STANDARD & POOR'S

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Bank Industry Risk Analysis: German Banks Profit From Healthier Credit Environment

Primary Credit Analyst:
Stefan Best
Frankfurt
(49) 69-33-999-154
stefan_best@
standardandpoors.com

Secondary Credit Analysts:
Volker von Kruechten
Frankfurt
(49) 69-33-999-164
volker_vonkruechten@
standardandpoors.com

Bernd Ackermann
Frankfurt
(49) 69-33-999-153
bernd_ackermann@
standardandpoors.com

Harm Semder
Frankfurt
(49) 69-33-999-158
harm_semder@
standardandpoors.com

Additional Contact:
Financial Institutions Ratings
Europe
FIG_Europe@
standardandpoors.com

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1. Executive Summary

Strengths:

- Wealth and diversity of the economy combined with a high level of political stability
- Much improved competitiveness of the corporate sector
- Stabilized real estate markets, which have started to pick up slowly and selectively
- High level of banking intermediation
- Improving financial profile of the banking sector

Weaknesses:

- Higher industry risk compared with other Western European banking systems due to a difficult competitive environment
- Dominance of less profit oriented financial institutions and fragmentation of banking industry add to inefficiencies
- Remaining fragility of the cyclical economic upswing due to structural reform deficits
- Slow growth of domestic banking business and persistent margin pressures
- Profitability and capitalization of large institutions well below European average

The financial stability of the German banking system has further improved on the back of a benign economic environment, in Standard & Poor's Ratings Services view. Germany's cyclical economic upswing in 2006 was more robust than expected and has gained a broader footing. Credit losses of German banks are at their lowest for many years, reflecting

improved corporate credit quality and a slow recovery of commercial real estate markets. The improved domestic economic environment and ongoing favorable global growth trends indicate that the more benign domestic credit environment is likely to prevail at least over the next 12-24 months.

Structural improvements in the German economy, in particular the restraint in wages over the past several years and its beneficial effect on cost of production, have improved the international competitiveness of German companies and boosted exports. Moreover, corporate and personal leverage in Germany has trended downward from above-average levels since the beginning of the decade, in contrast to most other mature economies. Germany's growth has not been based on increased borrowing and housing market inflation, instead it is broader based. In addition, interest rates are generally fixed over a longer period of time. As a consequence, Germany's economy and banking industry is less vulnerable to a rise in interest rates than those of most other mature economies.

Yet, Germany's banking industry risk is higher than that of other large developed economies in Europe, North America, and Australia as it still lags in terms of profitability and dynamism. The German banking system remains dominated by public law and cooperative banks, which are not primarily profit driven. While mergers within these respective sectors have substantially reduced the total number of banking units in the country, the public and cooperative ownership impedes deeper domestic consolidation and a move to more efficient and competitive institutions comparable to the diversified financial conglomerates that lead the banking industry in other large developed countries. Sectoral overcapacity combined with slow growth in banking revenues (the lowest in Western Europe) intensifies competition and pressures profit margins in Germany.

The industry is divided into three exclusive pillars: private sector, public law, and cooperative banks. This has led to unbalanced business profiles at individual banks. There is a sharp divide between smaller retail banks and large wholesale institutions with relatively underdeveloped retail franchises. With the exception of Deutsche Bank AG, German banking groups have been unable to build a meaningful franchise in growth markets abroad to offset domestic weaknesses, in part due to weak retained earnings. As a result, profitability levels are the lowest among Western European peers, and capitalization, particularly of the larger institutions, is below average.

"Banking industry country risk assessments" (BICRA): Group 2

The BICRA reflects the strengths and weaknesses of a country's banking system relative to those in other countries. BICRAs classify countries into 10 groups ranging from the strongest banking systems (Group 1) to the weakest (Group 10) from the perspective of country risk. Standard & Poor's analyzes the credit standing of financial institutions in the context of the broad economic, regulatory, legal, and competitive environment in which they operate. This sectoral analysis is integral to estimating the probability of a banking crisis, the potential severity of fallout in the event of a crisis, and the fundamental strength and creditworthiness of individual financial institutions operating in a country. The BICRA for Germany, upgraded to Group 2 from Group 3 on March 21, 2007, reflects the improved economic risk environment due to less leverage in the economy and the reduced credit risk of borrowers, balanced by relatively higher banking industry risk due to the difficult competitive structure of the sector and its relatively poor overall financial profile. (For further information see " Banking Industry Country Risk Assessment On Germany Raised To Group 2 From Group 3," published on March 21, 2007.) Other countries included in Group 2 are: Hong Kong; Italy; New Zealand; Norway; and Singapore. (For a full list of BICRA

Groups 1 to 10, see article entitled " Banking Industry Country Risk: These Are The Good Old Days," published on June 6, 2006, RatingsDirect.)

Germany classified in the "Supportive" category

Like most mature market economies, Germany is classified as supportive by Standard & Poor's. The credit ratings in supportive countries usually receive no uplift due to potential extraordinary future external government support over the stand-alone rating, but integrate important ongoing systemic elements.

2. Economic Risk

The ratings on the Federal Republic of Germany (AAA/Stable/A-1+) reflect:

Strengths:

- A wealthy, modern, highly diversified, and competitive economy.
- A stable political environment with a track record of prudent macroeconomic policies and pronounced government expenditure discipline.
- Resilience to large-scale economic shocks, as proven by reunification.

Weaknesses:

- Low growth potential due to structural weaknesses, a high tax wedge on labor, and an adverse demographic profile.
- Labor market rigidities, a comparatively generous welfare state, and reunification weighing on unemployment and fiscal balances.
- A political system that is not conducive to swift and decisive policy reform.

Cyclical recovery stronger than expected

With GDP up 2.7% in 2006 in line with the Eurozone average for the first time in more than a decade, Germany's economic growth turned out to be much stronger and more sustainable than initially expected (see chart 1). After five years of weak economic performance, deteriorating public finances, and a growing trade surplus as the major source of growth, the cyclical economic upswing has gained a much broader footing. The successful restructuring of the corporate sector and modest increases in labor costs have improved Germany's competitiveness, translating into strong export growth against a backdrop of a prolonged period of global economic growth. This combined with improved profitability has spurred corporate investments and employment, which in turn lifted private consumption from low levels. Overall, the more favorable picture that has emerged over the past few quarters, indicates that the negative impact from Germany's fiscal austerity measures in 2007 is likely to be only temporary and that the economy is expected to rebound quickly.

Structural weaknesses remain

Despite the cyclical recovery currently underway, concerns persist about Germany's longer-term growth prospects. Structural weaknesses such as the demographic change, a generous social security system, rigid labor markets, and structurally fiscal deficits have not been sufficiently addressed, and the political system remains an obstacle to extensive reforms as recently

demonstrated by the failed attempt to restructure the health care system and the debate about minimum wages. Consequently, at the next economic downturn Germany risks a deterioration in economic and fiscal indicators similar to, or even more protracted than the last period of stagnation in 2002-2005. (For further details see: " Germany (Federal Republic of)," published Nov. 16, 2006; " European Economic Forecast: Toward A More Balanced Growth Model For the German Economy," published Jan. 8, 2007; "European Economic Forecast: Rising Consumer Demand And Buoyant Business Investment Drive Growth In 2007-2008," published on Feb. 19, 2007, on Ratings Direct.)

Chart 1

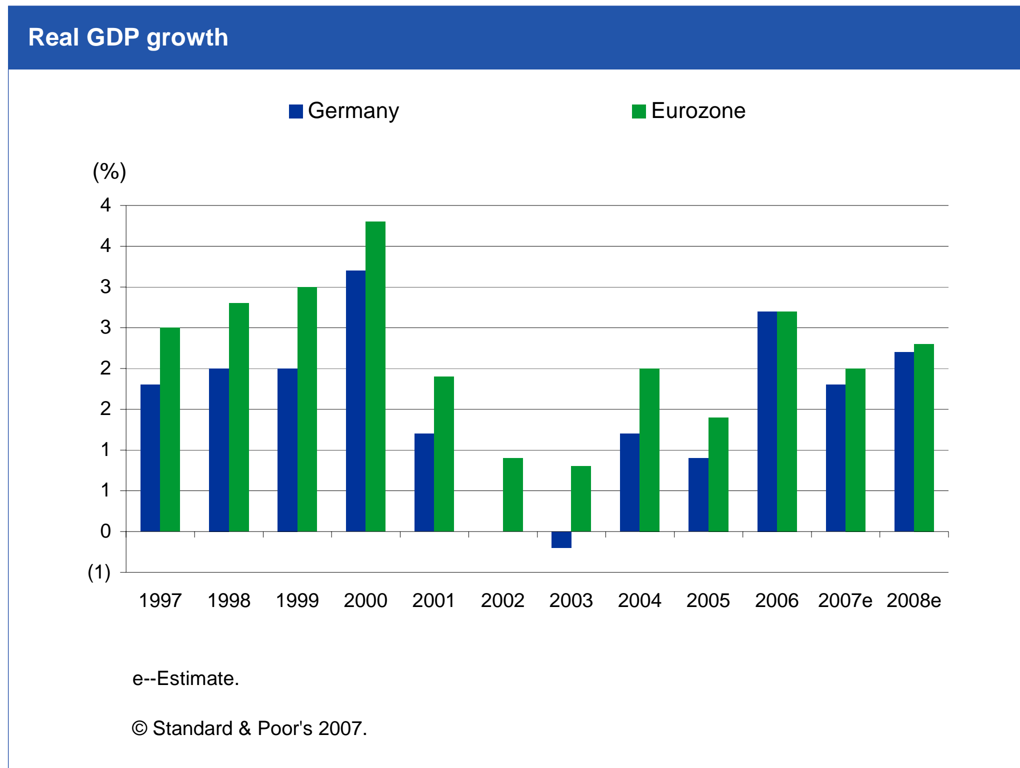

Table 1

Leading Economic Indicators—Germany (Federal Republic of)									
	2002	***2003***	***2004***	***2005***	***2006***	***2007***	***2008***	***2009***	***2010***
Real GDP (% change)	0.00	(0.19)	1.25	0.91	2.50	1.80	2.00	1.80	1.80
Real domestic demand (% change)	(2.59)	0.43	0.12	0.75	2.70	1.34	2.24	2.30	2.34
Real exports (% change)	4.29	2.40	9.63	6.88	10.00	6.50	N.A.	N.A.	N.A.
Real investment (% change)	(6.07)	(0.77)	(0.40)	0.78	3.90	3.40	4.00	4.00	4.00
GDP per capita ($)	24,451	29,559	33,212	33,790	35,192	38,645	42,769	41,365	41,056
Unemployment rate	7.6	8.7	9.2	9.1	8	7.6	7.4	7.2	7
Consumer price index (% change)	1.3815	1.0482	1.7635	1.9368	1.8	2.2986	1.9973	1.8076	1.794
Exchange rate year-end (LC/$)	0.9536	0.7918	0.7342	0.8477	0.7576	0.7143	0.7194	0.7692	0.8
Total domestic credit to public sector and NFPEs/GDP (%)	116.9	115.5	112.3	111.8	112.0	113.1	114.0	116.2	118.4
Population (mil.)	82.49	82.53	82.52	82.48	82.44	82.40	82.36	82.32	82.28
Nominal GDP (bil. $)	2,143.18	2,161.50	2,207.20	2,241.00	2,302.70	2,371.78	2,448.25	2,522.22	2,598.43

NFPEs—Nonfinancial private enterprises. N.A.—Not available.

