

Dominion Bond Rating Service

German Landesbanken: Analytical Background and Methodology

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Comprehensive Credible Consistent

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Dominion Bond Rating Service (DBRS) is a full-service credit rating agency established in 1976. Privately owned and operated without affiliation to any financial institution, DBRS is respected for its independent, third-party evaluations of corporate and government issues, spanning North America, Europe and Asia. DBRS's extensive coverage of securitizations and structured finance transactions solidifies our standing as a leading provider of comprehensive, in-depth credit analysis.

All DBRS ratings and research are available in hard-copy format and electronically on Bloomberg and at DBRS.com, our lead delivery tool for organized, web-based, up-to-the-minute information. We remain committed to continuously refining our expertise in the analysis of credit quality and are dedicated to maintaining objective and credible opinions within the global financial marketplace.

German Landesbanken: Analytical Background and Methodology

This report outlines the approach Dominion Bond Rating Service (DBRS) takes to analyzing the German Landesbanken. When rating Landesbanken, DBRS assigns a rating based on in-depth analysis of the following rating elements:

- (1) DBRS's opinion about the fundamental credit strength of the Landesbank or the regional group consisting of the Landesbank and savings banks (one of two DBRS building blocks for bank credit ratings, so-called Intrinsic Assessment (IA)).¹
- (2) DBRS's opinion about the bank's ownership and the likelihood and predictability of timely explicit or implicit external support for the Landesbank (Support Assessment (SA), the second building block of DBRS bank credit ratings).²
- (3) The support mechanism shared by savings banks, Landesbanken and Landesbausparkassen, which are members of the Sparkassen-Finanzgruppe, the group of savings banks, Landesbanken, Landesbausparkassen and associated companies (collectively, Savings Bank Finance Group).
- (4) In the case of the Landesbanken grandfathered debt – guaranteed liabilities that were agreed to on July 18, 2001, without time limits and liabilities agreed after that date until July 18, 2005, with maturities, which do not go beyond December 31, 2015 – DBRS will apply the legal framework of grandfathered debt "Gewährträgerhaftung" (see below).

The German group of Landesbanken is relatively diverse and, as a result, the analytical elements (1) to (3) for non-guaranteed ratings are applied on a case-by-case basis; however, this is not meant to imply that the analysis is simply an exercise in double counting, wherein each layer of analysis would lift the rating of a Landesbank. As it is, most Landesbanken are likely to be rated in

the "A" range, with the highest rated banks being able to achieve AA ratings. DBRS expects that Landesbanken with the highest ratings are those that exhibit the following characteristics:

- (1) Are owned by committed and economically strong states, allowing DBRS to utilize a notching-down approach (SA 1), and that possess both acceptable financial fundamentals and a defensible franchise (both normally associated with an IA in the "A" area); or
- (2) Those in which the cohesiveness between the regional savings banks and their Landesbank is so strong that the group could be viewed as a single economic unit, and, thus, DBRS is able to assign a "group rating."³ In order to achieve a rating of AA for such a group, the Landesbank is not expected to dominate the overall risk profile of the group.

At the lower end of the rating spectrum, DBRS believes it is possible that Landesbanken achieve a rating in the "A" range, a beneficial result derived from the support mechanism shared by savings banks, Landesbanken and Landesbausparkassen (i.e. the possibility of a "floor rating").⁴

The Landesbanken-guaranteed ratings are predominantly driven by the rating elements (2) and (4) and will provide ratings close to, or identical to, the level of the respective state guarantors (SA1), with ratings in the AA and AAA ranges.

This report is divided into three sections. Sections 1 and 2 introduce DBRS's current view of the German Landesbanken, with particular focus on the differences in business models, organisational, and legal structures, as well as future challenges DBRS believes Landesbanken will face. Section 3 describes the four analytical elements mentioned above in more detail.

¹ The IA summarises DBRS's assessment of a bank's (or group's) market position, franchise value, governance, ownership, management strength, and strategy; and its implementation, financial strength and earnings capacity, risk profile, and risk management – along with the strength and predictability of the operating and regulatory environment. For more details regarding the meaning of DBRS's Intrinsic Assessment, please see DBRS's methodology titled *Analytical Background and Methodology for European Bank Ratings* on www.dbrs.com, dated January 2006.

² For details regarding the meaning of DBRS's Support Assessment, please see *Analytical Background and Methodology for European Bank Ratings*, on www.dbrs.com, dated January 2006.

³ A rating for member banks of highly integrated groups will reflect the strength of the group as a whole and result in a full credit substitution. This is to be expected for a well-integrated (and in essence consolidated) group, because it is hard to separate the attributes of the single entity from those of the group as a whole. For details about the definition and meaning of group ratings, please see *Analytical Background and Methodology for European Co-operative Banks*, on www.dbrs.com, dated March 2006.

⁴ For a banking group that is comparatively less integrated, it would be incorrect to attribute the full strengths and financial resources of the wider group to a single particular bank, since those strengths and resources are not fully available to the said entities. However, even for members of this type of group, the rating will reflect both the member bank's own strengths and its ability, through a support system, to draw on the resources of all other entities within the group, should the need arise. For details about the definition and meaning of floor ratings, please see *Analytical Background and Methodology for European Co-operative Banks*, on www.dbrs.com, dated March 2006.

SECTION 1: THE TRANSFORMATION PROCESS OF GERMANY'S LANDESBANKEN

A. Landesbanken as Part of the Sparkassen-Finanzgruppe (Savings Bank Finance Group)

The Savings Bank Finance Group comprises approximately 660 member institutions in Germany – including 463 Sparkassen (savings banks), 11 Landesbanken, 11 Landesbausparkassen, and 12 public insurance companies and a number of asset management, leasing, and factoring companies – with combined total assets of EUR 3.2 trillion.

Within the Savings Bank Finance Group, the Landesbanken act as centres for payment systems (Girozentrale) and liquidity providers for the savings banks in their regions (states). Each sector is based on a division of labour (Subsidiaritätsprinzip), and Landesbanken serve as a link between the savings banks and their customers when it would be less efficient or economically impossible for the savings banks to keep certain products in store for a small number of customers. Examples of this would be private banking services, capital markets products, international trade financing capabilities, or instances in which customers pose too much of a concentration risk for the savings bank, especially in the lending business. As commercial banks in their own right, Landesbanken serve medium- to large-sized corporates in their regions, as well as multinationals via their own branches and representative offices abroad and their large network of correspondent banks. Some Landesbanken also command retail banking networks, while others have developed niches in corporate finance (e.g. financing ship or aircraft projects). The majority of Landesbanken also service the financing needs of the public sector, not as development banks but more as lenders for large commercially driven projects, such as infrastructure projects.

Landesbanken are owned by their respective states and regional savings banks (represented by the regional associations of savings banks). The Savings Bank Finance Group is represented at the national level by the Deutscher Sparkassen und Giroverband (German Savings Bank Association – or DSGV). The DSGV also administers the joint liability scheme, consisting of the 11 regional savings banks support funds, the Landesbanken Fund and the Landesbausparkassen Fund.

