Presenting Scope's European Bank Ratings

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November 2014

Scope has published so far long-term and short-term credit ratings on 24 large banks in 11 countries across Europe – Belgium, Denmark, France, Germany, Italy, Netherlands, Norway, Spain, Sweden, Switzerland, and the United Kingdom – as part of its continuing initiative to rate the banking industry. We believe that offering a new set of analyses and ratings on the banking industry, potentially differing in part from other existing rating narratives, contributes to a wider diversity of opinions, benefitting institutional investors and other market participants. The total assets of the banks currently rated by Scope represent nearly two-thirds of the aggregated balance sheet of the European banking market, with more than EUR half trillion of debt being rated.

The European banking sector has been emerging from a lengthy period of turmoil – the global financial crisis of 2007-2009 followed by the EU sovereign and banking crisis of 2010-2013. Profound adjustments driven by regulators and policy makers over several years have led to a successful rebooting of banks in some countries, while in others the legacy clean-up and restructuring remain work-in-progress, but generally on the right track. Substantially higher levels and quality of liquidity and capital demanded by Basel 3 and CRD 4-CRR, the recently inaugurated Banking Union for firms in the euro area (EA), and especially the emerging resolution and recovery regime across the EU/EEA – perhaps the most transformational regulatory change for European banks in many years – are all creating a new and arguably safer landscape across the industry.

More recently, the ECB's Comprehensive Assessment exercise, which we consider to have been relatively successful, has shed light on EA banks' asset quality and has led to new capital requirements for only a limited number of banks whose weak credit fundamentals had been in the public domain for some time. Also significant for EA banks, the Single Supervisory Mechanism (SSM) which became effective earlier this month should lead to increased consistency of the bank supervision process, based on risk-based and forward-looking principles and processes.

While many banks are safer on average compared to the pre-crisis years, investors in bank securities are more exposed than before to the risk of the firms they invest in. Banks may remain "too big to fail" but the burden of avoiding bank failures will be on investors and creditors rather than on taxpayers. In the case of important banks becoming critically stressed and unable to survive without some form of support, creditor bailin has been rightly identified as the least unappealing outcome, compared to either insolvency or taxpayer bailout.

What Scope's bank ratings are

Issuer Credit-Strength and long-term ratings

Scope's linchpin rating for banks is the Issuer Credit-Strength Rating (ICSR), assigned on a AAA-to-D scale with "+" and "-" additional sub-categories for rating categories from AA to B inclusive. The ICSR represents a credit opinion on a bank's ability to meet its contractual financial commitments on a timely basis and in full while remaining a going concern.

The rating assigned to each long-term security or class of long-term securities is based on (i) the issuer's credit strength (reflected by the ICSR) and (ii) the terms and conditions of the debt instrument itself.

Short-term ratings

Short-term bank ratings apply to debt with a maturity of 13 months or less as well as for other short-term financial commitments. As much of this debt is being issued on a rolling basis, the short-term ratings express a credit opinion on the issuing bank's capacity to preserve unimpeded its debt-rolling ability, which is based to a large extent on investors' and other market participants' views of the issuer's timely debt-repayment capacity. Scope uses five short-term rating categories, from S-1+ (the highest) to S-4 (the lowest).

We do not use additional rating scales or symbols for components of the main ratings, as we consider that a plethora of rating categories and sub-categories can and usually do blur the main credit message and add unnecessary confusion for rating users.

Rating bank capital securities

We also assign ratings to bank capital securities which are compliant under Basel 3/CRD 4 (not legacy hybrid securities issued mostly in the years before the crisis). Specifically we have rated 49 capital securities issued by 11 banking institutions that we already rate. These ratings are supported by 19 detailed analytical reports on the specific AT1 and Tier 2 securities (securities with similar terms and conditions by the same issuer are aggregated into one report).

Scope considers that bank capital securities (AT1 and T2) are subject to principal loss absorption risks. In addition, AT1 securities are exposed to coupon cancellation risks. When rating AT1 securities, Scope notches down from a bank's ICSR as follows: (i) at least two notches for the inherent coupon cancellation risks, plus (ii) at least two notches for the inherent principal loss absorption risks.