Resilience against severe economic stress has improved

Standard & Poor's addresses the possible or existing problems for every banking system by estimating the potential level of gross problematic assets (GPAs) in a financial system in a worst-case economic scenario, expressed as a percentage of domestic credit to private sector and nonfinancial public enterprises in the coming year. The assumptions behind these scenarios are severe and unlikely, but not impossible. Due to the improved resilience of the German banking system, we continue to estimate that GPAs could range from 5%-15% in the event of a severe economic downturn (the strongest out of five categories of potential GPAs).

Credit risk: Provisioning needs expected to remain below statistically expected levels as Germany's economic cycle is less advanced than in other European countries

The credit environment in Germany has significantly improved since the crisis years 2001-2003 reflecting:

- The successful restructuring of the domestic corporate sector and the absence of large insolvencies.
- The ongoing workout of legacy real estate loans and the bottoming out of domestic property markets.

Furthermore, the credit quality of large German banks' sizable international exposures have benefited from the favorable stage of the global credit cycle. Consequently, the level of problem loans, which is still higher than the Western European average, has continued to decline, partially reflecting the sale of distressed assets to international investors.

Net new provisioning needs to loans have declined to cyclically low levels, but have remained higher than those in many other European countries except the U.K. and Italy, whereas in Spain provisioning needs largely reflect general loan loss provisions due to regulatory requirements (see chart 2). Due to the more favorable economic outlook, and the absence of excessive asset-price inflation or lending growth, the cost of domestic credit risk is likely to remain at comparatively favorable levels over the next 12-24 months. Provisioning needs might increase, as the high releases of loan loss reserves seen over the past few quarters should progressively decline. Longer term concerns remain Germany's growth prospects and vulnerability to economic downturns combined with renewed margin pressure and a relaxation of credit standards as reported in the Bundesbank's recent domestic lending surveys. We also expect global default rates to gradually edge up in coming quarters. Leveraged finance in particular demonstrates an increasingly unsatisfactory risk-reward profile, given the ongoing decline of interest rate spreads. Finally, concentration risks at the large wholesale-oriented German banks as measured by the volume of their largest exposures to adjusted equity, although reduced in recent years, remain above the European average, reflecting their business profiles and comparatively modest capitalization.

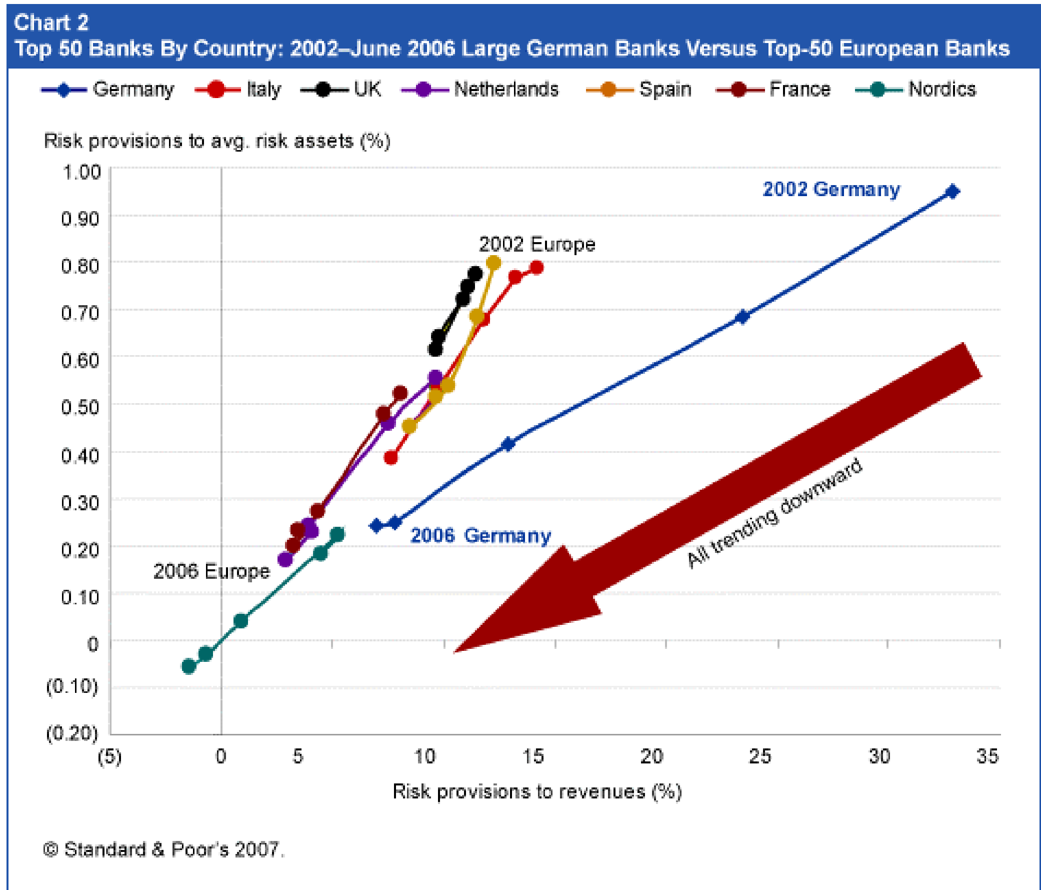

Chart 2
Top 50 Banks By Country: 2002–June 2006 Large German Banks Versus Top-50 European Banks

Lending growth the lowest in Europe despite economic recovery

The outstanding balance of German banks' loans to domestic enterprises and private individuals rose only 0.7% year-on-year in 2006 and has been fairly stagnant since year-end 2002. During the same period, loan volumes in the Eurozone excluding Germany rose by about 50%, while in Germany loans to GDP declined to 97% from 106%, but in other Eurozone members increased to 102% from 79% (see table 2). Overall, neither excessive credit growth, nor leverage or asset-price inflation can be observed over the past few years, reflecting Germany's economic underperformance between 2001 and 2005.

Table 2

Loan Growth—Germany Versus Eurozone		
(%)	*Germany*	*Eurozone*
Loans to enterprises and households		
Growth 2002-2006	(1)	52
As % of GDP		
2002	106	79
2006	97	102
Loans to enterprises		
Growth 2002-2006	(5)	43
As % of GDP		
2002	39	50
2006	35	42
Loans to households		
Growth 2002-2006	1	62
As % of GDP		
2002	66	37
2006	62	51

Corporate sector including the self-employed (54% of domestic credit to private sector)

Risk provisions declined due to improved credit risk of large corporates.

Both the number of corporate insolvencies and more importantly estimated creditors' losses continued to decline from their peaks in 2003, reflecting the improved corporate credit quality, particularly of the large and upper-end midsize corporates, which have substantially improved their international competitiveness (see chart 3). Improved economic prospects indicate that the positive trend will continue over the next 12-24 months.

Loan losses in recent years have concentrated on small and midsize enterprises (SMEs) and self-employed businesses, which constitute the backbone of the German corporate sector. Weakened by the protracted difficult environment with low consumer demand, in combination with modest capitalization, and high payroll expenditures, many small domestically oriented SMEs go bankrupt. However, creditors' losses are more widely spread among the banking industry and the more robust and broader based economic upswing should also increasingly benefit the lower-end SMEs.

Chart 3

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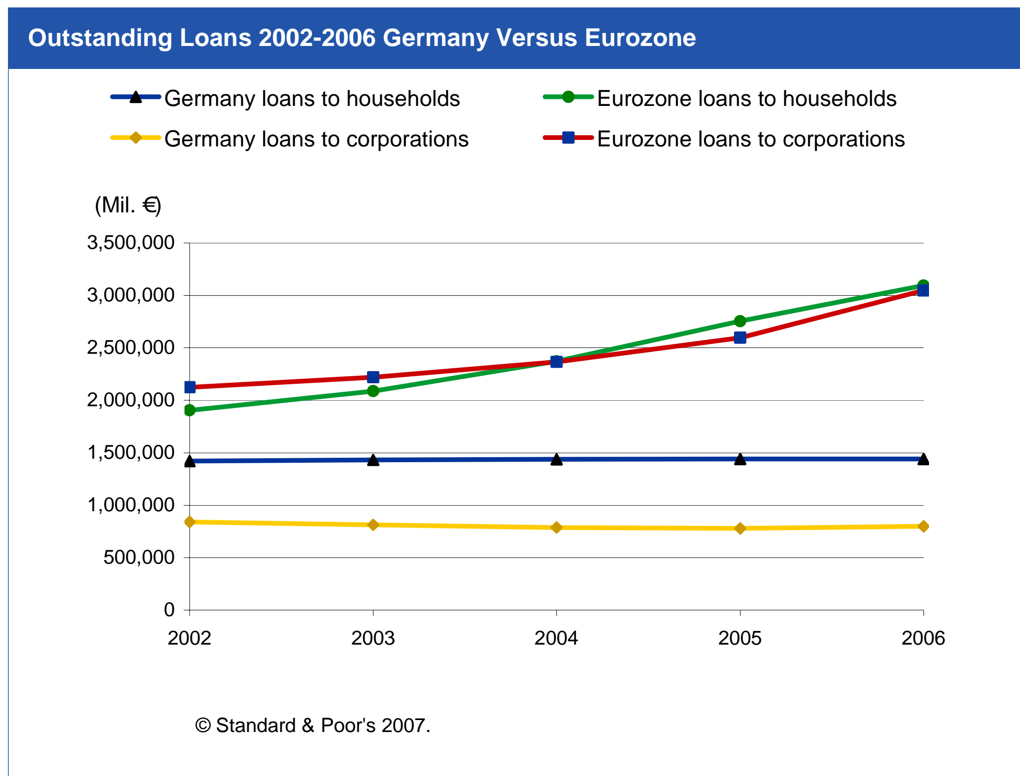
Lending volumes have started to grow slowly after years of contraction.