B. Landesbanken: A Heterogeneous Group of Banks

(i) Landesbank Baden-Württemberg (LBBW)

The largest German Landesbank is a corporation created by a public law decree and is headquartered in the city of Stuttgart in the state of Baden-Württemberg. As of December 31, 2005, LBBW had total consolidated assets of EUR 404 billion. LBBW is owned by the regional states of Baden-Württemberg (35.6%), the city of Stuttgart (18.9%), the savings bank associations of Baden-Württemberg (35.6%) and Rheinland-Pfalz (4.9%), and the development bank in Baden-Württemberg (Landeskreditbank Baden-Württemberg – Förderbank (4.9%)).

LBBW is a universal bank in its region and a commercial bank with an international branch network. Through its subsidiary, Baden-

Württembergische Bank (BW Bank), LBBW offers private and retail banking products and services, as well as corporate finance products for small and medium-sized companies in Baden-Württemberg and takes the role of a savings bank in the state capital, Stuttgart. LBBW functions as the central bank for the savings banks in Baden-Württemberg and, together with its 100% owned subsidiary, Landesbank Rheinland-Pfalz, as the central bank for the savings banks in Rheinland-Pfalz.

Although LBBW's activities through its subsidiary BW Bank are designed to be complementary and support the group of local savings banks in the state of Baden-Württemberg, DBRS believes that the potential for competition between LBBW and the savings banks is high.

LBBW has the advantage, in contrast to many of its peers, of substantial opportunities to strengthen its already existing and well-entrenched regional franchise with retail banking customers and small and medium-sized corporates in one of the economically strongest states in Germany. In this context, LBBW has historically shown a conservative appetite for risks.

(ii) LRP Landesbank Rheinland-Pfalz (LRP)

LBBW's 100% owned subsidiary, LRP, is headquartered in the city of Mainz in the state of Rheinland-Pfalz (Rhineland-Palatinate). As of December 31, 2005, LRP, in the legal form of a corporation established under public law, had total consolidated assets of EUR 67 billion. LRP is a commercial bank focusing on medium-sized corporates. In addition, in cooperation with LBBW, LRP complements the range of services offered by the savings banks of Rheinland-Pfalz, and LRP is the banker of the State of Rheinland-Pfalz and its municipal bank. DBRS believes LRP should benefit from its integration into the LBBW group, with greater access to products and an international branch network. Solely on its own, LRP would not have had the resources to build these up while maintaining the strong customer relationships it currently enjoys.

(iii) Bayerische Landesbank (BayernLB)

BayernLB is the second-largest Landesbank in Germany and is headquartered in Munich in the state of Bayern (Bavaria). BayernLB has the legal status of a corporation established under public law and is jointly owned by the Freistaat (Free State) of Bavaria and the Association of Bavarian Savings Banks, each with a 50% stake. In 2002, the two owners transferred their holdings in BayernLB to BayernLB Holding AG in exchange for 50% each of the shares. As of December 31, 2005, BayernLB had total consolidated assets of EUR 340 billion. BayernLB acts as principal bank to the Free State of Bavaria and as the central banking institution to the Bavarian savings banks. In addition, BayernLB is a commercial bank in its own right, servicing its customers, including small to medium-sized corporates, as well as multinational groups and institutional clients through its international branch network.

DBRS views BayernLB as one of the more diversified Landesbanken; first, because it kept the regional building society (i.e. LBS) within its group, whereas other Landesbanken transferred it into the ownership

of the savings banks. Second, BayernLB is more diversified because it owns the following two growing banks outside of its region: (1) Deutsche Kreditbank AG (DKB), whose products and services range from lending to housing associations predominantly in eastern Germany to direct banking services for retail banking clients in Germany as a whole; and (2) Hungarian Foreign Trade Bank (MKB), one of the largest corporate banking entities in Hungary. In addition, BayernLB is the majority owner of Landesbank Saar. BayernLB's past challenges were its relatively higher risk profile in comparison to most of its peers, while possessing one of the largest loan portfolios in Germany, and some concentration risk. However, as a result of its transformation process, BayernLB has addressed its risk management issues and, in 2004 and 2005, asset quality improved.

The cohesion between BayernLB and its regional savings banks was underpinned by the implementation of an additional solidarity fund (Regionaler Haftungsfonds) in 2005, which supplements the already existing support mechanism of the sector (see Section 3 for additional information).

(iv) Landesbank Saar (SaarLB)

SaarLB is the smallest Landesbank in Germany but the largest bank in Saarland, with a balance sheet total of EUR 18.1 billion as of December 31, 2005. SaarLB is an institution incorporated under public law and is the central bank among the Saarland savings banks. Its shareholders are BayernLB (75.1%), the regional savings banks association (Sparkassenverband Saar with 14.9%), and the State of Saarland (10.0%). SaarLB's core market is the State of Saarland and neighbouring regions in France. As in the case of LRP, DBRS believes that SaarLB benefits from access to a wider spectrum of products and networks without the risk of jeopardizing its customer relationships if these products were received from an outside party. In addition, the disadvantage of SaarLB's location in one of Germany's economically weakest regions (in terms of GDP/capita and unemployment) is balanced by SaarLB's dominant position in this market, which should allow for some positive lending decisions.

(v) WestLB AG (WestLB)

WestLB AG (rated "A"/R-1(low) by DBRS) is a financial institution with the legal status of a stock company. Its shareholders are the state of Nordrhein-Westfalen (North Rhine-Westphalia: 17.081% directly and 20.45% indirectly through its 64.744%-owned subsidiary, NRW. Bank) and the two savings banks associations of the state, Sparkassen- und Giroverband Rheinland and Westfälischer-Lippischer Sparkassen- und Giroverband (each 25.312%).

With total assets of EUR 265.0 billion as of December 31, 2005, WestLB is the third largest Landesbank in Germany, and it is the central institution for the savings banks in North Rhine-Westphalia (the most populous state in Germany) and Brandenburg. WestLB has a long history as an internationally operating commercial bank. More recently, WestLB strengthened its cooperation with the savings banks. This development was a result of a top management change in 2004, after the bank had suffered substantial losses in its project finance

and private equity businesses. As part of this re-orientation, WestLB extended its range of products and services – to include lending, structured finance, capital market and private equity products, asset management, transaction services, and real estate finance – with private banking services (through the acquisition of the Berlin-based Weberbank) and consumer payment services (through the acquisition of the Berlin-based ABC Privatkunden-Bank AG).

In the case of WestLB, the representatives of the government of the state of Nordrhein-Westfalen have stated publicly that a sale of the state's share in WestLB is under review so as to allow WestLB better future growth opportunities.⁵

DBRS believes this statement is vague enough not to allow speculations about the government's commitment to WestLB as of today, but it raises some uncertainty regarding the level of commitment over the medium term. However, under a partial privatization scenario the involvement of a highly rated financial institution could offset or even reverse any potential negative rating connotations.

(vi) NORD/LB Norddeutsche Landesbank Girozentrale (NORD/LB)

NORD/LB is the fourth largest Landesbank with a consolidated balance sheet of EUR 210 billion as of June 2005. NORD/LB is a public institution owned by the state of Niedersachsen (Lower Saxony, 41.75%), the state of Sachsen-Anhalt (Saxony-Anhalt, 8.25%) and savings associations or their investment vehicles in Niedersachsen (37.25%), Sachsen-Anhalt (7.53%), and Mecklenburg-Vorpommern (Mecklenburg-Western Pomerania, 5.22%). NORD/LB offers financial services to its private, corporate, and institutional clients and to the public sector, and NORD/LB – much like LBBW, Landesbank Berlin, and Landesbank Hessen-Thüringen Girozentrale (Helaba) – reigns in the regional savings bank tradition in the area of the city of Braunschweig.