The notching-down is based on the consideration that while the likelihood of coupon cancellation is materially less remote than the likelihood of principal conversion or write-down, the magnitude of loss stemming from principal conversion or write-down is materially higher than from missed coupons. The methodology notes that these are two distinct risks for AT1 investors and reflects this in separate notching gaps.

Further, there may be additional notching down – beyond the minimum four notches – due to either security-specific or issuer-specific considerations. These include the level of the trigger, the distance to trigger and to the combined buffer requirement, the status of the issuer within the group, the issuer's liability and capital structure, and last but not least specific regulatory requirements or guidelines.

Importantly, Scope does not assign so-called equity credit for issuers' AT1 securities and then based on such metrics make adjustments to banks' capital positions. We are of the view that it is regulatory metrics and not rating agency-adjusted capital that matter when assessing whether an issuer requires prompt regulatory action (the main driver of default-like scenarios for banks).

When rating T2 securities, Scope will begin with at least one notch down from the ICSR to reflect their junior status. As in the case with AT1 securities, additional notching down may be warranted due to security-specific or issuer-specific considerations.

Scope Ratings						
Bank	ICSR	Outlook	Short-term Rating	Short-term Rating Outlook	AT1	T2
Banco Santander SA	A	stable	S-1	stable	BB+	
Barclays Bank PLC	A	stable	S-1	stable	BB	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+	positive	S-2	positive		
Credit Agricole Group	A	positive	S-1	stable	BB+	BBB+
Credit Mutuel SA	A	stable	S-1	stable		
Credit Suisse AG	A+	negative	S-1	stable		A
Credit Suisse Group AG	A+	negative	S-1	stable	BBB, BBB-	BBB+
Danske Bank A/S	A-	stable	S-1	stable		
Deutsche Bank AG	A-	positive	S-1	stable	BB	
DNB Bank ASA	A+	stable	S-1	stable		
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
Lloyds Bank PLC	A	stable	S-1	stable	BB+	
Nordea AB	A+	stable	S-1	stable		
Rabobank Group	A+	stable	S-1	stable		
Royal Bank of Scotland PLC	BBB+	stable	S-2	stable		
Societe Generale SA	A	stable	S-1	stable	BBB-	
Swedbank AB	A-	stable	S-1	stable		
UBS Group AG	A	stable	S-1	stable		A-
Unicredit SPA	BBB	positive	S-2	stable		

* Rating benefit from a one-notch rating uplift due to the UK government's majority ownership

What our bank ratings reflect

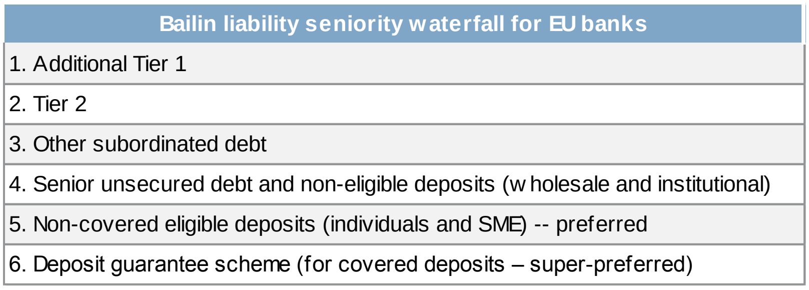
Looking at the track record of defaults related to regulated financial institutions across Europe and beyond, rare as they may be in recent history, we note that they were not the consequence of commercial bankruptcies like in other industry sectors but of regulatory action – ranging from the bank being prevented from making payments on specific categories of liabilities, such as junior securities, all the way to it being placed into insolvency proceedings. However, severe regulatory action would never relate to credit-healthy banks but only to firms which are in a financially critical situation, thus posing an immediate threat to depositors and to the financial system. Also, as evidenced when the financial crisis erupted, bank regulators may themselves be overcome by rapidly occurring negative developments, such as a funding and liquidity shortage, with their belated reaction coming as a surprise.

Consequently, our bank credit ratings and analyses aim to reflect proactively the extent to which banks' credit fundamentals evolve, either away from or towards the probability of severe regulatory action leading to default-like outcomes.

