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Wealth Management Research

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Corporate bonds

Germany: Landesbanken in transition

- The Landesbanken's search for a sustainable business profile without state support has been going on for years. In this report, we discuss the latest developments on the support mechanism, regulatory aspects, and the treatment of "silent participations."
- We analyze selected issuers and initiate coverage on Erste Abwicklungsanstalt (EEA), WestLB's bad bank.
- We recommend avoiding positions in WestLB and HSH Nordbank.

Related WMR publications

Understanding CoCo bonds	28.10.2010
Subordinated Bank bonds shine in light of Basel 3	16.09.2010
Basel 3 or when the regulatory curtains go up	14.09.2010
Basel 3 - regulation in motion	10.08.2010
Subordinated Bank bonds regain appeal	03.08.2010
Banks review and outlook	06.07.2010

Issuers covered in this report

Issuer	Moody's	S&P	Fitch
BAYERNLB	A1 stable		A+ Watch -
BREMER LANDESBANK	Aa2 neg		A stable
DEKABANK	Aa2 stable	A stable	
EAA	Aa1 stable	AA- stable	AAA stable
EAA Covered Bond Bank	*Aa1 stable*	*AA- stable*	
HELABA	Aa2 stable	A stable	A+ stable
HSH NORDBANK	A3 neg		A- Watch -
LANDESBANK BERLIN	A1 stable		AA- stable
LBBW	Aa2 neg		A+ stable
NORDLB	Aa2 neg	A- neg	A stable
WESTDT IMMOBILIEN BANK		BBB+ neg	
WESTLB	A3 neg	BBB+ neg	A- Watch -

Source: UBS WMR; rating agencies

In search of a future

Landesbanken reform has recently been under heavy and very public discussion in Germany. The Landesbanken's search for a sustainable business profile without state support has been going on for years.

The business model of the Landesbanken – German public-sector banks – is subject to fundamental changes as they are overly reliant on the fee-generating but highly cyclical investment banking business, while their high cost base leaves them vulnerable. They are characterized by comparatively weak credit profiles, and their profitability and capitalization metrics have historically remained below the European average.

In this report, we discuss the progress of their reorganization and their future strategies. We also offer some thoughts on consolidation.

Support – systemic or direct government

In total assets, the Landesbanken are assumed to be of sufficient size to trigger government or systemic support. The key to safeguarding the system against shocks has always been the availability of cross-sector support mechanisms that are partly pre-funded, as well as support from regional and local governments and – only as a last resort – the federal government (see Appendix, Table 6 for details).

Regardless of whether a Landesbank's owner is a federal state or an association of regional savings banks, these public-sector entities cannot easily withdraw from their responsibility as stakeholders.

Table 1: Support and stabilization measures in figures
in EUR bn

	Federal government (SoFFin)		Regional / Local government		Cooperative associations
	Liquity Guarantees	Capital injections (hybrid)	Guarantees (Asset protection)	Capital injections (hybrid)	Guarantees / hybrid capital
Aareal Bank AG	4.0	0.4*			
BayernLB	5.0		4.8	10	
Commerzbank AG	5.0	18.2			
Corealcredit Bank AG	0.5				
Deutsche Apotheker- und Ärztebank eG					0.2
Deutsche Pfandbriefbank AG / Hypo Real Estate Holding	124.0	7.7			
Düsseldorfer Hypothekenbank AG	2.4				
DZ Bank AG					1.1
HSH Nordbank AG	17.0		10	3	
IKB Deutsche Industriebank AG	10.0				
Landesbank Baden-Wuerttemberg (LBBW)			12.7	5	
Sicherungseinrichtungsgesellschaft deutscher Banken	6.7				
Sparkasse Köln/Bonn				0.35	0.3
WestLB / EAA Erste Abwicklungsanstalt		3.0	8.5		5.5
	174.6	**28.9**	**36.0**	**18.4**	**7.1**

Sources: UBS WMR; Moody's; * Aareal returned hybrid capital in July 2010

In some cases, public-sector owners readily provided assistance without the involvement of the central government. For a few of the Landesbanken, support measures have been so extensive that those providing support have stretched their own finances such that any further substantive aid would compromise their risk profiles. Thus, we are concerned that further support is becoming less likely for the Landesbanken (HSHN/WestLB). The German federal states have committed to a complete reorganization of the sector by 2011. In return, the government would help resolve their most burdensome problems of illiquid or toxic structured assets and problematic or high-risk business.

Approval by the European Commission (EC) for state aid typically requires targeted restructuring measures such as downsizing of international operations, cost-cutting, divestment of participations, and changes to the business model (BayernLB, HSH Nordbank and WestLB; LBBW is already approved).

We do not foresee a general weakening of Germany's important support mechanisms. We also believe any withdrawal of systemic support will not go so far as to compromise financial stability in Germany.

Regulatory aspects
Earlier this year, the federal parliament recently passed a law allowing German banks to transfer non-strategic assets and deteriorating securitization investments to individual run-off institutions. This is an important de-risking step that allows the banks to focus on their key challenges.

The German restructuring law is expected to come into force at year-end retrospectively (without any grandfathering). The law is intended to stipulate the orderly restructuring and liquidation of banks. It also

Table 2: Details of the restructuring law

- Considering the final draft, the main issues of the restructuring law will be the following:
- Introduction of a banking levy for German banks to finance a restructuring fund. It will be managed by the Federal Agency for Financial Market Stabilization (FSMA) and will take over the role of SoFFin, the bank rescue fund established in 2008.
- The restructuring fund will be raised over time up to EUR 70bn and can, among others:
  - launch a bridge institution and inject share capital
  - provide liability guarantees
  - inject capital
  - take over measures to stabilize the market.
- Introduction of three different levels of restructuring procedures (see below)

Source: UBS WMR; BMF; RBS

covers the role of participation of losses by ensuring loss absorbency of regulatory capital and senior creditors (in compliance to Basel 3 requirements). For details on the restructuring law, see Tables 2 and 3.

