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CREDIT OPINION
8 March 2019

Update

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RATINGS

NORD/LB Luxembourg S.A. Covered Bond Bank

Domicile	Luxembourg
Long Term CRR	Baa2 , Possible Upgrade
Type	LT Counterparty Risk Rating - Fgn Curr
Outlook	Not Assigned
Long Term Debt	(P)Baa2 , Possible Upgrade
Type	Senior Unsecured MTN - Dom Curr
Outlook	Not Assigned
Long Term Deposit	Baa2 , Possible Upgrade
Type	LT Bank Deposits - Fgn Curr
Outlook	Rating(s) Under Review

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 direction change to review for upgrade from direction uncertain

Summary

On 14 February 2019, we changed the direction of the ongoing review of NORD/LB Luxembourg S.A. Covered Bond Bank's (NORD/LB CBB) long-term ratings and rating inputs to review for upgrade from review direction uncertain, and confirmed its P-2 short-term ratings. The rating actions followed an ad hoc announcement by Norddeutsche Landesbank GZ's (NORD/LB) on 2 February 2019, stating the decisions of its owners to focus on capital strengthening and a realignment of the bank with Sparkassen-Finanzgruppe (S-Finanzgruppe, Aa2 stable, a2)[1], and not to proceed with an alternative option of a joint bid received from two private financial investors for now.

NORD/LB CBB's ratings reflect (1) the bank's b2 Baseline Credit Assessment (BCA); (2) its ba3 Adjusted BCA, incorporating two notches of affiliate support uplift, for support ultimately provided by Sparkassen-Finanzgruppe (S-Finanzgruppe, Aa2 stable, a2)[2], but through its parent NORD/LB; (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 the bank's deposit and senior unsecured programme ratings; and (4) our assumption of a moderate probability of the bank receiving support from the Government of Germany (Aaa stable), 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, as illustrated 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 available at the group level, that is, from NORD/LB's large volume of outstanding junior senior debt and subordinated instruments.

Credit challenges

» Close integration into NORD/LB implies downside risk for NORD/LB CBB's ratings.

» The bank strongly relies on market funding.

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

Outlook

» NORD/LB CBB's long-term ratings are on review for upgrade, mirroring the review for upgrade on NORD/LB's long-term ratings.

Factors that could lead to an upgrade

» 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 bank NORD/LB.

Factors that could lead to a downgrade

» We may downgrade the ratings of NORD/LB CBB if its parent bank's ratings are downgraded.

» We may downgrade NORD/LB's ratings during the review period if its BCA and Adjusted BCA are downgraded. The impact of a BCA downgrade on the long-term and short-term ratings could be decreased or even offset by our reassessment of the affiliate support, for example, if higher support assumptions are justified by credible capital and/or risk-reduction measures undertaken by S-Finanzgruppe.

» Downside potential for NORD/LB's BCA would arise if the planned de-risking and recapitalisation measures were to face major obstacles from one or several authorities that need to approve the transactions. Specifically, a failure to obtain DG Comp's approval could lead to NORD/LB's unwinding, with adverse implications for the bank's BCA.

Key indicators

Exhibit 1

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

	6-18[2]	12-17[2]	12-16[2]	12-15[2]	12-14[2]	CAGR/Avg.[3]
Total Assets (EUR million)	15,027	14,634	15,134	15,048	15,480	-0.8[4]
Total Assets (USD million)	17,545	17,573	15,963	16,346	18,732	-1.9[4]
Tangible Common Equity (EUR million)	621	664	667	671	702	-3.4[4]
Tangible Common Equity (USD million)	725	798	704	729	849	-4.4[4]
Problem Loans / Gross Loans (%)	-	0.3	0.8	2.1	1.9	1.3[5]
Tangible Common Equity / Risk Weighted Assets (%)	14.5	15.7	15.8	16.2	15.1	15.5[6]
Problem Loans / (Tangible Common Equity + Loan Loss Reserve) (%)	3.1	4.3	9.1	19.8	15.9	10.4[5]
Net Interest Margin (%)	0.7	0.7	0.6	0.6	0.6	0.7[5]
PPI / Average RWA (%)	-0.9	1.0	0.9	1.0	0.7	0.5[6]
Net Income / Tangible Assets (%)	-0.2	0.2	0.2	0.2	0.2	0.1[5]
Cost / Income Ratio (%)	333.4	55.9	52.6	53.5	62.3	111.5[5]
Market Funds / Tangible Banking Assets (%)	66.3	66.5	66.2	66.8	70.0	67.2[5]
Liquid Banking Assets / Tangible Banking Assets (%)	24.2	30.3	33.6	39.8	33.5	32.3[5]
Gross Loans / Due to Customers (%)	-	268.9	241.5	210.1	197.5	229.5[5]

[1] All figures and ratios are adjusted using Moody's standard adjustments. [2] Basel III - fully-loaded or transitional phase-in; IFRS. [3] May include rounding differences due to scale of reported amounts. [4] Compound Annual Growth Rate (%) based on time period presented for the latest accounting regime. [5] Simple average of periods presented for the latest accounting regime. [6] 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 2019, 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 €15.5 billion as of June 2018 and total outstanding covered bonds of €4.4 billion. NORD/LB has pledged to support its subsidiary based on a letter of comfort (*Patronatserklärung*).

