FITCH AFFIRMS BAYERISCHE LANDESBANK'S IDR AT 'A-'/STABLE; UPGRADES VR TO 'BBB+'

Fitch Ratings-frankfurt-20 April 2018: Fitch Ratings has affirmed Bayerische Landesbank's (BayernLB) Long-Term Issuer Default Rating (IDR) at 'A-' with a Stable Outlook and upgraded the bank's Viability Rating (VR) to 'bbb+' from 'bbb'. The Short-Term IDR has been affirmed at 'F1' and the Support Rating (SR) at '1'.

The rating actions have been taken in conjunction with Fitch's periodic review of three Landesbanken based in southern Germany.

A full list of rating actions is available at the end of this rating action commentary.

The affirmation of the IDRs and SR reflects Fitch's view of vert strong institutional support from the bank's owners.

The upgrade of the VR reflects the bank's improved capitalisation and company profile following the repayment of state aid to Bavaria in June 2017. Asset quality remained solid and risk costs contained due to the strength of Germany's operating environment. The VR also reflects moderate earnings prospects due to strong competition in the German banking sector, BayernLB's main operating focus, and our expectation that risk costs will normalise in the coming years.

KEY RATING DRIVERS
IDRS, SR AND SENIOR DEBT
BayernLB's IDRs, SR and senior debt ratings are driven by strong institutional support from the bank's owners, the regional state of Bavaria (AAA/Stable), Bavaria's savings banks and ultimately Germany's savings banks group, Sparkassen-Finanzgruppe (SFG, A+/Stable).

Fitch's institutional support assumptions are underpinned by provisions contained in the statutes of the institutional protection fund of SFG and the Landesbanken. Our support considerations are also based on the view that the owners view their investment in BayernLB as long-term and strategic. This is underpinned by BayernLB's focus on the bank's statutory roles, which include supporting the Bavarian economy as well as acting as the central institution for Bavaria's savings banks and as house bank for the State of Bavaria.

Fitch uses the lower Long-Term IDR of BayernLB's owners, SFG's Long-Term IDR, as anchor for determining the bank's support-driven ratings. Fitch believes support would need to be forthcoming from both SFG and the State of Bavaria to avoid triggering state-aid considerations and resolution under the German Recovery and Resolution Act if BayernLB fails. Our assessment of Bavaria's creditworthiness is underpinned by the stability of Germany's solidarity and financial equalisation system, which links Bavaria's creditworthiness to that of the German sovereign (AAA/Stable). SFG's support ability is strong, but not as strong as that of Bavaria.

We notch down BayernLB's Long-Term IDR twice from SFG's 'A+' because we view the bank's role for its owners to be strategic, but not key and integral, and because of potential legal and regulatory barriers related to state-aid considerations and provisions of German resolution legislation. The Stable Outlook reflects steady support assumptions and the Stable Outlook on SFG's Long-Term IDR.

The bank's Short-Term IDR is at the higher of the two Short-Term IDRs that map to an 'A-' Long-Term IDR on Fitch's rating scale. This reflects BayernLB's strong links to SFG and privileged access to SFG's ample liquidity and funding resources.

The ratings of BayernLB's senior unsecured obligations are equalised with the bank's IDRs.

VR
BayernLB's capitalisation has improved, driven by declining risk-weighted assets (RWAs) and profit retention. Its fully loaded common equity Tier 1 (CET1) ratio increased to 15.3% at end-2017 from 13.2% at end-2016. This represents a comfortable buffer over its individual regulatory requirements from the 2018 supervisory review and evaluation process. It should allow BayernLB to accommodate modest asset growth despite an expected medium-term increase in capital requirements under the revised Basel rules. The first-time implementation of IFRS 9 on 1 January 2018 is likely to be neutral because negative measurement differences on reported equity will almost be fully offset by a supervisory shortfall that is already deducted from its CET1 ratio. BayernLB's leverage ratio of 4% at end-2017 is acceptable but not strong.

The upgrade of BayernLB's VR also reflects the bank's improved company profile due to the full repayment of state aid ahead of schedule in June 2017. We expect BayernLB to make prudent use of strategic growth opportunities without fundamentally changing its risk profile.

Asset quality is sound and risk costs remain low, supported by Germany's benign economic environment and healthy corporate sector. However, the development of loan loss provisions was uneven across its business segments, and we expect limited scope for further loan loss releases. Similar to its Landesbanken peers, BayernLB's business model entails significant sector and single-name loan concentration, which weighs on our asset quality assessment.

BayernLB reported adequate earnings in 2017. The rise in net interest income was primarily driven by lower interest rate expenses for Bayern LB's debt and subsidiary DKB due to rising retail deposits and lower cost secured funding. We believe this will be difficult to repeat as funding spreads are low and BayernLB's practice of charging institutional client deposits with negative interest rates is already in line with market practice.

