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Delinking bank ratings from sovereign assessments

The case of large Spanish and Italian banks

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The vicious interaction between sovereign and bank credit risk has been one of the key challenges to the financial stability of the Eurozone in recent years. Bank credit has often traded as a proxy for sovereign risk, irrespective of the credit fundamentals of the issuer. Scope believes that, in light of the recent regulatory and policy developments, the nature of the sovereign/banking risk link in Europe has changed. Consequently, now more than ever investors should look at the credit risk of each bank on the basis of its own fundamentals, rather than as a proxy for sovereign risk or, conversely, as being sheltered by its home sovereign.

Executive Summary

- Scope Ratings does not see an analytical rationale for automatically linking bank ratings to sovereign assessments, especially for groups with a wide geographical diversification. Recent developments, including the move towards creditor bailins and the European Banking Union, have in our view weakened further the link between bank and sovereign credit risk.
- We believe that going forward the cost of bank rescues will fall, after the shareholders, on creditors rather than taxpayers. As such, we do not normally notch up bank ratings on account of state support.
- We do not mechanistically cap banks' ratings based on our assessment of domestic sovereign risk. Rather, we view domestic sovereign exposure as being a large credit risk concentration and assess it accordingly.
- For example, while we believe that the risk of a Spanish sovereign default has materially receded recently, we remain cautious about the high deficit and debt in Spain. That being said, the ample degree of geographic diversification of BBVA's and Santander's assets means that their capital base is relatively resilient even assuming losses on domestic sovereign exposures.
- The high level of public debt in Italy is a concern, although the debt/GDP trajectory is more stable due to the lower deficit. In Intesa's case, the exposure to sovereign risk is material at 13% of total assets (including bonds and loans), and we consider it a negative rating driver as losses would quickly eat through Intesa's capital base in case of even partial default. This is less the case for Unicredit, which has a relatively lower exposure to Italian sovereign risk, partly thanks to its more diversified geographic footprint.
- Finally, we stress that sovereign risk is not the best proxy for the banks' macro operating environment. Indeed, a weak economic environment has a strong negative impact on bank creditworthiness, primarily via high levels of impaired loans and reduced operating profitability.

Core Tier 1 Ratio* sensitivity to domestic sovereign haircuts

	ICSR	CT1 % 2013	CT1 % assuming haircut of 10%	20%	30%
Santander	A	12%	11%	10%	9%
BBVA	A	12%	10%	8%	7%
Unicredit	BBB**	10%	8%	7%	6%
Intesa	BBB+**	11%	8%	5%	3%

Source Companies data (December 2013), Scope Ratings
* Basel 2 basis. Calculated based on total sovereign exposures in the banking group, including loans.
** Positive outlook

Contacts

Marco Troiano (Author)
m.troiano@scoperatings.com

Sam Theodore
s.theodore@scoperatings.com

Scope Ratings GmbH

The Gridiron Building, 8th floor
One Pancras Square, London
N1C 4AG

T: +44 203 714 4980

Lennéstraße 5
10785 Berlin

T: +49 (0)30 27891-0
F: +49 (0)30 27891-100

info@scoperatings.com
www.scoperatings.com

Recent regulatory and policy developments have changed the nature of the bank/sovereign credit correlation

Since the re-appearance of sovereign credit risk in the summer of 2011, the vicious interaction between sovereign and bank credit risk has been one of the key challenges to the financial stability of the Eurozone.

- In some countries, such as Ireland or Spain, taxpayer-funded bailouts of banks worsened the state of public finances.
- In other countries, such as Italy or Greece, sharply falling sovereign bond prices cast doubts on the solvency of otherwise viable banks.
- As an additional negative impact, even stronger banks in affected countries faced higher funding costs across their entire capital structure as a result of investors' heightened perception of country-specific risk.

However, we believe the recent overhaul of European bank regulation, supervision and resolution with the aim of achieving a European banking union (EBU) and the structural changes European banks are undergoing as a result will progressively succeed in delinking sovereign and bank credit risk.

