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Impact of TLAC and MREL on future bank ratings

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In its recently updated bank rating methodology (May 2015), Scope looks at the latest regulatory developments related to implementing resolution tools, considering their likely impact on bank ratings. We believe that highlighting our thinking at an earlier stage for assessing the ratings and specific scenarios in a resolution and recovery environment adds to the rating and analytical transparency and clarity to which Scope is committed. This report summarizes these aspects:

Based on recent regulatory proposals, which should be finalised later this year, we expect resolvable banks to start allocating or issuing liabilities that would be included in the 'minimum requirements for own funds and eligible liabilities' (MREL) and/or 'total loss-absorbing capacity' (TLAC).

Senior unsecured debt to be included in MREL and/or TLAC would likely include debt: (i) with contractual bail-in clauses; (ii) issued by a top holding company; or (iii) specifically designated by regulators to be included in MREL and/or TLAC – *see below*. When a European bank allocates senior unsecured debt to MREL and/or TLAC, Scope considers that any senior unsecured debt which is *not* to be included in MREL and/or TLAC can be placed at the same level as the Issuer Credit-Strength Rating (ICSR) for the AAA-BB rating ranges, even when it is not ranked the most remote in the bail-in order. This would take into account the material level of protection for this debt category provided by MREL and/or TLAC liabilities, which need to absorb all losses before another layer of protection – namely outside resolution funds (from national or single resolution funds) – is put to use. Although the EU's Bank Resolution and Recovery Directive (BRRD) does allow other eligible liabilities (like non-MREL senior unsecured debt) to be bailed in, if MREL and outside resolution funds are insufficient for resolution (for example, to prevent insolvency proceedings), such a scenario appears very remote to us. This is especially in light of the 'no creditor worse off' (NCWO) principle codified in the BRRD, that is, no creditor should be treated worse off in resolution than in liquidation. It may however be less remote for banks with low ICSRs, specifically in the B range and below. In that case, Scope will aim to notch down *all* senior unsecured debt ratings from the respective ICSR even if a MREL protection does already exist.

For banks which do not allocate specific senior liabilities to MREL and/or TLAC and decide instead to leave the entire pool of senior unsecured debt as potentially eligible for MREL/TLAC, Scope maintains the current approach, as follows:

- For banks rated in the AAA-BBB ranges, there should be no notching down from the ICSR, as the probability of resolution affecting senior unsecured debt is extremely remote (marginally less so for the BBB range)
- For banks rated in the BB range, which would inherently be less remote in a resolution scenario, senior unsecured debt should be rated one notch down from the ICSR. The notching gap widens to two as the ICSR moves into the B range, thus closer to a resolution outcome. Such a rating approach could apply, for example, to senior unsecured debt issued by German banks if the current draft legislation is implemented (*SRM-Anpassungsgesetz*) – meaning senior unsecured debt ranks junior in insolvency (and thus, based on the NCWO principle, in bail-in) compared to other unsecured liabilities, such as deposits.

Scope will not rate senior unsecured debt and other eligible liabilities *higher* than the ICSR even if the amount, stability and predictability of liabilities qualifying as MREL and/or TLAC is very material. This is because a bank's liability mix – including the size, stability and predictability of liabilities qualifying as MREL and/or TLAC – is already an important factor in the analysis underpinning the ICSR, and using it again to notch up non-MREL/TLAC-qualifying debt ratings may in fact be double counting.

Forthcoming rating notching off the ICSR under BRRD

A. With MREL (and TLAC) senior debt allocation

ICSR	AAA/AA/A	BBB	BB	B	CCC/CC/C
Senior	0	0	0	1	≥ 1
Senior MREL/TLAC	0	1	2	3	≥ 2
Sub non T2	1	2	3	4	≥ 2
T2	≥ 2	≥ 3	≥ 4	≥ 5	≥ 2
AT1	≥ 4	≥ 5	≥ 6	≥ 5	≥ 2