The bailing-in of senior and subordinated debt will hurt German banks and pressure the European Union (EU) and the Basel Committee on Banking Supervision to set stricter rules. German Pfandbriefe are explicitly excluded from these regulations. Consequently, the German Pfandbrief Act will be amended to provide for the preferential treatment of Pfandbriefe creditors.

Stress-testing

In June, the Committee of European Banking Supervisors (CEBS) published the results of the EU-wide stress tests, making transparent the resilience of the European banking system. Overall, the German banks proved robust and resilient relative to the benchmark and the two stress scenarios. (For further details on the stress test, please refer to our 26 July publication, "European stress test – a missed opportunity.") The lack of a banking-book stress-test has put the Landesbanken in a better light. Because the tests only assumed sovereign haircuts for the trading book, the results were not too bad, although we think the capital ratios could be higher (see Fig. 2). Furthermore, the applied critical capital ratio – the decisive factor for passing the stress test – was far too low in our view.

Capitalization and Basel 3 requirements

We highlighted in recent publications that the capitalization of German public-sector banks is well below that of their European peers. Total equity as a percentage of total assets is just below 3%. And while their Tier 1 regulatory capital ratios were beefed up to 10.1% this year from 8% in 2007, this was achieved mostly through fresh government money. These significant capital injections also helped to materially improve their regulatory Tier 1 capital and leverage ratios (LBBW, LBW, HSHN, and WestLB). Considering the future regulatory requirements, the current capitalization levels, in our view, are far too low. (For details on future capital requirements, please see our 14 September publication, "Basel 3 or when the regulatory curtains go up."

As hybrid capital (and silent participations in particular) is not perfectly suited to absorb losses, a bank needs sufficient retained earnings to do so. The decisive factor for loss absorption is the amount of high-quality equity capital – not from a regulatory point of view, but from an economic one. In most cases, hybrid capital is not available to compensate for losses. As such, regardless of a potential transition period, we only focus on high-quality equity Tier 1 capital to evaluate adequate capitalization levels, especially against the background of privatization.

A hot topic: "silent participations"

Considering the tighter capital requirements, what makes the Landesbanken most vulnerable is the treatment of existing silent participations, which form a major part of their current Tier 1 capital. This structure will not meet the eligibility criteria for Tier 1 capital under Basel 3. The regulating authority will implement grandfathering of existing silent participations for a defined timeframe. The following statements from the Basel Committee's update on 12 September are key for this special type of hybrid capital:

Table 3: Levels of German restructuring mechanism

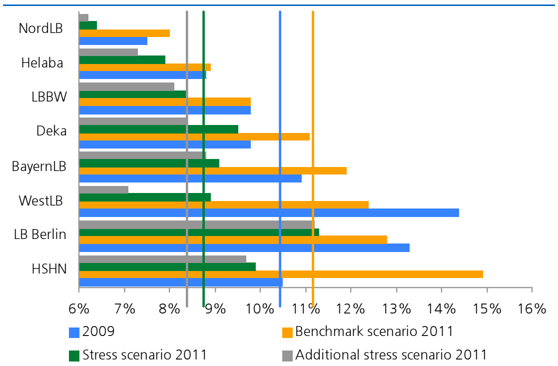
- **Restructuring**
  If a bank cannot meet its regulatory capital/liquidity requirements on a sustained basis, the bank will initiate a restructuring process approved by BAFin. It is an internal process that does not interfere with creditor's rights. Super senior debt is allowed to be raised up to 10% of own regulatory funds ("haftende Eigenmittel").

- **Reorganization**
  If a restructuring has failed or is deemed unsuccessful, the bank will initiate a reorganization process which may include debt-for- equity of subordinated and senior claims. Aside from spinning off assets and liabilities, deferring maturities or applying haircuts of outstanding debt is also a key mechanism.

- **Transfer Order**
  As a measure of last resort, the regulator can mandate a "transfer order" in case the existence of the bank is at risk (Bestandsgefährdung), the default of the respective bank marks a systemic risk to the financial system (Systemgefährdung), or in case there are no other ways to achieve a similar level of system stabilization.

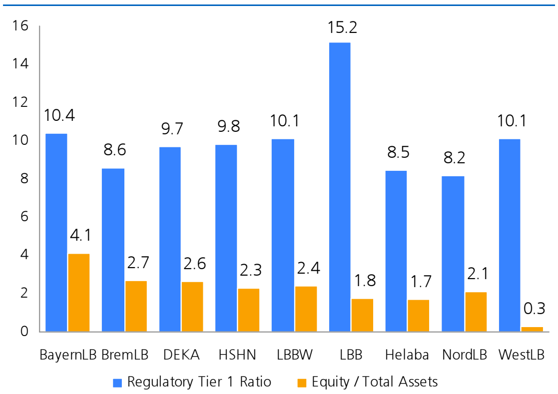
Source: UBS WMR; BMF; RBS

Fig. 1: Stress test results for Landesbanken
Core capital ratio



Source: UBS WMR, Deutsche Bundesbank, as of July 2010

Fig. 2: Capitalization of Landesbanken
in %



Source: UBS WMR, Fitch Ratings, as of 1H 2010

- "Capital instruments that no longer qualify as non-common equity Tier 1 capital or Tier 2 capital will be phased out over a 10-year horizon beginning 1 January 2013. Fixing the base at the nominal amount of such instruments outstanding on 1 January 2013, their recognition will be capped at 90% from 1 January 2013, with the cap reducing by 10 percentage points in each subsequent year. In addition, instruments with an incentive to be redeemed will be phased out at their effective maturity date."

- "Capital instruments that no longer qualify as common equity Tier 1 will be excluded from common equity Tier 1 as of 1 January 2013. However, instruments meeting the following three conditions will be phased out over the same horizon described in the previous bullet point: (1) they are issued by a non-joint stock company; (2) they are treated as equity under the prevailing accounting standards; and (3) they receive unlimited recognition as part of Tier 1 capital under current national banking law."

We view this statement as being tailor-made for the German Landesbanken, savings banks and co-operative banks. According to Germany's association of public-sector banks, there is a nominal volume of EUR 50bn of silent participations that could be "regulated away".

