

CREDIT OPINION

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Update

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Sparkassen-Finanzgruppe

Update to credit analysis following rating affirmation

Summary

On 01 November we affirmed [Sparkassen-Finanzgruppe's](#) (S-Finanzgruppe or the group) Aa2 Corporate Family Rating (CFR) with a stable outlook its a2 Baseline Credit Assessment (BCA) and a2 adjusted BCA.

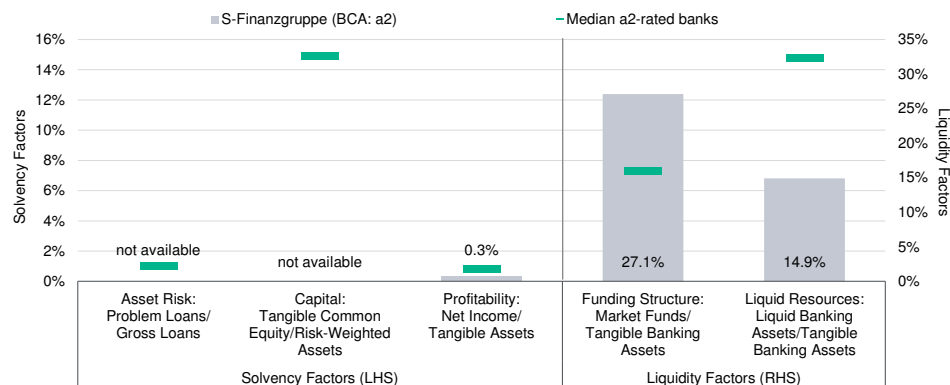
S-Finanzgruppe's Aa2 CFR and the stable outlook reflect (1) the group's a2 BCA; (2) the results of our Advanced Loss Given Failure analysis, providing two notches of rating uplift; and (3) our moderate government support assumptions that result in one notch of rating uplift.

The BCA reflects S-Finanzgruppe's takes into account the expectation of sustained economic growth in Germany which should keep credit risk at benign levels and allows for moderately increasing capitalization from already strong levels. It also reflects challenges from the low interest rate environment mostly pressuring the group's smaller member banks profitability.

In assigning the BCA and CFR to S-Finanzgruppe, we assess the group as though it operates as a single entity. This approach takes into consideration the cohesion and solidarity within S-Finanzgruppe, particularly between the savings banks, as well as the high level of co-operation among the members. However, the members of this group do not constitute a single economic entity that functions with centralised management and control at the group level. The BCA and CFR apply only to the creditworthiness of the group as a whole rather than to individual members of the group.

Exhibit 1

Rating Scorecard - Key financial ratios



Asset risk and capital ratios are not available for S-Finanzgruppe.

Source: Moody's Investors Service

Credit strengths

- » S-Finanzgruppe's strong capitalisation provides an increasing cushion for downside shocks.
- » The group's liquidity benefits from strong access to the German depositor base.
- » The ongoing de-risking of Landesbanks has reduced concentration risks for the group.

Credit challenges

- » S-Finanzgruppe's profitability is under pressure from low interest rates, with cost controls a key issue.
- » Despite a more balanced risk profile within the group, some tail risk from the Landesbanken's international exposures persists, such as commercial real estate and ship finance.

Outlook

- » The outlook on the Aa2 CFR is stable, based on our expectation of a stable fundamental credit profile.

Factors that could lead to an upgrade

- » Upward pressure on S-Finanzgruppe's CFR could arise from upward pressure on its BCA driven by a significantly and sustainably higher profitability of the sector together with improvements of its asset risk profile through reduced concentration risks and stronger capital levels.

Factors that could lead to a downgrade

- » Downward pressure on S-Finanzgruppe's CFR could originate from pressure on its BCA, driven, for instance, by a weakening in profitability, a reduction of its capitalization, or a deterioration in S-Finanzgruppe's funding and liquidity situation.
- » A support scenario for a number of member banks, in which necessary funds significantly compress the sector's overall capitalisation, could exert downward pressure on the rating. Additionally, a deterioration in Germany's Macro Profile could lead to downward rating pressure.

