Introducing Scope's European Bank Ratings

Contact:

Sam Theodore

s.theodore@scoperatings.com

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Scope has published so far long-term and short-term credit ratings on 20 large banks in eight countries across Europe – Belgium, France, Germany, Italy, Netherlands, Spain, Switzerland, and the United Kingdom -- as the first step in its rating coverage of 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, could contribute to a wider diversity of opinions, benefitting institutional investors and other market participants.

The European banking sector is 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 forthcoming Banking Union for firms in the euro area (EA), and especially the emerging resolution and recovery regime – perhaps the most transformational regulatory change for European banks in many years – are all creating a new and arguably safer landscape across the industry.

However, safer on average as many banks may be compared to the pre-crisis years, investors in bank securities are more exposed than before to the risk of the firms they invest in. "Too big to fail" will probably still hold true in the future, but the burden to avoid bank failures is likely to be on investors and creditors rather than on the taxpayers. In the case of important banks becoming critically stressed and unable to survive without some form of support, creditor bailin is emerging as the least unappealing outcome, compared to either insolvency or taxpayer bailout.

What Scope's bank ratings are

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 (incl.). 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 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' view of its timely debt-repayment capacity. Scope uses five short-term rating categories, from S-1+ (the highest) to S-4 (the lowest).

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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.

Scope will also rate in the near future banks' subordinated debt and capital instruments (Tier 2 and Additional Tier 1). The methodology is based on ratings being notched downward off the ICSR, according to (i) regulatory requirements and conditions for each class of securities as well as (ii) instrument-specific features and their relationship with the overall credit fundamentals of the issuing bank. A fine-tuned version of this methodology will be published shortly. Scope does not plan to follow the practice of assigning "equity credit" for junior securities and then based on such metrics to make adjustments to banks' regulatory capital positions.

Scope Ratings				
Financial Institution	**Issuer Credit Strength Rating (ICSR)**	**ICSR Outlook**	**Short term Rating**	**Short-term Rating Outlook**
Banco Santander SA	A	Stable	S-1	Stable
Barclays Bank plc	A	Stable	S-1	Stable
BBVA SA	A	Stable	S-1	Stable
BNP Paribas SA	A+	Negative	S-1	Stable
BPCE SA	A+	Stable	S-1	Stable
Commerzbank AG	BBB+	Positive	S-2	Positive
Credit Agricole SA	A	Positive	S-1	Stable
BFCM SA (Credit Mutuel)	A	Stable	S-1	Stable
Credit Suisse AG	A+	Negative	S-1	Stable
Deutsche Bank AG	A-	Positive	S-1	Stable
HSBC Holdings plc	AA-	Stable	S-1+	Stable
ING Bank NV	A	Stable	S-1	Stable
Intesa Sanpaolo SpA	BBB+	Positive	S-2	Stable
KBC Group NV	A-	Stable	S-1	Stable
Lloyds Bank plc	A	Stable	S-1	Stable
Rabobank	A+	Stable	S-1	Stable
Royal Bank of Scotland plc	BBB+*	Stable	S-2	Stable
Societe Generale SA	A	Stable	S-1	Stable
UBS AG	A	Stable	S-1	Stable
Unicredit SpA	BBB	Positive	S-2	Stable

**: Ratings 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 is now 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 situation of all 20 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 actually does occur senior unsecured liabilities will end up being bailed in.

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)
6. Deposit guarantee scheme (for covered deposits)
7. Covered Bonds

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 euro area (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.

Diminished 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 this scenario as 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 20 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 bank ratings from home sovereigns in the euro area (EA), as will the implementation of resolution and recovery measures across the EU which in essence aims to privatize bank rescues. Among the 20 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 that bank's rating, informing on trends in its asset quality, funding or 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 20 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	Crédit Agricole
BNP Paribas	Commerzbank	Credit Mutuel Group
Credit Suisse	ING Bank	Groupe BPCE
Deutsche Bank	KBC	Intesa
HSBC	RBS	Lloyds
Societe Generale	Santander	Rabobank
UBS	Unicredit	

We should highlight that in light of many banks reassessing their strategies further shifts in business models are likely which 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 or 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 2014-2015.

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 (published in February 2014). 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 changed 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.

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<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>
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<tr><td>AA+</td><td></td><td></td><td></td><td></td></tr>
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<tr><td>BBB</td><td></td><td></td><td rowspan="5">S-3</td><td></td></tr>
<tr><td>BBB-</td><td></td><td></td><td></td></tr>
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<tr><td>BB</td><td></td><td></td><td></td><td rowspan="7">S-4</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 20 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 20 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). As highlighted by the ECB, on aggregate Tier 1 capital of EA banks rose almost 60% between 2008 and 2012 – from 8% to 12.7%.

- 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 44 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.

Challenges ahead

Despite the improvements and readjustments significant challenges and potential threats are still ahead – both in the short and medium term. These challenges and threats are reflected in Scope's rating drivers and rating-change drivers and are highlighted in each rating report.

Difficult macro landscape, including popular backlash to austerity: A majority of European economies see stagnation, ongoing recession or at best modest growth – albeit from different levels. A significant challenge remains growing popular backlash against austerity which could bring new and potentially threatening dynamics to the economic and political situation of some EU countries.

Low interest rates potentially leading to higher risk-taking: While helping borrowers make payments on their loans and keeping EU economies from falling further, low rates do not shore up banks' earnings (low net interest margins) and drive many of them to search for higher yields. Accordingly many banks, considering that the crisis is behind them, may aim going up the risk curve, thus potentially planting the seeds of the next crisis when the cycle will peak again.

Sudden or unexpected interest-rate hikes: The medium-term threat is not so much of rates being lifted up – something that is a "when" rather than an "if" scenario -- but of a sudden or unexpected shift upwards. This scenario is not our base case, but nonetheless cannot be ignored. Banks with asset-liability mismatches could be impacted more materially, as would firms with more borderline loan assets.

Shadow-banking threats: Occurring outside clear regulatory frameworks (capital, liquidity, conduct, credit-risk management, etc.), an unchecked growth of credit provided by shadow bank-like entities could lead to renewed troubles ahead. Regulated banks would not be sheltered from excessive bubbles and from pockets of risk developing elsewhere in the financial system.

Fragmentation: Successfully implementing the Banking Union should lead one day to a better-integrated single market across the EA banking landscape but for the time being this remains an aspirational goal. While "balkanization" may be a term too far, we believe that in Europe a certain degree of banking-market fragmentation and understandable national bias will remain. Even with pan-EA supervision, banks in each country will still have to deal with the national economic, fiscal and political realities which surround them.

Overcapacity: During the decade and a half before the crisis started the banking industry in West European countries boosted significantly its capacity to offer an ever increasing range of financial products and services to an ever widening customer base. The lack of growth potential is a threat for the banking industry as much as credit uncertainty and low margins. As banks are refocusing on boosting earnings, efficiency and costs re-emerge as a key challenge. To be sure, the banking industry shed significant capacity during the crisis. The ECB reported that in 2012 there were 158 inhabitants per bank employee, vs. 145 at the beginning of the crisis.

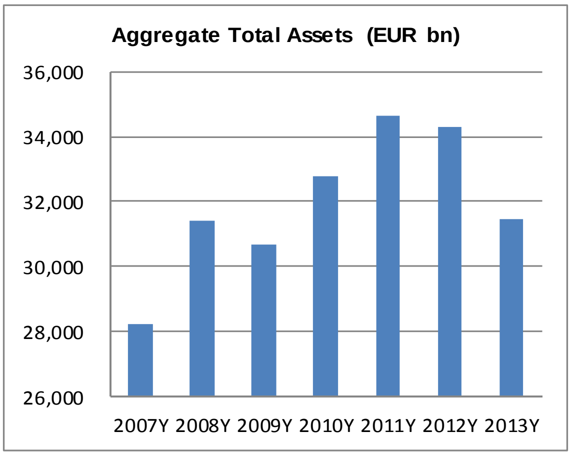
Cyber-security: Financial safety and financial matters are invariably at the top of everybody's concerns and the electronic meltdown of a bank account is a major nightmare for any business or household. In fact there are large swaths of the population which still do not trust the safety of online banking. Banks are investing significant resources in boosting cyber-security, as well as increasing cooperation. A bank hit by a major cyber-incident could suffer significantly in the absence of rapid and convincing remediation.

To conclude

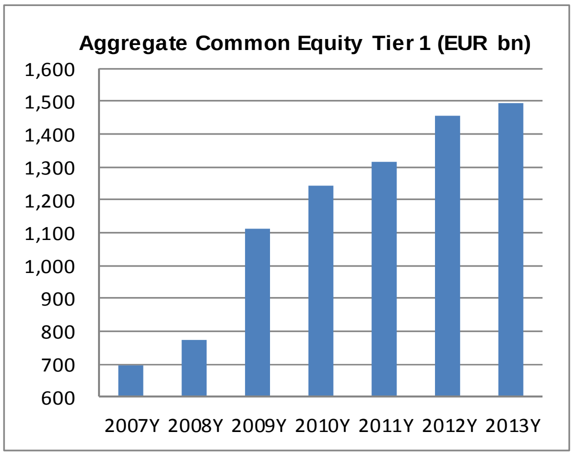
Scope believes that going forward credit ratings for European banks need to take account of a few essential new factors:

- 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.