NORD/LB was one of the first Landesbanken to adopt the strategy of being a consolidator in the sector when it acquired a stake in Bankgesellschaft Berlin in 1994 (the parent of Landesbank Berlin at that time). However, after Bankgesellschaft Berlin got into trouble at the turn of the century, NORD/LB narrowed its acquisitive focus outside of Germany, specifically to the Baltic area. In this context, NORD/LB's search for a cohesive new business strategy after the loss of the guarantee helped NORD/LB decide that its core market is closer to the region of its attached savings banks. As a result, in January 2006, NORD/LB started a joint venture with the largest Norwegian financial group, DnB NOR, under the name BANK DnB Nord. This new joint bank for northeastern Europe assumed NORD/LB's previous organically grown or acquired banking operations in that area.

(vii) Bremer Landesbank Kreditanstalt Oldenburg – Girozentrale (Bremer Landesbank)

Bremer Landesbank is a 92.5% subsidiary of NORD/LB. The balance is owned by Freie Hansestadt Bremen (Free Hanseatic City of Bremen). As of December 2005, Bremer Landesbank had total assets of EUR 32 billion. Bremer Landesbank is a commercial

⁵ Draft for the coalition agreement ("Koalitionsvereinbarung") between Christlich Demokratische Union (CDU) and Freie Demokratische Union (FDP) in order to establish a new state government in Nordrhein-Westfalen, Düsseldorf, 16 June 2005; www.cdu-nrw.de.

bank with a regional focus in the city of Bremen and the bordering northwestern part of Lower Saxony. After 2001, Bremer Landesbank started to concentrate on five business divisions: Corporate Banking, Special Financing, Private Banking, Retail Banking and Financial Markets. Similar to its peers NORD/LB and HSH Nordbank, Bremer Landesbank has an established position in ship financing and, increasingly, in alternative energy (solar energy). Bremer Landesbank is also well-established with the regional small and medium-sized enterprises (SMEs).

(viii) HSH Nordbank AG (HSH Nordbank)

Established on June 2, 2003, HSH Nordbank is the result of a merger between Hamburgische Landesbank and Landesbank Schleswig-Holstein (LB Kiel), and, as of December 31, 2005, had a total balance sheet of EUR 185 billion. HSH Nordbank has twin headquarters in Hamburg and Kiel. HSH Nordbank also became a stock company in 2003 and is owned by Freie und Hansestadt Hamburg (City State of Hamburg, 35.38%), the state of Schleswig-Holstein (19.55%), the Association of Savings Banks for Schleswig-Holstein (18.21%), and WestLB AG (26.86%).

HSH Nordbank is a commercial bank active in Northern Europe (and operates in other regions as well) and noted sector specialist in ship financing and real estate. DBRS believes that HSH Nordbank is closer to a commercial bank than to a traditional Landesbank in comparison to many of its peers, although in Schleswig-Holstein it is offering its services and products to the local savings banks. This is due to the fact that HSH Nordbank directly competes in Hamburg with the largest so-called freie (i.e. free) German savings bank, Hamburger Sparkasse. In addition, the savings banks in Schleswig-Holstein are, as a group, relatively small when compared to the size of HSH Nordbank.

DBRS believes that the business model of a focused commercial bank, which can implement strict cost control and sound risk management, is a viable alternative for Landesbanken, like HSH Nordbank, which are less entrenched in the regional savings banks sector.

(ix) Landesbank Hessen-Thüringen Girozentrale (Helaba)

Helaba is a legal entity under public law, headquartered in Frankfurt and Erfurt in the state of Hessen and Thüringen with total assets as of December 31, 2005, of EUR 164 billion (Helaba group). The owners of the bank are the association of savings banks in Hessen (Sparkassen- und Giroverband Hessen-Thüringen or Savings Banks Association of Hesse-Thuringia) with 85%, which reflects the highest share of savings banks ownership in any Landesbank, and the states of Hessen and Thüringen hold a share of 10% and 5%, respectively. DBRS believes that Helaba will benefit in the future from its strong integration in the regional savings bank group.

DBRS believes the following for two reasons: (1) the establishment in 2004 of the S-Finanzgruppe Hessen-Thüringen, which combines Helaba and its owner savings banks; and (2) the acquisition of Frankfurter Sparkasse (FraSpa) in 2005. Although FraSpa, which is the sixth largest savings bank in Germany, needed to be restructured

and is therefore expected to need some time before becoming a positive contributor to Helaba's overall financial fundamentals, with this acquisition, Helaba has created the potential to establish a meaningful retail banking franchise in one of the wealthiest cities in Germany. In this context, the S-Finanzgruppe Hessen-Thüringen is a framework for a wide-ranging system of cooperation between Helaba and the savings banks. The cohesion between Helaba and the savings banks is underpinned by a joint risk management, by consolidated accounts and by the Regional Reserve Fund of S-Finanzgruppe Hessen-Thüringen, established on January 1, 2004.

(x) Landesbank Berlin AG (LBB)

LBB is a stock company headquartered in Berlin and is a subsidiary of Bankgesellschaft Berlin (BGB), which had as of September 30, 2005, total assets of EUR 135 billion. The majority of those assets were contributed by Landesbank Berlin. BGB is a listed bank that is owned by the State of Berlin (81%), NORD/LB (10%), and Gothaer Finanzholding (2%), and the balance is made up by free-float. In 2001, BGB needed to be rescued by its owner. The costly rescue by the State of Berlin was defined as state aid by the European Commission, which requested the sale of Berlin's shares in BGB group in 2007.

On January 1, 2006, LBB was – according to a new savings bank law adapted in the summer of 2005 – transferred from a public sector entity to a stock company. At the same time, the State of Berlin entrusted LBB with the duties of the sole ownership of Berliner Sparkasse – now a branch of LBB. As of this writing, the business activities of BGB and LBB plan to merge in the summer of 2006, which would conclude the restructuring process.

Despite the uncertainty over LBB's future ownership, LBB has the potential to further strengthen its franchise and improve its financial fundamentals going forward in view of the progress the bank has made in recent years and its still solid market position in retail and corporate banking in Berlin.

(xi) Landesbank Sachsen Girozentrale (SachsenLB)

SachsenLB, founded in 1992, is the youngest Landesbank in Germany and is headquartered in Leipzig in the state of Saxony. At the end of 2005, it showed consolidated assets of EUR 68.4 billion. The bank is a public sector entity owned by the Freistaat Sachsen (directly by the Free State of Saxony, 37.04%, and indirectly through Sachsen-Finanzverband, 14.48%), and the municipals from Saxony (through the Sachsen-Finanzverband, 48.48%). SachsenLB's shareholder structure changed in December 2005 due to a EUR 300 million capital increase by the Free State of Saxony. DBRS views it positively, that in December 2005 Sachsen-Finanzgruppe, Sachsen LB and WestLB AG agreed on a partnership that encompasses the joint development and marketing of financial products that are tailored to the special requirements of the savings banks in Saxony and their customers. Sachsen LB will be able to strengthen the relationships with the savings banks in Saxony without incurring the investment and risks if it had to build up this expertise on its own.