Key indicators

Exhibit 2

Sparkassen-Finanzgruppe (Consolidated Financials) ^[1]

	12-16 ²	12-15 ²	12-14 ²	12-13 ³	12-12 ³	CAGR/Avg. ⁴
Total Assets (EUR billion)	2,119	2,158	2,252	2,264	2,427	-3.3 ⁵
Total Assets (USD billion)	2,235	2,344	2,725	3,120	3,199	-8.6 ⁵
Net Interest Margin (%)	1.5	1.5	1.5	1.4	1.4	1.4 ⁶
PPI / Average RWA (%)	1.3	1.3	1.3	1.4	1.5	1.3 ⁷
Net Income / Tangible Assets (%)	0.3	0.3	0.2	0.1	0.1	0.2 ⁶
Cost / Income Ratio (%)	68.4	69.2	69.7	66.1	62.4	67.1 ⁶
Market Funds / Tangible Banking Assets (%)	27.1	28.4	31.1	33.2	33.6	30.7 ⁶
Liquid Banking Assets / Tangible Banking Assets (%)	14.9	15.1	16.2	17.4	18.5	16.4 ⁶

[1] All figures and ratios are adjusted using Moody's standard adjustments [2] Basel III - fully-loaded or transitional phase-in; LOCAL GAAP [3] Basel II; LOCAL GAAP [4] May include rounding differences due to scale of reported amounts [5] Compound Annual Growth Rate (%) based on time period presented for the latest accounting regime [6] Simple average of periods presented for the latest accounting regime. [7] Simple average of Basel III periods presented

Source: Moody's Financial Metrics

This publication does not announce a credit rating action. For any credit ratings referenced in this publication, please see the ratings tab on the issuer/entity page on www.moody's.com for the most updated credit rating action information and rating history.

Profile

Sparkassen-Finanzgruppe is a German banking group that consisted of around 560 independent enterprises, including 403 savings banks, seven Landesbank groups, the securities firm [DekaBank Deutsche Girozentrale \(Deka\)](#) (Aa2 stable, Aa3 stable, baa2)¹, eight Landesbausparkassen (regional building societies) and 11 primary insurance groups, as of 31 December 2016. As of that date, S-Finanzgruppe held domestic market shares of 28.6% in terms of business volume (excluding derivative financial instruments in the trading portfolio and own bond issues repurchased), 42.2% in terms of corporate lending, 36.9% in terms of private housing construction loans, 23.4% in terms of consumer credit, 39.5% in terms of deposits from private individuals (excluding term deposits for a period of over two years) and 28.3% in terms of deposits from domestic enterprises. As of 31 December 2016, S-Finanzgruppe reported total aggregated assets of €2.1 trillion.

The German Savings Banks Association is the umbrella organisation of S-Finanzgruppe. The enterprises of S-Finanzgruppe are independent and managed on a decentralised basis. Most group savings banks are institutions incorporated under public law and operated under municipal trusteeship².

Detailed credit considerations

Capitalisation is providing a strong and increasing buffer

S-Finanzgruppe's solid and improving capitalization provides a substantial buffer against a more severe economic downturn. The group reported a Tier 1 ratio of 15.6% as of year-end 2016, up from 15.1% a year earlier, with the positive development supported by the two key membership groups, savings banks and Landesbanks. Taking into account the level of capitalisation, additional capital-equivalent reserves but also some limitations to capital fungibility within the group we assign a aa2 Capital score.

The aggregate financial fundamentals of the savings banks are underpinned by strong Common Equity Tier 1 capital ratios and total capital ratios (15.1% and 16.9%, respectively, as of year-end 2016) and limited leverage (8.7% according to Bundesbank data). In addition, the savings banks are able to absorb considerable adverse market developments owing to the sizeable, undisclosed and fully taxed reserves that they put aside under local GAAP. As of year-end 2016, the savings banks' Tier 1 ratio was 15.2% (up from 14.8% as of year-end 2015), based on the respective valid regulatory standards.

With a Tier 1 ratio of 16.5% as of year-end 2016 (2015: 15.6%; 2014: 14.7%), the reported regulatory capitalisation of the Landesbanks doubled since 2007. Significant strengthening in the Landesbanks capital quality was achieved in 2012 because several banks addressed the previously high content of hybrid capital to comply with the raised core Tier 1 targets set by the European Banking Authority.

However, capital buffers incorporate regulatory privileges linked to the sector's Institutional Protection Scheme, such as a 0% risk weighting for exposures held, primarily affecting the savings banks. A theoretical loss of the regulatory recognition for the scheme (for instance linked to a denial of support for a sector entity) may have negative repercussions for the capital levels. Although we regard this as unlikely, the impact would be credit negative.

Capital cannot be freely allocated to single members within S-Finanzgruppe, and the risk of renewed cases of distress as a result of capital shortfalls cannot be ruled out. Although the Landesbanks have improved their regulatory and economic capitalisation, they display a riskier business profile and higher leverage, which renders them more vulnerable to event risk or any renewed market disruption.