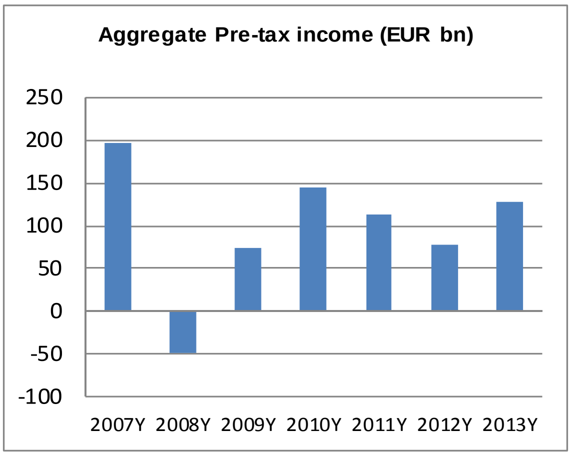
Appendix:
Key Financial Ratios
(aggregate of 44 large European banks)



Source: SNL Financial, Scope Ratings
Note : we use 2013H1 or 2012FY numbers as a proxy for banks which haven't reported 2013FY results



Source: SNL Financial, Scope Ratings
Note : we use 2013H1 or 2012FY numbers as a proxy for banks which haven't reported 2013FY results



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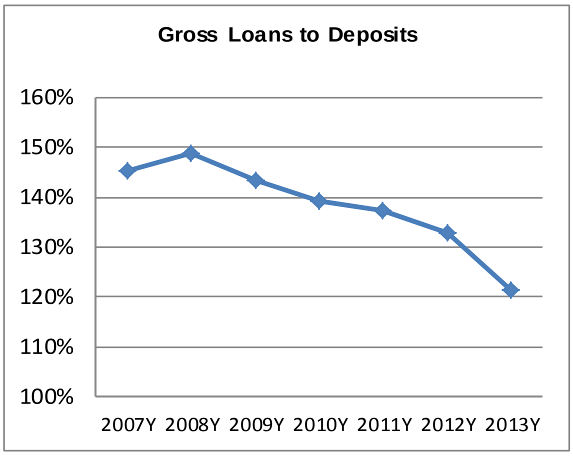
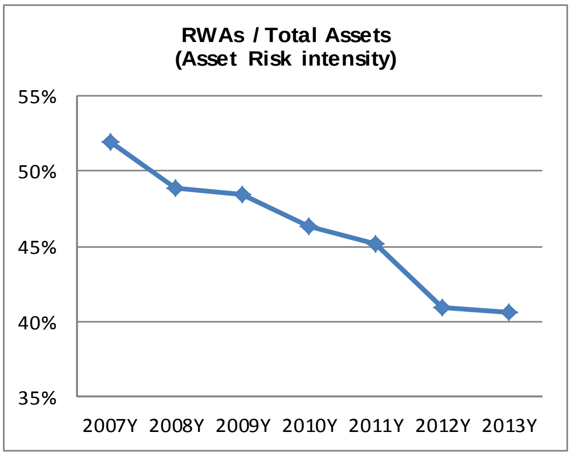
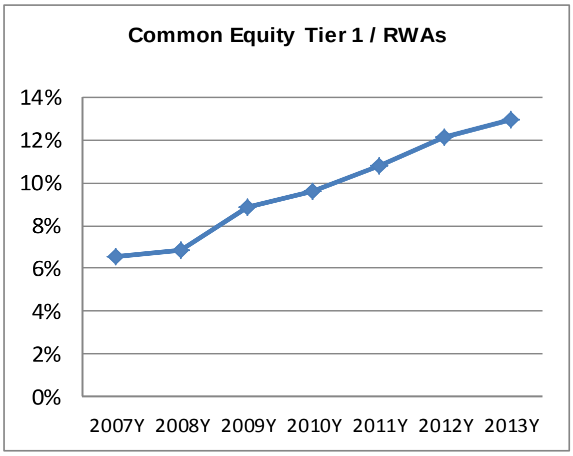
Note: we excluded banks which haven't reported 2013FY results



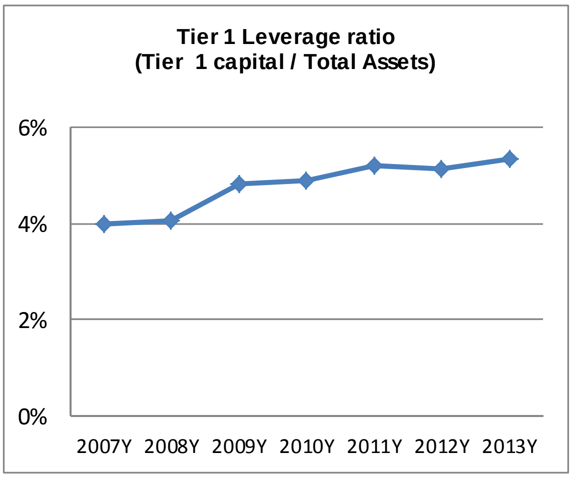
Source: SNL Financial, Scope Ratings



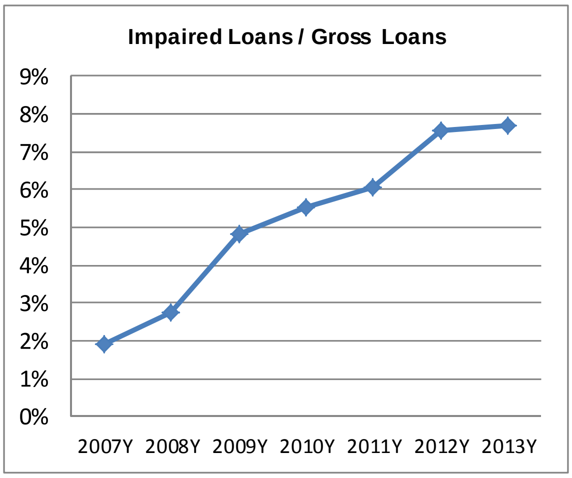
Source: SNL Financial, Scope Ratings



Source: SNL Financial, Scope Ratings



Source: SNL Financial, Scope Ratings



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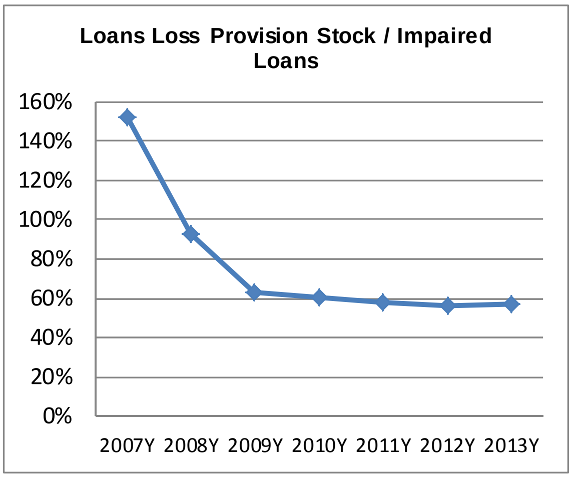

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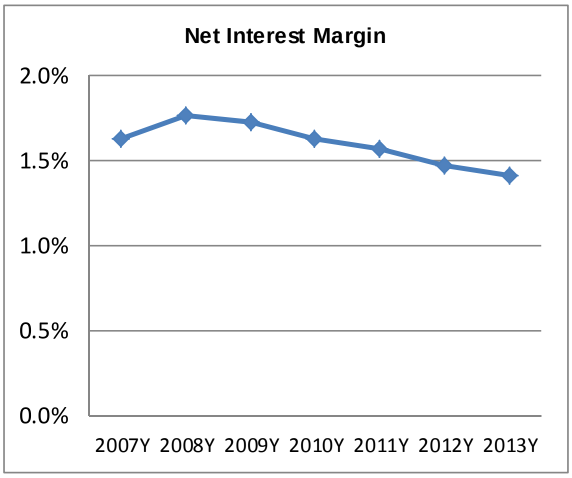
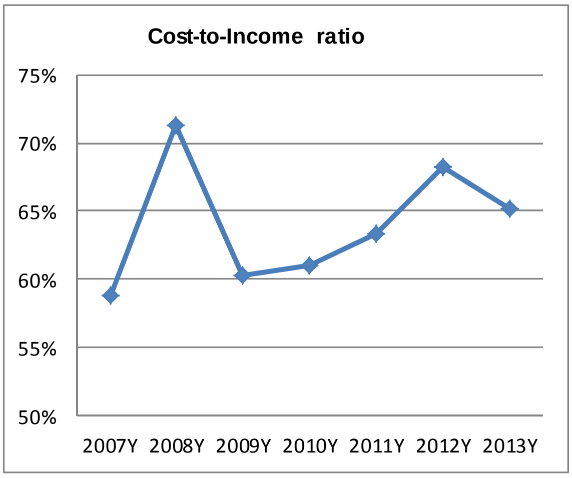


Source: SNL Financial, Scope Ratings



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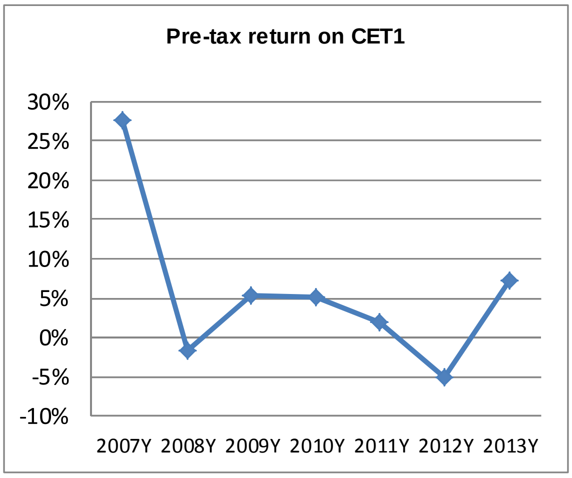


Source: SNL Financial, Scope Ratings

The 44 large European banks

ABN AMRO
Allied Irish Banks
Banca Monte dei Paschi di Siena
Banca Popolare di Milano
Banco Espírito Santo
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

Banco Santander SA
Issuer Rating Report

SCOPE

A STABLE OUTLOOK

Financial Institutions

Overview

Scope Ratings assigns an Issuer Credit-Strength Rating (ICSR) of A and a short-term debt rating of S-1 to Banco Santander SA, both with a stable outlook. The ratings are driven by the bank's strong retail and commercial banking business model, successfully replicated across several geographies in both developed and emerging markets, and producing a reliable and well-diversified earnings stream. This, in turn, translates into significant organic capital generation at the group level. Having withstood the global financial crisis, the Spanish real estate market collapse and the euro area sovereign crisis without damage to capital, the business model of Santander has proven its resilience to shocks in our view.

The weak macro environment in Spain continues to impact profitability and asset quality, which remains a concern, but the Spanish economy is showing some signs of improvement and a recovery should have positive impacts on asset quality in the coming years. We highlight, however, that we do not automatically link Santander's credit standing with a sovereign assessment on Spain, due to the banking group's business, revenue and risk diversification across several geographies.

The profitable emerging markets businesses, at present, are a key strength of the group, but are also potentially a material risk should weaknesses develop in specific markets. The ratings on Banco Santander SA are based on Santander Group's credit fundamentals and are not applicable to unguaranteed debt issued by subsidiaries of Banco Santander SA.

Issuer Credit-Strength Rating	
(assigned on April 2, 2014)	**A**
Outlook	Stable
Senior unsecured debt	A
Short term debt rating (May 22, 2014)	S-1
Short term debt rating outlook	Stable

Unsolicited ratings with issuer participation.