Among the key developments, we highlight:

1. **CRD4/CRR**. With the regulatory drive towards much higher capital and liquidity buffers than before the crisis, scenarios of a large bank failing are becoming more remote. In other words, once the CRR buffers are fully phased in and banks operate with more and better capital, the need for bank rescues will be lower.
2. **Single Supervisory Mechanism (SSM)**. The gradual adoption of a more harmonised set of rules (CRD4/CRR), as well as the centralised supervision of European banks, with the several transparency exercises planned for this year (AQR, Stress tests) should remove the uncertainty around the value of banks' assets by reassuring markets against the possibility of hidden losses.
3. **Bank Resolution.** The adoption of the bank resolution and recovery directive (BRRD) by the European Parliament last April is a further important step in reducing the impact of a large bank failure on government finances. Indeed, while insolvency proceedings remain a potentially disruptive solution for a large bank, the new resolution regime now allows a bank to be recapitalised while safeguarding its operations via bailin of creditors, thus terminating the practice of taxpayer-funded bailouts of bank creditors.
4. **Single Resolution Fund (SRF).** In the unlikely event of equity and creditor bailin funds not being sufficient to absorb losses, an EU-wide common resolution fund will be available to recapitalise banks without having to resort to national government finances.

As a result of the above regulatory and policy steps, which will be gradually implemented over the coming years, we believe that the nature of the sovereign/banking risk link in Europe has changed. We consider that, now more than ever, investors should look at the credit risk of each bank on the basis of its own fundamentals, rather than as a proxy for sovereign risk or, conversely, as being sheltered by its home sovereign.

Our approach to sovereign risk and bank ratings

No mechanistic link between bank rating and sovereign assessment.

As explained in our Bank Rating methodology (February 2014), Scope Ratings does not see an analytical reason for automatically linking bank ratings to sovereign assessments, especially for groups with a wide geographical diversification of revenues. An assessment of the home sovereign situation remains a key component of Scope's analysis, and there are instances where the exposure to a domestic sovereign can represent a material credit rating factor. These include cases in which the bank relies heavily on its domestic central bank for funding, is expected to materially contribute to the funding of its government, or has a public mission specifically linked with that of its sovereign.

Sovereign exposure is analysed as a concentrated credit exposure

A typical form of material sovereign exposure is the holding of large portfolios of government bonds of a domestic government. It is quite normal for a bank to hold large quantities of government bonds, which are typically used to hedge interest rate risk in the retail deposit bases or as a reserve of liquid assets. Nor is it uncommon for banks to be exposed to sovereign risk for a significant percentage of their balance sheet and often a multiple of their capital base. However, exposures vary quite significantly not only in terms of size, but also in terms of maturity and type of exposure. As such, only an ad hoc analysis of each bank´s concentrated exposure can provide an adequate understanding of the materiality of the exposure.

Stress testing for sovereign losses rather than capping ratings

At Scope Ratings, we typically adopt a stress test approach when evaluating the materiality of a sovereign exposure. We compare the bank´s total sovereign exposure (including loans and bonds) with the available disclosures of capital resources. We then simulate the impact of sovereign losses on the bank´s capital base. For consistency purposes, all the tables presented in this report refer to year-end 2013 data and, unless stated otherwise, to Basel 2 Core Tier 1 Capital and RWAs. However, we have run similar stress simulations using a variety of public sources for exposure information (including banks' annual reports, presentations, the EBA transparency exercise, and Pillar 3 reports) as well as different definitions of capital (Basel 2, EBA, CRD4 when available) to check the robustness of our conclusions. Our view is that a strong bank, with ample capital resources and a diversified and profitable franchise, can actually navigate losses from sovereign exposure (short of total default).

No notching uplift on account of sovereign support

In light of the newly adopted resolution regime, Scope does not normally assign any additional notches on account of state support for systemically important banks. Indeed, while large banks whose failure would pose a threat to financial stability still exist (and have indeed grown bigger in some cases), the likelihood of direct state support is now considerably more remote and it is creditors, rather than taxpayers, who are likely to provide the loss-absorbing resources to keep the bank running as a going concern. In some cases, a more explicit support exists that calls for an adjustment of the bank's ICSR (for example, public sector majority ownership, guarantees or specific public commitments). However, this is the exception rather than the rule and in such instances Scope will clearly disclose state support as a rating factor. Amongst the 20 banks we currently rate, only RBS's ICSR (BBB+) benefits from a one-notch sovereign uplift (the UK government being the majority owner of the bank). In some cases, ratings uplifts may only apply to some parts of the bank's capital structure (we generally do not see junior securities benefitting from state support).