Recent developments

Our 14 February rating actions followed NORD/LB's ad hoc announcement on 2 February, which declared the chosen bidder, that is, three groups forming part of the savings bank sector, and the measures planned by the bank's new group of stakeholders, subject to various authorities' approvals. The key measures and clarifying information included:

1. a €2.7 billion net loss for the year in the 2018 accounts under International Financial Reporting Standards (IFRS), caused by a €2.5 billion total charge of provisions for existing NPLs.
2. the sale of a €2.7 billion portfolio of ship finance loans, comprising 90% NPLs, to investors in the market.
3. €2.7 billion in fresh capital for NORD/LB, €1.2 billion (44%) of which will be borne by the three groups of new shareholders who all form part of the sector and who will inject €400 million each, specifically, (i) the regional savings banks that already are among the bank's owners, (ii) the group of German Landesbanken, and (iii) the nationwide group of savings banks.
4. an intermittent fall in NORD/LB's CET1 ratio to 6.0%-6.5% as per 31 December 2018 and beyond 31 March 2019, that is, until capital measures are effected in Q2 2019; the capital injections are to be accompanied by unspecified non-cash capital-strengthening measures.

The review for upgrade initiated in our rating actions on 14 February followed an approximately two-month period of a review with direction uncertain, which we had initiated on 18 December 2018.

NORD/LB's owners started the process of inviting a new investor into its group of stakeholders in late September 2018. The owners stated in December 2018 that they have received four offers, but required more time to decide on the varying offers.

Detailed credit considerations

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

NORD/LB CBB's credit profile is closely 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 the 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

NORD/LB CBB consistently made positive contributions to group profit in the five years ended 2017. The bank's cost-to-income ratio has been 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 risk provisions benefit from the credit protection sourced selectively from the parent bank. The respective guarantees provided by NORD/LB stood at €4.1 billion as of 30 June 2018, representing over 48% of the bank's €8.5 billion loan book.

NORD/LB CBB reported a €17.4 million pretax loss in the first half of 2018, which was mainly caused by a trading loss due to negative base effects of cross-currency swaps. With return on assets between -0.2% and 0.2% over 2015-H1 2018, the bank's profitability is moderate. The bank's profitability is constrained by its low net interest margin, which was 0.7% in 2017 and the first half of 2018, 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 30 June 2018, NORD/LB CBB reported an adequate Common Equity Tier 1 capital ratio of 14.2% (December 2017: 14.7%) and a relatively modest regulatory leverage ratio of 3.8% as of year-end 2017. 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. 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 48% of its €16.8 billion total exposure as of June 2018 was to financial institutions and public-sector clients. The bank's defaulted exposure amounted to a low €19 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. 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 28% of NORD/LB CBB's €15.5 billion total assets as of June 2018. NORD/LB's significant contribution to the subsidiary's funding needs underscores the importance of the group's funding support to 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 rating uplift for affiliate support. 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.

Loss Given Failure analysis

NORD/LB CBB is subject to the EU Bank Recovery and Resolution Directive (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 the resolution authority's 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%, post-failure losses of 8% of tangible banking assets, a 25% runoff in junior wholesale deposits and a 5% runoff 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 considerations

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, 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.

Methodology and scorecard

Methodology

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

About Moody's Bank Scorecard

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	Rating(s) Under Review
Counterparty Risk Rating	Baa2/P-2[1]
Bank Deposits	Baa2/P-2[1]
Baseline Credit Assessment	b2[2]
Adjusted Baseline Credit Assessment	ba3[2]
Counterparty Risk Assessment	Baa2(cr)/P-2(cr)[1]
Issuer Rating	Baa2[2]
Senior Unsecured MTN -Dom Curr	(P)Baa2[2]
ST Issuer Rating	P-2
PARENT: NORDDEUTSCHE LANDESBANK GZ	
Outlook	Rating(s) Under Review
Counterparty Risk Rating	Baa2/P-2[1]
Bank Deposits	Baa2/P-2[1]
Baseline Credit Assessment	b2[2]
Adjusted Baseline Credit Assessment	ba3[2]
Counterparty Risk Assessment	Baa2(cr)/P-2(cr)[1]
Issuer Rating	Baa2[2]
Senior Unsecured -Dom Curr	Baa2[2]
Junior Senior Unsecured	Ba1[3]
Junior Senior Unsecured MTN -Dom Curr	(P)Ba1[2]
Subordinate	B1[2]
Commercial Paper	P-2
Other Short Term -Dom Curr	(P)P-2

[1] Rating(s) within this class was/were placed on review on February 14 2019 [2] Placed under review for possible upgrade on February 14 2019 [3] Placed under review on February 14 2019
Source: Moody's Investors Service

Endnotes

1 The ratings reflect S-Finanzgruppe's corporate family rating and BCA.

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

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