Lead Analyst

Marco Troiano
m.troiano@scoperatings.com

Team Leader

Sam Theodore
s.theodore@scoperatings.com

Rating drivers (Summary)

The ratings drivers, in decreasing order of importance in the rating assignment, are:

+	A business model that withstood crisis challenges: cost-efficient provision of retail and commercial banking services (high pre-provision income buffer to absorb credit charges) and resilient group profitability.
+	Globally diversified revenue and earnings streams with strong market positions in several key markets, including Spain, Brazil, UK, Mexico, Chile and Poland.
–	A challenging macro environment in Spain hurting asset quality and profitability.
+	Ongoing improvement of capital, liquidity and funding position in recent years.
–	Intervention by host or home regulators could limit intragroup capital and liquidity flows across geographies at times of stress.

Rating change drivers

Turnaround in Spanish asset quality and profitability. Several macro indicators point to the start of an improvement in the macro environment in Spain. If this improvement is sustained, it should eventually lead to a stabilization and possible reversal of domestic asset quality trends (albeit with some lags). Management expects the Spanish cost of risk to decline from 143bps of loans in 2013 to c. 100bps in 2014 and to normalize further in the following years. Our forecasts include a slower decline in loan loss provisions in Spain (to 125 bps of loans in 2014 and 100 bps in 2015).

Further improvement in capital standing. Santander's organic capital generation has been significant over the past few years and our estimates point to further capital build-up in 2014 and 2015, which is already reflected in the current rating. However, we would see favorably any actions aimed at improving the CRD4 capital standing of Santander, particularly compared with other G-SIFIs in Europe.

Material deterioration of Brazilian asset quality. Despite accounting for only 10% of group loans, Brazil accounts for 38% of pre-provision profit and a third of net profit. A deterioration in asset quality metrics in Brazil could significantly impact the group's profitability.

Material increase in mortgage arrears in the UK due to future rate hikes. Santander UK is mainly a mortgage bank, with 90% of the loan book consisting of mortgages. The average loan to value is relatively low at 51% and asset performance in the UK is good (NPL ratio of 2%, cost of risk of 24 bps of loans in 2013). However, with the equivalent of c. EUR 230bn in loans, a material increase in the loss rate could have a significant impact on group profitability. An increase in the risk profile of the UK loan book, potentially driven by material portfolio diversification away from mortgages, could also have a negative impact on ratings.

The positive effect of the forthcoming Banking Union. We note the increased regulatory convergence across EU banking systems, especially for firms within the euro area, as a factor materially attenuating the potential impact on Santander's credit fundamentals of the home sovereign situation. We consider that the emergence later this year of a Banking Union (BU) for the euro area, underpinned by the Single Supervisory Mechanism (SSM) and a Single Resolution Mechanism (SRM), could be a positive rating driver to the extent that it will further de-link the credit standing of Santander from that of its home sovereign. At this time, such an outcome is not yet certain, but the current steps towards the creation of the BU are encouraging.

Event risk. Santander has been very active in M&A both before and during the crisis, acquiring banking franchises in several countries, including the UK, the US, Germany and Poland. This strategy goes beyond the group's more traditional effort to grow in Latin America, where the bank rightly claims to have a cultural-related competitive advantage. So far most acquisitions and mergers have been effectively and successfully integrated, but the risk remains that potentially unexpected large transactions could have negative consequences on the group's fundamentals, including prudential metrics.

Recent events

Q1 2014 results

In Q1 2014, Santander earned EUR 1.3bn in net profit, an 8% increase from a year before. At constant exchange rates, net profit would have risen 26% y-o-y, driven by revenue growth (+4%) and declining provisions (-4.2%).

Asset quality started to show signs of improvement: the NPL ratio slightly declined (to 5.52% from 5.61% in Q4 2013), and coverage rose to 66% (from 65%). The NPL of the Spain business was still increasing, albeit at a much lower pace compared to previous quarters.

CRD 4 CET1 ratio stood at 10.6%, and management confirmed a target of 9% for the fully phased CET1 ratio at the end of 2014.

Buyback of Brazilian minorities

On April 29, 2014, Santander announced an offer to acquire the minorities (c.25%) of its Brazilian subsidiary, in an all-share transaction. Subject to regulatory approvals, the transaction is expected to be completed in Q4 2014 with no material impact on the group's capital level. According to management, the transaction should have a c.EUR 500mn positive impact on group net earnings (based on consensus expectations) in 2015 and no impact on the current capital position, although it would have a positive impact of c. 20bps on fully phased CRD4 CET1 Ratio due to the lower minority deductions.

Monetization of DTAs

With the approval of the Royal Decree-Law 14/2013, effective from January 1, 2014, Spanish banks will be allowed to convert some deferred tax assets generated by time differences (arising from non-deductible provisions for loans and foreclosed assets and by employee pension payments) into tax credits.

Tax credits are valuable assets that do not depend on future profitability and therefore will no longer be deducted under CRD4 capital rules. The latest reported CRD4 CET1 Ratio of 10.6% (transitional basis) in March 2014 already includes this impact, which management has estimated at 100bps.

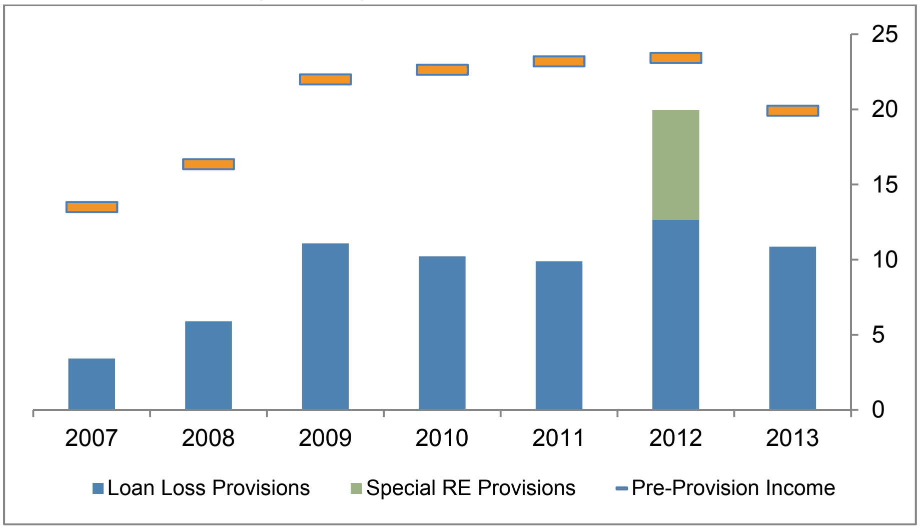
Rating drivers (Details)

1. **A business model that withstood crisis challenges: cost efficient provision of retail and commercial banking services (high pre-provision income buffer to absorb credit charges) and resilient group profitability.**

Santander's diversified retail business model has had a good track record in recent years. Despite significant challenges due to the burst of a domestic credit and real estate boom, as well as a sovereign crisis, the group was able to survive and emerge in a reassuring shape thanks to its earnings resilience. With a group cost-income ratio of approximately 47% (average 2011-2013), Santander makes on average about EUR 22bn in pre-provision profit annually. This gives it a buffer that can absorb a wide range of adverse asset quality shocks.

As shown in Chart 1, the profit buffer was sufficient to absorb losses throughout the crisis.

Chart 1: Recurring profitability absorbed credit provisions in 2007-2013, including special provisions on Spanish real estate (EUR bn)



Source: Company data, Scope Ratings

Indeed, Santander has not posted a single quarter of net losses since the beginning of the global financial crisis. This fact gives us some comfort about the group's protection against future risks: our forward-looking estimates point to a pre-provision profit buffer of approximately EUR 20bn in 2014, which would act as a first line of defence against adverse asset quality shocks.

We have stressed our group earnings and capital forecasts for Santander under several different adverse asset quality shock scenarios to test the bank's vulnerability to such shocks:

1. Significant Spanish asset quality deterioration.
   Santander Spanish total loan book (ex-real estate) is c. EUR 160bn. Although significant loss provisions have already been taken on real estate-related assets, NPLs are still accumulating in Spain, with business loans and residential mortgages remaining a concern. Our estimates include a mild decline in loan loss charges in Spain, but we stressed our estimates and note that a trebling of the Spanish loan-loss charges (from c. 140 bps to 420 bps of loans) would still see Santander profitable at the group level.
2. Significant Brazilian asset quality deterioration.
   The Brazilian loan book is the equivalent of c. EUR 70bn. While asset quality has so far remained relatively benign, fast credit growth in recent years raises the question of unrecognized asset risk in the country. On our numbers, Santander group could absorb a significant deterioration in Brazilian asset quality out of ordinary profitability before taking a hit to capital. In fact, Brazilian loan loss provisions would have to rise from the current 7% to over 15% of total loans to wipe out estimated group profits in 2014.
3. Significant UK mortgage asset quality deterioration
   Santander UK's total loan book is the equivalent of c. EUR 230bn. This mostly comprises mortgages (90% of total) with a relatively low LTV ratio of 51% on average. In the past three years, the loss rate in the UK has averaged 27 bps, reflecting the low-risk products as well as the high degree of collateralization, but also an exceptionally favorable interest rate environment, which has helped affordability. We currently model a modest increase in the loss rate in the UK, but this is unlikely to jeopardise group profitability. Even assuming an increase in the loss rate to 100bps of loans, the UK would post a pre-tax loss equivalent to just over EUR 200m, leaving the group with a pre-tax profit of over EUR 4bn.

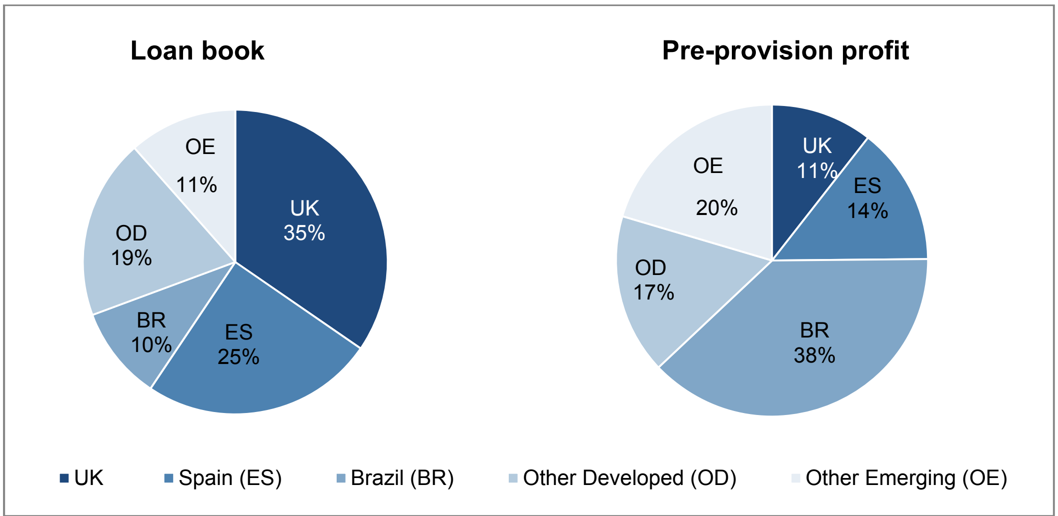
While each individual asset quality shock mentioned above could be absorbed by the bank's operating profitability cushions, there remains the more remote possibility of multiple shocks materializing at the same time and eroding Santander's capital base.