What are the key drivers of our rating methodology

Scope drafted its bank rating methodology aiming it to be anchored in the realities and dynamics of the post-crisis banking landscape which has been emerging. Other goals which underpin the methodology are the need to keep it straightforward and transparent, avoiding unnecessary complications, and also to focus the rating assessments on the future rather than on the past. Specifically:

Resolution and bailin: In banking systems with existing or emerging resolution and recovery regimes our ratings for specific liabilities reflect not only a bank's credit risk but also their priority of claim under resolution. Accordingly, for banks with ICSRs of BB+ and below, senior unsecured debt ratings will be notched down from the ICSR. However, for banks with investment-grade ICSRs (BBB- and above), which is the case of all 24 rated banks, there is no notching between the ICSR and the senior unsecured debt rating at this time. The lack of notching reflects (i) the remote likelihood of resolution for these banks, and (ii) the far more remote likelihood that if resolution does occur senior unsecured liabilities may end up being bailed in.



Bailin liability seniority waterfall for EU banks
1. Additional Tier 1
2. Tier 2
3. Other subordinated debt
4. Senior unsecured debt and non-eligible deposits (wholesale and institutional)
5. Non-covered eligible deposits (individuals and SME) -- preferred
6. Deposit guarantee scheme (for covered deposits – super-preferred)

Secured debt (such as covered bonds) and short-term debt with maturities of seven days or less are not subject to bailin.

Scope considers that a credible resolution and recovery regime should strengthen the stability and predictability of ICSRs over time, as insolvency proceedings scenarios become more remote. This is especially relevant when accompanied by enhanced supervisory rules and practices. These are well advanced in Switzerland, the US and several countries in the European Union and in time the successful implementation of the Single Supervisory Mechanism (SSM) should further strengthen them across the entire EA.

In the case of a severely stressed bank, if and when resolution is initiated its credit fundamentals are likely to stabilize and potentially even improve, although admittedly not at a very reassuring level. Even though this should be recognized by the ICSR, the ratings for various categories of the bank's bailinable liabilities would be lowered further as warranted.

Reduced likelihood of state support: In resolution-based banking systems timely external state support for distressed banks (bailout) is becoming a more improbable scenario. Accordingly Scope does not see it as a rating booster for the ICSR, notably for financially healthy banks. The possibility of some external support needs to be assessed for systemically important banks with ICSRs of BBB- and below, but this would not be tantamount to readily assuming that this scenario is likely to take place.

Notching up a rating based on expected state support could be envisioned only if (i) we had valid reasons to assume state support would be forthcoming in a timely manner, and (ii) these reasons are clear and transparent enough to be highlighted in our analysis. Among the 24 rated banks it is only RBS's ICSR and senior unsecured debt ratings which are boosted by an one-notch uplift due to the firm's majority ownership by the UK government.

No mechanistic links between banks and sovereigns: At this time Scope does not plan to assign public ratings on sovereigns but it does assess the credit risk of various sovereigns as a significant input in the ratings of banks or other issuers. That said we do not see a valid analytical reason for correlating bank ratings and sovereign assessments via mechanistic links. This is especially so for larger, geographically diversified banking groups. Furthermore, the emergence of the Banking Union should contribute to further delinking of bank ratings from home sovereigns in the EA, as will the implementation of resolution and recovery measures across the EU which in essence aims to privatize bank rescues. Among the 24 rated banks, this aspect is particularly relevant in the case of BBVA, Santander, Intesa and Unicredit.

The economic assessment of a bank's main market(s) – which is not necessarily tantamount to a national government's sovereign assessment – is part of our analysis underpinning a bank's rating, informing on trends in its asset quality, funding and revenue generation. Also, a bank's material exposure to a financially weak domestic sovereign is considered as a material concentration of credit risk.

Fundamental assessment is anchored in a bank's business model: When we assess the viability and sustainability of bank's business models we make appropriate comparisons to be able to identify outliers and to flag early-warning indicators coming from misalignment of business models with financial fundamentals (e.g. funding, asset and revenue mix) and market conditions.

