Moody's Investors Service

Credit Opinion: Sparkasse Aachen

Global Credit Research - 02 Dec 2009

Aachen, Germany

Ratings

Category	Moody's Rating
Outlook	Stable
Bank Deposits	Aa2/P-1
Bank Financial Strength	C+
Senior Unsecured -Dom Curr	NR

Contacts

Analyst	Phone
Barbara Behrends-Troost/Frankfurt	49.69.707.30.700
Katharina Barten/Frankfurt	
Carola Schuler/Frankfurt	
Tobias Lukesch/Frankfurt	

Key Indicators

Sparkasse Aachen

	[1][2]2008	2007	2006	2005	2004	[3]Avg.
Total assets (EUR billion)	9.65	9.12	9.36	9.50	9.31	[4]1.07
Total capital (EUR billion)	0.66	0.64	0.61	0.58	0.54	[4]5.29
Return on average assets	0.37	0.38	0.41	0.42	0.39	0.40
Recurring earnings power [5]	0.91	1.01	1.21	1.22	1.29	1.13
Net interest margin	2.15	1.93	2.09	2.25	2.22	2.13
Cost/income ratio (%)	68.17	66.00	59.77	61.16	58.61	62.74
Problem loans % net loans	--	--	--	--	--	--
Tier 1 ratio (%)	12.90	--	--	--	--	12.90

[1] As of December 31. [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

SUMMARY RATING RATIONALE

Moody's assigns a bank financial strength rating (BFSR) of C+ to Sparkasse Aachen (SK Aachen), which translates into a Baseline Credit Assessment (BCA) of A2. The C+ BFSR reflects SK Aachen's strong regional franchise, sound risk and liquidity management, and strong capitalisation.

SK Aachen's long-term global local currency (GLC) deposit rating is Aa2, which is based on the bank's A2 BCA and Moody's assessment of a very high probability of:

(i) cross-sector support from German public-sector banking peers;

(ii) support from the savings bank's public-sector owner, the regional district (Städteregion Aachen) and the City of Aachen (not rated); and

(iii) systemic support, in the event of need.

Under Moody's Joint Default Analysis (JDA) methodology, our support assessment - as highlighted above - gives SK Aachen's GLC deposit rating a three-notch uplift from its A2 BCA.

Credit Strengths

- Sound strategy, focusing on the good distribution power and seeking co-operations in scale-sensitive areas

- Robust franchise with dominant position in the regional retail banking market, supported by strong brand

- Stable financial profile, including predictable revenues and earnings, good efficiency, sound asset quality and very solid capitalisation

- Strong and resilient retail deposit base

- Good granularity of loan exposures and deposits; conservative maximum lending limits

- Considerable financial flexibility built into balance sheet and income statement

- No meaningful exposure to asset classes affected by the financial crisis

Credit Challenges

- Regional focus implies limited potential for asset and revenue diversification; partly mitigated by the prudent limits and relatively small single exposures

- Higher dependence on interest income could put pressure on profitability and efficiency, along with increasing competition from low-cost producers

- Maintaining asset quality at high standards during economic downturn

- Stake in WestLB AG represents concentration risk and weighs on efficiency, profitability and economic capitalisation

Rating Outlook

The outlook on all the ratings is stable, reflecting our expectation that SK Aachen will be able to sustain its franchise and protect market shares, and that external support will continue to be available. This is further supported by the fact that SK Aachen has been only mildly affected by the ongoing global financial crisis.

What Could Change the Rating - Up

For a rating upgrade, SK Aachen would have to demonstrate sustainably higher levels of profitability and efficiency while maintaining a prudent approach towards risk and capital management during the cycle.

Upward pressure on Sparkasse Aachen's GLC deposit rating could be triggered by a positive change in its BFSR, considering that our assessment of the probability of external support - and hence the rating uplift from its A2 Baseline Credit Assessment - is already very high.

What Could Change the Rating - Down

A rating downgrade of SK Aachen's C+ BFSR is currently not expected, given the bank's comfortable capital levels that could absorb even sizeable unforeseen losses.