2. Globally diversified revenue and earnings streams with strong market positions in several key markets, including Spain, Brazil, UK, Mexico, Chile, Poland

Significant geographical diversification is a key positive driver for Santander's rating. The group comprises several retail and commercial banks in the Americas and Europe, servicing over 100 million customers globally.

As shown in Chart 2, mature markets still account for a majority of the loan book (c. 80%), but the bulk of Santander's earnings power is actually derived from the emerging markets franchises.

Chart 2: Loan book and operating profit split



Source: Company data, Scope Ratings

The Santander franchise has been built over several years, mostly through acquisitions. In that respect, we believe Santander's track record in acquisitions and integrations is positive so far. Since 2007, it has acquired several competitors in its core geographies at attractive prices, often benefitting from public backstops to risk, as was the case with the acquisition of Bradford & Bingley and Alliance & Leicester in the UK. Other major acquisitions in recent years include ABN AMRO Banco Real in Brazil, Sovereign Bank in the US and Zachodni WBK and Kredyt bank in Poland, as well as the SEB retail business in Germany. We note that, despite a strong appetite for inorganic growth, Santander's franchise remains fairly focused, with top three market positions in most of its core markets (see Table 1 for details).

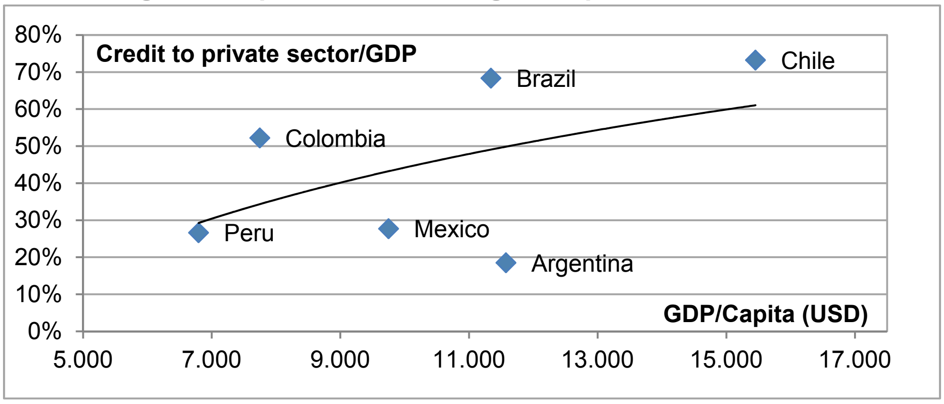
Table 1: Santander has a leading franchise with strong market shares in its core countries

	Spain	Mexico	Brazil	Chile	UK	Poland
Market Share (%)	13%	14%	11%	18%	11%	9%
Market Position (#)	2	3	3*	1	4	3

Source: Company data
**market position refers to private banks*

The emerging market franchise remains the main source of revenue and earnings growth for Santander. We note that, while some further catch-up in credit penetration compared with developed markets remains likely, both Chile and Brazil have a higher bank credit/GDP ratio than most other countries in Latin America (see Chart 3). As such, we expect revenue growth in these countries to be slower compared with the past few years.

Chart 3: High credit penetration limits growth potential in Brazil and Chile



Source: World Bank, Scope Ratings

As such, our positive view of the Group's international franchise relates not only to its growth potential, but especially to the earnings smoothing provided by the diversification: it would take synchronised recessions in the different countries of operation to seriously threaten group solvency.

3. A challenging macro environment in Spain hurting asset quality and profitability

The economic consensus on Spain has improved in recent months on the back of a number of positive data points. Starting in summer 2012, the picture emerging from Markit's PMI readings has brightened. Manufacturing PMIs began to signal expansion in Spain since July 2013 and have continued to improve since. GDP was marginally positive in the second half of 2013 and moved to +0.4% in Q1 2014.The unemployment rate has declined slightly from the peak of Q1 2013.

According to European Commission forecasts[1], Spain's GDP will grow 1.1% in 2014 and 2.1% in 2015. If this scenario materialises, we would expect the asset quality picture to improve. We note, however, that there are still significant headwinds to a sustained growth recovery in Spain. These include:

- A still challenged fiscal situation (government deficit/GDP of 7.2% and public debt/GDP at 94.3% in 2013[2]. The fiscal drag will likely keep weighing on the Spanish recovery in the coming years.
- A significantly negative net international investment position (-98.2% of GDP in 2013), resulting from a prolonged period of accumulated current account deficits. On this particular statistic[3], Spain is very much comparable to Greece (-119% of GDP), Portugal (-119% of GDP) and Ireland (-112% of GDP in 2012).

As such, we believe Spain remains prone to a relapse into recession and have therefore taken a cautious approach in forecasting forward profitability for Santander's Spanish unit. Nevertheless, as explained above, we deem Santander's profitability capable of absorbing significant asset quality shocks and hence do not consider Spanish asset quality an immediate threat to group solvency.

We do not anticipate a credit event on Spanish sovereign risk. However, the large exposure to Spanish sovereign risk remains a concern: according to the latest EBA data (June 2013), Santander had EUR 66bn in Spanish

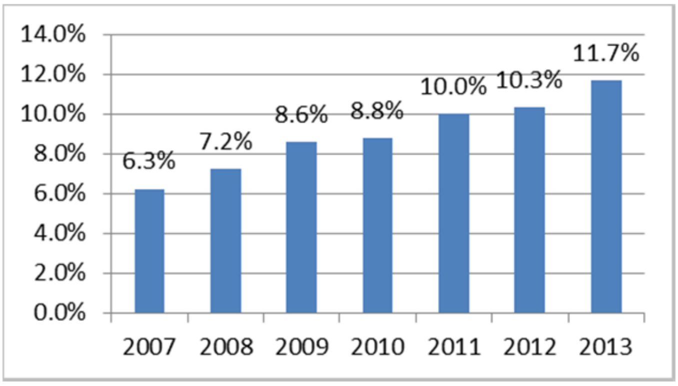
[1] European Commission, Spring Forecast 2014, published on May 5
[2] Source: European Commission
[3] Source: Eurostat

sovereign risk (including bonds and loans), equivalent to 123% of the group core capital base. In a simplified exercise (not accounting for tax impacts and offsetting management actions), for every 10% haircut to Spanish sovereign debt, Santander's consolidated core capital ratio would decline by 123bps. In other words, a 30% haircut would translate into a EUR 20bn loss and leave Santander on a 6.3% core capital ratio (based on EBA June 2013 data). Overall, the challenged macro environment weighs negatively on the credit assessment of the group.

4. Ongoing improvement of capital, liquidity and funding position in recent years

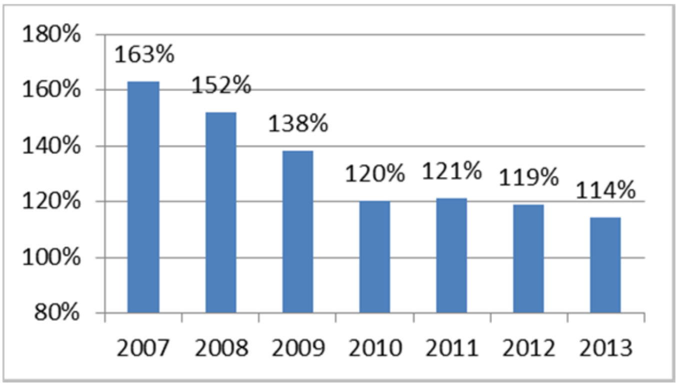
Santander is an efficient capital-generating operation on a group basis. Between 2007 and 2013, the Basel 2 capital ratio has moved from 6.3% to 11.7% (Chart 4.a), while tangible equity increased from EUR 57bn to EUR 81bn. The key to such an impressive capital build-up has been the high risk-adjusted asset profitability (RoRWA of 1.6% on average in 2007-2013), despite the performance drags in Spain and the high-risk intensity of Santander's balance sheet.

Chart 4.a: Santander Core Tier 1 capital ratio evolution (Basel 2), 2007-2013



Source: Company data, Scope Ratings

Chart 4.b: Santander gross Loan/Deposit evolution, 2007-2013



Source: Company data, Scope Ratings

As of December 31, 2013, Santander's capital position was satisfactory on a Basel 2 basis. Looking forward, the bank has a CRD4 CET1 Ratio (fully loaded) target of 9% in 2014, which is at the lower end of its peer group. Santander has not yet disclosed its actual CRD4 capital position on a fully loaded basis. On a phase-in basis, CRD4 CET1 Ratio is at 10.6% as of Q1 2014. A high average risk weighting of Santander's balance sheet partly mitigates the weak capital standing on a CRD4 basis.

Going forward, we believe Santander's capital position is set to improve further. Based on our projected return on RWAs (1.1% in 2014 vs 0.84% in 2013) and assuming flat RWAs (vs a decline in 2013), and a 25% cash dividend pay-out, Santander would still generate c. 80 bps of capital per year. Such capital generation capacity is strongly supportive of the bank's credit rating.

The funding and liquidity position has also significantly improved since the beginning of the crisis: the group's loan-to-deposit ratio went from over 160% in 2007 to c.114% in 2013 (Chart 4.b), and Santander has repaid the entirety of its LTRO loans in Spain, while it still retains some exposure in Portugal (EUR 4.5bn in 2013) and in the European consumer finance business (EUR 1bn). The sovereign crisis in Spain has accelerated the reduction in wholesale funding, which declined from EUR 162bn in 2010 to EUR 133bn in 2013. This has been the result of aggressive deposit acquisition (organic and inorganic) on the one hand and fast asset deleveraging, especially in Spain and Portugal, on the other. Going forward, there is still scope to rebalance the funding profiles of some subsidiaries, but we see the group funding profile as adequate and in line with international peers, so we do not expect a further significant decline at the group level.

5. Intervention by host or home regulators could limit intragroup capital and liquidity flows across geographies at times of stress

The recent financial crisis has shown that, in a period of stress, intragroup capital and liquidity mobility across geographies can significantly diminish, limiting a cross-border banking group's financial flexibility at a time when it needs it the most. Faced with such restrictions, steps ranging from the listing of a minority stake to the disposal of the entire business may be used by some banking groups as alternatives to unlocking capital from a subsidiary, for example. The extent to which cross-border banking groups have such alternatives at their disposal represents a mitigation to this risk.