With the exception of joint-stock companies WestLB, HSH Nordbank and LB Berlin, the above statement allows the Landesbanken to keep their existing silent participations as part of their core Tier 1 capital, subject to annual reductions of 10% starting 2013. They are allowed to include these instruments on the condition that they provide a loss absorbing option. Otherwise, either a change of respective contracts will be necessary or the instruments will no longer be eligible for Tier 1 after 2012.

Please see Table 4 for an overview of the grandfathering mechanism of these instruments.

Despite this Germany-specific exception, we think the Landesbanken will find it hard to replace those with common equity to meet the increasing minimum common equity Tier 1 ratio.

For details on the Landesbanken's Tier 1 securities, please refer to our 3 August report, "Subordinated Bank bonds regain appeal."

Future considerations
In our view, pressure on the Landesbanken considering transition arises from either the enhanced capital requirements of Basel 3 or the conditions attached to the government support they received, which include stringent compensation measures, lower targets for total and/or risk-weighted assets, and the sale of subsidiaries and participations. Against this backdrop, we expect the Landenbanken's already weak earnings to suffer further. In our view, only an efficient cash-generative business with higher returns on risk-weighted assets will allow the Landesbanken to beef up their capital or repay the government.

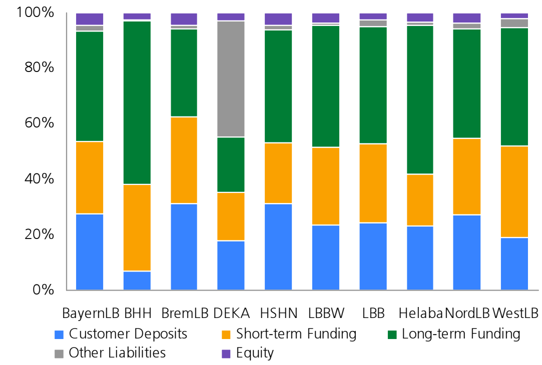
In addition, we consider government intervention to be less supportive of creditors in the future.

Table 4: Proposed treatment of silent participations according to Basel 3

Instrument	Eligibilty	Due date
Silent participations in a joint stock company	Excluded from common equity Tier 1	1 January 2013
Silent participations in a non-joint stock company	1) Phased out over 10 year horizon beginning 2013	1 January 2013
	2) Excluded from common equity Tier 1	1 January 2023
Silent participations provided as government support	Grandfathering / common equity Tier 1	1 January 2018

Source: UBS WMR, BIS

Fig. 3: Funding structure
Share of total assets



Source: UBS WMR, Fitch Ratings, as of H1 2010

To be sure, consolidation is worth consideration. On one hand, the system's main weaknesses – fragmentation, overcapacity and intense competition combined with low risk-adjusted returns and intrinsic balance sheet vulnerabilities – provide the best conditions for consolidation. Cost synergies given their similar business profiles also support the argument for mergers.

On the other hand, consolidation would trigger an even higher risk of systemic concentration. Conflicts of interest could also arise from the likely political battle that would arise over which branches and headcounts would survive.

Because local cooperative and savings banks have shown remarkable resilience, they have not been involved in consolidation discussions. Furthermore, we believe two sick banks do not make a healthy one.

Key challenges

The Landesbanken have shown a rarely profitable wholesale business. Their current restructuring efforts are focused on reducing secondary market investments and foreign operations, but not their domestic banking business. As Germany is overbanked, the system's overcapacities will persist and intensified competition will further increase pressure on margins. We view the transition to Basel 3 particularly challenging due to the Landesbanken's high reliance on hybrid Tier 1 capital.

According to Moody's, there is a political dilemma in consolidating the Landesbanken sector: Most banks are too fragile and not yet ready for a merger, but allowing more time bears the risk of the topic slipping off the agenda.

To conclude, we are in line with the rating agency and expect little progress on consolidation and no notable structural improvements for the next 12 to 18 months. In the following section, we highlight the latest developments on selected issuers.

Spotlight on selected issuers

Table 5: Ratings and credit risk views
Figures in EUR bn, as of June 2010

Issuer	Bloomberg	S&P / Fit / Mdy Outlook	Core Tier 1 ratio** Reg. Tier 1 ratio	Loans / Deposits Total Assets	Maturities '12 Total Bonds***	*Senior*	*Guarantd.*	*Subord.*	*Perpetual*
BayernLB	BYLAN	- / A+ / A1	7.9%	163.2%	53.7		- / AAA / Aaa	n.a. / A * - / A2	n.a. / B- / A2
		- / watch- / stable	10.4%	340.7	141.1				
BayernLabo	BYLABO	AAA / - / -	n.a.	n.a.	0.8		AAA / - / -	n.a.	n.a.
		stable / - / -	n.a.	n.a.	2.1				
Dekabank*	DEKA	A / - / Aa2	11.4%	101.5%	10.4		AA / - / Aaa	n.a.	n.a.
		stable / - / stable	11.9%	133.3	43.7				
HSH Nordbank	HSHN	- / A- / A3	4.6%	209.6%	35.9		- / AAA / Aaa	- / BBB+ * - / Baa1	- / - / Caa1
		- / watch- / neg	9.8%	175.7	71.6				
LBBW	LBBW	- / A+ / Aa2	6.0%	139.7%	92.2		- / AAA / Aaa	n.a.	n.a.
		- / stable / neg	10.1%	417.4	177.7				
LB Berlin	LBBER	- / AA- / A1	n.a.	135.3%	17.7		- / AAA / Aa1	- / A+ / A2	n.a.
		- / stable / stable	8.5%	144.8	45.6				
Berlin-Hannover Hyp	BHH	- / AA- / -	n.a.	765.4%	8.9			n.a.	n.a.
		- / stable / -	7.1%	41.9	19.4				
Landesbank Hessen-Thüringen (HELABA)	HESLAN	A- / A+ / Aa2	4.5%	214.8%	30.4		AA / AAA / Aaa	- / A / Aa3 (LT2)	- / - / Ba1
		neg / stable / stable	8.5%	180.7	75.3				
NordLB	NDB	A- / A / Aa2	4.8%	174.6%	56.4		- / AAA / Aa1	BBB+ / - / -	- / - / Baa2
		neg / stable / neg	8.2%	244.6	161.2				
Bremer Landesbank	BREMLB	- / A / Aa2	5.6%	200.7%	7.6		- / AAA / Aa1	n.a.	n.a.
		- / stable / neg	8.6%	35.1	21.4				
WestLB	WESTLB	BBB+ / A- / A3	0.7%	184.3%	17.1		AA- / AAA / Aa1	n.a.	- / - / Caa1
		neg / watch- / neg	10.1%	251.2	49.0				