Profitability is under pressure from the low interest-rate environment and cost pressures

For 2018, we expect persistent pressure on interest income, driven by the low interest-rate environment, to have offset any progress in cost reduction. As the savings banks continue to operate through an extensive branch network, and as their organisational structure remains fragmented, the potential for achieving economies of scale is somewhat limited without any decisive moves at the local levels³.

Nevertheless, the sector has continued to report solid results, with pre-tax profits at €5.2 billion in 2016, after €6.6 billion in 2015 and €3.6 billion in 2014 under local GAAP. Over the same period, our calculation of the pre-provision income of €12.6 billion (2015: €12.5 billion) reflected the high quality of capital generation. In particular, the sector has continued to build €4.5 billion capital reserves (340g reserves). The assigned Profitability score of ba2 already excludes the expenses booked to build up those reserves to reflect the capital-generation capacity of the sector.

In 2016, net interest income declined by 5.6% to €30.8 billion, and the net interest margin (calculated as net interest income as a proportion of loans and advances to non-banks) declined slightly to 2.6% from 2.7%. S-Finanzgruppe's efficiency metrics compare less favourably with those of its international peers; however, administrative expenses recorded a more pronounced 2.5% decline from the year earlier, with cost containment a key challenge for the group on back of the low interest-rate environment (see also our publication [Sparkassen-Finanzgruppe: Low Interest Rates Reveal the Regional Savings Banks' Profitability Challenges](#)).

Key risk drivers for asset quality reflect the medium-term challenges of the German economy, while some risks from the Landesbanken's shipping exposures persist

S-Finanzgruppe's Asset Risk score of a3 primarily reflects the average risk profile of German households and the corporate sector throughout the economic cycle. Risk concentrations in export-driven industries, such as the automotive sector, as well as the cyclical construction sector, are a function of Germany's economic structure, with the overall size and diversification of the loan book providing a positive effect. Credit conditions currently remain relatively benign, supported by expectations of robust economic growth in 2017 and 2018, accompanied with low unemployment rates, supporting the retail and corporate clients capacity to service its debts.

In addition, a high proportion of the savings banks' loan book is backed by conservatively valued residential properties. However, German residential real estate prices continue to accelerate, with indications of price growth outpacing fundamentals, particularly in large metropolitan areas. The savings banks' high and increasing exposure to residential property finance could impose future risks to asset quality and profitability. Significant price corrections, if paired with a higher share of above 100% loan/value mortgages, would significantly increase loan-loss charges in case of problem loan additions.

The group remains vulnerable in the context of its sizeable commercial real estate and ship-financing exposures at some of the Landesbanks; the latter might continue to cause elevated — although declining — from the 2016 peak, credit losses in 2017-18. The Landesbanks are also exposed to diverse international lending and asset-based finance activities, as well as large — although declining — investment portfolios, which led to major valuation and credit losses during the global financial crisis, even if exposures have been reduced significantly in the meantime.

Further, we identify a rising importance of interest-rate risks — which are catching regulatory attention as reflected by the introduction of separate capital buffers (see also our publication [New Interest Rate-Related Capital Buffers are Credit Positive](#)) — that may hurt more than half of the savings banks.

The group's BCA benefits from its Very Strong- Macro Profile, largely determined by the German environment, with very high economic, institutional and government financial strength and very low susceptibility to event risk. However, operating conditions for the German banking system are constrained by high fragmentation in an oversaturated market, low fee income generation and intensifying competition for domestic business.

The Liquidity profile benefits from prime access to the strong German domestic depositor base

The group's a1 Funding Structure score benefits from strong access to the German depositor base, with S-Finanzgruppe being the market leader in deposit-taking. The solid funding profile of the savings banks benefits strongly from their prime access to German deposits and is a key strength of the sector. The savings banks' deposits amounted to €890 billion as of year-end 2016 compared with €769 billion in loans. We note the significant potential for the savings banks to use their substantial mortgage books for secured funding in the capital market, while the Landesbanks continue to benefit from their existing covered bond franchise.

The Landesbanks continue to show a degree of wholesale funding dependence, while at the same time their deleveraging has resulted in a reduced dependence on interbank borrowings (€238 billion as of year-end 2016, down from €542 billion in 2008) and securitised liabilities (€190 billion, down from €440 billion). Excess funds from the savings banks are shared within the group, supporting the Landesbanks' funding profile, that is more reliant on market funding than the savings banks. About 21% of the €121 billion excess funding at the savings banks' level is directly lent to the Landesbanks, thereby helping close their funding gap, totaling €134 billion as of December 2016, defined as the difference between €273 billion in deposits and €408 billion in loans.