Following successful restructuring and de-leveraging particularly of larger, internationally oriented companies, which have strengthened their financial profiles and competitiveness on the back of declining funding and staff expenses, net new provisions in 2006 were substantially lower than the long-term average. The downside is that outstanding loans to domestic enterprises excluding self-employed declined 5% between 2002 and 2006. During the same period, loan volumes in the Eurozone excluding Germany rose about 40% and corporate loans to GDP declined to 35% from 39% in Germany, but increased to 50% from 42% in other Eurozone member states (see table 2). In line with increasing corporate investments, lending volumes have started to grow in the first quarter 2006 (see chart 4), but fierce competition has put pressure on margins and credit standards, which might be cause for higher credit losses in the future.

Chart 4



Private households (45% of domestic credit to private sector)

Comparatively lower credit risk owing to good collateralization and payment culture, but losses have risen.

Generally, risk from loans to private households is limited and less volatile due to the dominant proportion of well collateralized loans and a sound payment culture. Representing about three-quarters of the total, mortgage-secured loans typically have long-term fixed interest rate agreements and amortization schedules, which reduce exposure to interest rate and market-value fluctuations. However, provisioning needs have increased, reflecting a rising trend in unemployment, which only reversed in 2006, and a rising number of divorces. Legislative changes allowing for private insolvencies were introduced in 1999 and their number continued to soar, reaching about 90,000 in 2006, although this only seems to be the tip of the iceberg as more than three million households are estimated to be over-indebted. Furthermore, migration due to regional economic imbalances and a negative demographic trend have played a role. Finally, collateral values in Eastern Germany have significantly declined from their peak levels in the mid-1990s. Consequently, banks have been forced to adjust loan loss reserves for legacy loans, as losses and the time needed for workout have exceeded expectations. Improved prospects for employment, a respite from the aftermath of the real estate crisis, and reduced household leverage should help to stop and eventually reverse this trend.

Stagnant loan volumes distinguish Germany from the rest of Europe.

Outstanding loans to domestic households remained fairly stagnant between 2002 and 2006. During the same period, loan volumes in major Eurozone countries excluding Germany rose by a spectacular 62%. Various factors might explain these diverse trends. First, in the past, household leverage in Germany used to be much higher. Loans to households to GDP declined to 62% in 2006 from 66% back in 2002, whereas in the Eurozone this ratio increased to 51%—still below the German level—from 37% (see table 2). Second, Germany has suffered from the bursting of the real estate bubble that followed unification, whereas property prices in many other countries have risen at double-digit rates in recent years, providing a strong incentive to borrow. Third, to cope with rising government deficits, tax benefits for homeowners have steadily been reduced. Finally, widespread job insecurity has contributed to the relatively high household savings ratio of about 10%.

Fierce competition continues to squeeze interest margins.

Nevertheless, retail loans are seen strategically as key products by many banks, which currently aggressively vie for market share and economies of scale with attractive conditions for deposits as well as other banking services. While the long-term nature of the client relationship is regarded as a good basis for cross-selling initiatives, banks are also attracted by significantly lower capital requirements in the future under Basel II. Fierce competition has particularly squeezed residential mortgage margins, which are the lowest in Europe according to a recent study by the European Mortgage Federation.

Real estate: Markets benefit from strong investor demand and economic recovery

Exposures to real estate and construction-related sectors—including loans to professional real estate investors, housing associations, and construction companies—make up about one-third of total lending. Commercial property markets have finally bottomed-out, but the speed of recovery is slow. As a late indicator in the economic cycle, prices and rent levels have turned-around mainly at prime locations, whereas some lower tier properties continue to suffer from the fallout of the real estate bust that followed the post-reunification and the short-lived telecom boom. Therefore, a few banks still need to digest losses from a weaker credit portfolio. However, attracted by low prices and funding costs, investors—primarily international—drove the massive increase of turnover volumes in 2006 with strong overhang extending into 2007. Even in weaker centers such as Frankfurt, persistently high vacancy rates of about 16%-17% in 2006 have started to decline with the economic upswing due to slowly increasing net absorption and lower new construction—in a growing number of cases accompanied by rising prices. Although the short-term outlook for prime locations is more positive, uncertainties remain about longer term economic growth perspectives and the potentially negative impact on the markets once new developments reach the market and investors start executing their exit strategies considering that the average vacancy rate of office buildings in major cities was still at about 11% in 2006, although this was slightly below 2005 levels.

Residential property prizes sluggish, but pronounced regional differences.

The weak development of domestic housing prices is a key distinction to other Western European markets. Moreover, prices for residential property show significant regional differences. Broadly speaking, prices have declined only moderately in Western Germany over the past 10 years, whereas prices in Eastern Germany dropped sharply from their peaks in the mid-1990s until

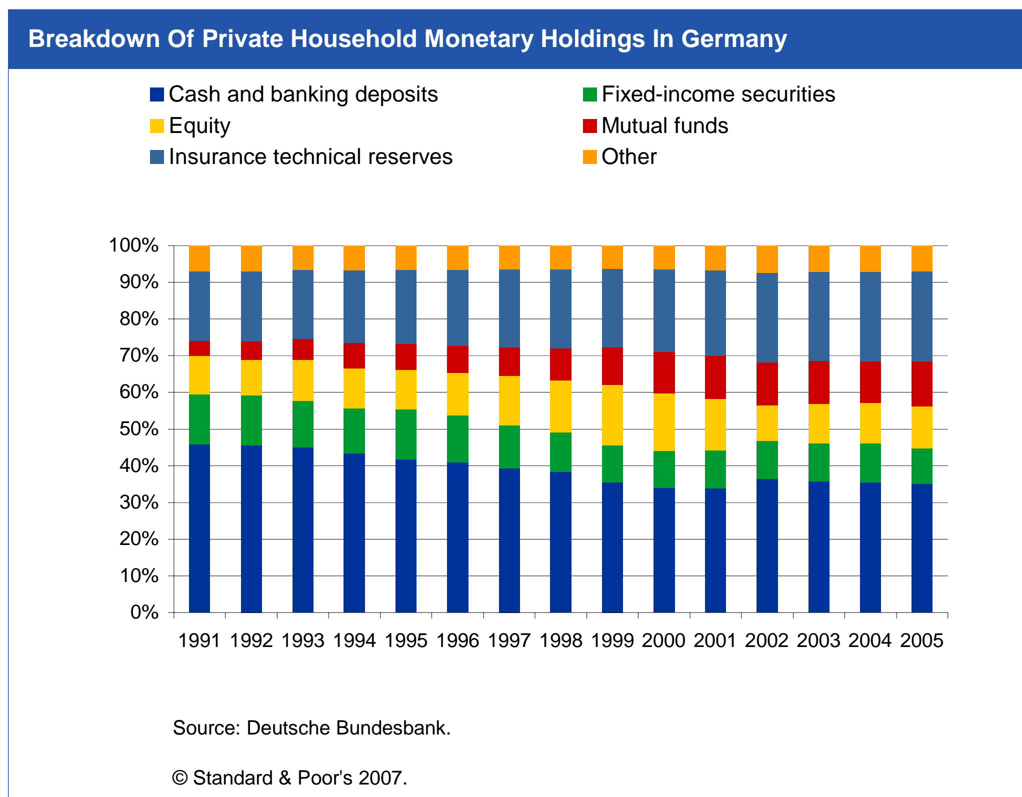
2001 and have continued declining very slowly since. The market is likely to remain sluggish due to reduced tax incentives and demographic change, while migration to the larger centers might aggravate regional differences.

Equity markets: Stellar performance in line with other major international stock indices

With the blue-chip DAX index rising by 22% in 2006, German stock markets recorded their fourth consecutive year of strong performance, luring an increasing number of companies to go public. Furthermore, turnover volumes in cash markets jumped 40% and the number of traded contracts at the Eurex derivative exchange soared 46%. The favorable global capital-market environment has helped German banks in two ways, although the four largest private banks benefited the most due to their more sophisticated know-how and superior sales and trading capabilities. First, earnings improved strongly, buoyed by higher trading and commission income. Second, rising share prices increased revaluation reserves and allowed banks to realize some of the gains on equity stakes, although holdings had been significantly reduced during the crisis years. Conversely, implications for private household wealth have remained moderate as only about one in six private individuals own shares—directly or indirectly through investment funds (see chart 5).

As long as positive factors such as the upward corporate earnings trend, which holds valuations at comparatively favorable levels, and the high liquidity of market participants—particularly of institutional investors—remain unchanged, bank revenues should further benefit from the positive capital-market environment, although further increases will likely be more modest. However, the risk of setbacks rises and an adverse change to the current benign environment could significantly reduce bank earnings, which to a varying degree have become increasingly reliant on positive financial-market conditions.

Chart 5



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3. Industry Risk

Structural factors raise industry risk

Industry risk compares unfavorably with other European countries and make it unlikely that the system's profitability, which improved substantially over the past few years, will catch up with peers in the short to medium term. The industry is characterized by the dominance of savings banks, Landesbanks, and cooperative banks that have ties to their local regions and are not primarily profit driven. This structure adds to margin pressure and hinders large-scale consolidation as due to their legal status neither savings banks nor cooperative banks can be acquired by private banks. Furthermore, merger plans among the large private banks have failed. Consequently, the market displays a high level of fragmentation with the five largest domestic banks capturing only 22% of the market compared with an average of 57% in other Eurozone member states. The industry structure also adds to higher levels of overcapacity, which harbors price competition as savings and cooperative banks, partly due to their ties to the local region, would rather accept an erosion of profit margins than losing market shares or actively cut staff levels. Finally, German banks have failed to broaden their geographic diversification to benefit from growth trends abroad, whereas for example the neighboring Austrian banks have successfully built leading market positions in promising Eastern European markets to offset the disadvantages of their equally difficult home markets.

