Credit Opinion: Landwirtschaftliche Rentenbank

Global Credit Research - 05 Jan 2012

Frankfurt am Main, Germany

Ratings

Category	Moody's Rating
Outlook	Stable
Bank Deposits	Aaa/P-1
Senior Secured -Dom Curr	Aaa
Senior Unsecured	Aaa
Subordinate	Aaa
Commercial Paper -Dom Curr	P-1
Other Short Term	(P)P-1

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Key Indicators

Landwirtschaftliche Rentenbank (Consolidated Financials)[1]

	[2]**6-11**	[2]**12-10**	[2]**12-09**	[2]**12-08**	[3]**12-07**	**Avg.**
Total Assets (EUR million)	**77,337.9**	**83,783.0**	**77,847.8**	**90,101.0**	**88,677.7**	[4]**-3.4**
Total Assets (USD million)	**112,127.8**	**112,398.5**	**111,691.4**	**125,244.6**	**129,651.4**	[4]**-3.6**
Tangible Common Equity (EUR million)	**2,687.5**	**2,547.7**	**2,407.9**	**2,493.0**	**2,041.1**	[4]**7.1**
Tangible Common Equity (USD million)	**3,896.5**	**3,417.9**	**3,454.7**	**3,465.4**	**2,984.1**	[4]**6.9**
Net Interest Margin (%)	**0.4**	**0.4**	**0.5**	**0.4**	**0.2**	[5]**0.4**
PPI / Avg RWA (%)	**2.7**	**1.3**	**-0.2**	**3.5**	**0.4**	[6]**1.8**
Net Income / Avg RWA (%)	**2.5**	**1.2**	**-0.6**	**3.1**	**0.3**	[6]**1.6**
(Market Funds - Liquid Assets) / Total Assets (%)	**4.9**	**4.1**	**11.2**	**22.4**	**9.1**	[5]**10.3**
Core Deposits / Average Gross Loans (%)	**357.8**	**526.0**	**163.1**	**66.1**	**--**	[5]**278.3**
Tier 1 Ratio (%)	**18.6**	**16.0**	**15.3**	**12.4**	**10.4**	[6]**15.6**
Tangible Common Equity / RWA (%)	**22.4**	**20.2**	**19.8**	**16.8**	**12.0**	[6]**19.8**
Cost / Income Ratio (%)	**11.3**	**23.0**	**429.2**	**6.8**	**33.0**	[5]**100.6**

Source: Moody's

[1] All ratios are adjusted using Moody's standard adjustments [2] Basel II; IFRS [3] Basel I; IFRS [4] Compound Annual Growth Rate based on IFRS reporting periods [5] IFRS reporting periods have been used for average calculation [6] Basel II & IFRS reporting periods have been used for average calculation

Opinion

SUMMARY RATING RATIONALE

In accordance with Moody's government-related issuer (GRI) rating methodology, the Aaa/Prime-1 ratings assigned to Germany's agricultural development bank, Landwirtschaftliche Rentenbank (Rentenbank), reflect the combination of the following inputs: (i) the baseline credit assessment (BCA); (ii) the Aaa rating of the Federal Republic of Germany (FRG; Aaa stable); (iii) very high dependence; and (iv) very high support.

Despite Rentenbank's low-risk operating model, we consider its risk positioning to have increased in the current challenging market environment given (i) its significant exposure to banks in peripheral countries and their deteriorating credit quality; and (ii) its high proportion of short-term funding particularly in US dollars under commercial paper and money market operations, although these are largely matched by short-term assets. Rentenbank's exposure to banks in peripheral countries comprises exposure to banks as primary counterparties as well as exposure as part of its liquidity portfolio.

Support is primarily provided in the form of Anstaltslast (a maintenance obligation or institutional liability, which, in essence, amounts to a guarantee) provided by the FRG, rated Aaa. As such, the support provider (FRG) is required to ensure that Rentenbank has sufficient funds to meet its obligations in a timely manner. In Moody's opinion, the absence of a direct guarantee does not diminish the timeliness, effectiveness or stability of support available to Rentenbank through Anstaltslast.

Anstaltslast does not differentiate between different classes of debt obligations. Nevertheless, unlike a guarantee, investors and creditors do not have direct recourse to the Anstaltslast provider, as the maintenance obligation is towards the guaranteed entity.