BayernLB is reliant on DKB's stable profits (42% of the group's pre-tax profits in 2017). The high earnings from BayernLB's remaining non-core assets in 2017 were driven by loan loss releases and recoveries (and masked some underlying weaknesses in the bank's loss-making corporate and Mittelstand business), but are unlikely to recur. Costs have remained sticky and we do not expect a material short-term improvement due to ongoing infrastructure and regulatory investments.

BayernLB's healthy liquidity is supported by a diversified funding mix both by funding source and customer. The bank's material reliance on wholesale funding is mitigated by access to the savings banks' strong liquidity and DKB's retail deposits.

GRANDFATHERED STATE-GUARANTEED SECURITIES
The ratings of the grandfathered state-guaranteed senior unsecured and Tier 2 subordinated notes are equalised with the State of Bavaria's Long-Term IDR as we believe Bavaria's ability and propensity to honour its guarantee is very strong.

NON-GUARANTEED TIER 2 SUBORDINATED DEBT
BayernLB's Tier 2 subordinated notes are notched down once from the bank's VR to reflect our assessment of the notes' relative loss severity.

DERIVATIVE COUNTERPARTY RATING (DCR) AND DEPOSIT RATINGS

BayernLB's DCR and Deposit Ratings are equalised with the bank's IDRs. We believe the bank's buffers of junior and vanilla senior debt do not afford any obvious incremental probability of default benefit over and above the multi-notch support benefit already factored into its IDRs. We do not apply any uplift for above-average recovery prospects in the event of default because of the limited visibility into recovery levels in such circumstances. In the highly unlikely event that BayernLB fails and is not supported by its savings banks and state owners, its balance sheet would most likely differ substantially from the current one.

RATING SENSITIVITIES
IDRS, SR AND SENIOR DEBT
The IDRs, SR and senior unsecured debt ratings are sensitive to changes in our assumptions around the propensity or ability of BayernLB's owners to provide timely support. This could result from a change to SFG's IDRs, to the owners' strategic commitment to BayernLB, or to the bank's importance for its home region or for the savings bank sector. A change to our assessment of the risks of triggering a resolution process ahead of support for Landesbanken could also affect the bank's IDRs, SR and senior unsecured debt ratings.

VR
An upgrade of VR is unlikely as it would require fundamental changes BayernLB's business model (including better diversification) to improve the bank's earnings capacity.

BayernLB's performance is highly dependent on Germany's economic environment. A significant weakening of the latter would likely put downward pressure on the VR through its impact on the bank's asset quality, earnings and capitalisation. The VR is also sensitive to significant changes to BayernLB's strategic objectives. It could come under pressure if we observe a material deviation from risk-conscious underwriting standards, which could erode BayernLB's asset quality and capitalisation.

GRANDFATHERED STATE-GUARANTEED SECURITIES
The ratings of the grandfathered state-guaranteed senior unsecured and Tier 2 subordinated notes are sensitive to changes in Fitch's view of Bavaria's creditworthiness, which is closely linked to that of Germany.

NON-GUARANTEED TIER 2 SUBORDINATED DEBT
The ratings of the Tier 2 subordinated notes are sensitive to the same considerations that may affect the bank's VR.

DCR AND DEPOSIT RATINGS
The DCR and Deposit Ratings are primarily sensitive to changes in the bank's IDRs.

The rating actions are as follows:

Bayerische Landesbank
Long-Term IDR: affirmed at 'A-'; Outlook Stable
Short-Term IDR: affirmed at 'F1'
Support Rating: affirmed at '1'
Viability Rating: upgraded to 'bbb+' from 'bbb'
Derivative Counterparty Rating: affirmed at 'A-(dcr)'
Deposit Ratings: affirmed at 'A-'/'F1'
Senior unsecured debt and debt issuance programme: affirmed at 'A-'/'F1'
Commercial paper programme: affirmed at 'F1'
Grandfathered state-guaranteed senior unsecured and Tier 2 subordinated debt: affirmed at 'AAA'
Tier 2 Subordinated debt: upgraded to 'BBB' from BBB-'

Contact:

Primary Analyst
Roger Schneider, CIIA
Director
+49 69 768 076 242
Fitch Deutschland GmbH
Neue Mainzer Strasse 46-50
60311 Frankfurt am Main

Secondary Analyst
Sebastian Schrimpf, CFA
Associate Director
+49 69 76 80 76 136

Committee Chairperson
Patrick Rioual
Senior Director
+49 69 76 80 76 123

Media Relations: Peter Fitzpatrick, London, Tel: +44 20 3530 1103, Email: peter.fitzpatrick@fitchratings.com.

Additional information is available on www.fitchratings.com

Applicable Criteria
Bank Rating Criteria (pub. 23 Mar 2018)
https://www.fitchratings.com/site/re/10023430