



Moody's Investors Service

Credit Opinion: Landesbank Baden-Württemberg

Global Credit Research - 14 Jan 2010

Stuttgart, Germany

Ratings

Category	Moody's Rating
Outlook	Negative
Bank Deposits	Aa2/P-1
Bkd Bank Deposits	Aaa/P-1
Bank Financial Strength	C-
Bkd Issuer Rating	Aaa
Senior Unsecured	Aa2
Subordinate	Aa3
Commercial Paper	P-1
Other Short Term -Dom Curr	P-1
Landesbank Baden-Wuerttemberg, Singapore Br	
Outlook	Negative
Senior Unsecured	Aa2
Subordinate MTN	Aa3
Other Short Term	P-1
Landesbank Baden-Wuerttemberg, New York	
Outlook	Negative
Bank Deposits	Aa2/--
Senior Unsecured	Aa2
Subordinate MTN	Aa3
Other Short Term	P-1
LBBW Luxemburg S.A.	
Outlook	Stable
Bkd Senior Unsecured	Aaa

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Key Indicators

Landesbank Baden-Wuerttemberg

	[1]2009	[2]2008	2007	2006	2005	[3]Avg.
Total assets (EUR billion)	447.75	447.93	443.40	417.28	404.91	[4]6.77
Total capital (EUR billion)	23.10	18.29	21.90	21.21	18.29	[4]2.67
Return on average assets	0.10	-0.44	0.08	0.23	0.17	0.04
Recurring earnings power [5]	0.46	-0.34	0.12	0.35	0.42	0.20
Net interest margin	0.54	0.55	0.53	0.55	0.48	0.54
Cost/income ratio (%)	55.85	828.24	75.96	56.71	64.68	218.36
Problem loans % net loans	2.81	2.83	2.14	3.30	--	2.76
Tier 1 ratio (%)	9.40	6.89	6.50	7.40	7.10	6.88

[1] As of June 30. [2] Statement period in which the bank switched to Basel II accounting framework. [3] The average calculations are based on Basel I and Basel II data where applicable. [4] Compound annual growth rate. [5] Preprovision income % average assets.

Opinion

RECENT CREDIT DEVELOPMENTS

On 23 July 2009, Moody's downgraded the bank financial strength rating (BFSR) of Landesbank

Baden-Wuerttemberg (LBBW) from C to C-, which translates into a baseline credit assessment (BCA) of Baa2. The downgrade was mainly driven by the bank's deteriorating asset quality, the additional burden of required compensation for support measures provided by the bank's public sector owners in Q2 2009 and the resulting limited scope for LBBW to generate and retain capital over the next few years. Concurrently, LBBW's senior debt and deposit ratings were downgraded to Aa2 from Aa1 and its rating for senior subordinated debt to Aa3 from Aa2. All ratings carry a negative outlook.

EUR 17.7 billion in support measures have stabilised LBBW

In late 2008, LBBW announced that it would receive EUR 5 billion in shareholders' capital from its public sector owners, which was subsequently injected in June 2009. In addition to the capital increase, LBBW was supported with a EUR 12.7 billion second-loss guaranty provided by the state of Baden-Württemberg to secure defaults on specified, higher-risk reference assets. These assets were largely related to securitisations inherited from the former Landesbank Sachsen AG (SachsenLB merged with LBBW in early 2008) and were subject to substantial adverse rating migration during H1 2009. Given these pressures, the support measures for LBBW were provided in a timely fashion in order to alleviate critical pressure on regulatory capitalisation. As a result, the Tier-1 ratio, which stood at 6.9% as at the end of 2008, improved to 9.4% as per 30 June 2009.

We believe these support measures represent an adequate cushion to help the bank weather a potentially extended period of financial strain at the current C- / Aa2 rating levels. In addition, these support measures reflect a high level of commitment from the bank's public sector owners and as a result, high probabilities of support continue to be factored into LBBW's long-term ratings.

EC approval obtained: Downsizing, restructuring will constrain LBBW's M/T performance

On 15 December 2009, the European Commission (EC) finally approved the above-mentioned support measures. As is typical for approvals of large-scale state-aid, the EC's consent has been given based on a mutual agreement on far-reaching and comprehensive downsizing and restructuring measures. These include a 40% reduction of total assets with a focus on reducing non-strategic activities and divesting participations, cutting 2,500 jobs and saving costs of around EUR 700 million per annum, which represents more than a third of costs. In addition LBBW has committed to change its corporate governance structure to ensure that the group will be adequately and professionally controlled by external bodies that include independent individuals.