Given the Aaa rating of the support provider, the BCA remains unpublished.

Credit Strengths

- The Aaa rating is underpinned by Anstaltslast provided by the FRG

- Proven business model as a development agency specialising in the promotion of agricultural business, resulting in a resilient and stable flow of net interest income

- Funding franchise both in Euros and particularly foreign currency, which is backed by its status as GRI related to the German government

- Asset quality, underpinned by the emphasis on secured interbank lending and its only very limited direct agribusiness exposure, as Rentenbank serves as a favourable refinancing source for financial institutions that bear primary counterparty risk

Credit Challenges

- Low recurring earnings power as a result of the bank's role as a government agency supporting German agriculture

- High proportion of short-term funding under commercial paper and money market operations, particularly in US dollars, although this is mitigated by maturity-matched short-term assets (mainly interbank repo)

- Despite an appropriate hedging strategy, the bank experiences considerable volatility in its financial performance under IFRS (fair value accounting)

- Significant exposure to banks in peripheral countries relative to its capitalisation

Rating Outlook

The outlook on Rentenbank's Aaa global local-currency deposit and debt rating is stable, reflecting the unchanged support mechanism in the form of Anstaltslast from the FRG.

What Could Change the Rating - Up

The Aaa/Prime-1 ratings are at their upper ceilings and therefore cannot be upgraded.

What Could Change the Rating - Down

The ratings could be adversely affected if (i) the credit profile of FRG was to weaken; and (ii) support from the FRG was to weaken or be removed, which, in our view, is currently unlikely.

Recent Results and Company Events

While Rentenbank reported steady and increasing net income in H1 2011, we note that the bank's exposure of approximately EUR 7 billion to banks in peripheral countries is high compared to the bank's Tier 1 capital of EUR 2.3 billion. Contrary to the bank's high regulatory capital ratios (Tier 1: 18.6%), its economic capitalisation and leverage as measured by equity to total assets - at 3% - is low.

H1 2011: VALUATION EFFECTS CONTINUE TO CONTRIBUTE TO EARNINGS VOLATILITY

As of H1 2011, Rentenbank's net income under IFRS increased to EUR 153.2 million from EUR 120.9 million in H1 2010. This was mainly due to a recovery in income from fair value measurement and hedge accounting to EUR 9.2 million after a loss of EUR 20.1 million in H1 2010. Net interest income was almost flat year-on-year at EUR 174.6 million (H1 2010: EUR 173.0 million). Pre-provision income (PPI) rose to EUR 162.0 million from EUR 130.7 million in H1 2010.

Comprehensive income was EUR 178.4 million, benefiting from a small increase in the bank's revaluation reserve resulting from fair value and hedge accounting for interest rate, foreign currency and basis swap risks. In H1 2010, the bank had to account for a EUR 245.6 million deterioration in its revaluation reserve, thereby erasing more than 10% of the bank's book equity.

While Rentenbank lends in Euros, the bank continues to benefit from an international funding base with the US dollar as its main funding source (41%). The bank hedges the currency risks resulting in a sizable derivatives portfolio which mostly drives the significant valuation effects. Even though we regard the economic risk as limited because the volatility is mainly accounting-driven, we caution that Rentenbank might record significant adverse effects in its comprehensive income for the full year 2011 given the persistent market volatility in credit markets during the second half of 2011.

VOLATILITY NOT FULLY CAPTURED UNDER LOCAL GAAP AND REGULATORY CAPITAL

We note that for regulatory purposes Rentenbank's stated performance under local GAAP (HGB) does not display the full market effect of spread widening recorded under IFRS. However, compared with Rentenbank's current Tier 1 capitalisation of EUR 2.3 billion as of H1 2011 (Tier 1 ratio: 18.6%), these valuation effects are sizeable. The combined exposure directly invested in the sovereigns of Portugal, Italy and Spain amounts to less than EUR 600 million (0.7% of total assets as at H1 2011); however, the exposure to the banking sector in these countries in the form of bonds and promissory note loans is considerably larger at approximately EUR 7 billion (8.6% of total assets at H1 2011). As such, these combined exposures are material and impact the bank's risk position; in our view, a severe market deterioration (impacting European banks as its major counterparties) would significantly pressure current economic capitalisation levels.