C. The Four-Year Period from July 18, 2001, to July 18, 2005

The European Commission and German banking representatives in Brussels agreed to abolish *Gewährträgerhaftung* (deficiency guarantee) and curtail *Anstaltslast* (maintenance guarantee) on July 18, 2001.⁶ That decision not only impacted the German Landesbanken and savings banks, which would be directly impacted by these legal changes, but the German banking sector as a whole, which anticipated numerous changes to the system. At that time, the Landesbanken and savings banks represented around only a third of all assets in the German banking system (and still do today). Historically, the Landesbanken in particular have benefited from attractive wholesale funding as a result of their high ratings, which in turn were based on state guarantees.

At the same time, for many public sector banks' top managers, the Brussels agreement came as a surprise, – although the European Banking Federation had filed a complaint against *Anstaltslast* and *Gewährträgerhaftung* as early as 1999 – and was viewed as a defeat, despite the generous transition period granted in the agreement.

Consequently, many Landesbanken found themselves ill-prepared for this “new world,” as their historically high debt ratings had lured them into the business of big-ticket lending – domestically or internationally – and in the form of plain vanilla transactions or more structured lending, such as project finance or asset-backed securities. Big balance sheets allowed for relatively sound efficiency ratios and acceptable profitability. This worked well in times of thinly priced loan books, large portfolios of asset swaps, less sophisticated risk management and inefficient organisational structures that were offset by a benign credit environment and economic growth in the domestic market.

However, when the credit cycles turned negative in Germany in the years 2001–2003, the risk profile of many Landesbanken deteriorated, and the vulnerabilities in their business models were highlighted. Notwithstanding that, although German banks in general, including the listed banks, suffered during this time, the severe problems experienced by numerous Landesbanken were still cocooned by their state guarantees, which blunted the full impact of these problems for the whole sector, whereas the private banks suffered direct pressure from the capital markets with periods of considerably increased funding costs and liquidity constraints.

As a result, investors and analysts who witnessed this development might have concluded that Landesbanken, with dented financial fundamentals, were relatively unprepared for the forthcoming loss of guarantees and more likely asked the question “when” rather than “if” the separation between the three pillars⁷ of the German banking system would fall. They tended to lean towards the expectation that the weakness of Landesbanken at that time would indicate the

upcoming and long-awaited consolidation within the German banking system because the Landesbanken were seen as the representatives of this sector.

DBRS agrees that, after 2001, the German banking system began to show signs of stronger consolidation, but not in the way it was expected. The assumption that the loss of their state guarantees would lead to the crumbling of Germany's public banking sector was evidently premature; more than that, DBRS believes that the public banking sector will remain an important one in the German banking system in the foreseeable future. One reason for this is the consolidation of the German banking system, which began within the public sector banking group (and was paralleled in the co-operative banking group for that matter), not just by mergers between savings banks but through stronger cooperation and cohesion between the members of the various regional groups. The increased cooperation is partially driven by so-called *Verbundvereinbarungen* which are built on a common strategy.⁸ Furthermore, before 2001, the capital markets focused mainly on the “visible” side of German public sector banking (i.e. the Landesbanken and their often modest financial fundamentals) but more or less ignored the fact that the savings bank sector – which is financially, contractually, and culturally linked (by different degrees depending on the state) to the Landesbanken – was (and remains) the dominant force in German retail banking and is characterized by stable financial fundamentals. The co-operative banks and savings banks control approximately 45% to 70% of Germany's core retail banking market, depending on products like savings, mortgage loans and loans to small and medium-sized companies.⁹ In addition, because of the changes of the guarantee mechanism in 2001 and the asset quality problems in 2002 and 2003, most Landesbanken came to the conclusion that their future strategy should incorporate a stronger alignment with the needs of their regional savings banks, in order to gain a competitive advantage in a more uncertain future.

Consequently, with the agreement of July 18, 2001, the Landesbanken set the first phase of their transformation process in motion. However, most of the initial progress was overshadowed by the financial problems in the 2001–2003 period, discussed above, or were of a more formalistic or organizational nature with greater long-term implications. In some instances, transformation started slowly and even haltingly in some instances, also discussed previously (e.g. WestLB). In WestLB's case, it was not until 2004 that the bank, under new management, belatedly began to make the bank operationally fit for the period after July 2005.

In general, the Landesbanken used the time until July 18, 2005, to do the following:

- (i) Adjust their previous business models. Landesbanken, in general, subscribed to a more competitive business approach, defining strategies similar to those of commercial

⁶ For liabilities that existed at 18 July 2001, *Gewährträgerhaftung* is maintained without any limits until they mature. For liabilities created between 19 July 2001, and 18 July 2005, *Gewährträgerhaftung* is maintained for those maturing before the end of 2015.

⁷ In Germany's banking system, there are three main banking sectors: the co-operative banks, the listed private banks or foreign banks, and public sector banks, including savings banks and Landesbanken.

⁸ *Verbundvereinbarungen* are agreements between Landesbanken and their regional savings banks detailing their cooperation; for example the kind of product or the amount of products the savings banks require and are willing to distribute. The common strategy DBRS refers to is laid out in “DSGV: Strategie der Sparkassen-Finanzgruppe”, September 2002.

⁹ For more details, please see *Analytical Background and Methodology for European Savings Bank Ratings* and *Analytical Background and Methodology for European Co-operative Banks*, on www.dbrs.com, dated April 2006.

banks. This included setting more ambitious financial targets than they had in the past and better targeting customer groups, geographic areas, and products, in order to develop defensible franchises. All Landesbanken stressed cooperation with their respective regional savings banks (including *Verbundvereinbarungen*, see above).

- (ii) Buy time and safeguarded their liquidity position beyond June 2005 by issuing excessively long-term guaranteed funding. They also increased their regulatory capital levels with the help of contributions from their owners and even managed a modest reduction in administrative costs.
- (iii) Some Landesbanken changed their legal status to listed companies, as in the case of WestLB and HSH Nordbank, or remained a public sector bank but transferred the ownership stakes to a private holding company as in the cases of BayernLB and BayernLB Holding AG, to broaden their future strategic alternatives. Some examples are to allow Landesbanken to tap the resources of private equity investors, form strategic alliances, or even entertain the possibility of future privatizations.
- (iv) In cooperation with their regional savings banks, some Landesbanken put in place regional support funds, for example in Bavaria, Lower Saxony, North Rhine-Westphalia or Hesse-Thuringia, thus increasing the visibility of their cohesiveness. Also, at the national level, the DSGV further developed the nationwide support system, that is, by implementing a risk monitoring system and increasing the amounts available to the support funds. These initiatives, albeit to various degrees, ensured that the economic, strategic, or managerial linkage between public sector banks increased.
- (v) Landesbanken began to take a different look at their traditional lending business. DBRS believes that Landesbanken are well advanced in implementing the tools that will enable them to apply risk-adjusted pricing. They are also moving away from buy-and-hold strategies for credit risk to a portfolio management approach (including hedging and trading of credit risk) and show a greater awareness of concentration risks in their loan portfolios. In view of the advancing Basel II implementation, the adoption of MaRisk, and the industry's recent asset quality problems, it is obvious that factors in addition to the abolition of state guarantees helped this process along.
- (vi) Most Landesbanken have settled their outstanding issues with the European Commission, including issues regarding the timeliness of the grandfathered *Gewährträgerhaftung* and also the state-aid proceedings, which were likened to the transfer of housing agencies to seven Landesbanken at the beginning of the 1990s.¹⁰
- (vii) Landesbanken have started to consolidate, albeit with limited

impact on the banking system as a whole or the individual banks involved, which means there has been no reduction in credit supply or meaningful reduction in workforce. It would be overly optimistic to assume that a consolidation between Landesbanken will extract meaningful benefits, especially in the area of efficiency, because of restrictive German labour laws. This lack of optimism applies specifically to public sector banks and political pressure exerted on them by their state owners. In this context, DBRS believes that if the Landesbanken would take a more radical approach to streamlining their operations, a more robust financial profile would be achievable.