Against this background, we look favorably at cross-border banking organizations that display reassuring capital and liquidity metrics not only at group level, but also at the subsidiary level.

The recent capital upstream from Brazil (where common equity was replaced by hybrids via the payment of a special dividend) partly allays concerns about intra-group capital mobility. During the Q4 2013 results conference call, Santander said that the parent company capital position was around 12% on a fully loaded CRD4 basis.

Peer comparison

At Scope Ratings, we compare banks within peer groups at domestic and cross border levels.

Santander's national peer group comprises mainly BBVA, Bankia and Caixabank, although it also includes mid-sized banks such as Sabadell, Popular and Bankinter. While Santander and BBVA pursued an international expansion whereby Spain now represents approximately one-quarter and one-half of their respective loan portfolios, the rest of their peers are largely domestic lenders.

At the cross border level, we compare Santander with large and diversified retail banks, including Unicredit, KBC, RBS, ING, Erste Bank, Nordea, Danske Bank, Commerzbank and RZB, as well as BBVA. The peer group is heterogeneous but its components share a predominant weight of retail in the banks' business model and exposure to several developed and emerging markets. Several of the above names fall under the definition of systemically important financial institutions and as such are required to carry additional capital buffers (1% in the case of Santander).

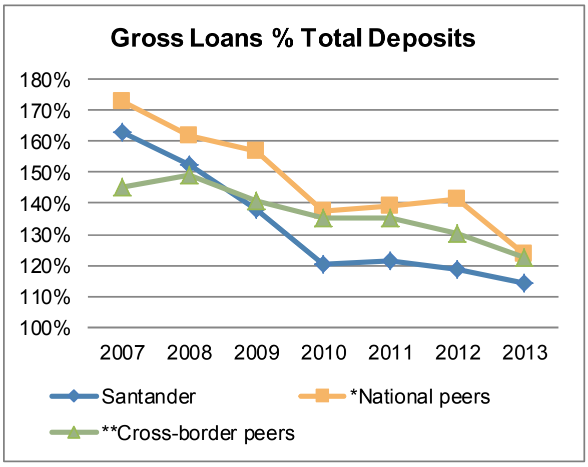
Despite the asset quality problems from its home business, Santander compares favourably with both domestic and international peers when it comes to asset quality and profitability. Compared with domestic peers, this can be ascribed to the well-executed diversification strategy. The profitability gap with international peers, on the other hand, reflects a higher (risk-adjusted) revenue productivity of banking assets in Latin America as well as the superior cost efficiency of Santander's operations. With a group cost-to-income ratio of approximately 50% in 2013, Santander is among the most efficient banks in Europe. While we anticipate some decline in revenue margins in Latin America as the credit markets deepen and the business mix shifts towards secured credit, we expect the process of convergence in profitability to be slow and gradual (although not linear).

From a funding and liquidity perspective, Santander's deleveraging in Spain and aggressive deposit acquisition campaigns in Spain and the UK have succeeded in bringing down the group's loan-to-deposit ratio to c.114% from over 160% in 2007, which is lower than both national and cross-border peers.

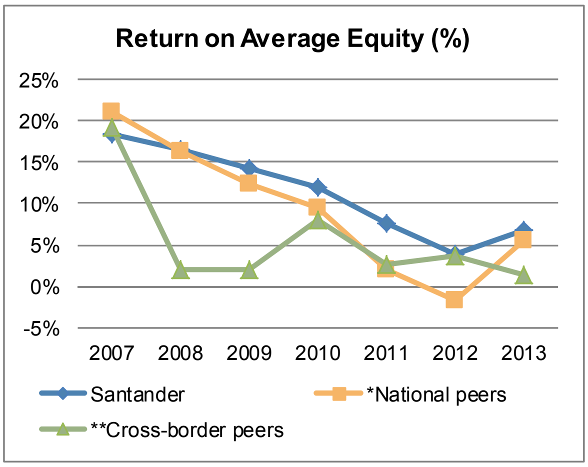
The strong and resilient group profitability has contributed to generating capital, although the bank remains at the lower end of its peer group on a fully loaded CRD4 CET1 Ratio basis. This is largely due to the high loan content of Santander's balance sheet. The bank leverage ratio is in line with its peer group.

Santander's capital position could benefit, in time, from a convergence towards a more level playing field due to RWA harmonisation, where Spanish practices are particularly conservative.

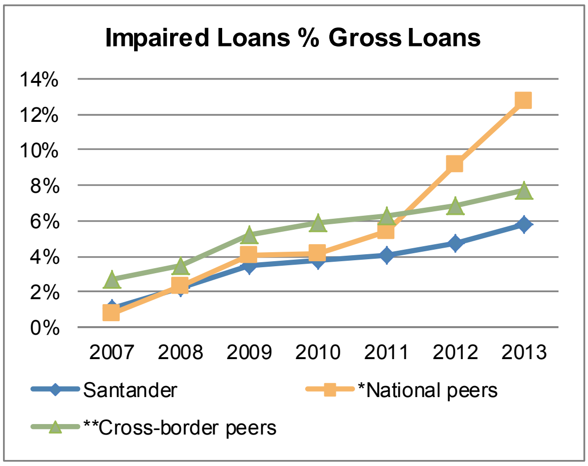
Peer Comparison - Santander group



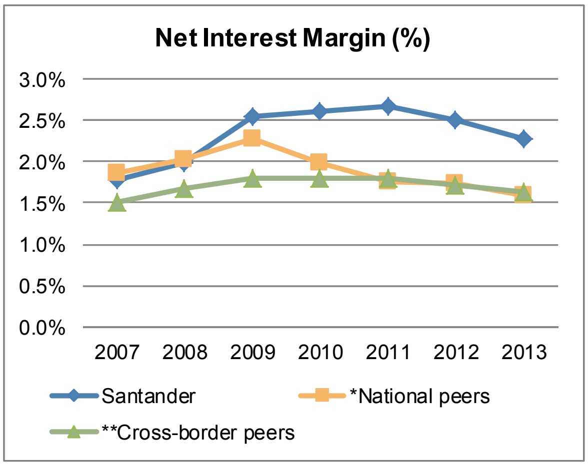
Source: SNL Financial, Scope Ratings



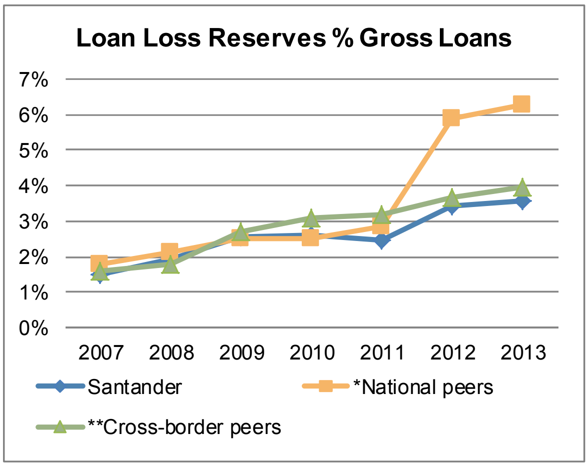
Source: SNL Financial, Scope Ratings



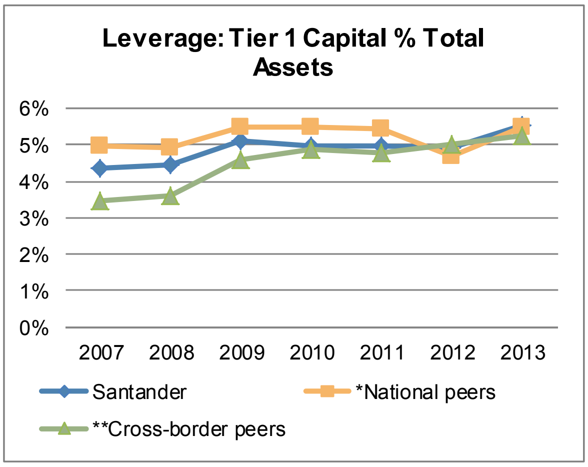
Source: SNL Financial, Scope Ratings



Source: SNL Financial, Scope Ratings



Source: SNL Financial, Scope Ratings



Source: SNL Financial, Scope Ratings

*National peers : Santander, BBVA, Caixabank, Bankia, Sabadell, Popular, Bankinter.
**Cross-border peers based on business model : Santander, BBVA, Unicredit, RBS, Erste Bank, RZB AG, Commerzbank, Nordea, KBC, Danske Bank, ING Bank.
Notes: Cross-border peer group averages exclude RZB in 2013