In the broadest terms we cluster banking activities into three categories: retail and commercial banking (RCB), wholesale and investment banking (WIB) and wealth and asset management (WAM). Within these categories we then analyse activities in terms of (i) specific business lines and main products and (ii) geographies. For example, we look separately at a cross-border bank's domestic and foreign retail and commercial banking activities.

We consider that looking at a bank's financial metrics in combination with its business model enhances the analytical value of the numbers and ratios which the respective bank displays.

Peer-group approach: In our view a bank's credit dynamics can only be fully understood in a peer-group context. Peer-group analysis is embedded in the rating assessment from the start (not as a latter-stage "health check" tool) due to the fact that our ratings and analyses assess bank credit risk from a relative perspective – across time but also compared to domestic and cross-border peers.

With respect to the 24 rated banks, we position them into three broad business model-driven peer groups: (i) universal banks including RCB, WIB and WAM alike; (ii) international retail and commercial banks which derive a significant majority of their earnings from retail – both domestic and in foreign markets; and (iii) predominantly domestic retail and commercial banks with less significant earnings generated by non-domestic retail activities. The table below illustrates this:

Scope Ratings' European Peer Groups

International Wholesale	International Retail	Domestic Retail
Barclays	BBVA SA	Credit Agricole
BNP Paribas	Commerzbank	Credit Mutuel Group
Credit Suisse	ING Bank	Danske Bank
Deutsche Bank	KBC	DNB
HSBC	Nordea	Groupe BPCE
Societe Generale	RBS	Intesa
UBS	Santander	Lloyds
	Unicredit	Rabobank
		Swedbank

We highlight that as many banks reassess their strategies further shifts in business models are likely and this should lead to changes in the composition of our cross-border peer groups. For example, severe stresses during the crisis years have led some large banking groups to scale down significantly their WIB activities -- e.g. ING Bank, RBS, Commerzbank, Credit Agricole, BPCE and UBS.

Regulatory risk is growing: This risk can manifest itself both with respect to prudential and conduct risk. While investors have focused historically on the former (e.g., the risk that a prudentially non-compliant bank would be subject to regulatory action), the latter has been becoming increasingly relevant. Spurred by many banks' questionable behaviour before and during the crisis, regulatory bodies across many jurisdictions including in Europe are focusing more on banks' conduct in both retail sectors and wholesale markets.

We believe that regulatory risk is more elevated for banks with material investment banking and trading activities and a high degree of interconnectedness, and at its highest for banks with any of the following: (i) past instances of prudential and conduct problems; (ii) risky business models and strategies; and (iii) more borderline prudential metrics.

Forecasts of bank financials underpin forward-looking ratings: Scope's rating opinions on banks are geared toward future expected trends and developments. This is true about both rating drivers and rating-change drivers. In fact these drivers represent the body of our reports, rather than historical descriptive narratives.

Scope supplements its assessments with forward-looking metrics and estimates, thus not limiting itself to assessing past performance alone. Financial estimates for balance sheet and earnings are based on data and information disclosed publicly by the banks. The framework for this area of analysis is detailed by Scope's separate methodology report titled "Forecasting Bank Financials". Overall, Scope adopts a cautious view and relies on plausible but conservative scenarios in its forecast analysis.

All rating reports include both historical data going back to year-end 2007 and financial forecasts for 2014-2016.

Relevance of market metrics and market sentiment: Although market metrics (CDS or bond spreads, share prices) do not drive our bank ratings, the message their relative positioning conveys is assessed as a relevant variable in the analysis. The crisis years made it painfully clear that market sentiment can create significant tailwinds and especially headwinds for a bank's ability to fund itself or to raise equity. In fact, the crisis has shown that it can become on its own a forceful agent of change.

No mechanistic correlation between short-term and long-term ratings: The analysis of a bank's funding and liquidity is a key element which is properly highlighted by Scope's bank rating methodology. For long-term ratings, it is part of a multi-pronged analysis, alongside other risks which may present more of a medium-term threat, rather than very short-term – doubtful business models, more aggressive risk cultures, deteriorating trends in asset quality, erosion of capital, challenges in keeping pace with regulatory changes, etc. For short-term ratings, however, the assessment of a bank's funding and liquidity characteristics – including the role played by potential changes in market sentiment – is paramount.