Given the constraints that these targets represent, LBBW's strategic and financial flexibility will, in our view, be materially compromised for the next three to five years; we expect that the challenging tasks of an accelerated asset reduction and defensive risk- and capital management will be driving, if not dictating, management decisions in the medium term. That said, the restructuring also has positive implications, chiefly the restoration of a client-centric business model and the reduction of high-risk investment activities. Both should gradually reduce concentration and market risk, thus lowering earnings volatility.

LBBW should remain a key player in the group of Landesbanken

The full extent of the financial crisis could not be predicted when LBBW ventured to acquire SachsenLB. In hindsight, the negative effects of this takeover appear to substantially outweigh the benefits of its addition to LBBW's franchise, especially when considering how the level of required downsizing may impact its support of SME clients abroad. That said, international operations have never been a strong contributor to its profits. Moreover, the bank hopes to build international co-operations designed to maintain the geographic reach and presence required to adequately serve its more international clientele, which may turn out to be more cost-efficient in the long term.

In spite of the bank's current pressures and limitations, we still believe that LBBW is a critically important Landesbank, not only for Baden-Wuerttemberg but for an increasingly broader economic region. We also consider the bank's client-driven franchise to be intact and its level of entrenchment in regional markets and value to the regional savings banks to be high. Whether it can and will be allowed to play an important role in the targeted consolidation of the Landesbanken remains to be seen.

SUMMARY RATING RATIONALE

Moody's assigns a bank financial strength rating (BFSR) of C- to LBBW, which translates into a BCA of Baa2. The rating remains underpinned by LBBW's strong regional franchise in both commercial and retail banking; however, the rating also factors in the risks posed by a potentially extended period of downsizing, de-risking and restructuring that is required in order to comply with the terms set by the EC in compensation for state aid. The higher risk profile resulting from the acquisition of Landesbank Sachsen AG and the currently weak performance due in part to the persistent financial crisis is only partly offset by the fresh capital and other support measures provided during 2009.

LBBW's global local currency (GLC) deposit ratings are at the Aa2/Prime-1 level, based on the bank's own BCA of Baa2 and our assumption that the probability of (i) cross-sector support from German public-sector banks, (ii) support from its public-sector owners, most prominently the State of Baden-Württemberg (rated Aaa), the City of Stuttgart (unrated) and the savings bank association of Baden-Württemberg (rated Aa3) and (iii) systemic support is very high in all cases.

Under Moody's joint default analysis (JDA) methodology, our support assessment as highlighted above gives LBBW's GLC long-term deposit rating a six-notch uplift from its Baa2 BCA.

Moody's maintains the bank's Aaa rating for debt qualifying for grandfathering.

Credit Strengths

- Strong franchise among its target clientele of larger mid-sized corporates in the well-diversified, strong regional economy of Baden-Württemberg and retail clients in the affluent Stuttgart area

- Well-established co-operation with savings banks in Baden-Württemberg
- Proven support and continued commitment from public sector owners, stabilised financial conditions with adequate capital levels after sizeable support measures in June 2009

Credit Challenges

- Merger with the former SachsenLB that included acquisition of large ABS portfolios has materially weakened LBBW's financial profile
- Limitations to the scope of independent strategic management and financial flexibility in the face of far reaching compensation measures for state aid (material downsizing, no further acquisitions);
- Substantial pressure on earnings for several years arising from additional costs for support measures

Rating Outlook

The outlook on all ratings was changed to negative on 23 July 2009. The negative outlook reflects a combination of adverse short- and medium-term factors, including potential pressures from LBBW's sizeable trading operations and investments in credit-spread-sensitive products. These pressures are in the context of continued uncertainty in international financial markets and possible changes in the Landesbank sector.

What Could Change the Rating - Up

There is currently no upside pressure on the BFSR. There is also no upward pressure on LBBW's GLC debt and deposit ratings considering that our assessment of the probability of external support is already very high.

What Could Change the Rating - Down

The current C- BFSR remains under pressure even though the rating 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 international financial markets, we do not rule out renewed rating pressure, in particular since LBBW has sizeable trading operations and large investments in credit-spread-sensitive products. Moody's is also concerned that LBBW's asset and risk profile may change over the medium term, as it may be part of a consolidation in the Landesbank sector.