Furthermore, the group keeps sufficient liquid assets within the sector to balance the mentioned market funding of Landesbanks and enjoys a strong covered bond franchise. Liquid assets include €51 billion in cash, €265 billion due from banks and a €355 billion

securities portfolio. The assigned a2 Liquid Resources score takes into account asset encumbrance (for instance via intra-group exposures) and the quality of liquid assets available.

Support and structural considerations

Notching for CFR

S-Finanzgruppe represents a conglomerate of diverse financial institutions in Germany. As such, it is not considered a banking group in the context of the European Capital Requirement Regulation. S-Finanzgruppe is, therefore, not a regulated group, but all of its affiliated institutions are subject to applicable regulation for banks or other financial institutions. As a result, the EU's Bank Recovery and Resolution Directive, which we consider to be an operational resolution regime, does not apply to S-Finanzgruppe but only to its member banking institutions individually. Thus, our CFR on S-Finanzgruppe represents the risk characteristics of a notional single class of debt assumed to fund its aggregate balance sheet.

Our Advanced Loss Given Failure analysis suggests that this notional instrument would face very low losses in resolution. This results in two notches of uplift to the CFR compared with S-Finanzgruppe's BCA of a2, and hence, a Preliminary Rating Assessment of aa3.

Government support

We expect a moderate probability of government support, resulting in a one-notch rating uplift for S-Finanzgruppe. Our government support assumption reflects the size and high systemic relevance of S-Finanzgruppe at the domestic level.

About Moody's Bank Scorecard

Our scorecard is designed to capture, express and explain in summary form our Rating Committee's judgement. When read in conjunction with our research, a fulsome presentation of our judgement is expressed. As a result, the output of our scorecard may materially differ from that suggested by raw data alone (though it has been calibrated to avoid the frequent need for strong divergence). The scorecard output and the individual scores are discussed in rating committees and may be adjusted up or down to reflect conditions specific to each rated entity.

Rating methodology and scorecard factors

Exhibit 3

Sparkassen-Finanzgruppe							
Macro Factors							
Weighted Macro Profile	Very Strong -						
Financial Profile							
Factor	Historic Ratio	Macro Adjusted Score	Credit Trend	Assigned Score	Key driver #1	Key driver #2	
Solvency							
Asset Risk							
Problem Loans / Gross Loans	--	--	--	a3	Quality of assets	Sector concentration	
Capital							
TCE / RWA	--	--	--	aa2	Risk-weighted capitalisation	Expected trend	
Profitability							
Net Income / Tangible Assets	0.3%	ba2	← →	ba2	Loan loss charge coverage	Earnings quality	
Combined Solvency Score				a3			
Liquidity							
Funding Structure							
Market Funds / Tangible Banking Assets	27.1%	baa2	← →	a1	Market funding quality	Deposit quality	
Liquid Resources							
Liquid Banking Assets / Tangible Banking Assets	14.9%	baa3	← →	a2	Quality of liquid assets	Additional liquid resources	
Combined Liquidity Score				a1			
Financial Profile				a2			
Qualitative Adjustments				Adjustment			
Business Diversification				0			
Opacity and Complexity				0			
Corporate Behavior				0			
Total Qualitative Adjustments				0			
Sovereign or Affiliate constraint				Aaa			
Scorecard Calculated BCA range				a1-a3			
Assigned BCA				a2			
Affiliate Support notching				0			
Adjusted BCA				a2			
Instrument Class	Loss Given Failure notching	Additional notching	Preliminary Rating Assessment	Government Support notching	Local Currency rating	Foreign Currency rating	
Corporate Family Rating	2	0	aa3	1	Aa2	--	

Source: Moody's Financial Metrics

Ratings

Exhibit 4

Category	Moody's Rating
SPARKASSEN-FINANZGRUPPE	
Outlook	Stable
Baseline Credit Assessment	a2
Adjusted Baseline Credit Assessment	a2
Corporate Family Rating -Dom Curr	Aa2

Source: Moody's Investors Service

Endnotes

- 1 The ratings shown are Deka's Long-term Senior Unsecured rating and outlook, Long-term Deposit ratings, as well as its Baseline Credit Assessment
- 2 For further details, please refer to [S-Finanzgruppe's Company profile](#) and the [German Banking System Profile](#).
- 3 See also [Sparkassen-Finanzgruppe: Low Interest Rates Reveal the Regional Savings Banks' Profitability Challenges](#).

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