Given these aspects, a certain degree of short-term/long-term rating correlation must exist, which indeed is the case. However, Scope does not establish strict mechanistic correlations between the two rating scales. The table below shows a certain degree of analytical discretion in assigning short-term ratings compared to the banks' long-term ratings.

<table>
<tr><th colspan="6">Scope Ratings</th></tr>
<tr><th></th><th>S-1+</th><th>S-1</th><th>S-2</th><th>S-3</th><th>S-4</th></tr>
<tr><td>AAA</td><td rowspan="5">S-1+</td><td></td><td></td><td></td><td></td></tr>
<tr><td>AA+</td><td></td><td></td><td></td><td></td></tr>
<tr><td>AA</td><td></td><td></td><td></td><td></td></tr>
<tr><td>AA-</td><td rowspan="4">S-1</td><td></td><td></td><td></td></tr>
<tr><td>A+</td><td></td><td></td><td></td></tr>
<tr><td>A</td><td></td><td rowspan="5">S-2</td><td></td><td></td></tr>
<tr><td>A-</td><td></td><td></td><td></td></tr>
<tr><td>BBB+</td><td></td><td></td><td></td><td></td></tr>
<tr><td>BBB</td><td></td><td></td><td rowspan="5">S-3</td><td></td></tr>
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<tr><td>B+</td><td></td><td></td><td></td><td></td></tr>
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<tr><td>B-</td><td></td><td></td><td></td><td></td></tr>
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Public vs. non-public information

The ratings assigned to the 24 European banks were not solicited by the issuers from Scope. A majority of the published rating reports have benefitted from issuer participation. Each report indicates clearly these details on its front page.

During the last decade or so, and especially since the onset of the crisis, public disclosure of the larger banks – including the rated banks – has improved significantly in both volume and quality and the degree of transparency on risk is now higher than ever. This can be found in increasingly voluminous annual reports, Pillar-3 reports, and detailed investor presentations accompanying quarterly results or other public events. Sources of information for the general background on banks include central bank reports, regulators' public statistics, reports from international organizations, comparative databases, industry reports, as well as market metrics.

In the future public information may be supplemented by information which may not be public in the case of issuers engaging in a rating relationship with Scope.

Under no circumstances would Scope assign or monitor a rating if the amount and quality of information, be it public or non-public, were not sufficient for an analytically consistent and balanced assessment.

Scope's ratings underpinned by strengthening credit fundamentals

The ratings being assigned to the 24 large European banks reflect several marked improvements in the banking sector's condition when compared to the state it was in at the onset of the crisis:

- Comprehensive strengthening of the regulatory environment both at national levels and at EU levels. This has led to a successful rebooting of banks in many countries, although challenges, stresses and uncertainties remain.
- More intrusive and effective risk-based supervision. After the crisis took hold supervisors have started to focus on areas less investigated before the crisis, such as liquidity and funding or business models, in addition to initiating ongoing stress-test processes.
- Business and balance-sheet de-risking and related adjustments in business models, although more radical shifts have been mostly the result of regulators' and policy makers' steering (for banks which had been given public support). By far the main strategic shift has been pulling back from wholesale and investment banking activities by financially stressed groups.
- Asset deleveraging, especially from cross-border wholesale banking and trading areas.
- Liquidity positions which are more ample and also of better quality (pre-crisis liquid assets included classes of high-risk structured products).
- Better funding mix, with reduced mismatching, notably away from short-term wholesale funds. Increased funding reliance on wholesale deposits (with relatively opaque disclosure) calls however for a note of caution.
- With respect to capital, significantly higher levels as well as improved mix (more equity and capital instruments with going-concern loss-absorbing clauses).
- Higher degree of market scrutiny which should keep banks "on their toes" more so than before the crisis. The implementation of resolution and bailin steps should enhance this even further as creditors and investors become even more sensitized to bank credit risk.

The credit improvements are also evident from the positive trend in several financial ratios, which we show on aggregate for a European peer group comprised of 43 large banks (including the rated banks). The trend in aggregate ratios also illustrates ongoing pressures on both revenue generation and asset-quality metrics (*see Appendix*). That said, Scope's profitability forecasts, undertaken using conservative estimates, show improving trends for a large majority of the rated banks. We point out however that the estimated improvement appears to be mainly the consequence of some reduction in credit costs in 2015 and only to a lesser extent from top-line revenue growth.