Sovereign risk is not a proxy for the macro environment

While our ratings do not establish a mechanistic correlation with sovereign assessments, they do reflect an analysis of the macro environment in which a bank operates. Indeed, the macro environment affects a bank's asset quality and profitability, which are key inputs to our analytical assessment. However, our view is that the assessment of sovereign risk is not necessarily the best proxy for the macro operating environment, although correlations clearly exist. Strong GDP growth, for example, can facilitate the servicing of even high levels of public debt, while an abrupt slowdown can suddenly reduce tax revenues while increasing the need for social transfers and having a negative impact on debt and deficit dynamics. On the other hand, a government with low levels of debt may still be able to service its debt despite an economic slowdown, which would have a greater impact on the banking sector's profit generation capacity.

Therefore, while there is a certain degree of overlap between the macro assessment of a bank's country(ies) of operation and sovereign assessments, the two have to be performed separately.

The case of large Spanish and Italian banks

Spanish banks: profitability and diversification offset exposure to sovereign risk

We remain cautious about the high public deficit and debt levels in Spain.

On April 2, we assigned ICSR of A to both BBVA and Santander. While Scope does not assign ratings to sovereigns, an assessment of the Spanish sovereign risk was an important part of our analysis. Although we believe that the risk of a Spanish sovereign default has materially receded in recent months thanks, amongst other things, to the effective backstop of the ECB in the summer of 2012, we remain concerned about the fragile state of public finances in Spain. The public debt/GDP trajectory remains worrying: Spain still had a public sector deficit of 7.1% of GDP in 2013, and the public sector debt is expected to grow to over 100% of GDP in 2014 and keep growing in 2015[1]. This trajectory, combined with the legacy of a high net international investment deficit, keeps us cautious about the prospects for Spanish sovereign debt. With that concern in mind, we have stressed BBVA's and Santander's balance sheets to assess the potential damage to their capital base from possible losses on Spanish sovereign debt. Such losses could be the result of a traumatic default or, more likely, of a managed debt reduction exercise, which could involve voluntary private sector involvement.

For Santander, the 2013 year-end exposure to Spanish sovereign risk was EUR 38bn, with two thirds of the exposure consisting of bonds and one third of loans.

Santander domestic sovereign exposure as of year end 2013	(EUR bn)	% of Core Tier 1 capital	% of total assets
Spanish sovereign exposure	38	67%	3%
o/w bonds	26		
o/w loans	13		
Core Tier 1*	57		
RWAs*	490		
Total Assets	1,116		

Source Company data (December 2013), Scope Ratings
* Basel 2 basis

Thanks to its diversification, Santander's Spanish sovereign exposure is only 3% of total assets

Thanks to Santander's high degree of diversification, this amount represented just 3% of group total assets and 67% of the group's Core Tier 1 capital base. In a simplified stress test exercise, which does not take into account possible tax shields arising from such losses or possible actions that management could put in place to strengthen the capital base, each 10% loss on Spanish sovereign bonds would translate in a 78 bps decline in the Core Tier 1 ratio.

Santander CT1 Ratio sensitivity to Spanish sovereign haircuts

Loss assumption (%)	Stressed CT1 Ratio *
0%	11.7%
10%	10.9%
20%	10.1%
30%	9.4%

Source Company data (December 2013), Scope Ratings
* Basel 2 basis

We note that Santander's exposure to sovereign risk has been decreasing in recent quarters and was over EUR 60bn in June 2013, at the time of the latest EBA transparency exercise. However, even taking that higher number in consideration we believe that the exposure is manageable when compared to group's capital resources.

BBVA's exposure to the Spanish sovereign was EUR 53bn at year end 2013 (EUR 30bn in bonds and EUR 23bn in loans).