Downward pressure on Sparkasse Aachen's deposit rating could be triggered by a change in the credit quality of potential support providers or by a lower probability of support from any one of them. However, any change in the probability of support from the cross-sector support mechanisms for public-sector banks in Germany is currently not expected.

Recent Results and Company Events

For the year 2008 SK Aachen's assets recorded growth of 5.8%, and, despite the extremely difficult environment for the entire banking sector, operating revenues in 2008 declined only by 2.4% or EUR 6 million to EUR 268 million demonstrating the exceptional resilience of the bank during the period. This result was partially due to the flat euro yield curve for most of the year which exerted some pressure on net interest income reported at EUR 168 million versus EUR 169 million in 2007, and reduced net interest margin to 1.97% (2.02% in 2007). Fee and commission income was broadly flat at EUR 57.8 million for the year (EUR 57.3 million in 2007).

Administrative costs in 2008 included a voluntary pension expense of EUR 20 million related to the defined benefit scheme at Rheinische Zusatzversorgungskasse (RZVK), which was beyond the fixed mandatory commitment. In 2007, SK Aachen's performance was affected by the one-off effect related to its participation in the risk shield for WestLB with charges of EUR 18.8 million, booked under administrative costs. We caution that some further charges might be required, given WestLB's financial weakness and continued need for external support.

Profitability (after risk charges) at EUR 64 million in FY 2008 included risk provisions of EUR 21.5 million, which were modestly below the level recorded in the previous year (EUR 23.1 million).

Given the above-mentioned factors, overall profitability was broadly flat for the year with net income at EUR 35.1 million versus EUR 35.5 million in 2007.

In Moody's opinion, reported profits, profitability metrics and capital ratios should be seen in connection with meaningful allocations to reserves according to Art. 340f HGB.

Equity grew by 4.3% to EUR 633 million or 6.6% of total assets. At year-end 2008, SK Aachen's Tier 1 ratio reached 12.9% which we view as very sound for German banks and for the savings bank sector.

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

Bank Financial Strength Rating

Moody's assigns a C+ BFSR to Sparkasse Aachen. As a point of reference, the assigned BFSR is one notch higher than the unadjusted outcome of Moody's bank financial strength scorecard. We have, however, made adjustments to several financial ratios to bring the accounting standards of the German Commercial Code (HGB) in line with IFRS.

Sparkasse Aachen's C+ BFSR is supported by the savings bank's very strong and deeply entrenched franchise in its regional retail banking market, evidenced by high and well-defended market shares as well as the strong brand value, low risk profile and good financial fundamentals.

Key positive elements driving Moody's bank financial strength scorecard outcome for SK Aachen are its high and sustainable market shares, resilient and predictable stream of quality earnings, good liquidity and risk management and strong economic capitalisation.

Key negative elements driving the scorecard outcome are the bank's improving asset quality, some concentration risks, as regards geographic and size concentrations and low financial reporting transparency.

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

Qualitative Rating Factors (50%)

Factor 1: Franchise Value

Trend: Neutral

Sparkasse Aachen operates in the regional district of Aachen with a population of approximately 570,000 and commands a large market share of 60% in retail banking through its network of 97 branches. It also maintains a house-bank function for SMEs and regional municipalities.

The dense branch network and strong local presence, as well as the often long-standing customer relationships associated with it and the good insight they allow into the customers' priorities, preferences or problems represent major competitive advantages for Sparkasse Aachen. The bank has an intimate knowledge of its local markets and customers, with positive implications for marketing, sales and pricing power. In the long run, this strong position might be less easy to defend against a background of rising competition and increasingly price-sensitive private clients.

Nevertheless, we currently assign a very high score for market share and sustainability, while the bank's regional limitation to its home region results in a weak score for geographic diversification.

Earnings stability is relatively high, given the fact that the majority of the bank's operating income is derived from net interest income. SK Aachen's interest income, however, is also subject to potential adverse effects from a flattening yield curve as evidenced over the past two years when net interest income remained under pressure. In addition to its predictable stream of interest income, SK Aachen's also benefits from stable fee and commission income, which we view as supportive for the overall earnings stability.