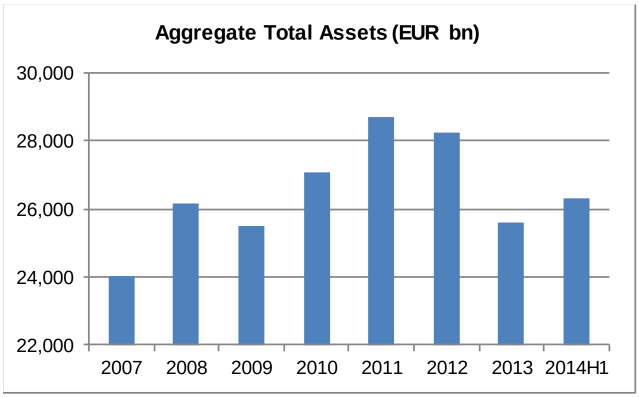
To conclude

Scope believes that going forward credit ratings for European banks need to take account of a few essential new factors:

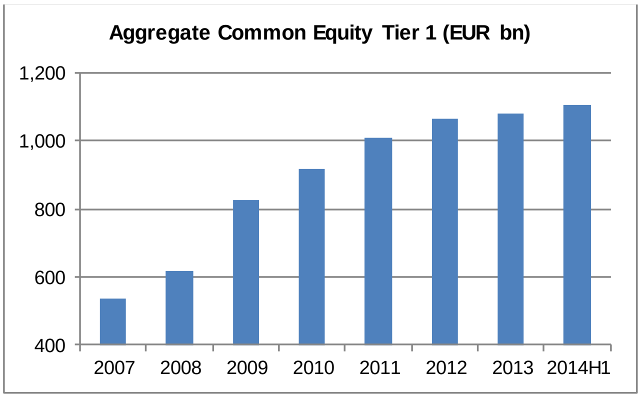
- As creditor bailin is replacing taxpayer bailout state support-based rating uplifts can no longer be justified except in very specific cases.
- Resolution and recovery frameworks should enhance the stability and predictability of the ratings of systemically important banks.
- The privatization of bank rescues brought about by resolution and bailin, as well as the emergence of the Banking Union, should contribute further to delinking large-bank credit from the credit of their home sovereigns.
- The gradually improving credit fundamentals of many banks at the tail-end of the crisis – including stronger prudential metrics – should be appropriately reflected in forward-looking credit ratings.

Appendix:
Key Financial Ratios (2007-first half 2014)

(aggregate of 43 large European banks)



Source: SNL Financial, Scope Ratings



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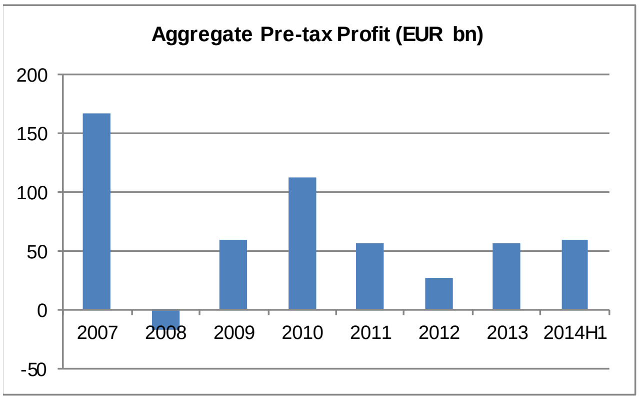

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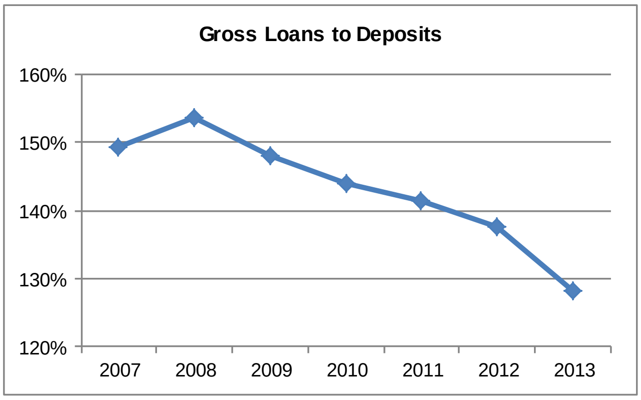