Source: UBS WMR, S&P, Fitch, Moody's, company reports. Bond maturities until end of 2012 and total bonds according to Bloomberg excluding certificates and structured notes.
* data reported partially as of Dec 2009 ** Core Tier 1 ratio = Core Tier 1 equity to total assets (according to Fitch ratings). It indicates the amount of high quality capital relative to unweighted assets, whereas the regulatory Tier 1 ratio includes lower quality capital and relates to risk-weighted assets. *** as of July 2010

Helaba has relatively stable financial fundamentals and franchise compared with other banks. Due to its conservative business profile, the bank's comparatively low capitalization level is mitigated.

Dekabank's credit profile benefits from the bank's importance to Germany's savings bank sector and comparatively strong capitalization. Nevertheless, its risk profile is burdened by a large volume of financial liabilities at fair value which include above all negative market values from derivatives and delivery commitments arising from short sales of securities.

As **LBB Group** is owned collectively by all German savings banks, the risk of future losses on the savings bank's Landesbank portfolio remains difficult to quantify. Probable support would be unrestricted if it was ever required, especially given the high integration of **Berlin Hyp** with Landesbank Berlin. **Landesbank Berlin**'s high loan loss provisions lead to sharp profit declines. Its performance will likely remain challenged by its considerable exposure to commercial real estate throughout the next two years. LBB remains especially vulnerable to event risk because its capitalization is only adequate and profitability is low. Berlin Hyp's non-performing loans are largely covered by collateral, which, however, depends on valuation and makes the bank sensitive to market value declines and, to a minor extent, loan loss reserves. Our credit view reflects the bank's focus on and exposure to commercial real estate markets and its concentration risks, as well as a reliance on wholesale funding and exposure to credit spread risks.

LBBW already received the EC state aid approval that requires a total asset reduction of 40% from 2008 to 2013. A mandatory haircut for

WMR assessment of credit risk

Very Low Credit Risk
The bonds are of high to very high credit quality. A default on these bonds is very unlikely in our view.

Medium Credit Risk
The bonds are of medium to slightly weaker credit quality. Although we do not expect multi-notch downgrades or even a default at this stage, we are highlighting the potentially higher spread volatility of these bonds. These instruments should therefore only be held in diversified portfolios of risk tolerant investors.

High Credit Risk
We expect credit losses either as a result of a default of the bonds or as a result of a multi-notch downgrade. Holding these instruments is seen as speculative.

Source: UBS WMR

all deep subs is imposed. The focus will be on client-driven business including capital market products. Furthermore, the bank should be converted into a joint-stock company by 2013.

NordLB and **BremerLB** have weathered the financial crisis relatively well. NordLB is well-capitalized in the context of its risk profile, despite the adverse trend in the credit cycle, and thus we consider the bank to be well positioned. Its current capital levels and conservative risk management should help NordLB withstand continued pressure on earnings and capital driven by considerable levels of loan losses on its shipping, commercial real estate and corporate portfolios. NordLB continues to benefit from a very high probability of cross-sector, owner or systemic support. BremerLB has a very limited mass market retail franchise, and is located in a less dynamic and successful economic region than its much larger peers. However, BremerLB has managed to overcome its structural disadvantages by devising a clear strategy focused on SMEs in its home region, encompassing a moderate appetite for market risks, concentrated credit exposure and noncore activities.

BayernLB

Due to state aid, BayernLB is required to reduce its balance sheet by 2013 to 40-50% compared to 2008 level.

The bank is bundling its non-core activities in an "internal restructuring unit". Capitalization levels are sufficient but not above average. Reducing silent participations leads to a significant equity capital reduction. As of end-September, risk provisions came down on a year-on-year comparison. However, more than three-fourths of credit risk provisions are related to its Hungarian subsidiary MKB.

BayernLB's solid credit profile is supported by rising operating results, and its ownership structure and membership in the German savings banks' joint liability scheme. The threat of privatization is remote for the time being. Final EC approval is still pending.

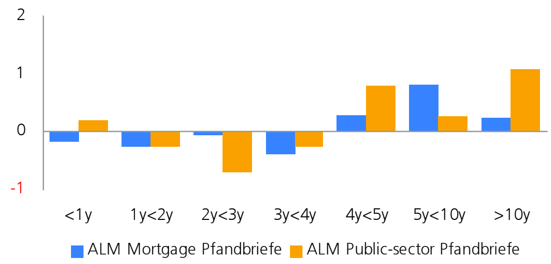
HSH Nordbank

Given the support providers' own stretched financial flexibility, we believe the probability of future support from these sources (the state of Schleswig-Holstein and the city-state of Hamburg) has diminished. HSH Nordbank's focus on ship financing has proved to be challenging for the bank, which is the world's largest ship financer, given the additional burden of volatile credit investments and its comparatively thin capitalization and weak profitability. We consider the risk associated with the shipping business to be persistent and significant as it is threatened by major bankruptcies in the shipping industry as a consequence of a renewed slump in asset prices.

HSHN has a highly capital-intensive lending franchise and limited access to capital. Consequently, the bank needs to shrink its balance sheet to release capital. Compared to its competitor WestLB, the timeframe for reduction of government stake is less tight. Its dependence on costly support from owners implies major uncertainties. HSHN has not yet stabilized to the extent that it fully deserves its current credit profile on the merit of its own financial strength. An additional challenge is restoring HSHN's reputation.