BALANCE SHEET REDUCTION DUE TO LOWER LEVELS OF PROMOTIONAL LENDING AND INTEREST RATE FLUCTUATIONS

Total assets decreased to EUR 77.3 billion as at H1 2011 (YE2010: EUR 83.8 billion) due to high volumes of maturing promotional loans and exchange-rate fluctuations. While the overall promotional lending volume moderately decreased to EUR 65.2 billion (H1 2010: EUR 66.5 billion), lending volumes in the bank's special promotional loan portfolio, which includes the renewable energy, agriculture and rural development sectors, increased by 5.7% to EUR 24.3 billion. In particular, the bank benefitted from the increasing demand for biogas and related facilities (nearly doubling new business volumes in biogas), while the demand for new loans in the photovoltaic industry sector plunged by over 50%.

DETAILED RATING CONSIDERATIONS

Detailed considerations for Rentenbank's currently assigned ratings are as follows:

Qualitative Rating Factors (50%)

Factor 1: Franchise Value

Trend: Neutral

Similar to other development banks, we consider Rentenbank's franchise value to be incomparable with those of commercially oriented banks given its defined mandate as a development bank which limits its product offering, geographic reach and market shares to its designated functions.

Rentenbank is the government's development agency specialising in the promotion of agricultural business. It operates under a policy mandate as stipulated by the Law Governing Landwirtschaftliche Rentenbank and its statutes. The bank mainly provides loans and other types of financing for the agricultural industry (including forestry, horticulture and fishing) and related sectors, as well as for rural development. Products and services include credit lines to German public and private-sector banks such as traditional loans and purchase of debt securities. Loans are mainly granted via the end-user's "housebank" to ensure compliance with competition-neutral activities.

Its activities are limited to EU or Organisation for Economic Co-operation and Development- (OECD-) member states. Within its legal framework and constraints, Rentenbank therefore occupies a unique position, mainly focusing on the German market, which accounts for almost 90% of the bank's exposure to financial institutions, but also extending its activities EU-wide through the re-financing of EU-based banks, supporting their agricultural lending activities.

Factor 2: Risk Positioning

Trend: Neutral

Despite Rentenbank's low-risk operating model, we consider its risk positioning to have increased in the current challenging market environment given (i) its significant exposure to banks in peripheral countries and their deteriorating credit quality; and (ii) its high proportion of short-term funding under commercial paper and money market operations, particularly in US dollars. Rentenbank's exposure to banks in peripheral countries comprises exposure to banks as primary counterparties as well as exposure as part of its liquidity portfolio.

Rentenbank's agricultural-development-based lending results in limited exposure to end-borrowers because its loans are typically channelled through the borrower's "housebank"; this bank, in turn, passes the loans through with the positive effect of assured funding while taking on the primary credit risk. As such, Rentenbank's direct credit exposure to the banking sector is high, given that EUR 47.4 billion or 61% of its EUR 78.3 billion exposures represent loans and advances to other banks as of 30 June 2011. The remainder relates to derivative financial instruments and financial investments most of which also relate to banks (EUR 27 billion). The proportion of loans and advances to foreign banks accounts for around 10% of its total loans and, according to the bank's mandate, only comprises EU-based institutions. Rentenbank mitigates its high nominal derivative exposures of EUR 126 billion through collateral agreements, with nearly all of its counterparties covering almost the entire exposure.

Rentenbank maintains a highly diversified funding franchise among currencies, investor classes and among issuing currencies. The bank generally seeks to minimise open positions by matching currency, duration and interest rates. Special promotional loans with fixed interest rates are either refinanced through traditional capital market instruments with matching maturities on a fixed-interest basis or swapped into floating-rate risk through interest-rate swaps. Derivatives are exclusively used for hedging purposes.

Rentenbank's manages liquidity risks by applying daily netting of cash flows over a two-year period, and quarterly monitoring over the medium and long-term horizon. The bank's main funding sources include a EUR 60 billion European Medium-Term Note (EMTN) programme and a EUR 20 billion European commercial paper (CP) programme, which are complemented by other selected sources such as its global bond issuances. Its special status and association with its guarantor enables Rentenbank to benefit from funding opportunities which are currently available only to issuers with a similar supported credit profile.