A. Business dynamics

Competitive dynamics: Dominance of less profit-oriented institutions and significant overcapacities are distinguishing characteristics of the banking system

The German banking system consists of three pillars:

- The 463 public law savings banks and 12 Landesbanks as their central banks; all of which lost their public guarantees in July 2005, but remain owned by the public sector.
- The 1,200 plus local cooperative banks and their two central banks; cooperative banks are owned by their customers and ownership stakes are not traded.
- About 400 privately-owned banks, including the "Big Five" listed banks and a number of regional banks or specialized institutions such as mortgage banks.

All three pillars offer the full range of banking and wealth-management services and both the public law and the cooperative banks also own insurance companies. Consolidation has been constrained to mergers within each pillar, which in contrast to other countries has prevented the creation of a small number of profitable national champions with a strong retail franchise and a market capitalization that allows them to compete internationally. Despite the overall high level of intermediation, profitability of the banking system falls well below the European average, however.

Chart 6

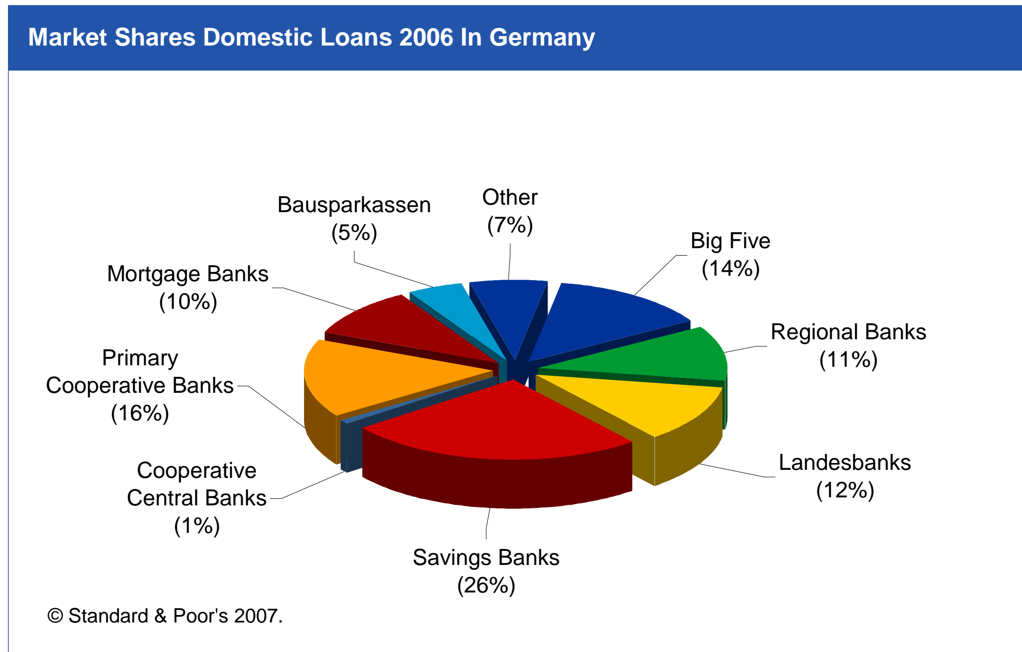
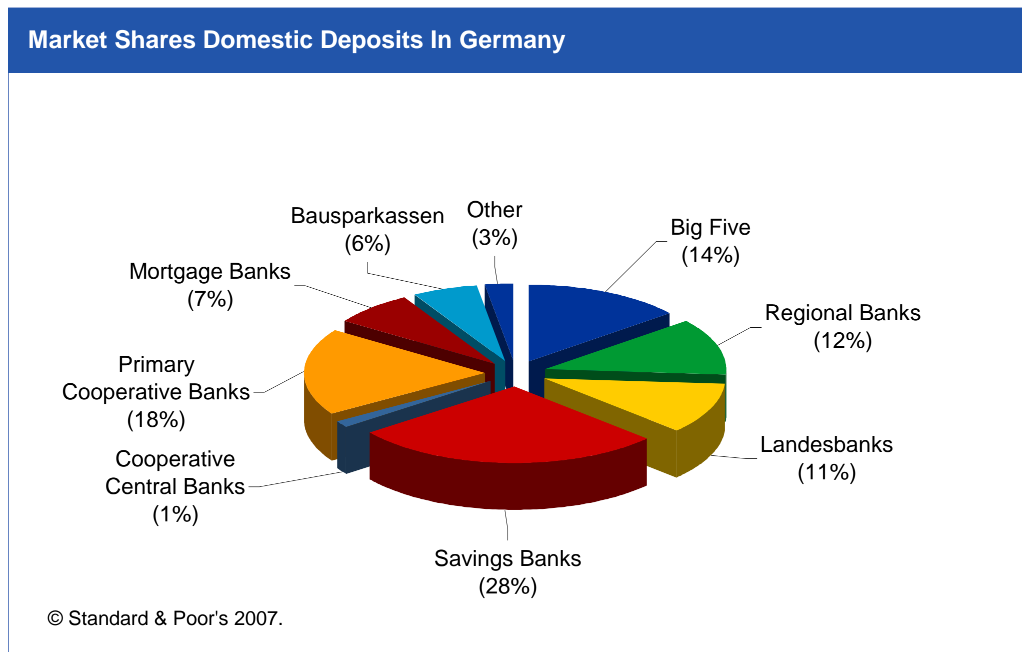


Chart 7



Industry structure leads to less balanced business profiles of individual banks and low profitability of most business lines

The dominance of less profit-oriented savings banks and cooperative banks in banking with retail and small business customers, persistent overcapacities in a low growth market, and renewed price competition, partially driven by the expected capital relief under Basel II, means that in contrast to other European countries German banks' retail business is not very profitable, not even for market leaders. The revival of branchless internet and phone banking and the emergence of still relatively

new yet sizable competitors such as Deutsche Postbank AG (A/Watch Neg/A-1) and ING-DIBA has increased price transparency, weakened customer loyalty, and reduced margins further. Consequently, retail banking only accounts for a smaller proportion of the assets and earnings of large private German banks, none of which command a market share of more than 5%. Although the German market is open to the acquisitions of private banks, foreign banks' have only a rather limited presence in this business line, with UniCredito Italiano SpA (A+/Stable/A-1)/ Bayerische Hypo- und Vereinsbank AG (A/Stable/A-1), Citibank, ING-DIBA, SEB AG, Santander the most prominent examples, which focus strongly on specific regions or product lines.

Conversely, large German banks dominate the corporate banking business, where lending margins have come under pressure as a result of low lending growth and improved creditworthiness of the corporate sector. The abolition of state guarantees for Landesbanks might also play a role as this had forced them raise substantial amounts of guaranteed debt until July 2005 and to seek customer-related business to offset the loss of revenues from pure rating arbitrage. Corporate lending is also seen as low margin business and rather serves to cross-sell corporate finance products to make client relationships profitable. The last credit cycle also displayed pronounced earnings volatility, indicating that risk-adjusted margins are too low to achieve adequate returns through the cycle. While the private banks have been increasingly successful in raising fee income, Landesbanks often lack the scale and scope. This is also true for investment-banking business, which boosted private banks' earnings in 2006, whereas Landesbank revenues still largely rely on net interest income. Investment banking is the area where competition from foreign banks has traditionally been strongest, particularly in M&A business. In recent years, a few more cash rich foreign banks have been attracted by the ongoing restructuring of the German corporate sector, competing for the more lucrative fee business, but their undertakings still appear rather opportunistic.

Commercial real estate lending is dominated by a few specialized institutions and the Landesbanks. The domestic business has been chronically unprofitable due to the real estate crisis, which has prompted banks to become more cautious and to focus on international lending to offset losses. While interest margins are still modest given the proven cyclicality of the business, the progress achieved in the workout of legacy problems is the key driver of earnings improvements.

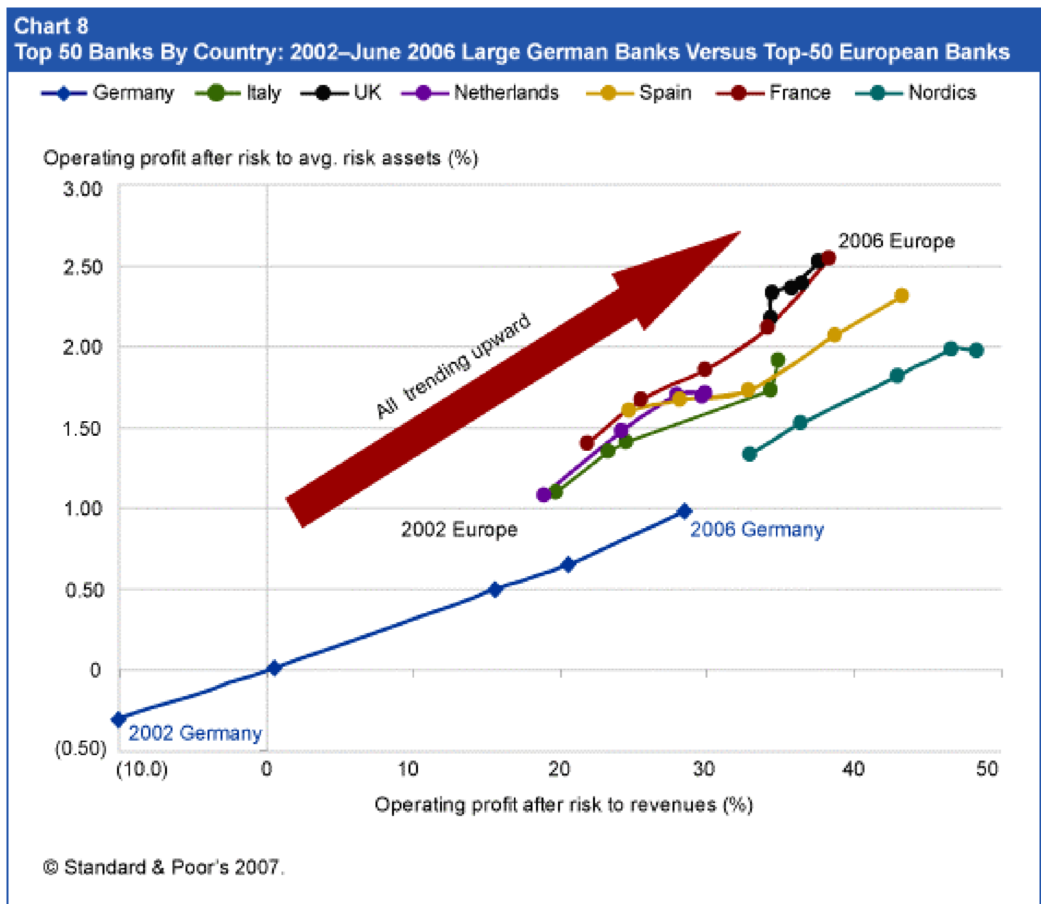
Franchise abroad not sufficiently strong to offset domestic weaknesses