[1] European Commission Spring Forecasts

BBVA domestic sovereign exposure as of year end 2013	(EUR bn)	% of Core Tier 1 capital	% of total assets
Spanish sovereign exposure	53	141%	9%
o/w bonds	30		
o/w loans	23		
Core Tier 1*	37		
RWAs*	324		
Total Assets	599		

Source Company data (December 2013), Scope Ratings
* Basel 2 basis

This exposure amounted to 9% of total group assets or 141% of group Core tier 1 capital base, meaning that the group's capital ratio sensitivity to sovereign losses is 164 bps for each 10% loss on the sovereign portfolio (excluding tax impacts).

BBVA CT1 Ratio sensitivity to Spanish sovereign haircuts	
Loss assumption (%)	**Stressed CT1 Ratio ***
0%	11.6%
10%	9.9%
20%	8.3%
30%	6.7%

Source Company data, Scope Ratings
* Basel 2 basis

BBVA's exposure is relatively larger and remains a concern, but is sufficiently offset by the group's strengths.

The larger relative size of this portfolio for BBVA compared with Santander appears a concern, as it has the potential to weaken the bank's capital base in stressed scenarios. As such, it is one of the negative rating drivers (together with the large exposure to Spanish non-sovereign risk) for BBVA. The group's several strengths elsewhere, primarily the strong capacity to absorb losses out of operating profitability and the ample, diversified and profitable emerging market franchise more than offset this weakness, as explained in our issuer rating report on the bank.

Italian banks: sovereign exposure remains a key rating driver for Intesa

Italian public debt is over 130% of GDP, but has stabilised.

On June 11, Scope Ratings published long-term ratings on Unicredit (BBB, positive outlook) and Intesa (BBB+, positive outlook). Both banks have a significant exposure to Italian sovereign risk in the form of loans as well as bonds. Despite the higher level of debt/GDP compared with Spain, the lower deficit means that the debt/GDP ratio will likely stabilize in the coming years and is expected to decline from 2015 onwards.

At 132% of group's capital base, Unicredit's exposure is material, but relatively less relevant than the high level of impaired loans in general.

Unicredit's total exposure to Italian sovereign risk is EUR 54bn, an amount similar to BBVA's. However, due to the larger balance sheet of the Italian bank, such exposure only represents 6% of total assets. We also note that Unicredit's exposure mostly consists of bonds, which may in theory be liquidated faster by either secondary sales or by not rolling the paper upon expiration.

Unicredit domestic sovereign exposure as of year end 2013	(EUR bn)	% of Core Tier 1 capital	% of total assets
Italian sovereign exposure	54	132%	6%
o/w bonds	47		
o/w loans	6		
Core Tier 1*	41		
RWAs*	424		
Total Assets	828		

Source Company data (December 2013), Scope Ratings
* Basel 2 basis

At 132% of group core tier 1 capital, this exposure is material and has the potential to erode Unicredit's capital base under stressed assumptions. However, it would take very deep losses to completely eat through Unicredit capital base: for example, we calculate that a 30% loss would take the core tier 1 ratio to 5.8% (excluding tax shields). While this is a low level, it is still a reasonable buffer for creditors situated high up in the bank's capital structure. As such, we believe that sovereign risk exposure is a factor weighing on Unicredit's rating, but that it is relatively less relevant than the high level of impaired loans in general.

Unicredit CT1 Ratio sensitivity to Italian sovereign haircuts

Loss assumption (%)	Stressed CT1 Ratio *
0%	9.6%
10%	8.3%
20%	7.1%
30%	5.8%

Source Company data, Scope Ratings
* Basel 2 basis

Of all the banks we rate in Spain and Italy, Intesa has the most significant exposure to sovereign risk. As shown in the table below, the total year-end exposure was EUR 81bn, 13% of group's total assets and 260% of the group's core capital base. The high exposure is a natural consequence of Intesa's lower degree of diversification compared with the above-mentioned peers. For Intesa, Italy remains by far the main country of operation, with c. 80% of loans.

Intesa domestic sovereign exposure as of year end 2013	(EUR bn)	% of Core Tier 1 capital	% of total assets
Italian sovereign exposure	81	260%	13%
o/w bonds	62		
o/w loans	20		
Core Tier 1*	31		
RWAs*	276		
Total Assets	624		

Source Company data (December 2013), Scope Ratings
* Basel 2 basis

A material exposure to Italian sovereign risk is a key negative rating driver for Intesa, as we calculate that losses would quickly eat through the bank's capital base.