Selected Financial Information - Santander group

	2007	2008	2009	2010	2011	2012	2013	2014E	2015E
Balance sheet summary (EUR billion)									
Assets									
Cash and balances with central banks	31.1	45.8	34.9	77.8	96.5	118.5	77.1	79.3	75.3
Interbank assets	57.6	78.8	79.8	79.9	51.7	73.9	75.0	75.0	75.0
Total securities	132.0	124.7	174.0	174.3	154.0	152.1	142.2	135.1	128.4
of which debt instruments	109.3	109.3	151.5	150.6	143.8	141.3	132.4	125.8	119.5
equity instruments	22.8	15.4	22.5	23.7	10.2	10.7	9.8	9.3	8.8
Derivatives	50.1	107.9	69.1	82.8	114.4	120.5	68.8	68.2	68.9
Gross customer loans	579.8	639.4	700.4	742.0	767.3	744.5	693.8	693.8	704.6
of which impaired loans	6.1	14.0	24.0	27.9	31.3	35.3	40.3	40.3	36.3
Total funded assets	859.8	954.1	1,045.8	1,134.2	1,140.6	1,152.8	1,051.4	1,045.7	1,047.5
Total Assets	**912.9**	**1,049.6**	**1,110.5**	**1,217.0**	**1,251.0**	**1,269.6**	**1,115.6**	**1,109.4**	**1,111.8**
Liabilities									
Interbank liabilities	112.9	129.9	142.1	140.1	143.1	153.0	109.9	106.6	103.4
Senior debt	233.3	236.4	212.0	192.9	197.4	206.0	175.5	157.9	142.1
Derivatives	53.1	95.6	64.7	82.7	110.4	116.8	64.3	63.7	64.3
Customer deposits	355.4	420.2	507.0	616.4	632.5	626.6	607.8	620.0	638.6
Subordinated debt + hybrid securities	36.2	38.9	36.8	30.5	23.0	18.2	16.1	14.5	13.1
Total Liabilities	**855.4**	**989.6**	**1,036.7**	**1,137.5**	**1,170.2**	**1,188.3**	**1,035.7**	**1,025.5**	**1,024.3**
Ordinary equity	48.1	50.4	61.5	65.0	65.8	71.6	70.4	74.4	78.0
Minority interests	2.4	2.4	5.2	5.9	6.4	9.4	9.3	9.3	9.3
Total Liabilities and Equity	**912.9**	**1,049.6**	**1,110.5**	**1,217.0**	**1,251.0**	**1,269.6**	**1,115.6**	**1,109.4**	**1,111.8**
Core Tier 1 Capital [1]	*32.2*	*37.2*	*48.4*	*53.2*	*56.7*	*57.6*	*57.3*	*61.3*	*65.0*
Income Statement summary (EUR billion)									
Net interest income	14.4	17.5	26.3	29.0	29.1	29.9	25.9	25.8	26.7
Net fee & commission income	7.9	8.3	9.1	9.7	10.2	10.3	9.8	9.8	10.2
Net trading income	3.0	3.5	4.2	2.6	2.3	2.7	3.5	3.0	3.0
Operating Income	**26.4**	**30.9**	**40.2**	**41.7**	**42.8**	**43.4**	**39.8**	**39.3**	**40.6**
Operating expenses	12.9	14.5	18.2	19.1	19.6	20.0	19.8	20.0	20.3
Loan loss provision charges	3.4	6.3	11.6	10.4	9.9	12.6	10.9	10.7	10.5
Non-recurring items	1.9	1.1	0.2	-0.2	-4.7	-5.3	-1.8	-0.6	-1.7
Pre-Tax Profit	**12.0**	**11.2**	**10.6**	**12.0**	**8.6**	**5.5**	**7.2**	**8.1**	**8.1**
Income tax	2.3	1.8	1.2	2.9	2.5	2.3	1.9	1.7	2.0
Net profit attributable to minority interests	0.6	0.5	0.5	0.9	0.8	0.9	1.0	1.0	1.2
Net Income Attributable to Parent	**9.1**	**8.9**	**8.9**	**8.2**	**5.4**	**2.3**	**4.4**	**5.3**	**4.9**

Source: SNL Financial and Scope Ratings for historical figures. Scope's forecasts are based on publicly available information. Please refer to "Methodologies Used for this Report" for further details.
[1] Basel 2 basis

Ratios - Santander group

	2007	2008	2009	2010	2011	2012	2013	2014E	2015E
Funding/Liquidity									
Gross loans % Total deposits	163.1%	152.1%	138.2%	120.4%	121.3%	118.8%	114.1%	111.9%	110.3%
Total deposits % Total funds	47.7%	50.5%	56.0%	62.4%	63.0%	62.4%	66.8%	68.9%	71.2%
Wholesale funds % Total funds	52.3%	49.5%	44.0%	37.6%	37.0%	37.6%	33.2%	31.1%	28.8%
ASSET MIX, QUALITY AND GROWTH									
Total loans % Funded assets	67.4%	67.0%	67.0%	65.4%	67.3%	64.6%	66.0%	66.3%	67.3%
Impaired loans % Gross loans	1.0%	2.2%	3.4%	3.8%	4.1%	4.7%	5.8%	5.8%	5.1%
Loan loss reserves % Impaired loans	143.2%	89.1%	74.4%	70.0%	60.2%	72.0%	61.8%	61.8%	61.8%
Gross loan growth (%)	8.0%	10.3%	9.6%	5.9%	3.4%	-3.0%	-6.8%	0.0%	1.6%
Impaired loan growth (%)	31.6%	130.5%	71.7%	16.0%	12.2%	12.9%	14.2%	0.0%	-10.0%
Funded assets growth (%)	8.6%	11.0%	9.6%	8.5%	0.6%	1.1%	-8.8%	-0.5%	0.2%
EARNINGS									
Net interest income % Revenues	54.7%	56.8%	65.4%	69.4%	68.1%	68.9%	65.2%	65.6%	65.8%
Fees & commissions % Revenues	29.8%	26.8%	22.6%	23.2%	23.9%	23.6%	24.6%	25.0%	25.1%
Trading income % Revenues	11.2%	11.2%	10.6%	6.3%	5.4%	6.2%	8.7%	7.5%	7.4%
Other income % Revenues	4.3%	5.2%	1.4%	1.2%	2.6%	1.2%	1.5%	1.8%	1.8%
Net Interest Margin (%)	2.0%	2.2%	2.9%	2.9%	2.8%	2.9%	2.6%	2.7%	2.8%
Pre-provision Income % Risk-weighted assets (RWAs)	2.6%	3.2%	3.9%	3.7%	4.1%	4.2%	4.1%	4.0%	4.2%
Loan loss provision charges % Pre-provision income	25.4%	38.4%	52.6%	45.9%	42.7%	54.0%	54.6%	55.1%	51.6%
Loan loss provision charges % Gross loans (cost of risk)	0.6%	1.0%	1.8%	1.5%	1.3%	1.7%	1.6%	1.6%	1.6%
Cost income ratio (%)	48.9%	47.1%	45.3%	45.7%	45.7%	46.0%	49.9%	50.8%	50.0%
Net Interest Income / Loan Loss Charges (x)	4.2	2.8	2.3	2.8	2.9	2.4	2.4	2.4	2.6
Return on average equity (ROAE) (%)	19.5%	18.0%	16.0%	13.0%	8.2%	3.3%	6.2%	7.3%	6.4%
Return on average funded assets (%)	0.7%	0.6%	0.6%	0.5%	0.3%	0.1%	0.3%	0.3%	0.3%
Retained earnings % Prior year's book equity	10.9%	8.6%	9.1%	7.7%	5.1%	1.7%	4.6%	5.6%	4.9%
Pre-tax return on core tier 1 capital	37.1%	30.0%	22.0%	22.6%	15.2%	9.6%	12.6%	13.1%	12.5%
CAPITAL AND RISK PROTECTION [1]									
Common equity tier 1 ratio (common equity tier 1 capital % RWAs)	6.3%	7.2%	8.6%	8.8%	10.0%	10.3%	11.7%	12.6%	13.3%
Tier 1 leverage ratio (%)	4.4%	4.3%	5.1%	5.0%	5.0%	4.9%	5.5%		
Median of tier 1 leverage ratio and core tier 1 ratio (%)	5.3%	5.8%	6.9%	6.9%	7.5%	7.6%	8.6%		
Total loss coverage (core tier 1 + loan loss provisions) % RWAs	7.9%	9.7%	11.8%	12.0%	13.3%	14.9%	16.8%	17.7%	17.9%
Non-senior bailinable debt Cushion (as % of Total liabilities)	5.0%	4.6%	4.2%	3.4%	2.7%	1.6%	1.6%		
Asset risk intensity (RWAs % Total assets)	56.4%	49.0%	50.6%	49.7%	45.2%	43.9%	43.9%	43.9%	43.9%

Source: SNL Financial and Scope Ratings for historical figures. Scope's forecasts are based on publicly available information. Please refer to "Methodologies Used for this Report" for further details.
[1] CRD 4 basis capital position not disclosed. CET1 Ratio based on Basel 2 Core Tier 1 capital

METHODOLOGIES USED FOR THIS REPORT

For the rating and analysis contents of this report, Scope has used the following methodologies which were published on www.scoperatings.com:

"Bank Rating Methodology" (February 2014)

"Forecasting Bank Financials Methodology" (February 2014)

Forecasting bank financials: Forward-looking estimates are an important analytical tool underpinning Scope's bank ratings. These forecasts cover the current financial year (before final year-end figures are published by the bank) plus the forthcoming two years. Depending on the complexity of the bank being assessed, different forecasting tools will be used. For a majority of banks operating primarily commercial and retail banking franchises (loans and deposits) the analysis is underpinned by an **accounting** forecast of the balance sheet and profit and loss account. For more complex groups with multiple ranges of activities – notably those with material wholesale and investment banking operations – Scope uses an **analytical** forecast, relying on the bank's business-line reporting to come up with plausible estimates. For all banks Scope also includes a **regulatory metrics** forecast, considering the growing importance of this aspect in bank analysis.

For complex banks, divisional data is used to forecast profit and loss accounts and basic divisional balance sheet metrics. For less complex banks, a line-by-line forecasting of major P&L elements is forecast.

For balance sheet forecasts, Scope estimates of all major balance sheet lines, using the P&L estimates to complete the forecast of the capital/shareholders' equity line. This comprehensive methodology for estimating the balance sheet is used for all the banks in our universe, irrespective of size and complexity.

Lastly, our forecasts include assessments of the major regulatory metrics: Tier 1 and CET 1 (historically CT1), Leverage, Liquidity Coverage Ratio, and Net Stable Funding Ratio (the latter two when and if sufficient public information to compute them is available).

Scope will not aim to forecast financials when it considers the public disclosure of the bank as insufficient for a transparent and credible outcome.

All Scope's bank financial forecasts are based on public information. For its forecasts Scope will not use any non-public information or data, even if such information or data were provided by rated banks. Scope's forecasting process is transparent, with a detailed roadmap provided in its *"Forecasting bank financials"* methodology.

Barclays Bank plc
Issuer Rating Report

A STABLE OUTLOOK
Financial Institutions

Overview

Scope Ratings assigns an Issuer Credit-Strength Rating (ICSR) of A and a short-term debt rating of S-1 to Barclays Bank plc, both with Stable outlooks. The ratings are driven by the Group's business model, with inherently volatile investment banking activities being offset to some extent by more stable retail and business banking activities primarily in the UK. Management has recently announced plans to refocus the Group so that the weight of investment banking activities will be meaningfully reduced. Further, Barclays needs to continue the progress made on capital, leverage and financial targets as well as repair reputational damage. If successful, Barclays will be better positioned to generate more sustainable earnings.

The ratings also apply to senior unsecured and short-term debt issued by Barclays's parent, Barclays plc. However, the ratings are not applicable to unguaranteed debt issued by subsidiaries of Barclays Bank plc.

Issuer Credit-Strength Rating (assigned April 2, 2014)	**A**
Outlook	Stable
Senior unsecured debt	A
Short term debt rating (May 22, 2014)	S-1
Short term debt rating outlook	Stable

Unsolicited ratings with issuer participation.

Lead Analyst

Pauline Lambert
p.lambert@scoperatings.com

Team Leader

Sam Theodore
s.theodore@scoperatings.com

Rating drivers (Summary)

The rating drivers, in decreasing order of importance in the rating assignment, are:

- (−) Inherently volatile investment banking activities currently account for nearly half of earnings.
- (+) Strong earnings from retail banking in the UK and the global card business lend stability.
- (+) Solid liquidity risk management.
- (+) Strategic focus on meeting leverage and capital requirements.
- (−) Reputational and conduct issues continue to hamper performance.