B. Without MREL (and TLAC) senior debt allocation

ICSR	AAA/AA/A	BBB	BB	B	CCC/CC/C
Senior	0	0	1	2	≥ 2
Sub non T2	1	2	3	4	≥ 2
T2	≥ 2	≥ 3	≥ 4	≥ 5	≥ 2
AT1	≥ 4	≥ 5	≥ 6	≥ 5	≥ 2

Source: Scope Ratings

The table above summarises Scope’s future notching approach regarding different bank debt classes compared to the ICSR for both those banks which will specifically allocate senior unsecured debt to MREL and/or TLAC and for those which will not. We point out again, however, that regulations on MREL and TLAC are yet to be finalised. Besides, Scope recognises that various supervisory authorities in Member States may adopt variations when regulating the BRRD, for example by excluding specific categories of eligible liabilities from the bail-in process. We already highlighted the draft legislation on bank debt in Germany.

Holding companies. Less widespread than in the US banking system, European banking groups would have a holding company (HC) structure, notably in the United Kingdom and Switzerland. We consider, all other things being equal, that as long as there are no grounds in a stress scenario to estimate that the HC’s creditors would be treated any differently from creditors of the operating bank(s), the rating of HC senior unsecured debt with similar term and conditions as the senior unsecured debt of the operating bank(s) should be the same. This would not be the case in the US, where the regulatory status of bank HCs has been different for many decades.

However, under contemplated resolution avenues, primarily under ‘single point of entry’ (SPE), HCs may be expected to issue debt – including senior -- which would be included in MREL and/or TLAC. Such debt would thus be less remote from a bail-in situation than other senior unsecured liabilities. If this was the case – either explicitly disclosed by the bank or its supervisory authority, or considered by Scope as a likely scenario – such debt would be rated below the ICSR according to the specific terms, conditions, and seniority.

As of 11 June 2015

Scope Ratings						
Bank	ICSR	Outlook	Short-term Rating	Short-term Rating Outlook	AT1	T2
Banco Santander SA	A+	Stable	S-1	Stable	BBB-	
Barclays Bank PLC	A	Stable	S-1	Stable	BB *(Barclays Plc)*	BBB+
BBVA SA	A	Stable	S-1	Stable	BB+	
BNP Paribas SA	A+	Negative	S-1	Stable		
BPCE SA	A+	Stable	S-1	Stable		
Commerzbank AG	BBB+[1]		S-2[1]			
Credit Agricole Group	A	Positive	S-1	Stable	BB+	BBB+
Credit Mutuel SA	A	Stable	S-1	Stable		
Credit Suisse AG	A	Stable	S-1	Stable	BBB-, BB+ *(CS Group)*	A-, BBB *(CS Group)*
Danske Bank A/S	A-	Stable	S-1	Stable	BB	
Deutsche Bank AG	A-	Stable	S-1	Stable	BB	
DNB Bank ASA	A+	Stable	S-1	Stable	BBB-	
HSBC Holdings PLC	AA-	Stable	S-1+	Stable	BBB	
ING Bank NV	A	Stable	S-1	Stable		
Intesa Sanpaolo SPA	BBB+	Positive	S-2	Stable		
KBC Group NV	A-	Stable	S-1	Stable	BB+	BBB *(KBC Bank NV)*
Lloyds Bank PLC	A	Stable	S-1	Stable	BB+ *(Lloyds Banking Group Plc)*	
Nordea Bank AB	A+	Stable	S-1	Stable	BBB-	
Rabobank Group	A+	Stable	S-1	Stable		
Royal Bank of Scotland PLC[2]	BBB+	Stable	S-2	Stable		
Societe Generale SA	A	Stable	S-1	Stable	BBB-	
Svenska Handelsbanken AB	A	Stable	S-1	Stable		
Swedbank AB	A-	Stable	S-1	Stable	BB	
UBS AG	A	Stable	S-1	Stable	BBB- *(UBS Group)*	A-
Unicredit SPA	BBB	Positive	S-2	Stable		

[1] Under review for possible upgrade

[2] Ratings benefit from a one-notch rating uplift due to the UK government's majority ownership

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