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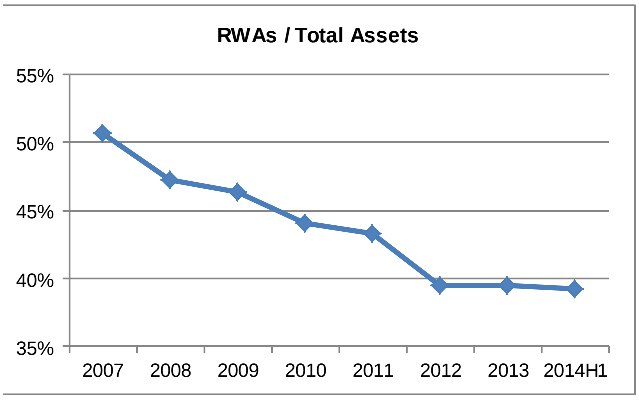

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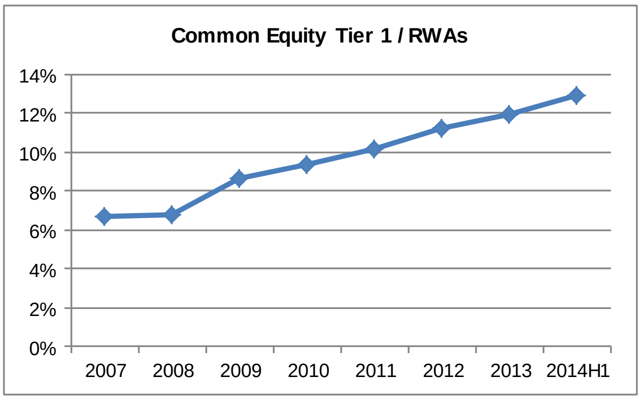

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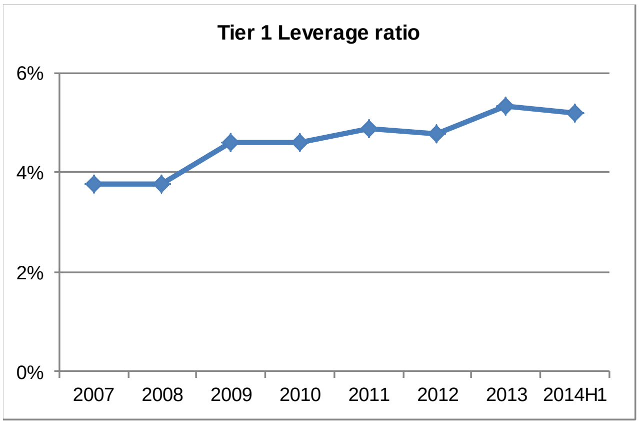

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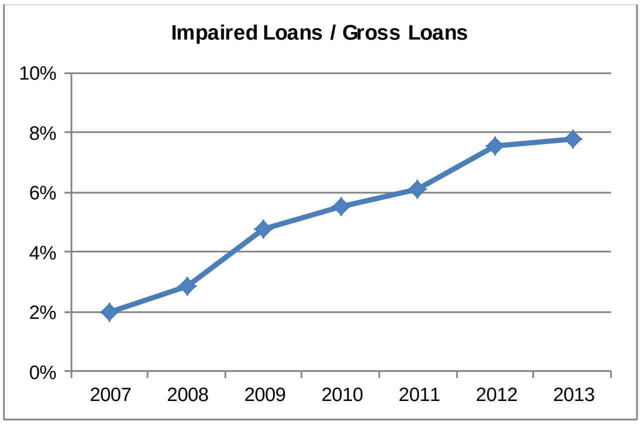