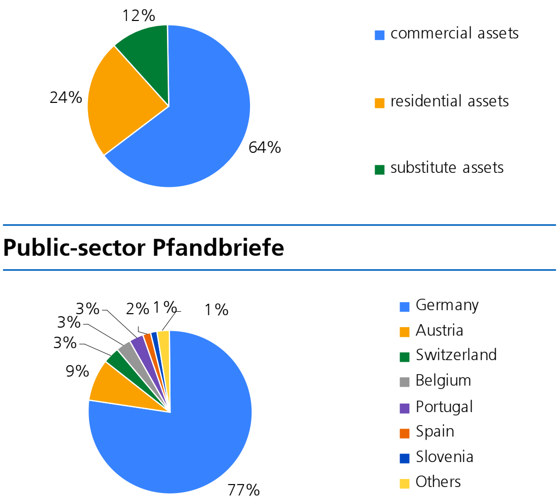
We recommend avoiding HSH Nordbank bonds except for (local) government-guaranteed and grandfathered debt.

Fig. 4: Asset liability matching of HSHN
in EUR bn



Source: UBS WMR; Fitch Ratings; HSHN; as of September 2010

Fig. 5: Diversification of HSHN's cover pools
Mortgage Pfandbriefe



Source: UBS WMR; Fitch Ratings; HSHN; as of September 2010

Tug-of-war on WestLB Group

WestLB
SoFFin injected EUR 3bn of capital into the WestLB core bank in the form of a silent participation that can be converted into shares from July 2010 in order to facilitate WestLB's restructuring.

The EC has approved the setting up of a "workout entity" (EAA, please see below).

In our view, the potential for loss of public-sector ownership by end-2011 as very likely. This results from the agreement with the European Commission on the restructuring process as support is considered to have reached the maximum level.

Except for the required sale of its mortgage lending subsidiary WestImmo (please see below), WestLB is forced to change its ownership structure by finding potential buyers or by consolidation.

Recently, BayernLB decided to break off merger talks with WestLB, saying "… the economic benefits of a tie up compared to the profitability of an independent BayernLB do not sufficiently outweigh the typical challenges of implementing a merger of this size."

WestLB has been offered a three-month breathing space after the bank admitted it is unable to meet key conditions set by the EC. The latter allowed an extension period in which the bank has to prepare a new restructuring plan.

WestLB has not stabilized to the extent that its credit profile is based on its own financial strength rather than the strong likelihood of support from its owners, particularly the state of North Rhine Westphalia (NRW).

Uncertainties prevail as to whether or not WestLB's business model will stand the test of time. In our view, its viability is questionable despite the restructuring efforts. As time is running out for an earnest search of equity investors or merger candidates, we cannot exclude an orderly liquidation of WestLB, which we consider as the most sensible solution.

Erste Abwicklungsanstalt (EAA)
WestLB's bad bank, Erste Abwicklungsanstalt (First Winding-up Agency; EAA) is an organizationally and economically independent public-law entity managed by the Financial Market Stabilization Authority (FMSA).

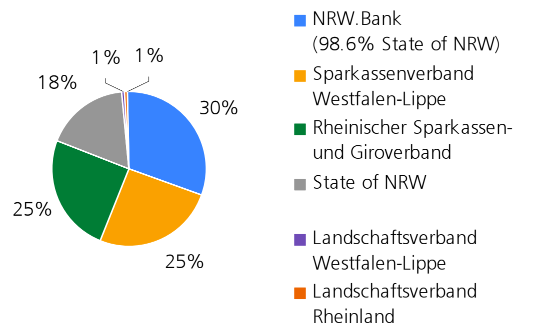
EAA took over a portfolio of toxic and non-strategic assets from WestLB worth EUR 77bn. The transfer of assets and liabilities has been part of a spin-off for absorption (Abspaltung zur Aufnahme) pursuant to the German Transformation Act (Umwandlungsgesetz).

EAA received approximately EUR 3bn in capital through that spin-off and EUR 1bn as a guarantee from the existing shareholders (see Fig. 7) and their protection schemes.

Additionally, WestLB transferred approximately EUR 26bn in liabilities to EAA in order to refinance the transferred assets. Among those are grandfathered senior unsecured bonds.

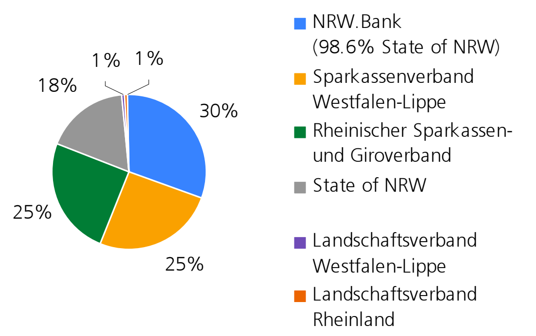
A full list of these securities is published in www.westlb.com/InvestorRelations/changeofissuer.

Fig. 6: WestLB's share capital



Source: UBS WMR, WestLB as of November 2010

Fig. 7: Stakeholders of EAA's share capital



Source: UBS WMR, EEA as of November 2010

According to its bylaws, EAA is the universal successor to all contractual and statutory obligations of WestLB arising in connection with the transferred liabilities. WestLB and the EAA have entered into a co-operation agreement pursuant to which WestLB continues to manage the transferred operations.

Investors of respective bonds are faced with a change of issuer from the bank WestLB to the non-bank EEA, which is rated Aa1 (Moody´s), AA- (S&P) and AAA (Fitch).

All payment obligations of respective liabilities will be resumed by EAA. The grandfathered guarantee of WestLB's owners will continue to exist. Nevertheless, these bonds lose the institutional protection under Germany's savings banks scheme: EAA does not constitute a financial institution within the definition of the German Banking Act.

EAA Covered Bond Bank plc
WestLB's Irish subsidiary WestLB Covered Bond Bank plc, which was established in order to fund the public sector portfolio through the issuance of Asset Covered Securities (ACS), was transferred to EAA and consequently renamed EAA Covered Bond Bank plc (EAACBB).

According to its bylaws, WestLB's guarantee for the Covered Bond Bank was replaced by an unconditional and irrevocable guarantee by EAA. Consequently, EAACBB is a wholly owned and guaranteed subsidiary of EAA and is rated AA- (S&P) and Aa1 (Moody's).