As a consequence of the high relative exposure, Intesa's capital base is very sensitive to potential losses on its domestic sovereign exposure. By our calculation, for each 10% of assumed loss, Intesa's Core Tier 1 Ratio would decline by almost 300 bps. A 30% loss would severely damage Intesa's capital base, as shown in the following table.

Intesa CT1 Ratio sensitivity to Italian sovereign haircuts

Loss assumption (%)	Stressed CT1 Ratio *
0%	11.3%
10%	8.4%
20%	5.4%
30%	2.5%

Source Company data, Scope Ratings

* Basel 2 basis

For this reason, exposure to sovereign risk is a negative rating driver for Intesa, together with the high level of impaired loans and credit costs in Italy.

Appendix 1 – Investigating the link between sovereign and bank credit risk

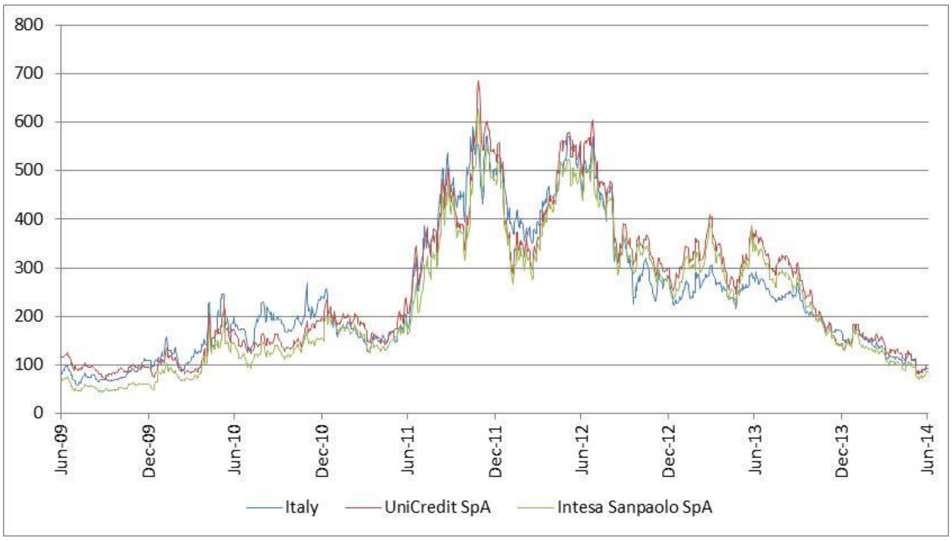
During the past few years, the vicious link between bank and sovereign credit risk has been a key issue facing banks' management, investors and policymakers. The bank/sovereign link typically works through several channels:

- **Bank-to-sovereign**: a banking crisis could require the government to intervene to preserve weak, systemically important institutions from failing, hence representing a constant contingent threat to public finances.
- **Sovereign-to-bank**: as weak banks typically hold large portfolios of domestic government bonds, a weakening of the sovereign's ability to repay its debt represents a key asset quality risk for the banks themselves.
- **Bank-to-bank**: through the sovereign channel, even a bank with limited counterparty exposures to other banks is indirectly exposed to weaker institutions in its country of operation. In fact, should a banking crisis require public sector intervention, even stronger banks could be impacted via a decline in value of their government bond portfolio, to the extent that the government credit standing suffers as a result of the public sector bailouts.

As a practical example, heightened sovereign borrowing costs in the Eurozone in 2011-2012 have typically been reflected in higher cost of funding for peripheral banks.