Rating change drivers

- (↑) Successful execution of new strategic plan which would increase the proportion of earnings from non-investment banking activities and thus, add further stability to Barclays' earnings and credit profile. As part of its plans to refocus the Group, management intends to reallocate capital towards traditional banking activities and growth businesses (i.e. Barclaycard and Africa Banking).

- (↑) Meeting and sustaining leverage and capital targets. Last June, the UK's Prudential Regulatory Authority (PRA) introduced a 7% PRA stressed CET1 ratio target to be met by year-end 2013 and a minimum 3%

leverage ratio target to be met by June 2014. Compared with international standards, these are accelerated timelines. At the end of Q1 2014, Barclays had met these targets. Barclays is now aiming for a CRD4 leverage ratio above 4% in 2016 and a fully loaded CRD4 CET1 ratio above 11% in 2016. Based on current regulatory requirements, the CET1 ratio target for 2019 is 11.5% to 12%.

- Inability to address evolving regulatory changes. These include ring-fencing in the UK's 2013 Banking Reform Act, new foreign banking organization rules in the US regarding capital and leverage and various issues related to investment banking activities such as central clearing and the review of trading books.

- Further and substantial conduct costs. Barclays faces ongoing investigations regarding capital raisings in 2008, LIBOR, other benchmarks and foreign exchange rates as well as power trading activities in the US between 2006 and 2008. We note that investigations are becoming broader in scope and penalties higher.

- Material deterioration in liquidity profile. During 2013, Barclays reduced its liquidity pool to GBP 127bn, from GBP 150bn at year-end 2012. This was done to reduce balance sheet leverage as well as to optimize the size of the liquidity pool. At year-end 2013, the liquidity pool remained in excess of internal and regulatory requirements and management has stated that there are no plans to further reduce the liquidity pool materially. However, as Barclays' business model remains sensitive to market confidence, we would view negatively a material deterioration in the Group's liquidity profile.

Recent events

Strategy update

In light of the changed regulatory and economic environment, Barclays has outlined plans to achieve a sustainable return on equity above the cost of equity. In effect, the Group will be "repositioned, simplified and reblanced to improve returns significantly". For 2016, Barclays now has a core adjusted ROE target above 12% (previously 11.5%).

Barclays intends to be a "focused international bank", with four core businesses: Personal and Corporate Banking, Barclaycard, Africa Banking and Investment Bank. Amongst the most significant changes is the planned reduction in the size of the Investment Bank, from 50% of Group RWAs to less than 30%, which addresses the increasing investor concerns about the size and profitability of the Investment Bank. Based on preliminary figures, the new Barclays in 2013 would have generated nearly GBP 26bn in income, over GBP 7bn in profit before tax and a ROE of around 12% with fewer RWAs and lower leverage.

Consequently, Barclays Non-Core is being created to hold those assets which do not fit the Group's strategic objectives or returns criteria (i.e. parts of the Investment Bank such as non-standard FICC derivatives, non-core commodities and Exit Quadrant assets (approximately GBP 90bn of RWAs), the entire Europe retail business (GBP 16bn) and certain Corporate, Barclaycard and Wealth RWAs (GBP 9bn). Barclays Non-Core will be comprised of about GBP 115bn in RWAs and GBP 400 bn in leverage exposure, with the goal to reduce this to GBP 50bn in RWAs and GBP 180bn in leverage exposure by the end of 2016.

Q1 2014 results

For the three months ending March 31, 2014, adjusted attributable profit was GBP 882m, down from GBP 1.0bn in the prior year period. The 14% fall in adjusted income was only partially offset by lower operating expenses (down 16%) and credit impairment charges (down 22%). In particular, Investment Bank income fell 28% to GBP 2.5bn, driven primarily by a 41% decrease in FICC income. While trading conditions were difficult and the Investment Bank was repositioning, the performance of Barclays was worse than peers. Meanwhile, most of the other businesses (UK retail, cards and corporate banking) generated higher returns year on year. On a reported basis, attributable profit was GBP 965m, compared to GBP 839m. During the quarter, Barclays' capital position continued to improve, with the CRD4 fully loaded CET1 ratio increasing 37bps to 9.6% and the PRA leverage ratio increasing 16bps to 3.1%.

Rating drivers (Details)

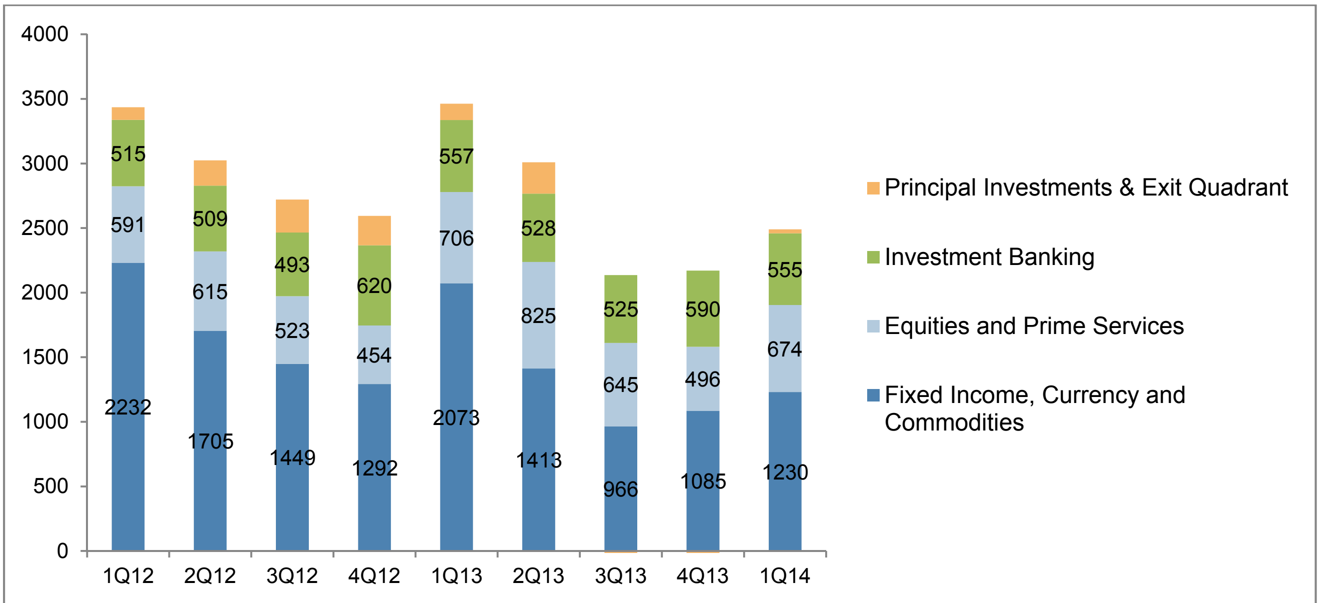
1. Inherently volatile investment banking activities currently account for nearly half of earnings

In September 2008, Barclays acquired the North American operations of Lehman for GBP 1bn, significantly changing its business profile. Prior to the acquisition, investment banking activities had accounted for about one-third of Barclays' earnings. Now, the Investment Bank is the largest business within Barclays. In 2013, the Investment Bank generated GBP 2.5bn in profit before tax, accounting for nearly half of total Group profit. And within the Investment Bank, FICC activities account for just over half of total revenues.

In its recent strategic update, management stated that "the Investment Bank is too exposed to volatility in FICC and the Group is too exposed to volatility in the Investment Bank." Consequently, Barclays intends to refocus the Investment Bank, driven by the origination needs of clients and its leading positions in two large home markets, the US and UK. The Group will concentrate on businesses capable of generating strong returns and where Barclays already has robust capabilities, such as credit, equities, rates and foreign exchange. In 2016, the core Investment Bank is expected to comprise around GBP 120bn in RWAs and GBP 400bn in leverage exposure, accounting for less than 30% of Group RWAs and leverage exposure, down from 50%. Management also specified that it has conservative views about future income growth and therefore future returns will be driven by structurally lower costs.

The non-core Investment Bank accounts for nearly 80% of Barclays Non-Core RWAs. Non-core Investment Bank includes Exit Quadrant assets of GBP 45bn (YE2012: GBP 79bn) plus the addition of physical commodities, other trading businesses including emerging markets and non-standard derivatives and other non-strategic businesses. Barclays intends to sell down or roll off the assets, acknowledging that some assets may take longer to exit. In 2013, the non-core Investment Bank accounted for GBP 1.5bn in income, with RWAs of GBP 90bn and leverage exposure of GBP 340bn.

Chart 1: Investment Bank income by business line (GBP m)



Source: Company data, Scope Ratings

2. Strong earnings from retail banking in the UK and the global card business lend stability

Positively, retail and business banking activities and in particular, UK Retail and Business Banking (UK RBB) and global cards (Barclaycard), help to stabilize Group earnings. The UK RBB division benefits from a leading franchise in its home market, the UK. There is a focus on the mass affluent and business clients as well as providing a differentiated customer experience through digital channels. Barclays holds about a 10% share of the UK mortgage market. Barclaycard is the 8th largest consumer payments company globally and ranks in the top three in all markets except the US where it is in the top ten.

In 2013, the returns on equity for the UK RBB and Barclaycard businesses were 4.9% and 8.3%, respectively. On an adjusted basis which excludes provisions for PPI redress, the respective ROEs were much higher at 11.5% and 18.4%.

Table 1: 2013 earnings by business division

	Total Income (GBP m)	Profit before Tax (GBP m)	ROAE (%)
UK Retail and Business Banking	4,523	1,195	11.5
Europe Retail and Business Banking	666	-996	-45.2
Africa Retail and Business Banking	2,617	404	0.4
Barclaycard	4,786	1,507	18.4
Investment Bank	10,733	2,523	8.2
Corporate Banking	3,115	801	3.1
Wealth & Investment Mgt	1,839	-19	-1.0
Head Office	-124	-248	
Group	**28,155**	**5,167**	**4.5**

Note: Income is net of insurance claims. Profit and ROAE figures are on an adjusted basis which excludes GBP 2bn of PPI and interest rate hedging costs in the UK Retail and Business Banking, Barclaycard and Corporate Banking divisions, GBP 0.8bn of goodwill impairment in the Wealth & Investment Mgt. division and GBP 0.2bn of own credit charges. Source: Company data, Scope Ratings

3. Solid liquidity risk management

Recognizing the need for a solid funding structure, Barclays aims to align the sources and uses of funding. Retail and commercial loans are largely funded by customer deposits while other assets together with other loans are funded by long term wholesale debt and equity.

