment to the EU Bank Recovery and Resolution Directive (BRRD) into domestic law.

We downgraded most of the German banks' senior unsecured bonds that were already outstanding on 20 July 2018 because the legislative change led us to abandon our previous assumption that these instruments would benefit from government support if required. This is because the new law ranks these legacy instruments alongside new junior senior instruments introduced to help EU banks achieve the minimum holdings of loss-absorbing debt stipulated under the BRRD's minimum requirements for own funds and eligible liabilities.

We also upgraded the banks' (and NORD/LB CBB's) issuer ratings and senior unsecured program ratings. This is because the law allows German banks for the first time since the implementation of Germany's first amendment to the national BRRD law to issue new preferred senior unsecured debt in plain vanilla format. These instruments, which rank as German lenders' most senior plain vanilla unsecured bonds, have become the reference point for their issuer ratings.

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 as a specialised financier within NORD/LB Group and its high proportion of intragroup liabilities, we consider the bank a highly integrated and harmonised subsidiary, with a limited proprietary franchise. The factors that led 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 consistently made positive contributions to group profit in the five years to 2017. The bank's cost-to-income ratio 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 because of 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. The bank'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, which 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 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 asset (RWA) density. The bank'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 most of its funding through debt issuance and interbank borrowings. Moreover, the bank participated in the TLTRO II programme of the European Central Bank in March 2017. However, we do not expect this setup to result in undue liquidity risk different 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 available to NORD/LB Group from the cross-sector support mechanism of S-Finanzgruppe, from which we expect the Luxembourg-based subsidiary to benefit equally.

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.

LGF analysis

NORD/LB CBB is subject to the EU BRRD, which we consider an operational resolution regime. We expect NORD/LB CBB to be included in the resolution perimeter of its parent, 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.

Our Advanced LGF analysis follows the recently revised insolvency legislation in Germany that became effective on 21 July 2018. Following the change in law, the legal hierarchy of bank claims in Germany is now consistent with that in most other EU countries, where statutes do not provide full preference to deposits over senior unsecured debt. However, in our Advanced LGF analysis, we now consider not only the results of the formal legal position (pari passu or de jure scenario), to which we assign a 75% probability, but also an alternative liability ranking, reflecting resolution authority discretion to prefer deposits over senior unsecured debt (full depositor preference or de facto scenario), to which we assign a 25% probability.

Furthermore, in our LGF analysis for NORD/LB Group, we assume residual tangible common equity of 3% and post-failure losses 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.

- 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 the senior unsecured debt and issuer ratings, our LGF analysis also indicates an extremely low loss given failure, leading to a three-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 (CRRs) and the Counterparty Risk (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 Banks, published in August 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	Baa2
Senior Unsecured MTN -Dom Curr	(P)Baa2
ST Issuer Rating	P-2
PARENT: NORDDEUTSCHE LANDESBANK GZ	
Outlook	Negative
Bank Deposits	Baa2/--
Issuer Rating	Baa2
Senior Unsecured -Dom Curr	Baa2

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 BCA.

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

REPORT NUMBER 1136696

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