Downward pressure on LBBW's GLC deposit rating could be triggered by a negative change in LBBW's BFSR, and/or a change in the probability of support from either its public-sector owners, especially the State of Baden-Württemberg if in connection with a change in ownership, or from the cross-sector support mechanisms for public-sector banks in Germany. Moody's will also closely monitor any signs that the likelihood of systemic support may decline once markets have fully recovered and stabilised.

Recent Results and Company Events

In spite of a strong EUR 1 billion trading result, LBBW reported a EUR 462 million pre-tax loss for the nine months to September 2009 (after a EUR 1.1 billion pre-tax loss for the same period in 2008), which reflected a heavily loss-making third quarter. The loss was driven by EUR 1.25 billion in risk provisions (of which EUR 528 million alone related to the third quarter) and a EUR 469 million net loss from investment securities. These effects were worsened by EUR 651 million in goodwill impairment and restructuring charges.

We believe that the group's underlying operating performance remains under pressure, partly as Q3 pre-provision income was weaker than that recorded in the previous two quarters. Based on our estimates, the reported 18.6% increase (+ EUR 309 million) in net interest income for the nine months was fully attributable to saved interest expenses on profit participation certificates and silent participations, as coupons will not be paid on hybrid instruments for 2009. The group had paid around EUR 530 million on such coupons in 2008 which included EUR 80 million of retroactively paid coupons of hybrids of SachsenLB. That said, net interest income also contained extraordinary costs relating to higher-than-usual liquidity levels throughout the year and one-off hedging costs which could be offset by improved gross interest income.

On a positive note, the EUR 533 million in net fee & commission income was considerably higher year-on-year (+31%), despite containing EUR 80 million in fees paid on the guarantee provided by the state of Baden-Württemberg. However, this amount reflects charges for just one quarter and related annual fees will thus heavily burden the group's fee & commission income over the coming years. Moreover, results for the nine months ending September 2009 do not reflect any progress in cost reductions (costs grew 0.8% year-on-year) although adverse consolidation effects limit comparability.

An important driver for LBBW's poor performance for the nine months ending September 2009 was the exceptionally high EUR 1.25 billion in risk provision. Moreover, the result contained almost the full provisioning of the bank's EUR 0.6 billion remaining exposure under a first-loss piece taken on a reference portfolio of structured credit products (under a risk-shield structure supported by the federal state; this is further explained under Capital Adequacy below). Any further charges relating to structured products should therefore be limited.

The Tier-1 ratio as at end - September 2009 was reported at 9.6% and the total capital ratio at 12.9%; these ratios are considered adequate against the group's risk profile and an important mitigant to the expected pressures on bottom line performance over the next few years.

DETAILED RATING CONSIDERATIONS

Detailed considerations for Landesbank Baden-Württemberg's currently assigned ratings are as follows:

Bank Financial Strength Rating

Moody's assigns a C- BFSR to LBBW. Key positive elements driving the BFSR are LBBW's strong regional franchise and sustainable market positioning among both retail and corporate customers in the region, satisfactory liquidity and adequate risk management capabilities. Key negative elements constraining the BFSR are (i) an increased risk profile following the integration of Sachsen Bank, (ii) limited scope for strategic steering and heightened costs following the recent support measures, (iii) our expectation of depressed risk-weighted profitability and poor capital generation capacity over the next two to three years, (iv) high concentration risks inherent in the bank's business model, and (v) the more volatile income from investment and corporate banking. The positive effects of the support measures on the bank's capital position have also been factored into the BFSR.

The assigned BFSR is in line with the outcome of Moody's bank financial strength scorecard.

Qualitative Rating Factors (50%)

Factor 1: Franchise Value

Trend: Neutral

LBBW is considered to be one of the strongest of the German Landesbanken in terms of its franchise, being a fully fledged universal bank with a well-entrenched regional franchise in the German State of Baden-Württemberg among medium-sized and large corporates, commanding high market shares in corporate banking. Additionally, the franchise is underpinned through BW-Bank, which assumes the function of the local savings bank in the Stuttgart area and claims a market share among the city's retail customers of approximately 50% across different products; furthermore, BW-Bank has a solid franchise mostly in private banking in the larger cities of Baden Württemberg. At the same time, the majority of the group's assets continue to be allocated to areas of wholesale banking, given that only one third of the total exposure is represented by loans & advances to corporates and retail clients. Moody's notes positively that the bank is committed to reducing its secondary market operations and related assets going forward.