- (viii) The Landesbanken started to review their investments in financial institutions and have made strategic divestments or acquisitions and joint ventures: for example, BayernLB sold its BAWAG (Austria) share, acquired a majority share in SaarLB, and closed national and international partnerships with several domestic and international banks; and LBBW acquired a private bank (BW Bank) and the neighbouring Landesbank in Rhineland Palatinate but divested its share in HSH Nordbank. In 2005, NORD/LB sold its non-strategic investments in MHB, *Mitteuropäische Handelsbank*, Frankfurt and disposed of NILEG Immobilien Holding GmbH, a property and real estate development company, Helaba acquired Frankfurter Sparkasse, Germany's sixth largest savings banks, which is also active in direct banking nationwide. More recently, WestLB acquired two smaller private banks (Weber Bank and ABC Privatkundenbank AG) and acquired an option on a minority stake in LBSachsen and NORD/LB expressed its interest to dispose its 10% minority stake in Bankgesellschaft Berlin. So far the strongest level of commitment to international cooperation was given by NORD/LB, which integrated its international operations in the Baltic region into a holding company that is majority owned by DnB Nord (see above).

This is just a partial list of the transactions that underscore the kind of dynamics that have unfolded since July 2001.

SECTION 2: THE CHALLENGES LYING AHEAD

A. Privatization

In July 2005, the Landesbanken entered the second stage of their transformation process, which implies the application and development of their "new" business models outside the protective umbrella of state guarantees. DBRS believes that DBRS will continue to see a strong link between Landesbanken and their owners for the foreseeable future, mainly because most of the Landesbanken will still be owned by their respective states and their regional savings banks. However, for those Landesbanken that are private companies, such as HSH Nordbank AG and WestLB AG, DBRS would not

¹⁰ Following a complaint lodged by the Association of German Banks, the European Commission ruled in 1999 that the incorporation of public housing agency funds into the capital of an internationally operated Landesbank without appropriate compensation is incompatible with European law on state aid. The following Landesbanken repaid the benefits received in 2004–2005: Landesbank Berlin (EUR 810 million plus interest), Norddeutsche Landesbank (EUR 472 million plus interest), Landesbank Schleswig-Holstein (today HSH Nordbank, EUR 432 million plus interest), Bayerische Landesbank (EUR 260 million plus interest), Hamburgische Landesbank (today HSH Nordbank, EUR 90 million plus interest), and Landesbank Hessen-Thüringen (EUR 6 million plus interest). Most states received a capital injection from their owners after the payment.

exclude a partial privatization in the medium term.¹¹ In the case of BayernLB, which is owned by a private holding company, DBRS understands that the holding structure was predominantly chosen to allow BayernLB to underpin its strategic alliance with other banks through cross-shareholdings.

However, the greater likelihood, albeit far from certain, is that Landesbank Berlin AG could be sold in 2007 to private investors if the DSGV ends up not coordinating a successful bid from various entities within the national sector or, alternatively, if there is no successful bid from a public sector bank. Again, it could be argued that after the loss of state guarantees, the potential sale of Sparkasse Berlin¹² could be a milestone on the way to an increasingly porous public sector banking group in Germany, especially if private investors are allowed to acquire the brand “Sparkasse.” DBRS believes that Berlin is, so far, a special case in that the state was forced to sell its bank without discriminating between investors, which means that the state cannot be seen as biased towards a bid from public-sector banks.

In general, privatisation is likely to have negative rating connotations for the respective Landesbank if the withdrawal of a committed state owner is not compensated by, for example, the strategic interest of a new owner with strong financial fundamentals. In this context, DBRS believes the legal status plays only a small role in determining the future success of a Landesbank’s strategy or business model.¹³

If it is not full privatisation that might change the future creditworthiness of the Landesbanken, a creeping estrangement between state and Landesbank might lead to a dilution of future state support. The second phase of the transformation process will be impacted by the fact that two layers of protective cushion will shrink over time. First, the amount of liabilities benefiting from the state guarantees are going to shrink over the next three to four years – potentially reducing the economic incentive for the state owner to support its respective Landesbank if trouble is foreseen. Second, with highly rated liabilities maturing, the Landesbanken are forced to refinance their low margin assets with liabilities priced somewhat closer to their intrinsic credit strength, which could lead to pressure on their profitability. In such a dilemma, the Landesbanken could turn to riskier business activities, which ultimately could alienate their owners, especially if these risks are assumed outside of regional markets, or as an economically more prudent alternative to further broaden regional activities, including their cooperation with savings banks regionally.

As this process as described will take years to unfold – and will likely be less dramatic, especially in regard to the funding disadvantage – a change in an entity’s risk profile and owner’s attitude can be monitored and reflected in rating changes; thus, at this stage, funding disadvantages are not a foregone conclusion.

B. Potential for Growing Disintegration Between and Within Landesbanken and Savings Banks

In this context, in several German states, for example Hesse and Saarland, politicians are discussing plans for amendments to existing savings bank laws. These proposed changes include:

- I. In Hesse, the government published the draft of a new savings bank law, which will allow savings banks to issue equity shares (an option that already exists in the state of Rhineland-Palatinate) and which also includes the transfer of shares between savings banks and public sector entities, including Helaba. The law will become effective in the first quarter of 2007.
- II. In Saarland, savings banks would be allowed to merge with savings banks outside their own state.

These changes would reflect similar steps previously implemented in Bremen and Saxony, where it is already possible to change the legal status of a savings bank from a public sector entity to a limited company. In North Rhine-Westphalia, a discussion about “modernising” the savings bank law has just begun.

Regional and national savings bank associations are concerned these adjustments to the established legal frameworks could ultimately lead to an erosion of the core principles of German public sector banking:

- I. The regional principle (which in essence means there is no direct competition between savings banks in the lending business).
- II. The substitution principle (only tasks that cannot be implemented at the savings bank level are transferred to centralised providers).
- III. The independence of savings banks, which are owned by their respective local municipalities (versus vertical integration between savings banks and Landesbanken or privatisation of savings banks).

DBRS cannot fully dismiss the idea that savings banks might follow the example of the Landesbanken, where DBRS has already witnessed considerable differences in strategies and business models. DBRS could use a continuum to describe the status quo; at one end, a bank like HSH Nordbank, a limited company with a strong wholesale banking oriented business model; on the other end NORD/LB or Landesbank Baden-Württemberg, which are both Landesbanken with universal business models and public sector status. In addition, competition among Landesbanken has been intensifying and in some cases it has even developed into competition between Landesbanken and savings banks (the direct banking activities of Landesbank Hessen-Thüringen and Bayerische Landesbank is a good illustration).