The combination of these factors results in a solid B- score for SK Aachen's franchise value.

Factor 2: Risk Positioning

Trend: Neutral

Sparkasse Aachen performs adequate risk management practices in light of its core activities and has a good track record in corporate governance. The bank's overall risk profile and culture is sound and benefits from a good and risk-conscious management team, which follows a clear strategy of focusing on its core clientele and competence.

The moderate risk profile is also supported by good liquidity management, i.e. effective measurement, monitoring and control systems. The prudent liquidity management is complemented by a sizeable portfolio of high-quality, liquid and ECB-eligible fixed-income securities, which are managed in accordance with conservative investment principles.

Credit risks from customer-related exposures constitute the main determinant of Sparkasse Aachen's risk profile, followed by risks inherent in the bank's participations (e.g. WestLB) and market risks. Sparkasse Aachen adheres to conservative approaches for quantifying its credit and participation risks and the corresponding consumption of economic capital, and we believe that the bank's methodologies for measuring its market risks are entirely appropriate for its size and risk appetite.

We also recognise that the bank has largely abstained from leveraging its balance sheet through engaging in client-remote, secondary market activities that have proved ill-fated for many banks in the German banking system. As a result, SK Aachen does not have any meaningful exposures to asset classes affected by the crisis in international capital markets and has, to date, absorbed the shock of the financial crisis without material impact.

Sparkasse Aachen's appetite for market risk, notably for interest-rate risk in its trading book and for its asset/liability management, is limited.

The loan portfolio is sufficiently diversified by industry, albeit with some single-borrower concentration risks. However, many of the largest borrowers have close relationships with either the Region of Aachen (StädteRegion Aachen) or the state of North Rhine-Westphalia and should display satisfactory creditworthiness in the longer term. Except for its exposure to WestLB, Sparkasse Aachen has no unduly high exposures to internationally active financial institutions.

The bank prepares its financial statements in accordance with German GAAP and relevant general bank accounting standards. Financial transparency is low, given that Sparkasse Aachen publishes its financial results only annually. According to Moody's definitions, the lack of public disclosure results in a weak score for quality of financial reporting.

The score for risk positioning is D- .

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.

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 to obtain a detailed discussion of the operating environment.

Quantitative Factors (50%)

Factor 5: Profitability

Trend: Neutral

Similar to other German savings banks, Sparkasse Aachen's management has to strike a balance between its public-service mission and the need to ensure a level of profitability, which enables the bank to protect its solid financial strength and to fund its growth internally. Management has therefore opted for a strategy that aims at ensuring a stable evolution of profits and a satisfactory level of profitability in order to preserve Sparkasse Aachen's financial independence in the long term.

Sparkasse Aachen's revenues and operating profits generally display only mild fluctuations that are typically in line with the economic cycle. We particularly recognise that profits, both before and after risk charges, have shown a very strong degree of resilience which is superior even to many of its fellow-savings banks. Thanks to its client-focused business model, revenues are of high quality and also show good diversification across customers and products. Thanks to their granularity, they imply a fair degree of predictability and stability and thus strongly underpin the bank's creditworthiness. The bank's relatively modest risk-adjusted profitability is, on the one hand, a function of a fixed cost base that is determined by its branch network, and, on the other hand, a function of its preference of a low-risk/ low return profile in its lending activities.

Going forward, we believe SK Aachen will benefit from the current, more favourable yield curve which should translate into improving interest income in addition to its stable fee and commission income; however, this may be offset by a rising trend in provisions for potential loan losses at this stage of the credit cycle.

The average profitability ratios result in a D+ score.