German banks' geographical diversification is limited and does not reflect the size of the economy and its position in international trade. Only Deutsche Bank has successfully built a leading investment banking franchise and also operates a niche retail business in Spain and Italy, but following HVB's sale of Bank Austria Creditanstalt AG (A+/Stable/A-1) to Unicredito none of the German banks have a strong regional franchise for example in the neighboring CEE region. This is because large German banks had strongly but less successfully focused on investment banking in the late 1990s and during the crisis that followed did not have the financial strength to expand abroad. International exposures are high though, but often reflect opportunistic credit investments to enhance the profitability of the international branch networks, which mainly serve German corporate clients' foreign operations. Such investments did not provide diversification benefits as they caused heavy losses during the last economic downturn due to their low diversification and the comparatively lower level of expertise in foreign markets.

German banks to remain less profitable than European peers

Despite the cyclical domestic economic recovery and significant earnings improvements over the past few years, the German banking system is expected to remain the least profitable in Western Europe, as economic and particularly industry risks continue to weigh on earnings. This becomes apparent when comparing profitability ratios of the largest domestic banking groups with the largest European peers; note this excludes Deutsche Bank AG (AA-/Positive/A-1+), which due to its size, profile, and superior performance distorts the picture. At mid-year 2006, operating return on risk-weighted assets was still about 2.5x less than levels at large European peers. At the same time, operating profit to revenues was about 30% below or three years behind large European peers (see chart 7). In 2006, profit growth was achieved on the back of low provisioning needs and a very favorable capital-market environment, which is unlikely to be sustained. Furthermore, the impaired ability to retain earnings also means that Standard & Poor's adjusted capital ratios at large German banks are distinctly lower.

Standard & Poor's believes that profit growth at the large private banks from improved 2006 levels will largely depend on capital-market trends, while savings and cooperative banks are up against further net interest margin erosion. The high level of releases of loan loss reserves seen over the past few quarters is likely to decline, but the domestic credit environment is expected to remain benign.



Unsatisfactory cost efficiency due to low revenue growth and high cost bases

Successful de-risking and cost-cutting strategies have substantially improved the system's health in recent years, but revenue growth from lending and deposit business will likely remain subdued in the fiercely competitive low growth environment. Profit margins might decline further due to the prevailing strategy to capture market shares from competitors. At the same time, a flattening yield curve with short-term rates rising faster than longer term rates is challenging as it reduces treasury income, which for many banks is an important source of revenues. Consequently, most banks are facing a decline in operating profits before risk provisions, which is often offset by lower provisioning needs, however. Only the four largest private banks have improved their cost-to-income ratios due to a very favorable capital-market environment, but uncertainties remain whether such high levels of market sensitive trading and commission income seen in 2006 can be sustained or even improved. At mid-year 2006, the proportion of market-sensitive income to profit before risk was almost 80%, the highest level compared with the top-50 Western European banks.

Cost efficiency remains unsatisfactory compared with international peers as a result of underdeveloped revenue bases and generally poor cross-selling ratios. Furthermore, while most German banks have held stable or cut costs by adapting staff numbers and other administrative expenses to the muted earnings outlook, strict labor laws and substantial workers' participation rights have made this process lengthy and costly, resulting in substantial restructuring costs mainly for the major commercial banks. At mid-year 2006, German banks' average cost-to-income ratios in the upper 60% range remained about 10 percentage points higher than those of large European peers. Comparisons of efficiency ratios (see table 3) between Germany and other Eurozone members also indicate that the domestic market is overbanked and overstaffed. However, the revenue gap due to much weaker generation of noninterest income, reflecting various factors such as competition, business mix, and sales efficiency, appears to be the main reason for German banks' underperformance. Large German banks' revenues to risk weighted assets excluding Deutsche Bank were about 300 basis points (bps) lower than the average of the top-50 banks in Western Europe, with noninterest income accounting for 200 bps at mid-year 2006.

Table 3

Efficiency Ratios 2005—Germany Versus Eurozone

	Germany	*Eurozone average (excl. Germany)*	*Germany Measured Against Eurozone average*
Population/Bank*	39,475	54,789	72
Population/Branch*	1,872	1,850	101
Population/Employees*	117	156	75
Employees/Bank*	337	351	96
Employees/Branch*	16	12	135
Customer loans/Population (€)	2,685	2,331	115
Customer loans/Employee (€)	314,067	363,355	86
Customer loans/Bank (€)	105,991,814	127,713,842	83
Customer loans/Branch (€)	5,027,175	4,312,702	117
Loans to enterprises/Employee (€)	109,802	177,688	62
Loans to enterprises/Bank (€)	37,056,247	62,454,752	59
Loans to enterprises/Branch (€)	1,757,572	2,109,002	83
Assets/Bank (mil. €)	3,268	5,371	61

*Actual number.

Beside labor market rigidities, operating flexibility is also constrained by an increasing administrative burden imposed by tax and other domestic authorities, but also by the steady flow of harmonization efforts within the EU, for example, in the field of transaction services or consumer protection laws. While this strain is likely to mount, further outsourcing efforts might mitigate bureaucracy-related cost increases. High domestic corporate tax rates are also a competitive disadvantage, although the large German banks can use large losses carried forward to reduce this burden. However, in 2008 corporate tax burden is likely to be reduced to 30% from 39% and banks stand benefit the most, as government measures to partly refinance the loss of tax revenues is unlikely to have a significant impact on financial institutions.

Deregulation: Wider introduction of IFRS and Basel II should lead to improved disclosure and transparency

The German banking market has been increasingly deregulated over the past 30 years. Major forthcoming changes are the wider introduction of IFRS accounting and Basel II. We welcome these changes, as they increase disclosure and transparency, and should promote improved risk-adjusted pricing and capital allocation.

B. Ownership

Public law institutions

The strong involvement of state or local governments in bank ownership (Landesbanks and savings banks) is a feature distinguishing the German banking system from banking systems in other western European countries. Standard & Poor's believes that ownership support will be forthcoming—but within the limitations of state-aid rules of the EC Treaty—for public sector banks from their respective owners in the event of stress even since the July 2005 abolition of guarantees. The unguaranteed long-term debt ratings on three German Landesbanks benefit from implicit ownership support by their respective state owners, although the state owners' commitments might change over time. Separately, the ratings on four Landesbanks mainly benefit from implicit support from their owner savings banks, reflecting their regional support systems, which are limited yet legally enforceable and underpin a growing level of cooperation at the regional level. The most prominent example is Landesbank Hessen-Thueringen Girozentrale (A/Stable/A-1) and its approximately 50 owner savings banks in the states of Hesse and Thuringia. Standard & Poor's considers the banks a cohesive, single economic group and assigned its "A/Stable/A-1" ratings and outlook to all member institutions in 2006.

Following the near collapse of former Bankgesellschaft Berlin AG (never rated), which was only prevented through substantial support from the majority state owner, the City-State of Berlin, the European Commission has directed the sale of the bank (renamed Landesbank Berlin AG) by year-end 2007. Furthermore, in 2006 a group of private investors acquired a minority stake in HSH Nordbank, which announced its intention to raise capital in the markets. Although the two cases can not necessarily be considered an indicator of a trend, given the unique circumstances, irrespective of this, Standard & Poor's continues to believe that over time the willingness of public sector owners—motivated most likely by fiscal, competitive, and political pressure—to consider structural changes and an opening up of the market place will increase.

Cooperative banking sector

We expect intragroup support among cooperative banks to be forthcoming in times of stress as demonstrated in the past (see also section "D. Regulatory Environment/Deposit protection schemes"). The cooperative banking group consists of more than 1,200 legally independent local retail banks, which operate under a joint brand and jointly own their two respective central clearing banks. In December 2006, Standard & Poor's assigned its 'A+/Stable/A-1' ratings and outlook to all local cooperative banks based on its view of the cooperative sector's consolidated financial strength, and the sound and proven level of solidarity, integration, and cooperation.

Private law institutions

While ratings on German private banks do not incorporate extraordinary state support or private support systems such as the existing deposit protection scheme, external ownership support is an important rating factor for many private law credit institutions. Notable exceptions are Deutsche Bank, Commerzbank AG (A/Stable/A-1), and Hypo Real Estate Bank AG (BBB+/Positive/A-2), whose ownership is widely spread, whereas ratings on Dresdner Bank AG (A+/Stable/A-1), Postbank, HVB, and Eurohypo AG (A/Stable/A-1) benefit from implicit support from their respective majority owners.

C. Industry Segment Review

UNIVERSAL BANKS

Private commercial banks: The "Big Five": Superior earnings diversification, but increasing reliance on benign capital markets

The so-called "Big Five" private commercial banks, namely, Deutsche Bank, HVB, Commerzbank, Dresdner Bank, and Postbank together accounted for only about 18% of Germany's total banking assets at Sept. 30, 2006. This figure does not fully reflect the extent of these banks' market position, however, as the groups' consolidated domestic and international subsidiaries are not included. More importantly, the Big Five have a superior revenue diversification demonstrated by the significantly better market position in commission income (36% share in 2005 of the whole banking system; see table 3) and trading income (94%, but due to a special valuation effect at Deutsche Bank abnormally high in 2005).

Table 4

Market Shares Of The "Big Five" By Revenues In 2005*

(Mil. €)	*Big Five*	*Total*	*Market share (%)*
Net interest income	19,419	88,245	22.0
Net commission income	10,076	27,803	36.2
Net trading income	10,775	11,429	94.3
Total	40,270	127,477	31.6

*Unconsolidated local GAAP figures.