Geographically, LBBW has significant operations in the State of Baden-Württemberg which is Germany's third-largest state by GDP (EUR 364 billion in 2008). The state stands out as displaying a rate of economic growth above the German average, very high employment and productivity and a relatively large share in German exports. However, its share of exports is also responsible for more pronounced business cycles when compared with other regions, with a more challenging environment during downturns. Nevertheless, thanks to the activities in neighbouring federal states and Saxony, this effect is somewhat mitigated, and overall geographical diversification is considered strong. LBBW had originally planned to use Sachsen Bank to enter new markets in Central and Eastern Europe. However, in accordance with the EC's restrictions associated with its aid package, the bank will need to scale down its international ambitions. That said, international operations have never been strong contributors to the group's earnings.

The score for franchise value is C.

Factor 2: Risk Positioning

Trend: Neutral

LBBW's overall risk positioning benefits from hands-on and capable risk management; however, the bank concedes that it has allowed too much growth in non-core investments which has resulted in rather high market risk, exacerbated by the acquisition of the former SachsenLB. As a result, the bank has started to reduce a variety of its risk positions, including secondary market ABS products, stocks, mutual funds investments, money market exposures and proprietary trading positions. LBBW will also need to optimise its RWA and capital management in accordance with reduction targets set by the EC. The reduction is expected to be achieved gradually over several years, thus potentially restricting new business opportunities and dictating prudent allocation of resources.

In our view, LBBW also has to revisit its risk culture and adjust earlier underwriting standards given that recent developments in its loan portfolios reflect a somewhat higher risk position than we had previously anticipated. Based on recently announced adjustments of its corporate governance structure, LBBW shows commitment to addressing these concerns.

LBBW's financial reporting and transparency has greatly improved in recent years and is now by and large comparable with international reporting standards. LBBW now provides interim financials on a quarterly basis, although detailed reports are published only semi-annually.

We continue to be concerned about sizeable risk concentrations to both corporates and financial institutions. The loan book contains sizeable concentrations on single borrower groups, which is a result of the bank's continued focus on wholesale banking. LBBW's high concentrations in certain industries also raise serious concerns as several of these are expected to come under severe pressure in the progressing global recession. In this context, we note that the group has a EUR 24.8 billion exposure to the commercial real estate sector, another EUR 11.2 billion to the construction industry and EUR 19.8 billion to the automotive industry (as at end - June 2009). These three sectors account for EUR 56 billion or one-third of LBBW's EUR 169 billion exposure to corporate customers. Given the high cyclicity that these sectors have in common, these exposures are likely to drive potentially large losses over the coming years. These concentrations are considered to be among LBBW's main risk drivers and continue to constrain its ratings.

Interest rate and credit spread risk represents the key market risk to which LBBW is exposed. The bank largely uses market price indicators for the valuation of its positions. Most of the balance sheet is match-funded in terms of liquidity and interest rate durations. The bank uses a Value-at-Risk model (VaR, 99% confidence interval, ten-day holding period) to perform risk estimates of the overall activity of its portfolios. Although such short-term VaR estimates have proved to be poor indicators of market risk during the financial crisis, the reported numbers showed that market risk faced by the group multiplied during 2008. During H1 2009, LBBW adjusted its approach to measuring market risk, which resulted in a further rise in reported VaR numbers.

Taking the above factors into consideration, an overall C- score is applied to risk positioning.

Factor 3: Regulatory Environment

Refer to Moody's latest Banking System Outlook for Germany to obtain a detailed discussion on the regulatory environment.

Factor 4: Operating Environment

Trend: Neutral

This factor is common to all German banks. Moody's assigns a B score for the overall operating environment. Refer to Moody's latest Banking System Outlook for Germany, published in April 2009, and Moody's most recent sovereign analysis on Germany, to obtain a detailed discussion on the operating environment.

Quantitative Rating Factors (50%)

Factor 5: Profitability

Trend: Improving

On a global comparison, LBBW's risk-weighted profitability was modest even during the better years before the crisis. While we note positively that LBBW has shown a very stable operating performance during the cycle, we believe that the bank has been somewhat under-exploiting the full potential of its franchise.