To date, however, DBRS can agree that German savings banks are still a relatively homogenous group, despite considerable differences

¹¹ See also public comments made by representatives of the State of NRW, Footnote 5.

¹² See above; the state of Berlin amended its savings bank law in the summer 2005 in order to allow a mother-daughter model, where the mother is a limited company owning a public sector entity, which in this case is the Berliner savings bank.

¹³ DBRS believes that it makes sense to differentiate public sector banks by form or content. A Landesbank can have the legal status of a company according to public law yet act like a commercial bank. A Landesbank could be an AG but still owned by the public sector and act as a public sector bank, meaning focusing less on maximising profits than on providing service to the regional economy.

in their size. DBRS could argue that the level of cohesion among Landesbanken today is weaker than among savings banks. However, if the law governing savings banks started to diverge across states, even if there is no dilution of the core principles mentioned above, this divergence might lead to a process of growing differences among the savings banks of different German states.

Further divergence of this kind, combined with the already existing differences among Landesbanken, could lead to more autonomous regional groups of public sector banks with different strategies and levels of operational cooperation and integration. The end result would be reduced national cohesion among regional groups.

In this context, DBRS does not expect further consolidation among the Landesbanken in the near to medium term, excluding the potential acquisition of the Landesbank Berlin AG in 2007 by another Landesbank. The smaller Landesbanken are already attached to larger ones (e.g. SaarLB is owned by BayernLB, LRP is owned by LBBW, and Bremer LB is owned by NORD/LB). More recently, WestLB secured an option of a minority stake in SachsenLB.

However, further consolidation among Sparkassen is more likely at the state level.¹⁴ If consolidation in the Sparkassen sector leads to an increasing number of bigger savings banks – for example, banks with balance sheets greater than EUR 10 billion¹⁵ – and if entities recently founded by savings banks,¹⁶ which bundle back-office tasks for the joining savings banks, expand their activities into areas that are currently covered by the regional Landesbank (e.g. Treasury or Capital Markets products), the relationships between Landesbank and regional savings banks could be redefined. Less operational linkages between a Landesbank and its respective regional savings banks or cooperation based only on transactions at market prices, could reduce cohesion at the sector's regional level.

To conclude, reduced national and regional cohesion could be harmful for all Landesbanken, even those with retail banking networks or defined niches in some areas of corporate finance. This is because the Landesbanken have little experience competing with savings banks (perhaps excepting Bremer Landesbank and HSH Nordbank), and the Landesbanken management could find it challenging to deal with such a scenario. In addition, although the services provided to savings banks and their customers are today only modestly profitable – they help cover they help cover the fixed costs of their growing capital markets activities.

Despite having outlined a relatively pessimistic scenario for the potential impact of changes to legal frameworks, DBRS does not anticipate such an extreme scenario any time soon. DBRS believes Germany's situation, for the time being, to remain different from that of Italy in the 1990s (first through the Amato Law in 1990 and then the Ciampi Law in 1998) or Austria (amendments in 1985 to the Aktiengesetz and 1998 to the Sparkassengesetz laid out the path that led to the privatisation of the largest savings banks in Austria, Bank-Austria Credianstalt and Erste Bank over recent years). In Germany, the federal system seems to be working as a “natural” barrier to radical changes, as the Landesbanken and savings bank law is state law, and the majority of local politicians support the status quo of public sector ownership. In addition, DBRS sees regional

groups displaying increasing cohesion in recent years, for example in Hesse, Lower Saxony and Bavaria but also in states like North Rhine-Westphalia, where, historically, the cooperation between savings banks and their Landesbank was less pronounced.

C. Developing and Strengthening Defendable Franchises with Relatively Stable Risk Return Profiles

State ownership and integration into the savings bank sector can provide the Landesbanken with a safety net. However, the Landesbanken are eager to develop new franchises or strengthen their existing ones so that the defendable customer relationships provide them with a stable, recurring earnings base.

Some Landesbanken viewed results for 2005 as evidence of being on the right track. Those Landesbanken that achieved the sector-wide required RoE of 15%, or the internal set cost-income ratio, quoted these good results in support of their strategies. In general, similar to most European banks, including in Germany, the Landesbanken showed materially improved results in 2005. Therefore, in this context, although the level of improvement differed between individual banks, when applied to the Landesbanken in general, the result was positive, regardless of their business models, legal status, different funding costs or economic regions. DBRS believes that structural progress can be better gauged through segment results and through reallocating expenses away from corporate centres down to each business line. In addition, current efficiency ratios do not take into account that the likelihood of future higher funding costs, although the rise will probably be less dramatic than feared. On the more positive side, DBRS believes the Landesbanken still have considerable room for improving their efficiency ratios.

However, realising these efficiency gains is not only a question of dealing with employees' contractual rights, which have traditionally exceeded those of Germany's rigid labour laws. More important is that the Landesbanken coordinate their activities better. Cooperation exists or is underway in back-office tasks, for example, on payment transfer systems or securities transaction processing, but there is less progress on the business side, for example in areas such as private banking, international branch network, institutional asset management, or capital markets (research). The cooperation that exists now has typically been the result of larger Landesbanken acquiring smaller ones.

However, DBRS believes Landesbanken have made progress in recent years, ranging from the Landesbanken that have strengthened their already existing franchises or, at the other end of the spectrum, the Landesbanken that have at least reduced their downside risks. Nevertheless, the Landesbanken, like most of the German banks, are constrained in their growth and profitability by the characteristics of their domestic market.

In this context, DBRS believes the operating environment for German Landesbanken will remain challenging. Growing competition, not only from peers within the sector but also from foreign banks, is combined with somewhat uncertain growth prospects and an indebted public

¹⁴ In the last ten years, the number of savings banks declined by 25% (from 624 in 1995 to 463 in 2005).

¹⁵ Currently, 11 savings banks have a balance sheet above EUR 10 billion, but 28 savings banks have a balance sheet between EUR 5 billion, and just below EUR 10 billion. These savings banks represent more than 40% of German savings banks sector.

¹⁶ For example, Sparkassen Dienstleistung Rheinland GmbH & Co KG (founded by the savings banks in Rhineland) or Norddeutsche Retail-Service AG (founded by the Hamburger Sparkasse and Sparkasse Bremen).

sector that has to curtail spending. Foreign investment banks and commercial banks are specialising in segments that are also the new areas of future expansion and diversification for the Landesbanken, such as structured finance, especially asset-backed or project finance, capital markets, and mezzanine and leveraged finance.

Landesbanken, with some exceptions, are also not actively present in the retail banking segment, which can generate relatively predictable sources of revenues – even in the German market (shown by very profitable niche players or well run savings banks and co-operative banks). The so-called *Subsidiaritäts* principle directs domestic retail banking as the business reserved for the savings banks. In a recent announcement, the Sparkassen and Finance Group stressed the entry of Landesbanken into this segment is not compatible with the core principle and philosophy of the group, whether it is pursued through acquisition of banks outside the sector, organic growth, or vertical integration.¹⁷ Landesbanken might even find it difficult to get their regional owners' approval for expanding into retail banking outside of Germany, if not only because of the prospects of potential higher risks that accompany such an endeavour but also less clear immediate benefits for the local economy.