Factor 6: Liquidity

Trend: Neutral

SK Aachen's strong liquidity benefits from a substantial amount of liquid assets, high and stable retail funding and additional alternative funding sources. Even though the business model of a savings bank naturally includes a level of maturity mismatch of total liabilities, stemming from the ample amount of short-term client deposits, this does not pose any undue risk. The bank's deposit base has historically - as well as throughout the financial crisis - been very stable, benefiting from (i) the loyalty of its retail clients, (ii) a high level of market trust in the sound franchises and conservative management of Germany's savings banks and (iii) the mutual support mechanisms of the public-sector banks. These aspects - in addition to SK Aachen's own sound business and risk profile - are in our view crucial factors in the bank's favour during distressed market conditions, and underpin its stability.

On the liability side, customer deposits grew by a strong 12% to EUR 7.650 billion in 2008 compensating for the 5% decrease in the previous year, as the bank was perceived as safe by depositors in current market conditions. Together with the large securities portfolio, these deposits should continue to support Sparkasse Aachen's solid liquidity profile.

With regard to alternative sources of funding, SK Aachen started to issue public sector covered bonds (Öffentliche Pfandbriefe) in 2004. In the future, the bank may also use mortgage covered bonds (Hypothekenpfandbriefe) to refinance its residential mortgage loan book. In the longer run, covered bond issuance could partially replace interbank borrowings and serve to extend the maturity profile of the liabilities, thereby helping to manage duration mismatches and further adding to the bank's financial flexibility.

The bank's prudent liquidity management is appropriate for its limited business and financial risks and complemented by a sizeable portfolio of good-quality, liquid and ECB-eligible fixed-income securities.

The bank scores A- for liquidity.

Factor 7: Capital Adequacy

Trend: Improving

Sparkasse Aachen benefits from a solid economic and regulatory capital base. The robust internal capital generation has been sufficient to facilitate growth internally while simultaneously bolstering its capital metrics. The bank reported equity of EUR 633 million as of December 2008, equivalent to a rather strong equity-to-total assets ratio of 6.6%, according to local GAAP.

In addition, the bank has pursued a prudent provisioning policy and has built up considerable fully taxed reserves that further enhance its substantial financial flexibility. In order to reflect this, Moody's includes the undisclosed reserves (pursuant to paragraph

340f of the German Commercial Code or HGB) and paragraph 26a of the German Banking Act or KGW) in its Tier-1 capital for 2008 and the previous years, lifting considerably the Tier-1 ratio to 20.7% in 2008 following these adjustments.

SK Aachen is among the very few German banks that managed to improve its regulatory capitalisation during the financial crisis, providing a very solid cushion at this stage of the cycle given its risk profile.

The bank's capital adequacy is strongly positioned in the A category.

Factor 8: Efficiency

Trend: Neutral

For a bank, which operates in the retail market and maintains an extensive branch network, Sparkasse Aachen shows a good level of operating efficiency and its cost base compares well with that of domestic and international peers.

In light of the ongoing investment requirements in the banking sector, notably in information technology, customer segmentation and risk management systems, we view positively the bank's decision to seek co-operative agreements with savings banks in neighbouring regions and/or to use the expertise and tools provided by the national savings banks' association (Deutscher Sparkassen- und Giroverband or DSGV). We note that SK Aachen's cost-to-income ratio has weakened somewhat recently, which was - apart from the more demanding operating environment - also because one-off items were included in operating costs. In 2007, SK Aachen took a EUR 18.8 million provision related to the reserve fund at RSGV (through which SK Aachen indirectly holds its stake in WestLB), and in 2008 a top-up pension provision of EUR 20 million is included. Taking out these effects, the cost-to-income ratio would have been largely in line with previous levels.

The C score for efficiency reflects the average cost-to-income ratio for the three years to 2008 and our expectation that the underlying operating efficiency will continue to support the bank's commercial and financial flexibility.

Factor 9: Asset Quality

Trend: Neutral

Conservative standards prevail with respect to the underwriting and approval process, the classification and monitoring of exposures and concentrations, the valuation of collateral and, importantly, the classification and provisioning of problem loans. This is evidenced by stable and satisfactory coverage ratios, the negligible amount of direct write-offs and significant releases of loan loss provisions in recent years. Nevertheless, due to Sparkasse Aachen's prominent position in the regional market, it remains a constant challenge to protect the quality of its loan portfolio in a persistently difficult economic environment.

