MOODY'S
INVESTORS SERVICE

CREDIT OPINION
13 February 2020

Update

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RATINGS

NORD/LB Luxembourg S.A. Covered Bond Bank

Domicile	Luxembourg
Long Term CRR	A3
Type	LT Counterparty Risk Rating - Fgn Curr
Outlook	Not Assigned
Long Term Debt	(P)A3
Type	Senior Unsecured MTN - Dom Curr
Outlook	Not Assigned
Long Term Deposit	A3
Type	LT Bank Deposits - Fgn Curr
Outlook	Stable

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 rating upgrade

Summary

On 9 January 2020, we upgraded NORD/LB Luxembourg S.A. Covered Bond Bank's (NORD/LB CBB) senior unsecured debt and deposit ratings to A3 from Baa2, with a stable outlook. We also upgraded NORD/LB CBB's Baseline Credit Assessment (BCA) to ba3 from b2 and its Adjusted BCA to ba1 from ba3. The bank's ratings are aligned with those of Norddeutsche Landesbank GZ (NORD/LB, A3 stable, ba3)[1] because of the Luxembourg-based bank's strong integration with the NORD/LB group.

NORD/LB CBB's ratings reflect (1) the bank's ba3 BCA; (2) its ba1 Adjusted BCA, which incorporates two notches of uplift stemming from affiliate support for the support ultimately provided by Sparkassen-Finanzgruppe (Aa2 negative, a2)[2] 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 ratings; and (4) our assumption of a moderate probability of the bank receiving support from the Government of Germany (Aaa stable), which results in a one-notch rating uplift.

NORD/LB CBB's ba3 BCA is aligned with that of its parent, NORD/LB, because we consider NORD/LB CBB a highly integrated and harmonised subsidiary.

Credit strengths

» Low-risk assets with sound asset quality, complemented by credit protection granted by NORD/LB

» Cost-efficient covered bond funding franchise (*lettre de gage*)

» In resolution, senior unsecured creditors face only 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 with NORD/LB limits the bank's standalone banking franchise and aligns the ratings with those of its parent bank.

» Moderate profitability reflects margin sharing with NORD/LB.

» Funding strongly relies on capital markets, mitigated by the issuance of covered bonds (*lettre de gage*) and sizeable intragroup funding from NORD/LB.

Outlook

The stable outlook on NORD/LB CBB's long-term ratings mirrors the stable outlook 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 debt and deposit ratings would be subject to a rating upgrade for NORD/LB.

» An upgrade of NORD/LB's BCA is likely if the bank successfully executes the planned measures under its transformation programme until 2024, leading to (1) a significantly smaller and de-risked balance sheet, including the disposal of remaining loans relating to ship finance; (2) a maintained or even increased capitalisation; and (3) a restored moderate level of profitability.

Factors that could lead to a downgrade

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

» NORD/LB's ratings may be downgraded if the bank's BCA or Adjusted BCA is downgraded, or there is a shift in its liability structure that results in decreasing volumes of bail-in-able debt instruments, which increases the expected loss under our Advanced LGF analysis.

» NORD/LB's BCA could be downgraded if the bank faces challenges in maintaining its franchise during the extended phase of transformation, or its capital significantly declines below the improved levels following the capital injection.