Landesbanken's strategic alternatives are somewhat limited because of their constrained access to capital. For example, a potential bid for the Landesbank Berlin by a Landesbank could only be successful if the regional savings banks of the respective Landesbank not only support the acquisition at supervisory board level but also financially as the state owners would be severely stretched. And any single regional group of savings banks would be challenged to raise the amounts necessary for a successful bid, especially when future capital generating capacity is constrained by growing demands from local municipalities for higher profits on pay-outs. Having said that, Landesbanken are increasingly taking the route of joint-ventures and partnerships with domestic and international associates (see above) whether in asset management (WestLB and Mellon; Helaba and Northern Trust) or international banking (BayernLB with a number of banks, like more recently the Russian JSC Bank of Moscow or ICICI Bank in India), which allows Landesbanken to access new skills and geographic regions within the constraints of their financial resources and risk appetites.

SECTION 3: RATING CRITERIA FOR LANDESBANKEN GUARANTEED AND NON-GUARANTEED RATINGS

A. Fundamental Landesbank Credit Strengths or the Regional Group of Landesbanken and Savings Banks (Intrinsic Assessment, IA)

In January 2006, DBRS published its Rating Methodology for European Banks, in which the analytical framework for deriving a bank's credit rating was fully explained.¹⁸ (See www.dbrs.com for a copy of the full report.)

Aiming for a higher degree of clarity and transparency, DBRS refers in its analysis to intrinsic assessments (IA) and support assessments

(SA) as the two building blocks for bank credit ratings. For more clarity about support assessments, DBRS introduced a simple four-notch scale from SA1 to SA4. Conversely, to avoid the introduction of a lengthy parallel scale for intrinsic assessments, which could create confusion, DBRS's analysis directly refers to the rating equivalent of DBRS's IA in its analytical communications.

The IA of a Landesbank relies on the analysis of various elements, such as market position, franchise value, governance, ownership, management strength, strategy and implementation, financial strength and earnings capacity as reflected in key ratios and qualitative parameters, and risk profile and risk management – along with the strength and predictability of the operating and regulatory environment. Thus, the IA of a Landesbank is the result of a comprehensive and multi-faceted analysis of its fundamentals, including both qualitative and quantitative elements.

In general, but specifically for Landesbanken, DBRS believes this is not purely an exercise for marking up a financial-ratio scorecard. The necessity of a forward-looking approach has been stated above. Unfortunately, the Landesbanken have a legacy that skews their present numbers positively, for example, cheap long-term funding and large balance sheets. But at the same time, the Landesbanken also have a legacy that constrains them, such as a public service mentality and a non-existent or underdeveloped cooperation with their savings banks.

In the special case of a Landesbank, which is a member of a highly integrated group comprising the Landesbank and the regional savings banks, the IA should reflect the strength of the group as a whole and may reflect full credit substitution (i.e. a group rating).¹⁹ For a well-integrated group, it is hard to separate the attributes of the single entity from those of the group as a whole. For example, risk management will be a seamless process pervading all areas of the group. In addition, the shared support mechanisms provide a solid link between the financial resources of each member of these banking groups with the financial health of the entire group. To enable DBRS to assign a group rating, the group has to (1) display significant economic, strategic, franchise-driven, and management cohesiveness; and (2) be underpinned by a support mechanism, which, when these two criteria are combined, transfers any credit risk for the individual member bank to the group.

DBRS highlighted in Section 1, A and B, above, that, for example, in the states of Hesse-Thuringia, North Rhine-Westphalia, Bavaria and Lower Saxony, the cohesion of the Landesbanken and savings banks was underpinned by additional support funds which supplement the DSGVO's joint liability scheme (for details, see Section 3, C, below). In the case of Hesse-Thuringia, the banks and the regional association of savings banks implemented other elements of a framework that could substitute the credit risk of the single bank with that of the combined group (for example, a group management committee, the publication of consolidated accounts, and a unified risk management system).

DBRS would expect IA equivalents would fall in the BBB to "A" range, reflecting the diverse characteristics of the various Landesbanken. Where it is concluded that the Landesbank has to be viewed as one

¹⁷ The so-called "Berliner Erklärung", 7 November 2005.

¹⁸ For more details, see Footnote 1.

¹⁹ For more details, see Footnote 3.

economic unit with the regional savings banks (group rating), DBRS would expect the rating range to fall between “A” and AA, reflecting the stability and predictability of the financial fundamentals, which the savings banks would contribute to the group assessment.

B. The Banks’ Ownership and Support Assessment (SA)

In a second step, DBRS incorporates in its analysis external support to assess the ultimate credit risk of a Landesbank. DBRS differentiates four levels of support, summarised with the acronyms SA1 to SA4, with SA1 reflecting DBRS’s expectation that support from a support provider will be forthcoming with no (or only modest) uncertainty over the timeliness of such support if the beneficiary is ever in need. DBRS believes that there is a strong case for an SA1 assessment of Landesbanken. As a result, the respective state would be the decisive factor of the ultimate credit risk faced by an investor of Landesbank debt. The reasons are the following:

- There is an economic incentive for a state to support its Landesbank in a crisis and, ideally, before a potential crisis arises. German states are substantial shareholders in their Landesbanken. A state’s stake in its regional Landesbank is becoming even more meaningful in view of the material amounts of silent participations (*stille Einlagen*) held by the respective states. In addition, due to the economic linkage between the Landesbank and attached savings banks – through capital (share capital and silent participations), intra-sector lending (savings banks holding Landesbanken debt), and syndicate lending (Landesbank is in a syndicate with a savings bank for a customer of the latter) – a Landesbank in serious trouble would cause stress for the regional savings banks and, ultimately, the regional economy. As mentioned previously, German states guarantee today, and over the medium term, most of the long-dated debt of a Landesbank. The failure of a bank whose debt is mostly state-guaranteed would pose a considerable embarrassment for the respective state. In this context, failure of a Landesbank would harm the reputation of the state, the owner of the Landesbank, and those carried by the Landesbanken. Thus, the failure would reflect negatively on their standing in the capital markets.
- The Landesbanken are banks with a public mission laid down in a state law that in essence serves the state, the local region and savings banks. The laws allow Landesbanken to pursue other businesses outside this public mission, but as Landesbanken are engaged in finding financial solutions for the state (for example, financing infrastructure projects or providing financial resources to the regional economy with mezzanine or loan products), they are also assuming risks, which are not only driven by purely commercial motives. DBRS believes this also poses a moral obligation to the state to support its Landesbank.
- In most cases, states have given some level of explicit reinforcement to their stakes in their respective Landesbank (e.g., declaring that the majority of the bank’s ownership will remain in the public sector or that the Landesbank is viewed as

important or that the term “Staatsbank” be used in the respective Landesbank law).

- When the EU and German representatives struck the agreement about the abolition of state guarantees for the Landesbanken and savings banks in 2001, they also agreed on the following: first, the European Commission would not object to financial institutions being run as public companies; second, the public owner of such an institution has to treat its investment in its Landesbank as a private investor would. In DBRS’s opinion, that also means that public owners cannot be disadvantaged when compared to private investors or owners, and that support from states to their Landesbank would not automatically be viewed as state aid by the Commission, unless it is economically sensible to do so (and DBRS believes a case for that can definitely be made).