Rentenbank controls and measures interest-rate risks through a Value-at-Risk approach supplemented by regular stress and scenario computations. Projected results are compared with actual results (back-testing), and limits are adjusted to reflect business growth. We view the interest-rate risk limits as prudent. However, we note that increased credit spread volatility caused by the current debt crisis is associated with significant revaluation movements for the bank including its own debt under fair value, which could cause further volatility in its financial performance.

Factor 3: Regulatory Environment

This factor does not address bank-specific issues; instead, it evaluates whether or not regulatory bodies are independent and credible, demonstrate enforcement powers and adhere to global standards of best practices for risk control. Refer to Moody's latest Banking System Outlook on Germany to obtain a detailed discussion of 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 on Germany and Moody's sovereign analysis on Germany to obtain a detailed discussion of the operating environment.

Quantitative Rating Factors (50%)

Factor 5: Profitability

Trend: Neutral

Given Rentenbank's government mandate and obligation to act in a competition-neutral manner (primarily restricted to interbank lending), the bank does not primarily pursue goals of profit maximisation, as reflected in its modest performance indicators. Profit levels are nevertheless aimed at supporting the continuation of the bank's development programmes in the form of regular allocations of a portion of earnings to the bank's capital reserves.

Although the bank is normally highly reliant on interest income as an earnings source (representing the vast majority of operating income), Rentenbank's modest net interest margins in the past compared unfavourably with those of some of its domestic peers. This is due to its predominant focus as a refinancing agency with minimal direct lending exposure (unlike other development banks) and its securities portfolio, which mainly comprises financial institutions and some sovereign risk. However, Rentenbank was able to expand its net interest margins as it benefited from the relative credit spread widening, and preserved its favourable refinancing conditions on the capital markets.

Rentenbank reported interest income under IFRS of EUR 351 million for FY2010 (FY2009: EUR 381 million), translating into an adjusted net interest margin of 42 basis points (bps) which almost matched the exceptional result of 2009 (46bps). For FY2010, Rentenbank's bank's pre-provision income turned positive to EUR 158.0 million from a negative EUR 37.5 million in 2009, primarily due to valuation effects. A such, the bank's pre-provision income as a percentage of risk-weighted assets (RWA) improved to 1.3% in 2010 (2009: -0.3%). For FY2010, Rentenbank posted a net profit of EUR 151.8 million (2009: net loss EUR 76.9 million). Net income as a percentage of RWA stood at 1.2% (2009: -0.6%).

Factor 6: Liquidity

Trend: Neutral

Rentenbank's creditors benefit from the 0% regulatory risk weighting for their loans, based on the maintenance obligation provided by FRG for the institution. This has helped to achieve advantageous funding costs from the issuance of unsecured debt. Together with the bank's Aaa debt and deposit ratings, this provides continuous access to liquidity for the institution during times of market distress.

Apart from KfW, Rentenbank is the development bank in Germany with the most visible international funding franchise. As of YE 2010, the main funding currencies were US dollars (41%) and Euros (36%) with the remaining 23% made up by a variety of currencies, including Australian dollars (8%) and other international currencies. Due to its strong capital market franchise on the back of the government guarantees, the bank was able to comfortably switch funding channels by tapping the home (euro-denominated funding) market during the peak of the financial crisis, at a time when the US dollar-denominated funding market was more difficult and expensive to access for several months. The bank's diversified funding and liquidity sources helped it to balance margin pressure and maintain a steady flow of interest income.

At YE2010, Rentenbank's total funding amounted to EUR 77.5 billion, including market funds of EUR 71.8 billion and institutional deposits of EUR 5.6 billion. Its medium and long-term capital market funding needs are approximately EUR 10 billion per year, primarily funded out of its EUR 60 billion EMTN programme and benchmark bonds. By raising EUR 7.5 billion funds, Rentenbank has already covered most of it 2011 medium and long-term funding in H1 2011, which were again largely made up of the US dollar (42.1%), the euro (26.4%) and the Australian dollar (19.4%).

At YE2010, the bank maintained relatively high short-term maturities under drawings of its EUR 20 billion CP programme and other money market operations. These funds are largely matched by Rentenbank's traditionally very liquid balance sheet with time deposits placed with other banks and promissory note loans from financial institutions. Furthermore, Rentenbank's alternative liquidity in form of its EUR 25 billion securities holdings provides further cushion. Rentenbank can mitigate short term market disruption by raising liquidity through its refinancing facilities with the central bank and through repos with Eurex Clearing.

