NORD/LB capital plan rests on ECB patience and State aid investigation

NORD/LB's decision to pursue a public-sector solution as its primary option was not a major surprise. Resolution under the BRRD is off the table, unless the European Commission demands punitive remedies to keep the plan within State aid rules.

NORD/LB is working with the Savings Banks Association (DSGV), banking supervisor BaFin and the European Commission to clarify outstanding issues quickly, but major hurdles need to be overcome. The bank received a green light from the State of Lower Saxony cabinet for the State's EUR 1.5bn capital injection. Getting it through the ECB, and clearing Commission rules on State aid will be more difficult and will take months.

In the interim, BaFin has effectively given a nod to allow the bank to operate on a CET1 ratio of 6%-6.5%, i.e. well below its 10.5% regulatory minimum. NORD/LB will not pay coupons on outstanding AT1s – the next payments are scheduled for June – but expects to have its recap concluded by the end of September. The EC's assessment of NORD/LB's business plan will be a critical element of the process.

The current plan foresees the savings banks injecting EUR 1.2bn of capital (EUR 400m from savings bank shareholders and EUR 800m from the DSGV's central back-up funds) on top of the State of Lower Saxony's EUR 1.5bn. The bank may also benefit from state guarantees on certain parts of the loan book, notably to assist the transfer of parts of the shipping book to a bad bank instead of an outright sale.

The big question is whether the Commission will accept that the savings banks' investment meets the private investor test. While the savings banks are raising the funds from their own reserves, they are public-law institutions that consider their cost of capital to be lower than the market.

Key precedents here are the contributions by Italy's deposit insurance fund to support bank rescues in Italy, and the Portuguese government's recapitalisation of 100% State-owned Caixa Geral de Depositos; neither of which were considered to have infringed State aid rules. Any additional state guarantees for specific assets would have to be priced at an arm's length basis to avoid EU scrutiny, which in the past has proved to be very costly for NORD/LB.

On economics, the public-sector solution for NORD/LB is likely to turn out cheaper than either sale to private equity or resolution. And politically more palatable: the private equity transaction will result in a lower up-front cash outlay – just EUR 600m for just shy of half the ownership of the bank – but higher guarantees. The private equity bid, incidentally, is good until March 21.

"[The private equity solution] will leave most of the upside with the private investors while the downside will be borne by the state owners, *inter alia* via funding guarantees through the public sector support mechanism. Resolution is likely to be equally costly and will hit the savings banks much harder, without generating any going-concern value," said Dierk Brandenburg, executive director in the banks team of Scope Ratings.

In fact, the very act of providing State guarantees on funding under the private capital solution will draw scrutiny from the Commission. That would appear to undermine the rationale for a private capital solution, which was to avoid such scrutiny in the first place.

Author

Keith Mullin
k.mullin@scopegroup.com

Analyst

Dierk Brandenburg
d.brandenburg@scoperatings.com

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Time running short for NORD/LB
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Scope Ratings GmbH

Suite 301
2 Angel Square
London EC1V 1NY

Phone +44 20 3457 0444

Headquarters

Lennéstraße 5
10785 Berlin

Phone +49 30 27891 0
Fax +49 30 27891 100

info@scoperatings.com
www.scoperatings.com

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Added benefits

The public solution has benefits beyond the capital injections and guarantees: the added strategic advantage of enabling potential mergers in the future within Germany's public-sector bank segment. "Politically this is a big victory for the DSGV, which will push hard to make this the first step in further Landesbank/Sparkassen consolidation. The State of Lower Saxony, which will initially keep control of NORD/LB, has also made it clear that it is open for further consolidation within the public bank sector," said Brandenburg, notwithstanding strong opposition likely from the Landesbanks in southern Germany.

NORD/LB's recap plan contains a significant restructuring element that foresees a sharp reduction of the balance sheet through a combination of asset sales, business closures and divestments of major subsidiaries. The latter could include the retail business BLSK, Deutsche Hyp or NORD/LB Luxembourg. "The target is to reduce the balance sheet to below EUR 100bn and lift the CET1 ratio to 14%. This is not that different from the private equity plan, though the pace of restructuring and job cuts is likely to be much slower. So far, management has announced 1,250 job losses out to 2020 but the number will go up significantly," Brandenburg noted.

Shipping offloads

NORD/LB's shipping exposure remains in the spotlight. Some 68.5% of its EUR 10.8bn exposure (as of end-September 2018) was non-performing, with coverage at 43%. Unreserved shipping loans represent 75% of CET1 capital. Other areas of the loan portfolio such as aircraft (EUR 6bn) also require attention. All-in, NORD/LB lists EUR 10bn (5.8%) of assets as below satisfactory and a further EUR 4bn (2.3%) at the bottom of its satisfactory category.

The bank is working to offload its shipping exposure and reduce its non-performing shipping loans to zero. Management is in exclusive discussions with Cerberus over the sale of portfolios with a face value of EUR 6.5bn. The initial EUR 2.5bn 'Big Ben' tranche closed in January. The rest ('Tower Bridge') will take longer, although a decision on a sale is expected soon. The goal is to exit all shipping NPLs by the end of 2019, either through a sale or, possibly, a guarantee scheme.

Capital waiver

Since the mark-to-market value of the loans – 57% as of Q3 2018 – is significantly below their book value, Nord LB will crystallise significant losses upon exit. The additional EUR 2.5bn in provisions the bank announced will cover the losses and take coverage of the entire shipping NPL book to 80%.

"This is higher than expected and demonstrates that the bank is serious about exiting the business," Brandenburg noted. "Following the sale of the shipping NPLs, NORD/LB's NPL ratio drops to around 1%. However, Scope estimates the bank has had an NPL ratio of around 6% on average over the past 13 years, so a 1% ratio may not be representative for the business going forward."

In light of the Q4 loss that will take full-year losses to EUR 2.7bn, management expects the CET1 ratio to fall to 6%-6.5% at year-end, significantly below its regulatory minimum of 10.5%. The ECB/SSM have given a waiver, subject to the bank presenting a recapitalisation plan by the end of the month.

Scope Ratings GmbH

Headquarters Berlin

Lennéstraße 5
D-10785 Berlin

Phone +49 30 27891 0

Frankfurt am Main

Neue Mainzer Straße 66-68
D-60311 Frankfurt am Main

Phone +49 69 66 77 389 0

Paris

1 Cour du Havre
F-75008 Paris

Phone +33 1 8288 5557

London

Suite 301
2 Angel Square
London EC1V 1NY

Phone +44 20 3457 0444

Madrid

Paseo de la Castellana 95
Edificio Torre Europa
E-28046 Madrid

Phone +34 914 186 973

Milan

Via Paleocapa 7
IT-20121 Milan

Phone +39 02 30315 814

Oslo

Haakon VII's gate 6
N-0161 Oslo

Phone +47 21 62 31 42

info@scoperatings.com
www.scoperatings.com

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