Although the total amount of problem loans as a percentage of shareholders' equity plus loan loss reserves decreased moderately over the past few years, we remain cautious about the future trend given the difficult economic outlook.

Nevertheless, risk coverage of problem loans is satisfactory, especially as specific loan-loss provisions are complemented by general risk provisions. The uncovered portion of problem loans is partly supported by collateral, which is, however, generally not considered in Moody's scorecard. When looking at the largest commitments, which require a specific provision, we note positively that their average size is rather moderate and not disproportionate to the bank's operating profits or economic capital resources. Furthermore, with few exceptions, these exposures generally triggered only minor incremental provisioning needs.

The bank's very high quality securities portfolio represents roughly a quarter of the balance sheet and is conservatively managed. The portfolio has a strong domestic bias, with most of the non-domestic exposures concentrated in Western European countries and the US. In line with Sparkasse Aachen's cautious business approach, secured bank debt (e.g. covered bonds) and sovereign debt dominate the portfolio. Exposures to foreign financial institutions, corporate credits and equities are small and their management is mostly delegated to third-party fund managers. Furthermore, we note that SK Aachen has no meaningful exposure to securitisation or structured credit products. Thanks to its low-risk characteristics, the portfolio contributes significantly to the bank's stable quality earnings and underpins its strong liquidity profile.

These ratios result in an adjusted score of C for asset quality, which does not factor in the additional comfort level obtained from the high level of good-quality collateral.

Global Local Currency Deposit Rating (Joint Default Analysis)

Moody's assigns a global local currency (GLC) deposit rating of Aa2 to Sparkasse Aachen. The rating is supported by the following four main elements:

(i) Sparkasse Aachen's Baseline Credit Assessment of A2;

(ii) The very high probability of cross-sector support from the public sector banks;

(iii) Moody's assessment of a very high probability of support by its public-sector owner, the City of Aachen;

(iv) Moody's assessment of a very high probability of systemic support from the German authorities.

Moody's assessment of those support probabilities results from Sparkasse Aachen's important role in the regional economy, given its strong and well-entrenched franchise. This, along with its integration into the public-sector support mechanisms, makes support from the various sources highly likely in the event of a stress scenario.

Germany is considered a medium support country.

Sparkasse Aachen's senior unsecured foreign currency debt rating is Aa2.

Sparkasse Aachen's issuer rating is Aa2, consistent with its Aa2 GLC deposit rating.

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.

Issuer Rating

Issuer ratings are opinions of the ability of entities to honour senior unsecured financial obligations and contracts. Moody's rating symbols for issuer ratings are identical to those used to indicate the credit quality of long-term obligations.

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

Sparkasse Aachen

Rating Factors [1]	A	B	C	D	E	Total Score	Trend
Qualitative Factors (50%)						C	
Factor: Franchise Value						B-	Neutral
Market Share and Sustainability	x						
Geographical Diversification					x		
Earnings Stability	x						
Earnings Diversification [2]							
Factor: Risk Positioning						D-	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	--	--	--	--	--		
- Borrower Concentration	--	--	--	--	--		
- Industry Concentration	--	--	--	--	--		
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%)						C+	
Factor: Profitability						D+	Neutral
PPP % Avg RWA - Basel II			1,75%				
Net Income % Avg RWA - Basel II				0,72%			
Factor: Liquidity						A-	Neutral
(Mkt funds-Liquid Assets) % Total Assets		-6,44%					
Liquidity Management	x						
Factor: Capital Adequacy						A	Improving
Tier 1 ratio (%) - Basel II	12,90%						
Tangible Common Equity / RWA - Basel II	20,70%						
Factor: Efficiency						C	Neutral
Cost/income ratio			64,65%				
Factor: Asset Quality						C	Neutral
Problem Loans % Gross Loans			4,75%				
Problem Loans % (Equity + LLR)			24,39%				
Lowest Combined Score (15%)						C-	
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