With the exception of globally active Deutsche Bank, which leverages its expertise from its strong investment-banking activities in the current favorable capital-market environment, the franchises of the other four major banks are mainly focused on the German market. While rigorous cost-cutting and de-risking have had significant positive implications for the profitability of the German operations in recent years, revenue growth has been the major challenge. The unsatisfactory cost efficiency still differentiate them from international peers, which often have a significantly better retail franchises and geographic diversification with a good presence in growth markets. While all banks have sharpened their business profiles and renewed their emphasis on less developed retail activities, expansion in commission income but even more so in trading profits from business with institutional clients has gained momentum. Conversely, net interest income has been stagnant or declining for the whole domestic banking industry as a result of low volume growth, still low yields, declining credit spreads, and a flattening yield curve. With the exception of Postbank, the large private banks' superior capital-market expertise compared with the public law and cooperative banking sectors is expected to continue to allow them above-average growth as long as the benign market conditions prevail. However, the proportion of market-sensitive income to revenues was 1.4x higher than for the foreign top-50 European banks at mid-year 2006, indicating an increasing reliance on such favorable trends.

Since 2000 all merger attempts among the Big Five have failed and renewed talks are considered as unlikely. Three high-profile transactions in 2005 have further diminished opportunities for large-scale consolidation among private banks. Therefore, collaboration will probably remain restricted to the outsourcing of some back-office functions, such as payment transactions, which allows only limited cost savings.

Regional and other credit institutions (excluding Big Five): Some foreign banks have gained good positions in profitable niches

The 350 regional and other institutions, including subsidiaries of foreign banks, vary significantly by size and operating focus. Some of the most prominent are foreign-owned banks, such as Citibank, and ING-DIBA, which have achieved good positions in consumer finance and retail deposits, and major U.S. investment banks. In the past, foreign banks, deterred by the fierce competitive environment, have mainly focused on their strengths in specific niches, but their interest in the German market appears to be growing.

Public sector banks: Landesbanks and Savings banks: Sector reacting slowly to considerable challenges

Savings banks face gradual erosion of their strong franchises.

The savings banks' strong retail franchise is based on the densest branch network in Germany, with its almost 14,000 outlets (year-end 2005) and their proximity to and intimate knowledge of local customers. Limited legally to their respective home region, the activities of about 460 savings banks comprise a full range of banking services to retail customers, small business clients, and midsize companies.

Current interest environment burdens interest income as dominant income source.

Profitability still benefits from relatively good interest margins. However, they have resumed their long-term downward trend, due to low interest rates and the flattening yield curve, but also owing to pricing concessions to rekindle growth in core products. Primarily, high market shares in

savings deposits, which provide a cheap funding source, and homeowner financing have come under pressure by the entry of new competitors such as online banks in recent years. Their slow approach to better exploit their excellent retail franchise through improved marketing strategies and their limited willingness to respond to considerable investment needs with rationalization efforts through staff cuts make savings banks vulnerable to a gradual erosion of their market position. We expect the slow consolidation trend and the cooperation in IT and back offices, which help to stabilize cost bases, to continue. For 2006, savings banks are expected to report relatively stable profits after risk, as reduced provisioning needs are likely to have offset somewhat weaker operating revenues. Future profitability will be closely linked to the outlook for the German economy, but will also depend on their ability to more quickly adapt to the challenging competitive environment.

Landesbanks need to further adapt their business models to lift modest profitability levels.

Landesbanks beyond their primary role as central banks for their local savings banks and bankers for their respective states engage in large-scale corporate and real estate business, cross-border operations, and investment banking. Landesbanks still need to further adapt their business models, however, improve efficiency, and upgrade risk-management systems to cope with gradually increasing funding costs after the abolition of state guarantees because compared with private banking peers their ability to benefit from growth trends and raise fee or sales income remains underdeveloped. Their more concentrated loan portfolios and generally uniform credit strategies, with a strong focus on large-scale structured finance transactions, asset-based lending, and opportunistic securitized credit investments in the current low credit spread environment make Landesbanks more susceptible to declining corporate credit quality. Relatively low capital ratios, which limit opportunities for organic or external growth, provide relatively smaller buffers against unexpected events, however. (For further information see article " German Landesbanks' Transformation On Track To Become More Resilient," published Aug. 1, 2006.)

Cooperation with associated savings banks still remains underleveraged.

Given that cooperation with their associated savings banks has significantly intensified, but still remains underleveraged, Landesbanks' profitability is expected to grow only gradually from current modest levels. While political interference remains strong, cooperation of Landesbanks across regions is considered an option, reflecting overcapacities and the need to achieve economies of scope and scale.

Cooperative banks and their central institutions: Germany's second-largest banking sector is viewed as a cohesive group based on long-term evidence of strong intragroup solidarity

Strong market position is based on a dense branch network and close integration of specialized entities with supplementary functions.

Standard & Poor's views the German cooperative banking sector as a single economic group based on the sector's system of solidarity and its comprehensive protective scheme, which has prevented insolvencies of member institutions for about 70 years. Local cooperative banks (Volks- und Raiffeisenbanken) are deeply entrenched in their communities, benefit from a loyal customer base, and through their strong retail franchise of about 14,000 outlets they serve more than 15 million members—who are customers and shareholders of local banks. Like savings banks, cooperative banks offer a full range of banking services, but concentrate on retail customers and

small businesses. Consolidation has about halved their number to less than 1,300 (year-end 2005) over the past decade, a development that will likely continue, although at a slower pace.

The two central institutions— DZ BANK AG Deutsche Zentral-Genossenschaftsbank (A+/Stable/A-1) and WGZ Bank (not rated)—act as wholesale commercial banks and provide services that cannot be carried out by the independent cooperative banks, including payment and foreign transactions, securities business, technological support, and advisory functions. As a second merger attempt between the two central banks failed only recently, it will probably take some time before the banks resume negotiations on how to pool resources to raise synergies. Supplemented by specialized entities, such as in the field of insurance, fund management, mortgage banking, and building savings business, the cooperative sector offers a complete range of financial services.

Improvements in the sector's profitability are expected to be sustainable, but level of operating performance will remain modest.

While improvements in the asset quality of the sector in 2006 and further progress in DZ BANK's profitability are expected to be sustainable, the level of operating performance is expected to remain below that of other European retail banks, given that local cooperative banks similar to the savings banks are facing mounting competition from specialized low-cost niche players, which might gradually encroach on their solid market position in traditional core retail deposits and mortgage loans. Increasing pressure on interest margins and securities valuation results, exacerbated by the current environment of rising interest rates and flatter yield curves, should be offset by further growing sales in specialized sector entity products, given that the generally sound cooperation in the sector continues to intensify. Synergies from consolidation at local cooperative banks are filtering through only slowly, however, and may allow no more than a stabilization of costs.

OTHER FINANCIAL INSTITUTIONS

Mortgage banks: Some weaker lenders still struggling to cope with the aftermath of the protracted property market weakness

The amended Covered Bond Act has eliminated former business limitations for Mortgage Banks, but little impact expected.

The German Covered Bond Act (Pfandbriefgesetz), which—amended in July 2005—governs the issuance of Pfandbriefe of both private and public sector banks, is aimed at keeping Germany well positioned within the highly competitive and further growing European Covered Bond family. The 24 mortgage banks have now been issued general banking licenses, while in turn the privilege to issue Pfandbriefe has been extended to all German banks—provided that minimum criteria are met. The implications of the legislative changes on mortgage banks' profiles have been minimal and new covered bond issuers have been scarce. The Covered Bond Act has not affected the ratings on Pfandbriefe, as it continues to allow Standard & Poor's to assign ratings "de-linked" from an issuer's rating, provided that the qualities of the cover pool and cash flows remain sufficient in a stressed environment to service principal and interest in a timely manner despite the insolvency of the issuer.

Improved risk management and recovering domestic property markets provide basis for brighter profitability prospects.

Some weaker mortgage lenders are still struggling to overcome the protracted period of mediocre performance since the millennium, when weak real estate markets particularly in eastern Germany, fierce competition, and a challenging interest rate environment for often sizable treasury operations adversely affected profitability. More favorable margin and risk profiles from expanded foreign operations, enhanced risk management, and better risk-adjusted pricing in recovering domestic property markets should allow further improving performance from still overall moderate levels. The prospects for purely treasury driven public finance business remain dim in times of rising yields and a flattening yield curve, however.

Building savings banks (Bausparkassen): Difficult operating environment in the protracted low interest rate environment

Sophisticated management of the trade-off between profitability and liquidity requirements necessary.

The 26 building savings banks, 11 of which are public law institutions, offer medium-term and interim homeowner financing. The market is highly regulated, given that numerous options embedded in the Bauspar product make the trade-off between profitability and liquidity management difficult to manage—particularly in the protracted low interest environment. While competition is intense as products are relatively standardized, the Bauspar product is to a certain degree dependent on tax incentives for both Bauspar depositors and homeownership, which due to cuts in subsidies in recent years has prompted significant fluctuations in new business volumes.

Some weaker institutions still suffer from unsound tariff structures.

Aggressive sales of imprudently calculated Bauspar tariffs proved to be costly management failures for some institutions, as they were based on the expectation of rising interest rates. These tariffs—under which these institutions were obliged to pay attractive rates on Bauspar deposits, but were also required to offer credit conditions above market rates, deterring customers to apply for Bauspar loans—have substantially squeezed margins and put earnings under severe pressure over the past few years. Tariff adjustments with lower deposit and loan rates and the generally rising interest rate trend will only gradually help to close the gap between expensive funding costs but lower-than-expected return on alternative assets other than Bauspar loans.

Investment funds: Disappointing sales performance in 2006 despite need to raise savings in long-term instruments for pensions

At Dec. 31, 2006, total domestic assets managed by investments funds (Kapitalanlagegesellschaften), which are classed as banks according to the German Banking Act, amounted to €1.03 trillion up from €0.98 trillion in 2005 in about 5,900 individual funds. Business volume with retail customers (public funds amounting to €0.35 trillion) was virtually stagnant, however, reflecting large outflows from real estate and fixed-income funds. In contrast, major banks with significant investment banking business could offset the relative weakness of investment funds, with soaring sales volumes of competing yet high margin certificate products to the upper end of their private investor clientele. Moreover, these institutions have benefited from closer ties to institutional funds' investors, where new business increased substantially in 2006.