DBRS also believes that the most likely scenario for support would be that of a Landesbank faced with a gradual deterioration versus an unexpected eruption of problems, especially due to the reduced downside risks in the Landesbanken sector since their difficulties during 2001–2003. Therefore, a state should have time to prepare its help, for an example, a capital injection, and also to link the help with seeing the implementation of managerial and strategic changes.

Having made the case for SA1, DBRS will secondly differentiate among Landesbanken based on their heterogeneity (see above) and DBRS’s assessment should lead to a different notching between the states’ creditworthiness and the Landesbanken, ranging from one to three notches. The notching will depend on the level of ownership (and financial commitment through other forms of capital like for example Tier 1 hybrid capital), the likelihood of a potential privatisation in the medium to long term future, the Landesbank’s importance to the regional economy, the Landesbank’s integration in the regional economy and the savings bank sector, whether statements of explicit or implicit support exist, and, to some extent, the risk profile of the bank itself.

After incorporating external support DBRS expects that most Landesbanken will be rated in a range of “A” to AA based on SA1. The relatively high ratings are reflecting the implicit support from the respective German states and their individual economic strengths and the revenue equalization among the German states (based on Art. 107 § 2 of the *Grundgesetz*, Basic Law).²⁰ As a result of the revenue equalization system, including the possibility for so-called extra contributions from the federal government (*Bundesergänzungszuweisungen*) in cases of extreme budget situations, in combination with an inherent and partially forced²¹ cohesion among the states and the federal government, implied ratings for German states are closely linked to the credit strength of the Federal Republic of Germany, but not at the same level, considering that there is no outright guarantee mechanism shared among the states and the federal government. DBRS expects the implied ratings for German states will range from AAA to AA (low). The lower end of this rating range is reserved for states with comparatively weak fiscal and economic data, which also follow a negative trend and which increases the likelihood that the state might need help beyond the

²⁰ In order to level out financial disparities between the Länder (states) Germany implemented a system of vertical and horizontal “fiscal equalization” transfers.

²¹ In 1992 (other supporting decisions 1986 and 1999) the Federal Constitutional Court made its decision stipulating that the constitution required the Bund to make additional payments to the states of Bremen and Saarland by adding to their supplementary transfers in order to reduce public debt without severe expenditure cuts.

normal horizontal and vertical system of intergovernmental fiscal equalization.

Landesbanken, which are subsidiaries of other Landesbanken, concretely SaarLB, Bremer Landesbank, Landesbank Rheinland-Pfalz, are likely to qualify as a SA1 but the support is coming from the respective parents. If DBRS concluded that it could assign a group rating to a Landesbank (see intrinsic assessment section above), then the support for the Landesbank from the state owner could give uplift to the group rating. For instance, DBRS takes the more likely case that the risk profile of a Landesbank is more of a constraining element for the group rating. If in this particular group of savings banks and Landesbanken, the Landesbank would benefit from an SA1 support assessment from its state owner, the group rating could be lifted up to the level of the individual Landesbank rating based on SA1, even though the support from the state only deals with potential problems at the Landesbank. DBRS takes the view that the risk a problem at the Landesbank could contaminate the whole group is considerably reduced.

C. The Support Mechanism Shared Between Savings Banks, Landesbanken and Landesbausparkassen

Landesbanken share a support system that is administered by the DSGV and is integrated into the Joint Liability Scheme of the Savings Bank Finance Group (which includes the savings banks, Landesbanken, and Landesbausparkassen, here referred to as the DSGV Group, but not all associated companies).²² The Landesbanken support system is funded by annual contributions and is addressing the affiliated institutions themselves (in contrast to deposits only) and, in particular, safeguards their liquidity and solvency.

However, Landesbanken or investors holding debt of Landesbanken do not have a direct claim against the fund for support and no contractual obligation exists that ensures timely support if it is ever needed. Due to these limitations, DBRS has to assess the cohesiveness between the Landesbanken and the savings banks, because if the Landesbanken support fund proves to be insufficient in a rescue situation, the request for further funds would spill over to the support funds of the savings banks and building societies (following certain rules and procedures).

In previous sections DBRS points to the fact that Landesbanken compete with each other and that the level of cooperation between them is relatively basic. In addition, DBRS believes the level of entrenchment in the regional economy and integration in the regional savings bank sector differs in each state. DBRS recognises that centrifugal powers exist within the DSGV group that could dilute the national cohesion of Landesbanken.

Consequently, DBRS believes that the cohesion of Landesbanken and savings banks at a national level is less pronounced than at the regional level. Therefore, it would be incorrect to attribute the full strengths and financial resources of the DSGV Group to a single Landesbank or savings bank, since those strengths and resources are not fully available to the said entity. However, DBRS believes the rating of

a member of the DSGV group will reflect both the member bank's own strengths and its ability, through the above-mentioned shared support system, to draw on resources of other entities within the group, should the need arise. This is particularly true after the DSGV in 2006 implemented amendments to the rules for the guarantee funds, especially an increase in the volume covered by the Joint Liability Scheme and better risk monitoring, which should allow the DSGV to identify potential risks at an early stage – especially when risk-based computation of contributions to the guarantee schemes are implemented in 2007. But unlike fully integrated groups, which DBRS might find at a regional level, DBRS's support assessment will signal the marginally less integrated nature of the group at a national level and may take the form of a floor rating.²³

In other words, DBRS would set a floor rating, below which none of the Landesbanken and savings banks would be rated. In practice, DBRS would expect that the floor rating would apply to all Landesbanken, benefiting especially those that:

- Are relatively less integrated in the regional savings bank sector and not strongly entrenched in the regional economy.
- Have support coming from a state that is more dependent on the state equalization scheme than other German states.

DBRS believes that its fundamental analysis of the national sector could set the floor rating in the single “A” range, reflecting the dominating position of German savings banks in the German retail banking market, the sector's acceptable risk profile, and predictable financial fundamentals on an aggregate basis, as well as the reduced downside risks in the Landesbanken sector.

D. “Grandfathered” Debt Ratings

In the case of Landesbanken's “grandfathered” debt – guaranteed liabilities that were agreed to by July 18, 2001, without time limits, and liabilities agreed after that date until July 18, 2005, with maturities that do not extend beyond December 31, 2015 – DBRS's analysis is that an SA1 is justified, in which case the rating will not move down from the implied rating of the guarantors. The rating level will over time be determined by the creditworthiness of the state and its implicit support to the Landesbank. Implicit support is critical because the wording of the grandfathered Gewährträgerhaftung (joint guarantee obligation) does not ensure timeliness of payment and more closely resembles a deficiency guarantee.

The implicit support will be driven by the level of state ownership and integration of the Landesbanken in the regional economy and savings bank sector. But even if a Landesbank is privatised, DBRS expects the guaranteed ratings will remain relatively close to the guarantors' ratings because at that point, the amount of liabilities that are covered by the guarantee should become more manageable. In addition, the reputation risks for the state remain high if debt that is perceived by the capital markets as being guaranteed by the respective state is not serviced in fully and timely.

²² Since the establishment of the Joint Liability Scheme of the Savings Bank Finance Group in the 1970s, no customer of a member institution has ever lost his or her deposits; it has never been necessary to indemnify depositors; and no member institution has ever defaulted on its financial obligations, let alone become insolvent. For more details, see www.dsgv.de.

²³ For more details on the concept of floor ratings, please see Footnote 4.

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