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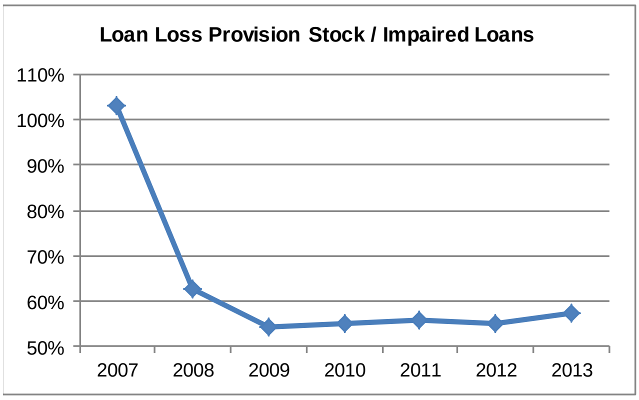

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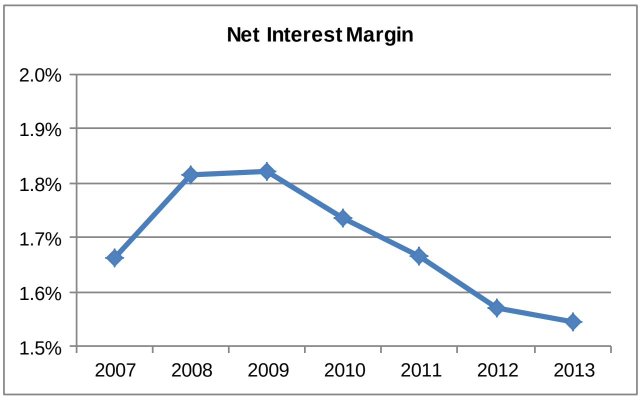

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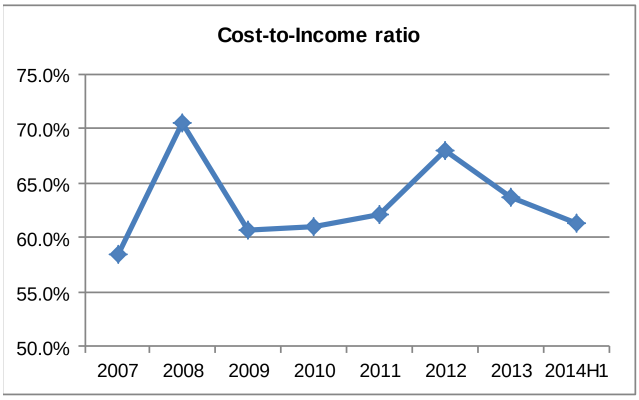

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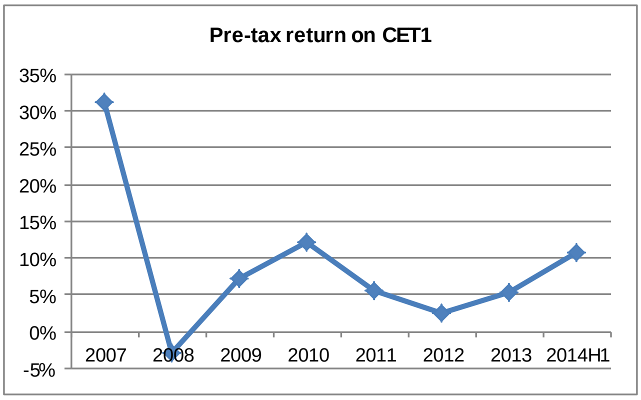

Source: SNL Financial, Scope Ratings

Note: 2014H1 annualised

The 43 large European banks

ABN AMRO
Allied Irish Banks
Banca Monte dei Paschi di Siena
Banca Popolare di Milano
Banco Popolare
Banco Popular Español
Banco Sabadell
Bank of Ireland
Bankia
Bankinter
Banque Federative du Credit Mutuel
Barclays
BBVA
BCP
BNP Paribas
CaixaBank
Caixa Geral de Depositos
Commerzbank
Credit Agricole Group
Credit Suisse
Danske Bank
Deutsche Bank
DNB
Erste Bank
Groupe BPCE
Handelsbanken
HSBC
ING Groep
Intesa Sanpaolo
KBC
Lloyds Banking Group
Nordea
Nykredit
Rabobank
RBS
RZB
Santander
SEB
Societe Generale
Swedbank
UBI
UBS
Unicredit

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