Rentenbank is able to fund a high proportion of its funding in the confidence-sensitive money market due to its Aaa rating on the back of the support by FRG. In case the guarantor's rating were to come under pressure and/or the government's support (Anstaltslast) were to weaken, and consequently the access to the money market would weaken as well, we would expect significant reductions in the bank's short-term assets and liabilities if the bank is not able to maintain or replace existing short-term funds.

Factor 7: Capital Adequacy

Trend: Neutral

With a Tier 1 ratio of 18.6% as of H1 2011, Rentenbank reports a comfortable regulatory capital ratio under German GAAP. The bank applies the standard approach and benefits from exemptions for risk weights, including credit risks to German public-sector financial institutions, and a risk weight of 20% applies for loans to commercial banks. We note that potential higher future risk weighting could put additional pressure on Rentenbank to further improve its capitalisation.

The bank's core capital at EUR 2.3 billion as of H1 2011 (YE2010: EUR 2.1 billion) incorporates the bank's regular reserves and special reserves allowable under German local GAAP of EUR 1.1 billion. We consider Rentenbank's Tier 1 capital to be of good quality, as it does not include any hybrid components. Rentenbank's internal capital generation is underpinned by its exemption from the payment of corporate/trade tax, as well as the fact that it is not required to make dividend payments.

However, Moody's also notes that the regulatory capital ratios do not display the full market effect of spread widening recorded under IFRS accounts. Compared with Rentenbank's current Tier 1 capital of EUR 2.3 billion, these valuation effects are sizeable. While the combined exposure directly invested in the sovereigns of Portugal, Italy and Spain amounts to less than EUR 600 million (0.7% of total assets as at H1 2011), the exposure to the banking sector in these countries in the form of bonds and promissory note loans is considerably larger at approximately EUR 7 billion (8.6% of total assets as at H1 2011). As such, these combined exposures are material and impact the bank's risk position; in our view, a severe market deterioration (impacting European banks as its major counterparties) would significantly pressure current capitalisation levels.

The Tier 1 capital ratio and tangible common equity (TCE) ratio stood at 16.0% and 20.2%, respectively, at YE2010 (YE2009: 15.3% and 19.8%). The leverage ratio was only modest at 2.6% at YE2010 and improved to 3.0% as at H1 2011.

Factor 8: Efficiency

Trend: Neutral

Rentenbank's administrative expenses increased by 2.1% to EUR 49.2 million in 2010, driven by both higher personnel expenses and overhead costs. Its efficiency is sound as it does not require the same operational framework as that needed by a commercial lender.

Rentenbank's cost-to-income ratio was at 23% in 2010.

Factor 9: Asset Quality

Trend: Neutral

Rentenbank's risk profile is primarily underpinned by its legal and regulatory framework. Its sound asset quality is supported by its exceptional track record in loan losses. However, as a result of its business model, Rentenbank's credit exposure mainly relates to banks and is partly concentrated with single institutions. The bank's considerable derivative counterparty exposure adds operational risk.

Promotional loans are typically channelled through other financial institutions, which, in turn, carry the risk of the end-borrower defaulting, with the result that the related credit risk does not rest directly with

Rentenbank. Rentenbank provides refinancing to a variety of institutions within the EU involved in financing agriculture, irrespective of their legal form or association membership (standard promotional loans). Therefore, interbank lending - at approximately EUR 50 billion at YE2010 - accounts for more than half of its total balance sheet volume, almost 90% of which relates to German banks with the rest related to other EU banks. Direct customer lending (without the use of an intermediary) at EUR 1.5 billion as at YE2010 constitutes only a minor proportion of Rentenbank's business activities and is subject to certain limitations in accordance with the bank's legal and statutory regulations.

Rentenbank's financial investments comprise almost exclusively exposures to banks and amount to EUR 26.5 billion as at YE2010. The vast majority of these securities are highly rated and eligible as collateral with the ECB.

The reported combined disclosed exposure to banks located in Portugal, Italy and Spain amounted to more than EUR 7 billion as of June 2011. We consider this amount to be high given the bank's Tier 1 capital of EUR 2.3 billion. We understand that Rentenbank is in the process of reducing this amount by applying a focused business selection of its counterparties.

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 honor 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 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.

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