Open-ended real estate mutual funds, which became very popular after the equity bubble burst, again experienced very sizable outflows in 2006 owing to uncertain performance prospects. Many were able, however, to use recovering property values to sell significant portions of their domestic assets and to report positive investment returns despite remaining needs for value adjustments.

Banks with special functions: State guaranteed due to specific public policy roles

Banks with special functions—such as: KfW (AAA/Stable/A-1+), L-Bank (AA/Stable/A-1+), and NRW.BANK (AA-/Stable/A-1+)—are essentially public sector development banks. As they fulfill a specific public policy role, these banks continue to benefit from state guarantees, but must refrain from competition with unguaranteed institutions.

D. Regulatory Environment

Germany classified in the "Supportive" category

Like most mature market economies, Germany is classified as supportive by Standard & Poor's. The credit ratings in supportive countries usually receive no uplift due to potential extraordinary future external government support over the stand-alone rating, but integrate important ongoing systemic elements. Despite this, Standard & Poor's factors in government support into credit ratings on some German banks to the extent ongoing support is likely to reduce their default probability. Examples are the two rated state-guaranteed policy banks and the formerly state-guaranteed Landesbanks.

Standard & Poor's is confident that the regulatory environment in Germany—in connection with deposit-insurance systems—is suitable to safeguard the stability of the banking sector in general and to resolve smaller problems that might arise at individual banks. If an institution's potential financial problems were capable of leading to a systemic crisis and possibly endangering domestic payment systems, the federal government has the power to impose a payment moratorium, prohibit insolvency proceedings, and temporarily close the institution's customer business. Regulators have demonstrated that they are prepared to let less important banks fail, however.

Quality of regulation and crisis management: Adequate supervision to cope with major problems

German regulators move toward a more proactive approach in monitoring banks.

The quality of supervision by German regulators is adequate, but responses to major issues sometimes appear to come late, as highlighted by severe asset quality problems at institutions, such as Bankgesellschaft Berlin and SchmidtBank, as well as to some mortgage banks' excessive market risk taking. Coping with the workload from the high number of individual institutions, and the implementation of Basel II remain challenging tasks for regulators. This is mitigated by the fact that the various associations of the savings and the cooperative banks coordinate and support implementation of regulatory changes, and that problems have regularly been solved within the respective sectors. Overall, it seems that following the creation of the German Financial Supervisory Authority (BaFin) in 2002 as the sole regulator for all financial services in Germany, regulators are moving toward a more proactive approach in monitoring the performances of banks.

BaFin has significant powers to take preventive action in times of stress.

The BaFin is equipped with significant power to take preventive action in times of stress at individual institutions. Actions as in the case of Allgemeine Hypothekenbank Rheinboden AG (AHBR; BB/Negative/B) have demonstrated that it is increasingly willing to use these powers.

Regulatory power to prevent a crisis at an individual institution include the ability to:

Revoke an institution or management's license and enforce orders to an institution's management if the institution's ability to meet its obligations is jeopardized, for example if it incurs losses of more than 50% of its regulatory capital or has lost more than 10% of its regulatory capital in each of three consecutive years.

- Request information from and inspect an institution any time at its discretion.
- Participate in board meetings.
- Prohibit dividend payments and new lending in times of stressed liquidity or solvency.
- Close an institution temporarily to avoid insolvency.

Primary goal of supervision is to safeguard the viability of the banking industry by protecting creditors.

The regulatory and supervisory structure in Germany is conducted by the BaFin as the primary supervisor sharing certain responsibilities with Deutsche Bundesbank. The legal basis for banking supervision is the German Banking Act (KWG), which covers nearly all kinds of financial services that are offered commercially. The KWG is aimed at safeguarding the viability of the banking industry by protecting creditors and regulates, for example, capital and liquidity requirements; surveillance of the lending business; information requirements and audits; licensing; and enforceability and sanctions. Supplementary laws are notably the Covered Bond Act, the Building Savings Banks Act, and the Investment Companies Act.

Statutory capital requirements sometimes differ from international rules.

Banks are generally required to meet the capital requirements according to the KWG, while only internationally operating banks also need to meet the Bank for International Settlements (BIS) guidelines. A major difference is the different treatment of mortgage loans with LTV ratios of up to 60% (always 50% weighting under German regulations; BIS rules: 100% to commercial, 50% to residential property loans). Goodwill, in contrast to BIS rules, is not immediately deducted from capital in full, but with linearly increasing amounts after 10 years. Furthermore, capital consolidation for groups follows rules that are different from accounting standards. Capital requirements are about to change significantly with the new Basel II regime that banks have started implementing since the beginning of 2007. The most recent impact study indicates that capital requirements could decline by about 7%, which is somewhat below the EU average, with the smaller retail-oriented banks benefiting most. The favorable credit cycle and ongoing refinements in the banks' approaches might further reduce capital needs of the largest banks, which opted to apply advanced approaches in 2008. Furthermore, since January 2007, the computation of regulatory capital ratios for banking groups reporting under IFRS is no longer based on German GAAP.

With increasing regulatory approval of hybrid capital instruments as Tier 1 capital, the use of these instruments has grown enormously over the past years, especially because distributions are

tax deductible. Since October 1998, the BIS rules limit the inclusion of dated hybrid instruments into Tier 1 to a maximum of 15% of Tier 1 capital. Outstanding issues were grandfathered, however. German regulators have not officially limited the use of these instruments. Standard & Poor's considers that hybrid capital instruments represent lower quality capital, but considers certain instruments in its capital analysis.

Deposit protection systems: Stabilizing factors to the banking system

The deposit insurance systems have historically allowed the problems of bank failures to be solved satisfactorily.

Standard & Poor's regards the three deposit insurance systems—administered by the banking associations of the three major banking sectors—as stabilizing factors to the banking system. All of these deposit insurance systems have the power to intervene to resolve a member bank's difficulties, and historically have generally allowed an orderly wind-down or restructuring of any failed institution. Moreover, the deposit-insurance systems and the statutory deposit protection system give savers a high degree of confidence, helping to avoid a general run on bank deposits.

None of the protection systems would intervene in the event of a general banking crisis, however, and regulators are not responsible for any shortfalls. In addition, investors holding commercial bonds would not be covered and might suffer in a bank's debt restructuring even if the bank is rescued. This is particularly the case for holders of hybrid capital instruments, as recently evidenced at the restructuring of AHBR. Only the commercial bank deposit-insurance system sector directly protects deposits, whereas the savings bank sector and cooperative sector's insurance systems are aimed at protecting the solvency of member institutions and therefore indirectly protect bondholders as well. All of them might—at the least—experience timeliness problems, however, if the resources of several larger members were stressed simultaneously. In recent years, savings banks and their Landesbanks have established four regional supplementary protection systems, which are also limited in size but are legally enforceable and directly protect deposits and senior debt.

Deposit protection schemes are important factors in the ratings on some banks, notably the ratings on members of the cooperative banking sector, and the ratings on four Landesbanks, namely Landesbank Hessen-Thüringen Girozentrale, WestLB AG (A-/Stable/A-2), Bayerische Landesbank (A/Stable/A-1) and Norddeutsche Landesbank Girozentrale (A/Stable/A-1). We consider protection schemes as important, but only one element in the assessment of banking groups, however, with the level of cooperation, integration, and solidarity considered equally important factors.

Private sector banks

The "Einlagensicherungsfonds" of the private banks grants relatively high protection for individual banks' depositors, but timeliness of payment is not guaranteed. In the case of AHBR, member banks on behalf of the fund provided a temporary liquidity shield, which helped to ensure ongoing payments on deposits and unsecured and subordinated debt, whereas holders of hybrid capital suffered losses. Standard & Poor's believes that in this particular case safeguarding the reputation of the Pfandbriefe market was the overriding concern both for the fund and for regulators, however. Nonsecuritized deposits (mainly sight, time, and savings deposits, but also bonds in registered form) are protected for up to 30% of a bank's liable capital (as defined in Section 10[2] of the KWG, with prudential supplementary capital only included up to 25% of the core capital) per customer if the customer is a nonbank. Nonbanks are defined as individuals, corporations, and

deposits of a capital investment company, or a trust bank if these deposits form part of a fund. It is uncertain whether the protection scheme could provide such comprehensive protection in times of stress of a large institution, however.

Savings banks sector

Protection schemes have gained increasing importance due to the abolition of state guarantees. The protective scheme of the savings bank sector consists of 12 regional savings banks' guarantee funds, the guarantee fund of the Landesbanks, and the fund of the building savings banks. These funds jointly aim to protect the solvency of those institutions, but banks or creditors have no legal claim against the funds, which handle each case at their own discretion.

The scheme was strengthened in 2004 by increasing the amount available in times of stress and by improving the monitoring of member institutions. The amendments, however, do not sufficiently address our concerns about the ongoing solidarity within the sector across regions. Considering the conflicting interests of the Landesbanks' owners and the varying financial profiles of individual Landesbanks, we continue to believe that stronger cooperation and integration between Landesbanks and savings banks is more likely to be achieved within a region.

Separate regional protective schemes on top of the federal protection scheme have already been put into place in four regions—Hesse-Thuringia, North-Rhine Westphalia, Bavaria, and Lower Saxony—and have been complemented by comprehensive cooperation agreements. These regional schemes are limited in their amount, but grant investors a direct claim on the fund (excluding investors in instruments, which qualify as regulatory capital). In our view, such systems are further strengthening the existing ties between Landesbanks and their respective owner savings banks.

Cooperative banking sector

The ratings on the 1,200 plus local banks and specialized financial service providers of Germany's cooperative banking sector are based on the banks' solid integration into the sector, and their membership in the sector's comprehensive protection scheme. The scheme is designed to protect the solvency of its member institutions and has prevented bankruptcies of individual member banks for about 70 years, although member banks or investors have no legal claim on the protective scheme. Creditors and owners have not incurred any losses to date.