More importantly, LBBW has been one of those German banks most heavily affected by losses attributable to the global financial crisis, driven by both its credit and market risk. The bank continues to post losses driven by (i) subdued revenues; (ii) pronounced impairment charges on loans, securities and participations; and (iii) increasing additional costs relating to the aid measures of June 2009. It will likely take LBBW until late 2010 to turn the situation around, if not later.

Moody's continues to be concerned about two factors: (i) the high volatility of earnings which are driven by a rather erratic trading income as market risk can only be gradually reduced over time; and (ii) the continued disproportion of group earnings and its overall risk profile. At the same time, Moody's acknowledges that the majority of 2008 / 2009 losses were contributed by its former subsidiaries - in particular SachsenLB - and that LBBW is committed to reduce secondary market exposures.

Major negative one-off effects that have caused recent losses are not expected to be reiterated in 2010 and beyond, especially write-downs on secondary market investments. In addition, restructuring charges are expected to remain below the level required in 2009. However, further impairment charges on participations are possible and credit risk provisions on the group's core lending exposure will likely remain at a high level for several quarters, potentially absorbing pre-provision income throughout 2010. Additionally, the bank will need to pay approximately EUR 330 million per annum in fees for the EUR 12.7 billion guaranty provided by the federal state and, once LBBW returns to profitability, a preferred dividend of around EUR 400 million per annum on the EUR 5 billion fresh capital (as agreed with the EC). Moreover, cumulative coupons on hybrid instruments (profit participation certificates and silent participations) not paid for 2009 and 2010 will need to be paid retroactively, possibly in 2011 or 2012. It will thus take several years before LBBW's profitability will return to more normal levels.

The assessment stated above is reflected in an E score for profitability.

Factor 6: Liquidity

Trend: Neutral

Moody's notes positively that LBBW did not face any shortage of liquidity during 2008, despite the market disruptions that followed the bankruptcy of Lehman Brothers on 15 September 2008. Prior to that date, LBBW had conservatively taken on more funding >1 year than was required by its ongoing lending business. However, more importantly, the group's liquidity reserves (i.e. funding available on the same day via the ECB and the Fed based on unencumbered, eligible securities) remained at a high level throughout the period and was reported at almost EUR 44 billion at the end of December 2008. The capital injection of EUR 5 billion given in June 2009 further supports the bank's liquidity profile. With ECB-eligible, unencumbered assets of currently around EUR 49 billion, LBBW can cover all funding needs on a 12-month horizon.

LBBW has maintained very good access to market funding throughout the crisis and continued to issue comparatively large tranches of new debt, including Pfandbriefe, reflecting a high level of financial flexibility and resilience to adverse market conditions. Besides, funding costs have remained more favourable than for many peers in the German market, and the bank has had no need to use ECB tenders for its short-term funding.

The liabilities of the former SachsenLB were assumed by LBBW as part of the merger as per 1 April 2008, and group liquidity -- including the funding of SachsenLB -- have since been taken care of by LBBW's central treasury function. The former SachsenLB had medium-term debt (> 1 year) of around EUR 18 billion, the bulk of which will fall due only in 2015 (grandfathered debt).

LBBW scores B- for liquidity.

Factor 7: Capital Adequacy

Trend: Improving

Following the support measures in Q2 2009, LBBW reported considerably higher Tier 1 and total capital ratios as at end - June 2009 of 9.4% and 12.8%, respectively (6.9% and 10.1%, respectively at year-end 2008). These ratios improved further during the three months to September 2009, reported at 9.6% and 12.9%, respectively. The improvement achieved through support measures in the Tier 1 ratio was in line with earlier expectations of a rise to a level above 9%.

The ratios greatly benefited from the two support measures which provided both additional capital and substantial RWA relief. The measures comprised a EUR 5.0 billion capital injection and a EUR 12.7 billion risk takeover. The EUR 12.7 billion risk takeover consists of two guarantees: (i) a EUR 6.7 billion second loss guaranty (after a EUR 1.9 billion first - loss piece remaining with LBBW)

on a EUR 17.6 billion reference portfolio of structured credit products; and (ii) a EUR 6.0 billion guaranty to cover a junior loan of LBBW to Sealink Funding Ltd, an SPV that has assumed securitised assets of SachsenLB and benefits from a EUR 2.75 billion first loss guaranty from the State of Saxony.