Continuing to operate under the Asset Covered Securities Act, the cover pool will be managed by EAACBB.

Consequences for outstanding bonds of WestLB group
We generally recommend avoiding WestLB and its subsidiaries.

We cannot completely exclude haircuts for bondholders in the event of a potential asset stripping by WestLB due to the new restructuring law. Furthermore, we view the credit profile of WestLB's major shareholder, the state of NRW, the weakest among German federal states.

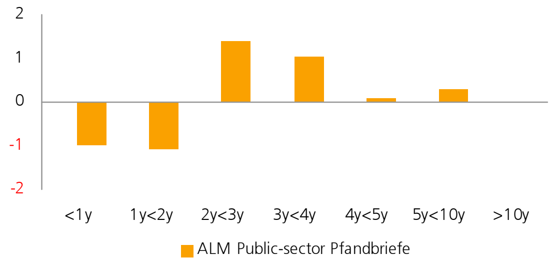
We believe that respective bonds should not be sold, but we recommend not committing new funds to any asset class mentioned below.

Government-guaranteed debt: Nearly all of WestLB's grandfathered liabilities (Gewährträgerhaftung, see Appendix) have been transferred to EAA. It is important to note the change in borrower's identity: the "new" debtor will be a state-guaranteed agency.
We recommend holding grandfathered senior unsecured bonds due to their state-guaranteed status.

WestLB Public-sector Pfandbriefe: German public-sector Pfandbriefe remain within in WestLB. We recommend holding these bonds due to their sound collateral and structural features typically connected with German Pfandbriefe legislation.

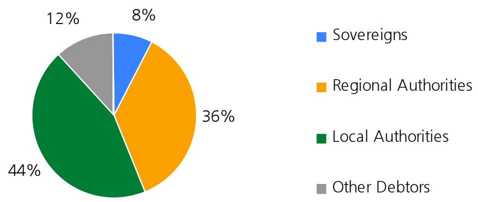
ACS: We recommend holding Asset Covered Securities issued by EAA Covered Bond Bank due to the issuer's state-guaranteed status.

Fig. 8: Asset liability matching of WestLB
in EUR bn

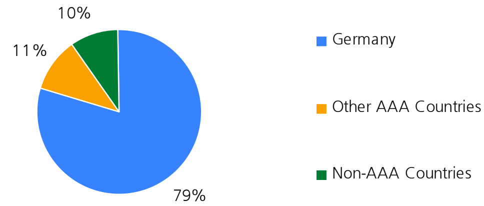


Source: UBS WMR; WestLB; September 2010

Fig. 9: Diversification of WestLB's public-sector Pfandbriefe cover pool
by region



by rating category



Source: UBS WMR; WestLB; September 2010

Corporate bonds

WestImmo Pfandbriefe: Westdeutsche Immobilienbank (WestImmo) is part of the WestLB group which is required by the EC decision to be sold at the end of February 2011. It is mainly responsible for the financing activities of residential and commercial properties of the group and aims to refinance this business predominantly via mortgage Covered Bonds. The pool exhibits a high proportion of commercial mortgage assets. Additionally, we expect limited secondary market liquidity for most of the cover assets. Therefore, we consider the credit quality of the mortgage Pfandbriefe as not very high and recommend avoiding them. The same recommendation applies to public-sector Pfandbriefe.

Senior unsecured debt: If WestLB were not to restructure successfully, it could expect support in an orderly wind-down, in our view. A default on any senior obligations remains unlikely, but haircuts could arise. The restructuring process may take some years.

Hybrid capital: We see most risk with respect to the state-aid ruling for WestLB, and its Hybrid Capital Funding issues may incur a total loss in an adverse scenario. We advise selling these positions. For further details, please refer to our 3 August report, "Subordinated Bank bonds regain appeal."

Appendix

Table 6: Overview state-aid for German public-sector banks

Bank	Owners	Capital injection	Guarantees / risk shield	Fees on guarantees	Restructuring plans	Future strategy	EC approval stage
LBBW	1) Sparkassenverband Baden-Württemberg (40.534%) 2) State of Baden-Württemberg (19.57%) 3) City of Stuttgart (18.932%) 4) Landesbeteiligungen Baden-Württemberg GmbH1 (18.258%) 5) L-Bank (2.706%)	EUR 5bn • EUR 1.2bn ordinary shares • EUR 3.8bn share premium	EUR 12.7bn for portfolio for stuctured products; two tranches of EUR 6.7bn & EUR 6bn	EUR 336m p.a.	Balance sheet reduction until 2013; less 40% vs. 2008	• regional banking business • limit capital market activities to client's needs	Restructuring plan and state aid approved
BayernLB	1) Free State of Bavaria (94.03%) 2) Sparkassenverband Bavaria (5.97%)	EUR 10bn by 1) • EUR 7bn preference shares (BayernLB Holding) • EUR 3bn silent participations	• EUR 4.8bn risk-shield for ABS portfolio (EUR 20bn) • EUR 5bn SoFFin guaranteed bond	risk-shield fees under negotiation	• Bundling of non-core activities into a internal restructuring unit • Balance sheet reduction until 2013; less 40 to 50% vs. 2008	• Focus on core activities • limit capital market activities to client's needs	Temporary approval to state aid
HSH Nordbank	1) HSH Finanzfonds AöR4 (64.2%) 2) City State of Hamburg (10.9%) 3)State of Schleswig-Holstein (10.4%) 4) J.C. Flowers-led Trusts (9.2%) 5) SGV Schleswig-Holstein (5.3%)	EUR 3bn • EUR 1.5 bn each of 2) and 3) • 2), 3) and 5) committed to keeping a majority of the shares at least until 2013	• EUR 10bn risk-shield for asset portfolio (EUR 172bn) • EUR 9bn SoFFin guaranteed bonds • EUR 8bn SoFFin guaranteed isntruments	4% p.a. risk-shield fee	Reorganisation in two units • "Core bank" • Non-strategic assets transfered to "Restructuring Unit"and subject to be wound down	• Focus on regional activities and international activities with key competences (shipping, transport, energy) • limit capital market activities to client's needs	Temporary approval to state aid
NordLB	1) State of Lower Saxony (41.75%) 2) Sparkassenverband Lower Saxony (37.25%) 3) State of Saxony-Anhalt (8.25%) 4) Sparkassenbeteiligungs-verband Saxony-Anhalt (7.53%) 5) Sparkassenbeteiligungs-zweckverband Mecklenburg-Western Pomerania (5.22%)		Guarantee for a EUR 10bn secured Medium-Term Note programme (GMTN); 83.5% by 1) and 16.5% by 2)	20bp + 5y CDS spread of outst. guaranteed bonds			Temporary approval to state aid
WestLB	1) NRW.Bank (30.862%) 2) SGV Rhineland (25.032%) 3) SGV Westphalia-Lippe (25.032%) 4) State of North Rhine-Westphalia (17.766%) 5) Regional Association of the Rhineland (0.654%) 6) Regional Association of Westphalia-Lippe (0.654%)	• EUR 3bn silent participations by SoFFin	• EUR 5bn risk-shield for asset portfolio (EUR 23bn) • EUR 6.4bn sub-portfolio of structured securities guaranteed by SoFFin with a pro rata counter-guarantee amounting to EUR 4bn from owners. • EUR 1bn guarantee on the workout entity's losses	n.a.	•Reducing balance sheet and RWA by 50% by March 2011 •The bank has to be sold in whole or in parts by 2011 – public tender procedure to be launched by August 2010 • €77bn of non strategic-assets are transferred to 'Erste Abwicklungsanstalt'	• Refocus on 3 core businesses: 'Transaction Banking'; 'Verbund/Mid Caps'; and 'Capital Markets, Corporates and Structured Finance'. • Reorganisation in such a way that all three businesses can be sold together or separately	Temporary approval to state aid

