FitchRatings

RATING ACTION COMMENTARY

Fitch Upgrades BayernLB's Viability Rating to 'bbb+'; Affirms IDR at 'A-'/Stable

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Fitch Ratings - Frankfurt am Main - 07 Mar 2023: Fitch Ratings has upgraded Bayerische Landesbank's (BayernLB) Viability Rating (VR) to 'bbb+' from 'bbb', while affirming its Long-Term Issuer Default Rating (IDR) at 'A-' with a Stable Outlook. A full list of rating actions is below.

The upgrade of the VR primarily reflects our expectation that earnings should remain broadly stable with an operating profit at about 1% of risk-weighted assets (RWAs) through the cycle. This should support internal capital generation, although the bank's profitability will remain constrained by its business model. We also believe that the bank will maintain capital ratios to provide a substantial cushion against downside risks stemming from the recession in Germany.

KEY RATING DRIVERS

Support Drives IDR: BayernLB's IDRs and Shareholder Support Rating (SSR) are driven by Fitch's view of support from the bank's owners, the savings banks (Sparkassen-Finanzgruppe (Sparkassen); SFG, A+/Stable) and the State of Bavaria. Fitch uses SFG's Long-Term IDR as the anchor rating because 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.

The Stable Outlook on BayernLB's Long-Term IDR mirrors that of SFG. Fitch believes that Bavaria, which owns 75% of BayernLB, would participate in support measures for

the bank, but BayernLB's SSR does not factor in support from the federal state as it is based on the lower of the two owners' ratings.

We notch down BayernLB's Long-Term IDR twice from SFG's 'A+' to reflect regulatory restrictions on support, due to the requirement for state-aid examination under the EU competition rules. The two-notch difference also reflects BayernLB's strategic, but not key and integral, role for its owners.

Adequate Business Profile: BayernLB's VR reflects the bank's largely wholesale-driven business model, moderate earnings-generation capacity and adequate asset quality. It also reflects its healthy capital ratios providing satisfactory buffers over regulatory minimums, and a fairly stable funding profile.

Mainly Wholesale-Driven: BayernLB's business model is largely driven by wholesale funding and sensitive to interest rates, given its reliance on net interest income, similarly to its Landesbanken peers. Intense competition in most business segments structurally limits BayernLB's pricing power and weighs on its profitability.

The bank's selective approach to foreign business results in moderate geographic diversification. Its retail-banking activities undertaken by its subsidiary Deutsche Kreditbank AG (DKB) enhance the group's revenue mix and are critical to maintaining acceptable profitability.

Moderate Profitability: We expect the bank's four-year average operating profit to remain at about 1% of RWAs through the economic cycle. In the coming quarters, profitability could temporarily fall below this level as a challenging operating environment in Germany is likely to weaken loan demand and lead to higher loan impairment charges (LICs), which might only be partially offset by higher revenue from higher interest rates. Impaired loans and Stage 2 exposures are adequately covered by loan loss allowances including management's adjustments, which support the bank's capacity to cover impaired loans resulting from the economic downturn.

Resilient Asset Quality: We expect BayernLB's impaired loans ratio to deteriorate modestly in 2023 as a result of the economic downturn, rising interest rates and inflation, but for it to remain below 2% in the medium term. The bank's large sector exposure to certain industries, including mobility and energy in addition to its focus on cyclical commercial real estate lending with inherently high loan concentration, constrains our asset-quality assessment.

Robust Capital: BayernLB's common equity Tier 1 (CET1) ratio stood at 16.1% at end-3Q22, which is strong compared with peers' and above the bank's year-end target of

above 15%. It provides a reasonable cushion against a more adverse economic environment and offers a reasonable buffer over regulatory requirements. BayernLB could face challenges from an increase in RWAs resulting from loan growth and potential credit deterioration due to the recession in Germany, but we expect BayernLB's CET1 ratio to remain well above 15% in the medium term.

Sound Funding and Liquidity: BayernLB is primarily wholesale-funded, which is reflected in a moderately higher loans/deposits ratio than commercial bank peers'. However, it benefits from a high share of deposit-driven retail business at DKB and moderate capital-market funding requirements, due to the bank's reliable placement capacity within the savings bank sector. Its liquidity position is strong, covered by a large portfolio of liquid assets.

RATING SENSITIVITIES

Factors that could, individually or collectively, lead to negative rating action/downgrade:

A downgrade of SFG's IDRs, or an adverse change in BayernLB's ownership structure or in SFG's strategic commitment could lead to a downgrade of BayernLB's IDRs and SSR.

The VR would likely be downgraded if we expect the bank's impaired loans ratio to rise to and remain above 3%, if the CET1 ratio falls durably below 13% or if operating profit declines below 0.7% of RWAs on a sustained basis without clear recovery prospects. Also, a significant adverse change in its corporate structure could put pressure on its VR, particularly if it impairs the bank's revenue-generating capacity.

Factors that could, individually or collectively, lead to positive rating action/upgrade:

An upgrade of the IDRs and SSR are primarily sensitive to positive changes in our assumptions around the propensity or ability of BayernLB's owners, primarily SFG, to provide timely support. An upgrade of SFG's IDRs could lead to an upgrade of BayernLB's IDRs.