We note that the EUR 6.7 billion guaranty has been structured in a way that allows LBBW to use EUR 1.3 billion of earlier write-downs on structured products against the EUR 1.9 billion first - loss piece, so that further pressure on capital from these higher-risk portfolios should be limited. Moreover, the guaranty should shield the bank from the RWA effects of any further adverse rating migration in these portfolios.

Apart from an analysis of the potential risk posed by structured products, Moody's recently also stress-tested LBBW's core asset portfolios and evaluated the potential impact of expected credit losses on the group's capitalisation. We concluded that, in line with the current C- BFSR level, the bank's capitalisation is expected to be solid enough to absorb the costs and losses that are envisaged to be incurred over the next four to six quarters, during which we expect risk charges to peak. In the absence of further unforeseen events or turbulence, we thus expect LBBW to manage the challenging time ahead without the need for further capital support.

The Tangible Common Equity (TCE) ratio, as shown on the scorecard, excludes silent participations; however, given the loss-absorbing capacity of these instruments, we have adjusted this ratio to include a portion of these instruments in our calculation. While the scorecard shows the average ratio of the past three years at 5.3%, we note that the recent capital measures have resulted in an increase to roughly 7.8%, which is considered satisfactory.

The average ratios for the three years to 2008 lead to an unadjusted C score for capital adequacy.

Factor 8: Efficiency

Trend: Improving

LBBW has traditionally had a relatively high cost base. While cost - containment efforts have yielded some efficiency improvements in recent years, recent indicators are somewhat distorted by volatile operating revenue and - in 2008 - by the first-time consolidation and integration of the former SachsenLB. As a result, total staff costs were higher by 4.4% at EUR 1.0 billion in 2008, and total other administrative expenses by 16.6%, reaching EUR 653 million. It is noteworthy that some of the growth in staff numbers also resulted from additions in strategic growth segments. The relatively small increase in staff costs (+4.4% costs vs. +8.7% in headcount) was due to lower provisions for performance-related payments and helped offset some of the adverse effects.

LBBW recently set itself the ambitious target of cutting costs by around EUR 700 million per annum. While this target is not unrealistic, it will take time before LBBW can restore its key efficiency metrics: Firstly, it will be challenging for the bank to reduce costs at the same pace as assets (or net interest income). Secondly, headcount reductions may be partly offset by rising performance-related payments, as we believe that bonus cuts cannot be sustained for several years. Moreover, growth targets in selected strategic businesses and locations may require some further investment. The above mentioned cost-savings are expected to be fully achieved by 2013.

The E score for efficiency reflects the average cost-to-income ratio for the three years to 2008.

Factor 9: Asset Quality

Trend: Weakening

Germany's south-western region benefits from a strong and diversified regional economy, based on a mixture of medium-sized companies and several large corporations (DaimlerChrysler, Porsche, SAP, IBM). While the market structure supports the performance of corporate banking activities during boom times, the pressure on export-reliant SMEs and large corporates translates into heightened credit risk for LBBW during recessions. This feature, in our view, requires somewhat higher buffers for LBBW's business model to absorb credit losses. Moreover, at this point in time, LBBW remains exposed to secondary market investments, although the lion's share of the bank's structured product portfolio now benefits from guarantees provided by the state of Baden-Wuerttemberg. These guarantees will effectively shield LBBW from any excessive (unforeseen) losses on its higher-risk exposures.

LBBW reported a total exposure of EUR 538 billion as at end - June 2009, which comprised roughly EUR 266 billion to financial institutions (FIs, 49.4%), EUR 169 billion to corporates (31.3%), EUR 82.5 billion to the public sector (15.3%), and EUR 21 billion to private clients (3.9%).

Developments during H1 2009 continued to reflect adverse - in some areas sharp - rating migration and a 5% increase in loans categorised as 'in default'; these accounted for EUR 7.2 billion or 1.34% of the total exposure at end - June 2009 (EUR 6.9 billion or 1.25% as at year - end 2008). The bank also reported a high 30% of loans in default (EUR 2.2 billion) related to exposures to FIs.

The main asset quality deterioration, however, was recorded in corporate lending, in particular in exposures to the automotive and commercial real estate (CRE) sectors, where LBBW is heavily concentrated. A jump of exposures in default during the six months to June 2009 was most pronounced in the automotive sector (+55% to EUR 0.55 billion), while sub-investment grade exposures tripled to EUR 0.9 billion.