Source: UBS WMR, Morgan Stanley

Maintenance (Anstaltslast) and Guarantee Obligation (Gewährträgerhaftung)

Some of the outstanding Landesbanken debt is grandfathered guaranteed according to an EU Agreement.
On 17 July 2003, an agreement regarding federal state guarantees (Maintenance/"Anstaltslast" and Guarantee Obligation/"Gewährträgerhaftung") was reached between the EU Commission and the German federal government. This stipulates that Maintenance Obligation should be transformed into a market-based ownership relationship and that Guarantee Obligation should be abolished. A transitional period for full implementation of four years until 18 July 2005 was agreed upon. A grandfathering clause is provided for all commitments made prior to or during the transitional period.

Table 7: Grandfathering of liabilities

Date of issuance	Maturitiy of liabilities		
	up to 18 July 2005	19 Juli 2005 to 31 December 2015	From 01 January 2016
up to 18 July 2001	Maintenance and Guarantee Obligation	Guarantee Obligation	Guarantee Obligation
19 July 2001 to 18 July 2005	Maintenance and Guarantee Obligation	Guarantee Obligation	No Guarantee
After 18 July 2005		No Guarantee	No Guarantee

Sources: UBS WMR; EU, HSHN

Corporate bonds

Table 8: Overview Pfandbriefe ratings and credit view

Issuer	Issuer rating	Public-sector Pfandbriefe		Mortgage Pfandbriefe		Other	
	Moody's / S&P / Fitch	M / S&P / F	WMR	M / S&P / F	WMR	M / S&P / F	WMR
GERMANY							
BAYERNLB	A1 / - / A+ stable / - / Watch -	Aaa / - / AAA - / - / -		Aaa / - / AAA - / - / -		- / - / - - / - / -	n.a.
BERLIN HANNOVERSCHE HYP	- / - / AA- - / - / stable	Aaa / - / AAA - / - / -		Aa1 / - / AA+ - / - / -		- / - / - - / - / -	n.a.
BREMER LANDESBANK	Aa2 / - / A neg / - / stable	- / - / - - / - / -		- / - / - - / - / -		- / - / - - / - / -	n.a.
COREALCREDIT	- / - / BBB- - / - / stable	- / - / AAA - / - / -		- / - / AA- - / - / -		- / - / - - / - / -	n.a.
DEKABANK	Aa2 / A / - stable / stable / -	Aaa / AAA / - - / stable / -		- / - / - - / - / -	n.a.	- / - / - - / - / -	n.a.
DEUTSCHE BANK	Aa3 / A+ / AA- stable / stable / neg	- / - / - - / - / -	n.a.	Aaa / AAA / - - / stable / -		- / - / - - / - / -	n.a.
DEUTSCHE HYPO	A1 / - / - neg / - / -	Aaa / - / - - / - / -		Aaa / - / - - / - / -		- / - / - - / - / -	n.a.
DEUTSCHE KREDITBANK	- / - / - - / - / -	Aaa / - / - - / - / -		Aaa / - / - - / - / -	n.a.	- / - / - - / - / -	n.a.
DEUTSCHE PFANDBRIEFBANK	A3 / BBB / A- stable / stable / stable	Aaa / AA+ / AAA - / stable / -		Aa3 / AA+ / AA+ - / stable / -		- / - / - - / - / -	n.a.
DEUTSCHE POSTBANK	A1 / A- / A+ neg / Watch + / stable	Aaa / AAA / AAA - / stable / -		Aaa / AAA / AAA - / stable / -		- / - / - - / - / -	n.a.
DEXIA KOMMULBANK	- / - / - - / - / -	- / AAA / - - / stable / -		- / - / - - / - / -	n.a.	- / - / - - / - / -	n.a.
DG HYP	- / A / A+ - / neg / stable	- / AAA / AAA - / stable / -		- / AAA / AAA - / stable / -		- / - / - - / - / -	n.a.
DUESSELDORFER HYPO	- / - / BBB- - / - / stable	- / - / AAA - / - / -		- / - / - - / - / -	n.a.	- / - / - - / - / -	n.a.
DZ BANK	Aa3 / A+ / A+ stable / stable / stable	- / - / - - / - / -	n.a.	- / - / - - / - / -	n.a.	- / AAA / AAA - / stable / -	
EUROHYPO	A1 / A- / A neg / neg / Watch -	Aaa / AAA / AAA - / neg / -		Aaa / AAA / AAA - / stable / -		- / - / - - / - / -	n.a.
HELABA	Aa2 / A / A+ stable / stable / stable	Aaa / AAA / AAA - / stable / -		- / - / AAA - / - / -		- / - / - - / - / -	n.a.
HSH NORDBANK	A3 / - / A- neg / - / Watch -	Aaa / - / AAA - / - / -		- / - / AAA - / - / -		A2 / - / - - / - / -	
LANDESBANK BERLIN	A1 / - / AA- stable / - / stable	Aaa / - / AAA - / - / -		Aaa / - / - - / - / -		- / - / - - / - / -	n.a.
LBBW	Aa2 / - / A+ neg / - / stable	Aaa / - / AAA - / - / -		Aaa / - / AAA - / - / -		- / - / - - / - / -	n.a.
MUENCHENER HYP	A1 / - / A+ neg / - / stable	Aaa / - / - - / - / -		Aaa / - / - - / - / -		- / - / - - / - / -	n.a.
NORDLB	Aa2 / A- / A neg / neg / stable	Aaa / - / - - / - / -		Aaa / - / - - / - / -		- / - / - - / - / -	n.a.
NRW.BANK	Aa1 / AA- / AAA stable / stable / stable	- / AAA / AAA - / stable / -		- / - / - - / - / -	n.a.	- / - / - - / - / -	n.a.
SEB AG	Baa1 / - / A+ stable / - / stable	Aa1 / - / - - / - / -		Aa1 / - / - - / - / -		- / - / - - / - / -	n.a.
UNICREDIT BANK AG (HVB)	A1 / A / A+ stable / stable / stable	Aaa / AAA / AAA - / stable / -		Aa1 / - / AAA - / - / -		- / - / - - / - / -	n.a.
WESTDT IMMOBILIEN BANK	- / BBB+ / - - / neg / -	- / AAA / - - / neg / -		- / AAA / - - / neg / -		- / - / - - / - / -	n.a.
WESTLB	A3 / BBB+ / A- neg / neg / Watch -	Aaa / AAA / - - / neg / -		- / - / - - / - / -	n.a.	- / - / - - / - / -	n.a.
WL BANK	- / A+ / - - / stable / -	- / AAA / - - / stable / -		- / AAA / - - / stable / -		- / - / - - / - / -	n.a.