An upgrade of the VR would require a significantly stronger franchise, including more diversified customer and revenue bases, which would take considerable time to achieve. An upgrade would also be contingent on a structural improvement in BayernLB's profitability, with an operating profit sustainably above 2% of RWAs, without negatively affecting the bank's risk profile and capitalisation.

OTHER DEBT AND ISSUER RATINGS: KEY RATING DRIVERS

BayernLB's Derivative Counterparty Rating (DCR), long-term deposit rating and senior preferred debt ratings are one notch above its Long-Term IDR. This reflects the protection of preferred creditors arising from the bank's large resolution buffers including senior non-preferred and more junior debt. For the same reason, the senior non-preferred debt rating is in line with the bank's Long-Term IDR.

The short-term deposit rating is the lower of two ratings that map to its 'A' long-term deposit rating, in line with Landesbanken peers'. This is because we believe that, despite the owners' very high propensity to provide support to BayernLB, we see potential impediments to the prompt flow of funds, given the lengthy process required to support a Landesbank, which are not commensurate with an 'F1+' short-term rating.

The 'AAA' ratings of BayernLB's grandfathered state-guaranteed senior unsecured and Tier 2 subordinated notes reflect our view of the creditworthiness of the State of Bavaria, which is closely linked to that of Germany (AAA/Stable), and reflect outstanding recovery prospects arising from the guarantee of Bavaria.

BayernLB's non-guaranteed Tier 2 subordinated bond rating is notched down twice from the bank's VR to reflect loss severity that is in line with Fitch's baseline approach.

OTHER DEBT AND ISSUER RATINGS: RATING SENSITIVITIES

Factors that could, individually or collectively, lead to negative rating action/downgrade:

A downgrade of BayernLB's IDRs would trigger a downgrade of its DCR, deposit, senior preferred and non-preferred debts. We could also downgrade these ratings if we expect its junior and senior preferred debt buffer to fall below 10% of its RWAs on a sustained basis.

Adverse changes in Fitch's view of Bavaria's creditworthiness, which is closely linked to that of Germany, would lead to a downgrade of BayernLB's guaranteed debt ratings.

A downgrade of BayernLB's VR would lead to a downgrade of its subordinated debt ratings.

Factors that could, individually or collectively, lead to positive rating action/upgrade:

An upgrade of the IDRs would trigger an upgrade of the DCR, deposit and senior debt ratings, unless its resolution buffers decrease below 10% of its RWAs.

The 'AAA' ratings of the grandfathered state-guaranteed senior unsecured and Tier 2 subordinated notes are the highest level on Fitch's scale, and therefore cannot be upgraded.

An upgrade to the bank's VR would lead to an upgrade of its subordinated debt ratings.

VR ADJUSTMENTS

The business profile score of 'bbb' is below the 'a' implied category score, due to the following adjustment reason: business model (negative).

The asset quality score of 'a-' is below the 'aa' implied category score, due to the following adjustment reason: concentrations (negative).

The capitalisation and leverage score of 'a-' is below the 'aa' implied category score, due to the following adjustment reasons: internal capital generation and growth (negative)

BEST/WORST CASE RATING SCENARIO

International scale credit ratings of Financial Institutions and Covered Bond issuers have a best-case rating upgrade scenario (defined as the 99th percentile of rating transitions, measured in a positive direction) of three notches over a three-year rating horizon; and a worst-case rating downgrade scenario (defined as the 99th percentile of rating transitions, measured in a negative direction) of four notches over three years. The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Best- and worst-case scenario credit ratings are based on historical performance. For more information about the methodology used to determine sector-specific best- and worst-case scenario credit ratings, visit https://www.fitchratings.com/site/re/10111579

REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING

The principal sources of information used in the analysis are described in the Applicable Criteria.

PUBLIC RATINGS WITH CREDIT LINKAGE TO OTHER RATINGS

BayernLB's IDRs are linked to the ratings of SFG.

BayernLB's grandfathered state-guaranteed senior unsecured and Tier 2 subordinated notes are linked to Fitch's assessment of Bavaria's creditworthiness and, by extension, to Germany's ratings.

ESG CONSIDERATIONS

Unless stated otherwise in this section Bayern LB's highest level of ESG credit relevance is a score of '3'. This means ESG issues are credit neutral or have only a minimal credit impact, either due to their nature or the way in which they are being managed by the bank. For more information see fitchratings.com/esg.

RATING ACTIONS

ENTITY / DEBT	RATING	PRIOR
Bayerische Landesbank	LT IDR A- Rating Outlook Stable Affirmed	A- Rating Outlook Stable
	ST IDR F1 Affirmed	F1
	Viability bbb+ Upgrade	bbb
	DCR A(dcr) Affirmed	A(dcr)
	Shareholder Support a- Affirmed	a-
senior unsecured	LT AAA Affirmed	AAA
subordinated	LT AAA Affirmed	AAA
Senior non-preferred	LT A- Affirmed	A-
subordinated	LT BBB- Upgrade	BB+
long-term deposits	LT A Affirmed	A

VIEW ADDITIONAL RATING DETAILS

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APPLICABLE CRITERIA

Bank Rating Criteria (pub. 07 Sep 2022) (including rating assumption sensitivity)

ADDITIONAL DISCLOSURES

Dodd-Frank Rating Information Disclosure Form

Solicitation Status

Endorsement Policy

ENDORSEMENT STATUS

Bayerische Landesbank	EU Issued, UK Endorsed

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