Given the latest developments as well as the general time lag of defaults during recessions, we expect that LBBW will continue to suffer asset quality deterioration and high risk charges over the coming four to six quarters, driven by a rising number of corporate defaults. We do not expect further losses on FI exposures in the foreseeable future, although this may change over time as single FIs may be allowed to default once the financial markets have fully recovered.

LBBW is additionally exposed to substantial structured credit product portfolios, which was reported at EUR 27.6 billion as at end - June 2009. The majority of this is, however, now shielded from credit losses thanks to the EUR 6.7 billion guaranty made available by the State of Baden-Wuerttemberg in June 2009. The remaining portfolio that does not fall under this guarantee, either because it relates to LBBW's EUR 1.9 billion first - loss obligation or because the portfolios are not covered by the guaranty, amounted to EUR 12.3 billion at end-June 2009. We note with some concern that EUR 2.5 billion of this exposure relates to sub-investment grade CDO

and RMBS exposures. That said, a large portion of this exposure - in particular relating to its first - loss obligation - has already been provisioned.

Based on Moody's calculations, the problem loan ratio (total problem loans as a percentage of gross loans, for exposures relating to loans to customers) still remained below 3% at the end of 2008, which compares favourably with its peers. Risk coverage of problem loans is considered adequate as the uncovered portion is largely supported by collateral, although this is generally not considered in our scorecard.

The average ratios of the three years to 2008 lead to a D+ score for asset quality.

Global Local Currency Deposit Rating (Joint Default Analysis)

Moody's assigns global local currency (GLC) deposit ratings of Aa2/Prime-1 to LBBW. The ratings are supported by four main elements. They are:

- (i) LBBW's Baseline Credit Assessment of Baa2;
- (ii) The very high probability of cross-sector support from public sector banks;
- (iii) The very high probability of regional government support from the State of Baden-Württemberg, amongst others; and
- (iv) The very high probability of systemic support from the central government of Germany.

Moody's assessment of these support probabilities results from LBBW's important role in the regional economy, given its strong franchise among the region's medium and large enterprises. Additionally, the fully integrated BW-Bank claims a market penetration of around 50% in the Stuttgart area. These factors, along with the bank's size and its integration into the public-sector support mechanisms, make support from the various sources highly likely in the event of a stress scenario.

Germany is considered a medium support country. Whereas the German banking market is highly fragmented, Moody's acknowledges the favourable track record for systemic support to financial institutions in times of financial distress.

Notching Considerations

Moody's assigns a Aa3 local currency debt rating for senior and junior subordinated debt. Upper Tier 2 instruments such as profit participation rights ("Genussscheine") issued by LBBW are rated Ba2, 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.

Foreign Currency Deposit Rating

LBBW's foreign currency deposit ratings are Aa2/P-1.

Foreign Currency Debt Rating

LBBW's senior unsecured foreign currency debt ratings are Aa2/P-1.

ABOUT MOODY'S BANK RATINGS

Bank Financial Strength Rating

Moody's Bank Financial Strength Ratings (BFSRs) represent Moody's opinion of a bank's intrinsic safety and soundness and, as such, exclude certain external credit risks and credit support elements that are addressed by Moody's Bank Deposit Ratings. BFSRs do not take into account the probability that the bank will receive such external support, nor do they address risks arising from sovereign actions that may interfere with a bank's ability to honour its domestic or foreign currency obligations. Factors considered in the assignment of BFSRs include bank-specific elements such as financial fundamentals, franchise value, and business and asset diversification. Although BFSRs exclude the external factors specified above, they do take into account other risk factors in the bank's operating environment, including the strength and prospective performance of the economy, as well as the structure and relative fragility of the financial system, and the quality of banking regulation and supervision.

Global Local Currency Deposit Rating

A deposit rating, as an opinion of relative credit risk, incorporates the BFSR as well as Moody's opinion of any external support. Specifically, Moody's Bank Deposit Ratings are opinions of a bank's ability to repay punctually its deposit obligations. As such, they are intended to incorporate those aspects of credit risk relevant to the prospective payment performance of rated banks with respect to deposit obligations, which includes: intrinsic financial strength, sovereign transfer risk (in the case of foreign currency deposit ratings), and both implicit and explicit external support elements. Moody's Bank Deposit Ratings do not take into account the benefit of deposit insurance schemes which make payments to depositors, but they do recognize the potential support from schemes that may provide assistance to banks directly.