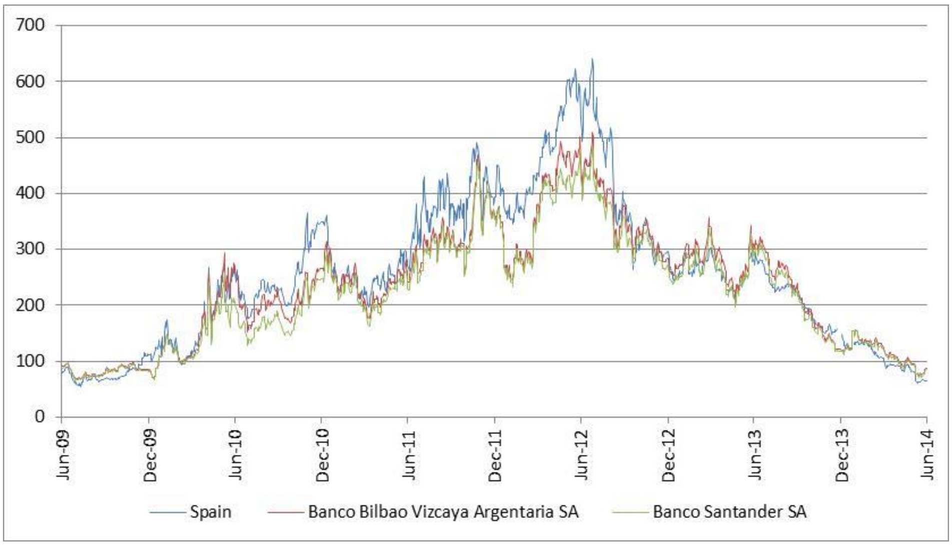
The following charts, showing the evolution of Intesa and Unicredit CDS spreads compared to the Italian sovereign, as well as BBVA and Santander CDS spreads compared to the Spanish sovereign, illustrate this dynamic.

Italian banks 5 years CDS have tracked closely their domestic Sovereign



Source: Bloomberg, Scope Ratings

Despite their diversification, BBVA's and Santander's 5-year CDS have moved in line with Spain's sovereign credit risk.

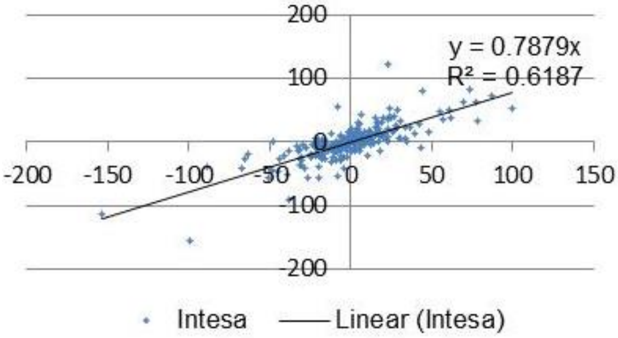


Source: Bloomberg, Scope Ratings

According to our analysis, which is based on 5-year CDS weekly returns, changes in sovereign CDS explain over 60% of the variance in the CDS of the major peripheral banks we have rated.

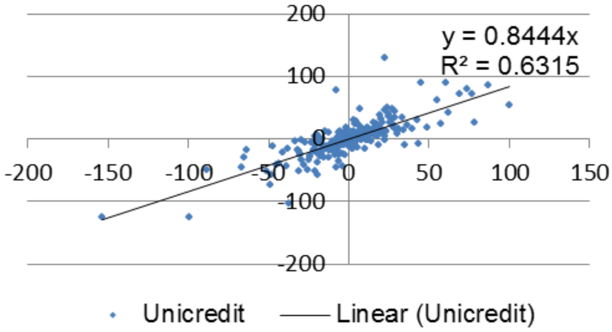
Interestingly, we note that the correlations between the CDS of Intesa, Unicredit, Santander and BBVA with their domestic sovereign CDS are not materially different. We find that counterintuitive, given that the degree of exposure to their domestic sovereigns and economies varies significantly amongst these names: Spain accounts for only 25% of Santander's loan book, while the weight of Italy in Intesa's loan book is 80%. Similarly, the relative exposure to domestic sovereign risk (adjusted for balance sheet size) at Intesa is four times the size of Santander's. Going forward, we would expect the correlation between banks and sovereign credit risk to loosen as the European Banking Union is implemented. This is especially true for large, geographically diversified groups.