Sources: UBS WMR; Rating agencies; as of 10 November 2010

Appendix

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Most Preferred	49.55%	(52.60%*)
Neutral View	15.76%	(63.46%*)
Least Preferred	12.27%	(49.38%*)
Suspended	0.61%	(100.00%*)
Discontinued	21.82%	(33.33%*)

*Percentage of companies within this rating for which investment banking services were provided by UBS AG or UBS Securities LLC or its affiliates within the past 12 months.

Appendix

Credit issuer/bond recommendation definitions

Recommendation	Time horizon		WMR terminology	Definition
WMR credit/bond* rating	Longer term	Investment grade	AAA	Issuer / Bonds have exceptionally strong credit quality. AAA is the best credit quality.
			High AA	Issuer / Bonds have very strong credit quality.
			Mid AA	
			Low AA	
			High A	Issuer / Bonds have high credit quality.
			Mid A	
			Low A	
			High BBB	Issuer / Bonds have adequate credit quality. This is the lowest investment grade category.
			Mid BBB	
			Low BBB	
		Speculative grade	High BB	Issuer / Bonds have weak credit quality. This is the highest speculative grade category.
			Mid BB	
			Low BB	
			High B	Issuer / Bonds have very weak credit quality.
			Mid B	
			Low B	
			High CCC	Issuer / Bonds have extremely weak credit quality.
			Mid CCC	
			Low CCC	
			CC	Issuer / Bonds have a very high risk of default.
			C	
			D	Obligor failed to make payment on one or more of its financial commitments. This is the lowest quality of the speculative grade category.
WMR credit trend			Improving	Reflects the analyst's expectation that the credit issuer's fundamentals will improve.
			Stable	Reflects the analyst's expectation that the credit issuer's fundamentals will remain stable.
			Deteriorating	Reflects the analyst's expectation that the credit issuer's fundamentals will deteriorate.
	Review within a couple of months		Watch +	Increased likelihood of UBS WMR credit rating upgrade(s).
	Review within a couple of months		Watch	Increased likelihood of UBS WMR credit rating change(s).
	Review within a couple of months		Watch -	Increased likelihood of UBS WMR credit rating downgrade(s).

Recommendation	WMR terminology	Definition
Bond recommendation	Outperform (OUT)	The bond is expected to earn a higher total return than a liquid bond benchmark representing a comparable level of risk.
	Marketperform (MKT)	The bond is expected to earn a total return in line with a liquid bond benchmark representing a comparable level of risk.
	Underperform (UND)	The bond is expected to earn a lower total return than a liquid bond benchmark representing a comparable level of risk.
	Sell (Sell)	In light of substantial downside credit or default risk, and the expectation of a lower total return than a liquid bond benchmark representing a comparable risk, investors should sell their bonds.

*The WMR bond rating reflects WMR's opinion of the credit quality of a bond. The WMR bond rating is derived by adjusting the WMR credit rating of the issuer for any collateral-type and capital structure considerations specific to that bond. This may result in the bond having a different risk profile, and therefore a different rating than the issuer, as well as other bonds of the issuer.

Appendix

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In general, as currently released, the Proposed Amendments may require an investor that has acquired a “participating interest” other than an “exempt interest” (as defined in the Proposed Amendments) in a FIE, to include in income for income tax purposes each year (i) an amount equal to a prescribed percentage of the designated cost of its participating interest in the FIE; (ii) in limited circumstances, its gain on its participating interest in FIEs, on a mark-to-market basis whether or not such gain has been realized; or (iii) in limited circumstances, its proportionate share of the FIE’s income (or loss) calculated using Canadian tax rules. Accordingly, if the Proposed Amendments apply to an investor, the investor may be required to include in taxable income amounts that the investor has not earned or received. 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