Moody's Investors Service

**Rating Action:** **Moody's downgrades LBBW's debt ratings to Aa2, BFSR to C-**

**Global Credit Research - 23 Jul 2009**

**Downgrades driven by Moody's expectations of rising credit costs and weak capital retention**

Frankfurt, July 23, 2009 -- Moody's Investors Service today downgraded the bank financial strength rating (BFSR) of Landesbank Baden-Wuerttemberg (LBBW) to C- from C. The C- rating translates to a baseline credit assessment (BCA) of Baa2. Concurrently, the rating agency downgraded LBBW's senior debt and deposit ratings to Aa2 from Aa1 and its rating for senior subordinated debt to Aa3 from Aa2. All these ratings now carry a negative outlook.

Furthermore, Moody's downgraded LBBW's upper Tier 2 instruments ("Genussscheine") to Ba2 from Aa2, based on the individual expected-loss analysis on these instruments. The Ba2 ratings are based on the assumption that the coupons may be deferred for two years (with a medium probability) and not fully paid by the time the instruments fall due, given their short time to maturity of 2.5 years. These ratings carry a stable outlook.

Today's rating actions conclude Moody's review for possible downgrade initiated on 23 June 2009. The ratings for grandfathered debt and the Prime-1 short-term debt ratings are not affected.

DOWNGRADE OF THE BFSR DRIVEN BY RISING CREDIT COSTS AND WEAK CAPITAL RETENTION GOING FORWARD

Moody's downgrade of the BFSR to C- from C was driven by the following considerations: (i) the rating agency's expectation that deteriorating asset quality in LBBW's corporate and commercial real estate exposures will likely lead to rapidly rising credit losses; (ii) the additional charges to the income statement and a minimum dividend to be paid in compensation for various support measures (which include a EUR12.7 billion guarantee and EUR5 billion of fresh capital) recently provided by the bank's public sector owners; and (iii) the resulting very limited scope for LBBW to generate and retain capital over the next few years.

The rating agency says that it considers the first issue as representing a critical pressure point for the bank's ratings over the next two to three years, as high single borrower concentrations and large exposures to cyclical industries may result in sizeable credit losses that could largely, if not fully, absorb pre-provision income over the next few quarters. Moody's further expresses concern over the high dividend payouts on the new EUR5 billion of fresh capital injected last month in addition to the considerable fees on the guarantee, which the European Commission demands as compensation for the state aid received.

"Moody's recognises the recently achieved, more comfortable capital levels as well as the risk-weighted asset relief from the guarantee, which currently support a BFSR within the C range. However, the costs attached to the support measures, coupled with rising credit losses, will pose a challenge to LBBW and limit its financial flexibility", says Katharina Barten, a Moody's Vice President-Senior Analyst and Lead Analyst for LBBW Group.

Furthermore, Moody's notes that the downgrade also reflects a degree of uncertainty linked to the approval of state aid, which has been given for a period of six months. Before the end of this period, LBBW will have to present a restructuring plan that may need to involve a downsizing of its balance sheet, which will likely affect not only non-core secondary market investments, but also some of its participations. That said, the rating agency does not expect that the group will be required to fundamentally change its business model, as restructuring targets will likely aim at reducing costs and freeing up capital, which the bank will in any case pursue as a matter of prudence.

STRONG DEBT AND DEPOSIT RATINGS UNDERPINNED BY HIGH PROBABILITY OF STAKEHOLDER SUPPORT

Moody's recognises the strong commitment that LBBW's owners have shown by providing adequate additional resources for the bank to rebuild weakened capital levels and to weather rising credit losses as the global recession deepens. The rating agency believes that this high level of support will likely continue as long as the current ownership structure is maintained, which benefits from relatively uniform stakeholder interests among the bank's owners.

NEGATIVE OUTLOOK DRIVEN BY CONTINUED VOLATILITY OF LBBW'S PERFORMANCE AND THE LOW PREDICTABILITY OF THE FUTURE OF GERMANY'S LANDESBANKEN

The current C- BFSR has factored in substantial room for credit losses and charges against capital, which makes renewed rating pressure in the foreseeable future relatively unlikely. However, in the context of continued uncertainty in the international financial markets, the rating agency does not rule out renewed rating pressure over the next two years, in particular since LBBW has sizeable trading operations and large investments in credit-spread-sensitive products, which in Moody's view warrants a negative outlook on the C- BFSR.

Moody's additionally takes into account the medium-term probability of LBBW participating in the widely expected consolidation process of the German Landesbanken. This has to be seen in the context of rising political pressure to pursue a consolidation of the Landesbanken and the fact that the next steps in this process may involve LBBW as well as those other banks that have received external support during the financial crisis. These banks are WestLB (A2 negative/Prime-1/E+), Bayerische Landesbank (A1 stable/Prime-1/D-) and HSH Nordbank (A2 stable/Prime-1/E+); all of which are substantially weaker than LBBW in terms of franchise value and financial profile.

In this context, Moody's is concerned that LBBW's asset and risk profile may change over the medium term, although the bank itself stressed that it will abstain from any transaction that would unduly put it at risk. However, any M&A transaction involving other Landesbanken will likely be rating-negative for LBBW. While this is not expected to happen in the near term, the rating agency believes that the likelihood of further transactions for LBBW within two to three years is relatively high. Any such transaction may then also trigger changes in the bank's ownership and potentially Moody's assumptions regarding the probability of future support. These considerations are additionally responsible for the negative outlook on the Aa2 senior debt and deposit ratings.

RATING HISTORY AND MOODY'S METHODOLOGIES

The last rating action on LBBW was on 23 June 2009, when Moody's placed its BFSR, long-term debt and deposit ratings and subordinated debt ratings on review for possible downgrade.

The principal methodologies used in rating LBBW are "Bank Financial Strength Ratings: Global Methodology", "Incorporation of Joint Default Analysis into Moody's Bank Ratings: A Refined Methodology" as well as "Guidelines for Rating Bank Junior Securities", which can be found on www.moodys.com in the Credit Policy & Methodologies directory, in the Ratings Methodologies sub-directory. Other methodologies and factors that may have been considered in the process of rating the issuer can also be found in the Credit Policy & Methodologies directory.

With respect to hybrid instruments and subordinated debt, Moody's adds that it released a Request for Comment entitled, "Moody's Proposed Changes to Bank Subordinated Capital Ratings", dated June 2009. In this comment, the rating agency requested market feedback on potential changes to its bank hybrid rating methodology. Should Moody's implement this revised methodology as proposed, the ratings of LBBW's instruments will most likely not be affected.

Domiciled in Stuttgart, Germany, LBBW reported total assets of EUR448 billion at 31 December 2008 and a consolidated net loss for the year of EUR2.1 billion.

Frankfurt
Katharina Barten
Vice President - Senior Analyst
Financial Institutions Group
Moody's Deutschland GmbH
JOURNALISTS: 44 20 7772 5456
SUBSCRIBERS: 44 20 7772 5454

Frankfurt
Carola Schuler
Managing Director
Financial Institutions Group
Moody's Deutschland GmbH
JOURNALISTS: 44 20 7772 5456
SUBSCRIBERS: 44 20 7772 5454

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