Intesa (Y axis) vs. Italy (X axis) 5y CDS weekly change correlation



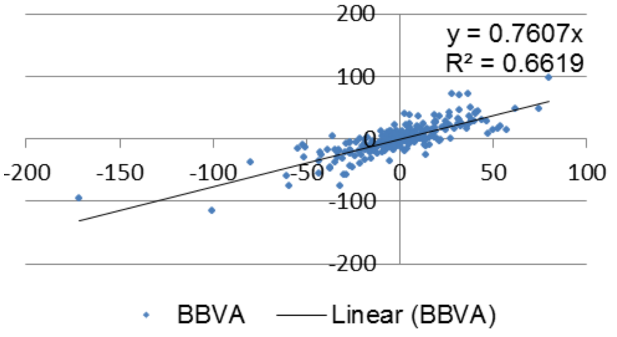
Source: Bloomberg, Scope Ratings

Unicredit ((Y axis) vs. Italy (X axis) 5y CDS weekly change correlation



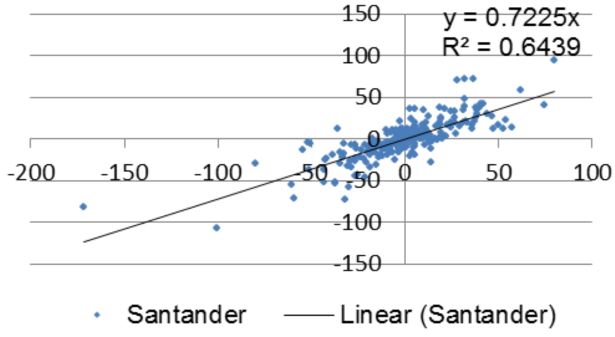
Source: Bloomberg, Scope Ratings

BBVA (Y axis) vs. Spain (X axis) 5y CDS weekly change correlation



Source: Bloomberg, Scope Ratings

Santander (Y axis) vs. Spain (X axis) 5y CDS weekly change correlation



Source: Bloomberg, Scope Ratings

Appendix 2 - Sovereign analysis guidelines

Scope will assess the credit fundamentals of sovereigns as part of its analysis for credit ratings, including banks. However the agency does not plan at this time to rate sovereigns and thus its analysis is not aimed at such an outcome.

Overview

Scope considers that a country's solvency and credit risk are reflected in its financial accounts. Debt levels, economic growth, the current account and other fundamental data testify to the sustainability or weaknesses of government policy. They shape the future and how financial markets judge the creditworthiness of the country.

Scope would conduct a time-series analysis of the country's macroeconomic data to assess its vulnerability over a period of time. The most important parameters are the national accounts, central bank data on financial and currency markets, together with domestic and foreign trade figures and structural data provided by the national central bank, the International Monetary Fund, the World Bank, the OECD, the European Union and other international institutions – global or regional.

Scope's sovereign analysis encompasses the following six areas, each divided into several segments:

1. Fiscal sustainability – central government debt and budget
2. Banking system stability – size, financial condition, interconnectedness
3. Financial stability – monetary policy and stability, credit supply
4. External sustainability – foreign exchange balance, external debt and reserves, currency strength
5. Political reliability – central government performance and track record
6. Economic strength – domestic performance and international competitiveness**.**

In the case of banks, Scope will aim to assess the degree to which a sovereign's credit fundamentals, reflected in the six areas of analysis above, affect the performance and credit quality of the institution(s) being rated. This would apply both to banks' home sovereigns and to sovereigns of non-domestic markets where the respective bank has a significant presence – reflected in a material share of assets, liabilities, or revenues, or where a material share of group capital has been allocated.

Disclaimer

Scope's Bank Rating Team

Lead Analysts
Jacques-Henri Gaulard
j-h.gaulard@scoperatings.com
Pauline Lambert
p.lambert@scoperatings.com
Marco Troiano
m.troiano@scoperatings.com

Associate Analysts
Juan Villalobos
j.villalobos@scoperatings.com

Team Leader
Sam Theodore
s.theodore@scoperatings.com

Scope Ratings GmbH
The Gridiron Building, 8th floor
One Pancras Square, London N1C 4AG
T: +44 203 714 4980

Lennéstraße 5
10785 Berlin
T: +49 (0)30 27891-0
F: +49 (0)30 27891-100
info@scoperatings.com

www.scoperatings.com