Key indicators

Exhibit 1

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

	06-19[2]	12-18[2]	12-17[2]	12-16[2]	12-15[2]	CAGR/Avg.[3]
Total Assets (EUR Million)	15,795.7	16,522.6	14,634.1	15,134.3	15,047.7	1.4[4]
Total Assets (USD Million)	17,988.1	18,887.7	17,572.6	15,962.9	16,346.2	2.8[4]
Tangible Common Equity (EUR Million)	636.2	631.9	664.3	667.2	671.3	(1.5)[4]
Tangible Common Equity (USD Million)	724.5	722.4	797.7	703.7	729.2	(0.2)[4]
Problem Loans / Gross Loans (%)	0.1	0.1	0.3	0.8	2.1	0.7[5]
Tangible Common Equity / Risk Weighted Assets (%)	15.1	14.2	15.7	15.8	16.2	15.4[6]
Problem Loans / (Tangible Common Equity + Loan Loss Reserve) (%)	2.0	1.7	4.2	9.1	19.8	7.4[5]
Net Interest Margin (%)	0.8	0.7	0.7	0.6	0.6	0.7[5]
PPI / Average RWA (%)	0.3	-0.1	0.9	0.9	1.0	0.6[6]
Net Income / Tangible Assets (%)	0.1	0.0	0.2	0.2	0.2	0.1[5]
Cost / Income Ratio (%)	80.1	110.0	58.1	52.6	53.5	70.9[5]
Market Funds / Tangible Banking Assets (%)	68.0	64.1	66.5	66.2	66.8	66.3[5]
Liquid Banking Assets / Tangible Banking Assets (%)	19.8	25.7	21.2	33.6	39.8	28.0[5]
Gross Loans / Due to Customers (%)	288.5	206.2	269.3	241.5	210.1	243.1[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.

Sources: Moody's Investors Service and company filings

Profile

NORD/LB Luxembourg S.A. Covered Bond Bank (NORD/LB CBB) is a specialised issuer of covered bonds (*lettres de gage*) that contributes to the diversified funding structure and funding sources of the Germany-based NORD/LB, its 100% owner. This issuance tool allows the 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 reported total assets of €16.5 billion and outstanding covered bonds of €4.5 billion as of 30 June 2019. NORD/LB has pledged to support its subsidiary based on a letter of comfort (*Patronatserklärung*).

Recent developments

On 23 December 2019, NORD/LB announced that the combined capital strengthening of €3.6 billion from its public-sector owners was successfully completed. The support package included fresh capital of €2.835 billion, of which €1.7 billion will be injected by Lower Saxony and Saxony-Anhalt. The rest was provided by Sparkassen-Finanzgruppe, which injected a combined €1.1 billion. In addition, Lower Saxony provides risk shields on certain assets, relieving capital by an equivalent to around €800 million. We expect NORD/LB's Common Equity Tier 1 (CET1) capital ratio to increase to more than 14.0% by year-end 2019, compared with 6.5% as of 30 September 2019.

On 5 December 2019, the European Commission approved the capital strengthening measures on the basis that they were in line with state aid rules, arguing that the support was on market terms and provided adequate compensation to NORD/LB's owners.

Detailed credit considerations

Tight integration with NORD/LB means that the ratings of NORD/LB CBB move in tandem with those of its parent bank

NORD/LB CBB's credit profile is closely linked with that of NORD/LB. Considering that the subsidiary and the parent share the same name, its role as a specialised financier within the group and its high proportion of intragroup liabilities, we consider NORD/LB CBB a highly integrated and harmonised subsidiary, with a limited proprietary banking franchise. Our assessment implies a high correlation of risk between the Luxembourg-based bank and its parent.

NORD/LB CBB's close integration with NORD/LB limits the significance of a standalone analysis, based on the subsidiary's financials. Although NORD/LB CBB holds an insignificant amount of high-risk assets and is adequately capitalised, our assessment of NORD/LB's credit strengths and challenges drives NORD/LB CBB's BCA and ratings. This view is further supported by NORD/LB CBB's exemption from large lending limits with regard to intragroup exposures, based on a waiver from the Luxembourg regulator.

Moderate profitability reflects low asset-risk profile and margin sharing with NORD/LB

NORD/LB CBB has consistently made positive contributions to NORD/LB's consolidated income and reported annual return on assets of around 20 basis points. The bank's moderate profitability is driven by sharing the net interest margin, earned on loans, with its parent bank, NORD/LB.

This margin sharing is reflected in NORD/LB CBB's large provision expenses, which also include fees paid for credit protection on select exposures provided by its parent bank. These guarantees accounted for €5.3 billion as of 30 June 2019 (2018: €4.9 billion), representing around 54% of gross loans (2018: 52%).