According to Moody's joint default analysis (JDA) methodology, the global local currency deposit rating of a bank is determined by the incorporation of external elements of support into the bank's Baseline Credit Assessment. In calculating the Global Local Currency Deposit rating for a bank, the JDA methodology also factors in the rating of the support provider, in the form of the local currency deposit ceiling for a country, Moody's assessment of the probability of systemic support for the bank in the event of a stress situation and the degree of dependence between the issuer rating and the Local Currency Deposit Ceiling.

National Scale Rating

National scale ratings are intended primarily for use by domestic investors and are not comparable to Moody's globally applicable ratings; rather they address relative credit risk within a given country. A Aaa rating on Moody's National Scale indicates an issuer or issue with the strongest creditworthiness and the lowest likelihood of credit loss relative to other domestic issuers. National Scale Ratings, therefore, rank domestic issuers relative to each other and not relative to absolute default risks. National ratings isolate systemic risks; they do not address loss expectation associated with systemic events that could affect all issuers, even those that receive the highest ratings on the National Scale.

Foreign Currency Deposit Rating

Moody's ratings on foreign currency bank obligations derive from the bank's local currency rating for the same class of obligation. The implementation of JDA for banks can lead to high local currency ratings for certain banks, which could also produce high foreign currency ratings. Nevertheless, it should be noted that foreign currency deposit ratings are in all cases constrained by the country ceiling for foreign currency bank deposits. This may result in the assignment of a different, and typically lower, rating for the foreign currency deposits relative to the bank's rating for local currency obligations.

Foreign Currency Debt Rating

Foreign currency debt ratings are derived from the bank's local currency debt rating. In a similar way to foreign currency deposit ratings, foreign currency debt ratings may also be constrained by the country ceiling for foreign currency bonds and notes; however, in some cases the ratings on foreign currency debt obligations may be allowed to pierce the foreign currency ceiling. A particular mix of rating factors are taken into consideration in order to assess whether a foreign currency bond rating pierces the country ceiling. They include the issuer's global local currency rating, the foreign currency government bond rating, the country ceiling for bonds and the debt's eligibility to pierce that ceiling.

About Moody's Bank Financial Strength Scorecard

Moody's bank financial strength model (see scorecard below) is a strategic input in the assessment of the financial strength of a bank, used as a key tool by Moody's analysts to ensure consistency of approach across banks and regions. The model 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 Factors

Landesbank Baden-Württemberg

Rating Factors [1]	A	B	C	D	E	Total Score	Trend
Qualitative Factors (50%)						C	
Factor: Franchise Value						C	Neutral
Market Share and Sustainability		x					
Geographical Diversification			x				
Earnings Stability				x			
Earnings Diversification [2]							
Factor: Risk Positioning						C-	Neutral
Corporate Governance [2]							
- Ownership and Organizational Complexity							
- Key Man Risk							
- Insider and Related-Party Risks							
Controls and Risk Management			x				
- Risk Management				x			
- Controls		x					
Financial Reporting Transparency		x					
- Global Comparability	x						
- Frequency and Timeliness		x					
- Quality of Financial Information		x					
Credit Risk Concentration					x		
- Borrower Concentration					x		
- Industry Concentration					x		
Liquidity Management		x					
Market Risk Appetite		x					
Factor: Operating Environment						B	Neutral
Economic Stability			x				
Integrity and Corruption		x					
Legal System	x						
Financial Factors (50%)						D	
Factor: Profitability						E	Improving
PPP % Avg RWA - Basel II					0,12%		

Net Income % Avg RWA - Basel II					-0,12%		
Factor: Liquidity						B-	Neutral
(Mkt funds-Liquid Assets) % Total Assets			8,39%				
Liquidity Management		x					
Factor: Capital Adequacy						C	Improving
Tier 1 ratio (%) - Basel II			6,93%				
Tangible Common Equity / RWA - Basel II			5,31%				
Factor: Efficiency						E	Improving
Cost/income ratio					107,26%		
Factor: Asset Quality						D+	Weakening
Problem Loans % Gross Loans			2,71%				
Problem Loans % (Equity + LLR)				43,01%			
Lowest Combined Score (15%)						E	
Economic Insolvency Override						Neutral	
Aggregate Score						C-	
Assigned BFSR						C-	

[1] - Where dashes are shown for a particular factor (or sub-factor), the score is based on non public information [2] - A blank score under Earnings diversification or Corporate Governance indicates the risk is neutral



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