E. Accounting Policies

Statutory accounting rules tend to prevent investors from gaining insight into critical areas

The lack of transparency in German bank accounting has been an area of dissatisfaction, as disclosure according to statutory accounting rules falls short of that of many international peers. In particular, limited financial disclosure, the use of taxed hidden reserves, and the netting of certain items prevents investors from gaining insight into critical areas like asset quality or capitalization, and allows German banks to smoothen reported profits. Moreover, we believe that the weak performance of German banks have undermined once conservative accounting practices. These were the result of creditor protection as the overriding principle in German accounting, and mitigated the limited and flexible disclosure in the past.

Competition for international funds and increasing pressure from shareholders have forced banks to improve their level of disclosure. Some commercial banks, including the "Big Five", have reported their results in line with IFRS (Deutsche Bank: U.S. GAAP) for years.

Transition to IFRS to be completed with reporting on 2007 results

EU regulation calls for compulsory reporting of consolidated accounts under IFRS from 2005 onward for companies with listed equity. Germany has extended this deadline to 2007 for banks that only have debt instruments quoted on an exchange or report under U.S. GAAP. Therefore, larger financial institutions with listed debt outstanding will report either mid-year or full-year 2007 financial statements under IFRS for the first time, whereas the majority of German banks, mainly savings and cooperative banks, will continue to report under local GAAP. Among the banks rated by Standard & Poor's, the transition will mainly affect the German Landesbanks as the large rated private banks have already adopted IFRS some years ago. This trend toward more transparency is welcomed by Standard & Poor's, although IFRS generally leads to a more volatile earnings performance compared with German accounting standards. For more information on the impact of transition to IFRS on major Western European Banks see Standard & Poor's analysis "How IFRS Transition Affected the Financial Disclosure of Major Western European Banks," published on Jan. 23, 2007, on RatingsDirect.

The most important differences between German accounting and IFRS affect the following areas:

Risk provisions

The almost complete lack of meaningful insight into German banks' asset quality and provisioning policy has always been criticized. Banks are allowed to offset the net evaluation result of their liquidity portfolio securities (all securities that are not classified as trading or investment securities) with the evaluation of their credit risks and taxed general reserves (table 4 details the various items, which banks can net within the single line item "risk provisions"). This makes it difficult to interpret the resulting net figure for risk provisions, as comparisons over time or between banks can sometimes be misleading. German banks are not required to report their credit losses, nor the level of risk provisions or NPLs.

In the past, German banks often used this flexibility to build or release risk provisions in the absence of strict guidelines to smooth earnings. Since 1999, however, certain excessive risk provisions are no longer accepted by the tax authorities. Furthermore, banks are required to acknowledge the appreciation of loans and securities if the reason for the provision ceases to exist.

Table 5

Risk Provisions According To German Accounting Rules

Credit risks	*Liquidity security portfolio*
Gross new specific provision for credit or off-balance sheet risks	Realized losses
Direct write-offs	Write-downs (unrealized losses)
Increase of taxed hidden reserves	Increase of taxed hidden reserves
Increase of untaxed general reserves	Increase of untaxed general reserves
can be compensated with (only in full)	can be compensated with (only in full)
Release of specific provision for credit or off-balance sheet risks	Realized gains (NOT: Unrealized gains)
Release of taxed hidden reserves	Income from write-backs
Release of untaxed general reserves	Release of taxed hidden reserves
Recoveries of loans written-off in earlier years	Release of untaxed general reserves

Table 5

Risk Provisions According To German Accounting Rules (cont.'d)	
Credit risks	*Liquidity security portfolio*
Income from write-back of loans	
= Evaluation of credit risks	= Evaluation of liquidity security portfolio
Cross-compensation of both evaluations allowed (only in full)	Cross-compensation of both evaluations allowed (only in full)
Risk provisions (Risikovorsorge) according to German accounting rules	Risk provisions (Risikovorsorge) according to German accounting rules

Loan classification

In contrast to many other countries, there are currently no mandatory regulatory requirements regarding LLPs in Germany and there are no universally valid classifications of NPLs, loans past due, or restructured loans. Regarding specific provisions, the somewhat vague guidelines state that doubtful debts are to be shown at their realizable value and that bad debts must be written off. However, it is at the discretion of banks and their auditors to decide when a loan becomes doubtful. The tax authorities decide each case on its own merit.

One reason for this somewhat "lax" approach is that historically, German banks generally applied conservative provisioning policies, thus understating their profits. In recent years, the difficult domestic credit environment, pressure on margins, shareholder value considerations, as well as tax regulations have reduced the banks' ability and willingness to apply cautious provisioning. During the long-lasting downturn of domestic real estate markets, banks and auditors have often relied too heavily and too long on the property (that is, the collateral) and less on the cash flows, the tenants, and the borrower, and have therefore failed to fully reflect the significant deterioration in the value or, even worse, illiquidity of the underlying collateral. As a consequence, the legacy of underprovisioned real estate loan portfolios has been a strain on profitability for many years. We believe that stricter rules on risk provisions and valuation of collateral, combined with an improved level of transparency could help to detect problems at an earlier stage. The introduction of the new regulatory minimum requirements for risk management is expected to improve the quality of risk policies, methodologies, and supervision. By contrast IFRS sets out strict rules for loan provisioning.

Trading activities

The accounting of a bank's trading activities principally requires profits to be booked only when they have been realized. For unrealized losses, the prudence concept requires immediate write-downs on the position unless the netting of unrealized losses and profits within a specified portfolio, including derivatives for hedging purposes, is accepted. Although strictly speaking unrealized profits must not be taken into consideration, many of the large banks recognize unrealized profits after certain deductions for the value-at-risk of the portfolio. The practice is inconsistent within the industry, however, which makes comparisons more difficult. Interest income, dividends, and funding costs of the trading portfolio are recorded under net interest income instead of trading income. Owing to the mark-to-market principle under IFRS, the volatility of trading results is generally significantly higher.

Securities portfolio

German accounting rules differentiate between three types of securities: trading, liquidity, and investment securities. Trading securities and liquidity securities have to be valued at the lower of cost or market, whereas investment securities are valued at cost and only below cost if a loss of value is considered permanent. The classification is, to a certain degree, at the discretion of management.

Hidden reserves

German banks may smooth earnings in a volatile environment by building or releasing hidden reserves. According to Section 340f of the German Commercial Code (HGB), banks are allowed to create undisclosed hidden reserves of up to 4% of certain assets—that is loans to customers and banks and liquidity securities. In addition, banks can build a Fund for General Banking Risks according to Section 340g of the HGB, which is recorded as a liability. Allocations and releases of both types of reserves affect the profit and loss statement. Although essentially the same as reserves according to Section 340f (both are taxed and are fully available to absorb losses), only S.340g reserves are accepted as Tier 1 capital (S.340f reserves only as Tier 2) to encourage banks to disclose their reserves. Standard & Poor's gives full credit for S.340f hidden reserves in its calculation of a bank's core capital. Hidden reserves are not permitted under IFRS.

VALUATION OF OTHER BALANCE SHEET ITEMS

Goodwill

German banks have various options on how to treat goodwill. Accounting standards allow the profit and loss neutral deduction from equity, regular amortization over the expected useful life of the intangible asset, and a mixture of both. Under IFRS goodwill amortization is not permitted, instead annual impairment tests are required. Standard & Poor's deducts goodwill and intangibles from its calculation of a bank's adjusted common equity.

Pensions and other postretirement benefits

Strongly influenced by tax considerations, German accounting rules significantly understate pension liabilities and related expenses in profit and loss accounts in the current low yield environment. This is because, for example, future increases in salaries and retirement benefits are not taken into account, while a fixed discount factor (6%) for measuring future obligations is used, irrespective of actual market yields. In the meantime, many banks have reduced their discount factors to varying degrees to better reflect the real nature of pension liabilities. As we view pension deficits as debt like, Standard & Poor's adjusts equity to include unrecognized amounts, net of tax, if the bank's pension plan overall is in deficit. IFRS has detailed rules for the measurement of postretirement benefits. Standard & Poor's has carried out a detailed study of the pension obligations of Western European banks including German Banks, for details see article "Accounting For Defined-Benefit Pension Obligations: Past Promises Return to Haunt Western European Banks," published on Nov. 10, 2006, on RatingsDirect.

Other differences exist in the areas of:

Broader scope of full consolidation under IFRS of controlled entities such as banks' own special investment funds or special purpose vehicles.

- Increased recognition of deferred tax assets and liabilities under IFRS, based on the broader temporary difference concept in contrast to the more narrow deferral/timing difference concept under German GAAP.
- Stricter limitations on the formation of provisions for future expenses under IFRS (for example, restructuring expenses).
- Specific rules on hedge accounting under IAS 39; all derivatives are brought on balance sheet and changes in their fair value are normally included in earnings immediately, whereas fair value changes of cash flow hedges are reflected in equity if hedge accounting rules apply.
- The generally considerably more detailed footnote disclosure under IFRS.

Appendix: Basic Data: German Banking System

Number of banks

At Nov. 30, 2006, there were 2,047 authorized banks and building savings banks in Germany, including 1,257 local cooperative banks and 457 savings banks. German banks' international networks comprise 303 subsidiaries in other countries. There are 139 banks in Germany with foreign bank ownership.

System deposits

German residents' total deposits (enterprises and private individuals excluding public sector) amounted to €2,260 billion at Dec. 31, 2006.

Deposits per capita

€27,400 at Dec. 31, 2006.

Form of regulation

The responsibilities for bank regulation and supervision are shared between the German Financial Supervisory Authority (BaFin) and the German Central Bank (Deutsche Bundesbank). Although BaFin is the primary bank regulatory and supervisory authority, it works closely with the central bank. The two are considered partners in the formulation of regulatory and supervisory policies. In Germany, external auditors perform the examination function through various audits. All banks licensed in Germany, with the exception of banks domiciled in the EU, must be audited annually. Detailed reports and information must be submitted to regulators.

On May 1, 2002, the BaFin became the sole state regulator for all financial services in Germany, when the functions of the former offices for banking supervision (BaKred), insurance supervision (BaV), and securities supervision (BaWe) were combined.

The BaFin supervises banks under the German Banking Act (KWG) and several supplementary laws, notably the Covered Bond Act, the Building Savings Bank Act, and the Investment Companies Act. Following the sixth amendment of the KWG, nearly every type of financial service that is offered commercially must be approved by the BaFin and subsequently regulated.

Bank Superintendent

President of the BaFin is Mr. Jochen Sanio, who had been appointed President of the former Federal Banking Supervisory Office (BaKred) in 2000.

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