For the period between January 2019 and June 2019, NORD/LB CBB reported a return to positive net income to €7.6 million, compared with a net loss of €12.9 million in the previous year. Positive income from fair value accounting was the main driver, while net interest income and fees expenses continued to increase moderately. The bank's operating expenses decreased by €3.1 million to €14.7 million, reflecting the effect of the groupwide restructuring efforts. NORD/LB CBB continued to benefit from reversals of credit provisions, at €3.5 million, compared with €1.2 million in the previous year.

In 2018, NORD/LB CBB reported a net income of €1 million, compared with €29 million in 2017. The difference mainly reflects a huge swing from the fair value of financial assets, at a negative €25 million for 2018 compared with a positive effect of around €6 million in 2017, and was driven by unfavourable changes in credit spreads. Net interest income, the bank's most important revenue item, moderately increased to €114 million from €109 million, driven by increases in loans and extraordinary interest income from its participation in refinancing operations of the European Central Bank (TLTRO II). The margin sharing (*Verrechnungspreismodell*) is reflected in NORD/LB CBB's fee expenses, which increased to €41.2 million in 2018 from €38.5 million in 2017. In 2018, the bank's operating expenses remained stable at €38 million compared with 2017. Like the year before, NORD/LB CBB continued to benefit from the reversal of credit provisions of €5.1 million, compared with €1.9 million in 2017.

NORD/LB CBB is adequately capitalised and benefits from low-risk assets as well as risk transfers to its parent bank

NORD/LB CBB is adequately capitalised in the context of its low-risk credit profile. Our assessment takes into account the bank's reported CET1 ratio of 15.6% as of 30 June 2019 (2018: 13.8%), as well as its relatively modest regulatory leverage ratio of 3.4% as of year-end 2018 (latest available figure; 2017: 3.8%).

The bank's low leverage ratio reflects its low-risk assets, underpinned by sizeable exposures to high-quality financial institutions, accounting for 35.1% of the total (2018: 38.1%), and credit risk transfers to NORD/LB through individually guaranteed loan exposures. These allow the bank to operate with a low risk-weighted assets (RWA) density, defined as RWA divided by assets. As of 30 June 2019, NORD/LB CBB reported RWA of €4.2 billion, equivalent to 25% of assets (2018: €4.4 billion, 26%).

Funding relies on capital markets, mitigated by its covered bond franchise and access to parent funding

NORD/LB CBB sources most of its funding through debt issuance and intragroup borrowings. However, we do not expect this setup to result in undue liquidity risks different from that of NORD/LB, given the high integration of the subsidiary in the parent's treasury management. Our assessment also takes into account NORD/LB CBB's standalone access to funding via public covered bonds (*lettres de gage publiques*) and renewable energy covered bonds (*lettres de gage énergies renouvelables*).

In addition, NORD/LB provides medium- and long-term senior unsecured funding to its Luxembourg-based subsidiary, with initial maturities greater than two years. As of 30 June 2019, NORD/LB provided funding, equivalent to around 30% of NORD/LB CBB's assets, unchanged from the level in 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.

Environmental, social and governance (ESG) considerations

The global banking sector has been classified as “Low” risk in our environmental risk heat map[3] and as “Moderate” risk in our social risk heat map[4]. For NORD/LB, and thus NORD/LB CBB, the exposure to environmental and social risks is in line with our general assessment for the global banking industry.

Corporate governance is a well-established key driver for banks, and related risks are typically included in our evaluation of banks' financial profile[5]. For NORD/LB, and thus NORD/LB CBB, we do not have any particular governance concern. However, we apply a negative adjustment to NORD/LB's ba2 financial profile to reflect the high execution risks under its transformation plan until 2024. Please refer to NORD/LB's Credit Opinion.

Support and structural considerations

Affiliate support

We align NORD/LB CBB's Adjusted BCA with the ba1 Adjusted BCA of NORD/LB. This assessment results in two notches of rating uplift stemming from affiliate support for NORD/LB CBB.

NORD/LB CBB's Adjusted BCA incorporates the high likelihood of support available to NORD/LB from the cross-sector support mechanism of Sparkassen-Finanzgruppe, from which we expect the Luxembourg-based subsidiary to benefit equally. NORD/LB has pledged to support its subsidiary based on a letter of comfort (*Patronatserklärung*).

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. 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.

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 ba1 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 ba1 Adjusted BCA.

Government support considerations

As a result of the close integration of the Luxembourg-based bank into NORD/LB, we expect any potential support from the German government, which would be made available through Sparkassen-Finanzgruppe, to be available to both NORD/LB and NORD/LB CBB. Therefore, we include one notch for government support from Germany to the long-term deposit and issuer ratings, as well as the Counterparty Risk Ratings and the Counterparty Risk 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 A3/P-2

The CRRs, before government support, are positioned three notches above the Adjusted BCA of ba1, 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 Assessment is positioned at A3(cr)/P-2(cr)
The CR Assessment, before 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 used

The principal methodology used in rating NORD/LB CBB was our Banks Methodology, published in November 2019.

About Moody's Bank Scorecard

We do not apply the Bank Scorecard for the positioning of NORD/LB CBB's BCA, given the alignment of the bank's BCA with that of NORD/LB.

Ratings

Exhibit 2

Category	Moody's Rating
NORD/LB LUXEMBOURG S.A. COVERED BOND BANK	
Outlook	Stable
Counterparty Risk Rating	A3/P-2
Bank Deposits	A3/P-2
Baseline Credit Assessment	ba3
Adjusted Baseline Credit Assessment	ba1
Counterparty Risk Assessment	A3(cr)/P-2(cr)
Issuer Rating	A3
Senior Unsecured MTN -Dom Curr	(P)A3
ST Issuer Rating	P-2
PARENT: NORDDEUTSCHE LANDESBANK GZ	
Outlook	Stable
Counterparty Risk Rating	A3/P-2
Bank Deposits	A3/P-2
Baseline Credit Assessment	ba3
Adjusted Baseline Credit Assessment	ba1
Counterparty Risk Assessment	A3(cr)/P-2(cr)
Issuer Rating	A3
Senior Unsecured -Dom Curr	A3
Junior Senior Unsecured	Baa2
Junior Senior Unsecured MTN -Dom Curr	(P)Baa2
Subordinate	Ba2
Commercial Paper	P-2
Other Short Term -Dom Curr	(P)P-2

Source: Moody's Investors Service

Endnotes

1 The rating shown is NORD/LB's senior unsecured debt rating and outlook, and its BCA.

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

3 Environmental risks can be defined as environmental hazards encompassing the impact of air pollution, soil pollution and water pollution, water shortages and natural and man-made hazards (physical risks). Additionally, regulatory or policy risks, such as the impact of carbon regulation or other regulatory restrictions, including the related transition risks like policy, legal, technology and market shifts, which could impair the evaluation of assets are an important factor. Certain banks could face a higher risk from concentrated lending to individual sectors or operations exposed to the aforementioned risks.

4 Social risk considerations represent a broad spectrum, including customer relations, human capital, demographic and societal trends, health and safety and responsible production. The most relevant social risks for banks arise from the way they interact with their customers. Social risks are particularly high in the area of data security and customer privacy, which are partly mitigated by sizeable technology investments and banks' long track record of handling sensitive client data. Fines and reputational damage because of product mis-selling or other types of misconduct are further social risks. Societal trends are also relevant in a number of areas, such as shifting customer preferences towards digital banking services increasing information technology costs, ageing population concerns in several countries affecting demand for financial services or socially driven policy agendas that may translate into regulations that affect banks' revenue bases.

5 Further, factors like specific corporate behaviour, key person risk, insider and related-party risk, strategy and management risk factors and dividend policy may be captured in individual adjustments to the BCA, if deemed applicable. Corporate governance weaknesses can lead to a deterioration in a bank's credit quality, while governance strengths can benefit its credit profile. When credit quality deteriorates because of poor governance, such as breakdown in controls resulting in financial misconduct, it can take a long time to recover. Governance risks are also largely internal rather than externally driven.

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