Barclays has increased customer deposits and reduced reliance on wholesale unsecured funding. In 2013, the reported loan to deposit ratio was 101%, down from 118% in 2011. At year-end 2013, Group wholesale funding amounted to GBP 186bn (2011: 265bn), with GBP 82bn (2011: GBP 130bn) maturing in less than one year. The average maturity of wholesale funding, net of the liquidity pool, was at least 69 months (2011: 58 months). The use of short-term wholesale funding appears relatively high but has been declining and this is offset to some extent by the large liquidity pool. Barclays states that the liquidity pool is sufficient to fund the business for an estimated 42 months with no access to wholesale markets.

The liquidity pool is managed on a centralized basis and is available to meet liquidity needs across the Group. At year-end 2013, the liquidity pool stood at GBP 127bn, with GBP 43bn in cash and deposits with central banks. An additional GBP 62bn is held in government bonds, of which over 85% are comprised of UK, US, Japanese, French, German, Danish, Swiss and Dutch securities. At year-end 2013, Barclays estimated its Liquidity Coverage Ratio to be 102% (2012: 126%) and its Net Stable Funding Ratio to be 110% (2012: 112%).

Table 2: Barclays 2013 funding structure (GBP bn)

Assets		Liabilities	
Customer loans and advances	430	Customer deposits	428
Trading portfolio assets	63	Repos	196
Reverse repos	133		
Reverse repos	53	Trading portfolio liabilities	53
Derivative financial instruments	323	Derivative financial instruments	319
Liquidity pool	127	< 1 year wholesale debt	82
Other assets	119	> 1 year wholesale debt and equity	164

Note: Other assets include available for sale investments, trading portfolio assets, financial assets designated at fair value and loans and advances to banks. Source: Company data, Scope Ratings

4. Strategic focus on meeting leverage and capital requirements

Barclays navigated through the financial crisis with less difficulty than some other UK and global peers. The Group continued to generate earnings and took measures to strengthen its liquidity and capital position, avoiding direct aid from the UK government. Throughout the second half of 2008, Barclays raised over GBP 12bn in capital, including approximately GBP 700m for the purchase of Lehman. Further, in 2009, Barclays sold its asset management business (Barclays Global Investors) to Blackrock for USD 13.5bn, realizing a gain of GBP 6.3bn.

Under the new management team, Barclays decided to address the PRA's leverage and capital requirements quickly as investor concerns about capital had materially impacted the Group's valuation. Last July, Barclays announced a plan to meet the PRA's 3% leverage ratio target by June 2014 and had done so at the end of Q1 2014. Actions taken to achieve the target included a GBP 5.8bn rights issue in October 2013, the issuance of GBP 2.1bn of Additional Tier 1 securities and reducing the balance sheet by GBP 140bn, excluding forex impacts. The PRA's leverage ratio is calculated on the fully loaded CRD4 Tier 1 capital base adjusted for certain PRA defined deductions and a PRA adjusted CRD4 leverage exposure figure.

On a fully-loaded CRD4 basis, Barclays' leverage ratio was 3.1% at year-end 2013. This is based on an estimated leverage exposure of GBP 1,377bn (June 30, 2013: GBP 1,559bn). Within this, major exposures include GBP 320bn for derivatives, GBP 92bn for securities financing transactions and GBP 179bn for undrawn commitments. The Group continues to refine its risk capital allocation framework – with risk weighted measures being supplemented by a "leverage lens." The 3.1% figure does not take into consideration the Basel Committee's final rules for calculating the Basel 3 leverage ratio published on January 12, 2014. Based on an initial analysis, Barclays estimates that these changes would decrease the CRD4 leverage ratio by approximately 20bps.

Barclays has recently provided details on its capital plans which incorporate the progressive implementation of CRD4 requirements. For 2015, the Group expects its Basel 3 fully loaded CET1 ratio to reach 10.5% and RWAs to be at GBP 440bn. At year-end 2013, these were 9.3% and GBP 436bn, respectively. Management has also stated that it will not increase its dividend payout ratio target from 40% until capital targets have been achieved. In 2019, Barclays estimates that its CET1 ratio will be in the range of 11.5% to 12%, which includes a 2.5% capital conservation buffer, a 2% G-SIFI buffer, a Pillar 2A buffer of 1.4% and a management buffer of up to 1.5%. With regard to leverage, Barclays is now aiming for a 3.5% fully loaded CRD4 leverage ratio in 2015 and then above 4% in 2016.

5. Reputational and conduct issues continue to hamper performance

2012 was a particularly difficult year for Barclays in regards to conduct issues. Barclays made a GBP 290m settlement relating to the manipulation of LIBOR rates and added GBP 2.5bn in provisions for PPI and interest rate hedging products. In August 2012, Antony Jenkins, the previous head of retail and business banking was appointed as CEO, replacing the previous CEO who came from the investment banking business. With this change, we sense that the Group is aiming for a more balanced business profile, with all businesses garnering management attention.

In the fall of 2012, the new CEO announced the Transform program, which involves turnaround, the return of acceptable numbers and sustaining forward momentum, with balance sheet optimization and costs being key focus areas. In addition, there are efforts to run Barclays the "right way" with the "right culture." These institutional and cultural changes are likely to take time to become embedded. With its 2013 results announcement, Barclays published for the first time its "Balanced Scorecard" which includes six metrics to measure performance in the areas of customers and clients, colleagues, citizenship and conduct as well as two metrics for returns and capital.

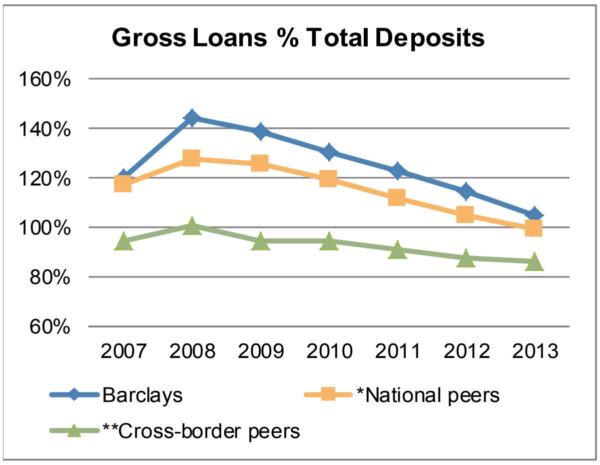
Peer comparison

Within the UK, Barclays is among the top four players that dominate the market. However, the Group cannot be easily compared with the other UK banks currently due to its more investment banking driven business model. Lloyds and RBS are primarily UK-focused retail and commercial banks and continue to be partly owned by the UK government. In comparison to HSBC, Barclays' has more significant investment banking activities but also operates in different markets geographically. Barclays does not have the same exposure to emerging markets as HSBC – Barclays is active in Africa while HSBC is active in Asia as well as Latin America.

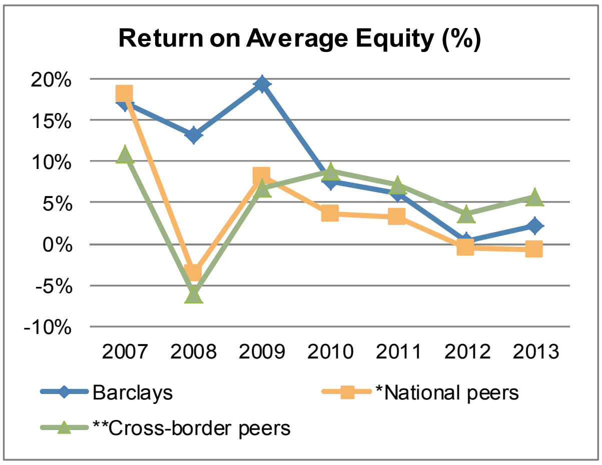
At Scope Ratings, we compare banks within peer groups and Barclays has been included in the peer group of large universal banks. This peer group includes HSBC, BNP Paribas, Societe Generale, Deutsche Bank, UBS and Credit Suisse as well as Citigroup, Bank of America and JP Morgan in the United States.

As shown on the following page, Barclay's profitability and capital position are below the average for cross-border peers. Earnings have been negatively impacted by legacy assets as well as by conduct issues. Moreover, both the proportion of operating income derived from trading income and the cost-income ratio are higher than average due to the size of the Investment Bank within the Group. Unsurprisingly, Barclays' recent strategic update addresses these relative weaknesses. In order to improve earnings, Barclays is focusing and reducing the size of the Investment Bank, managing costs and investing in growth businesses such as Barclaycard and Africa Banking. And urged by the PRA, Barclays is bolstering its capital and balance sheet leverage. In addition, under the new Federal Reserve rules for foreign banks, Barclays will need to meet enhanced capital and leverage requirements for its operations in the US.

Peer Comparison - Barclays plc



Source: SNL Financial, Scope Ratings



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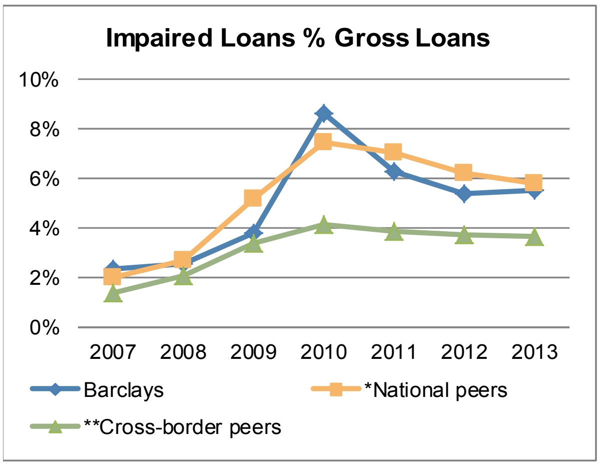

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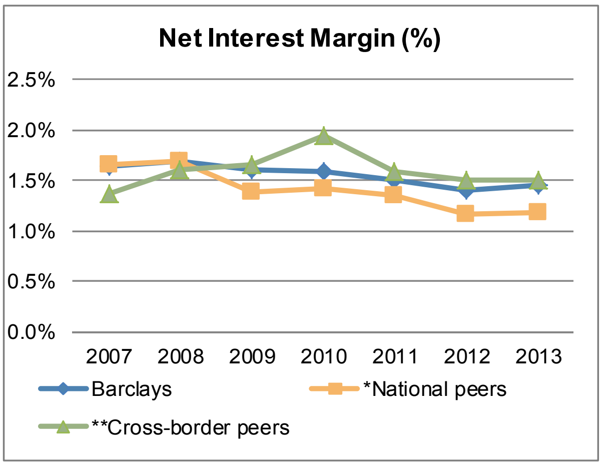

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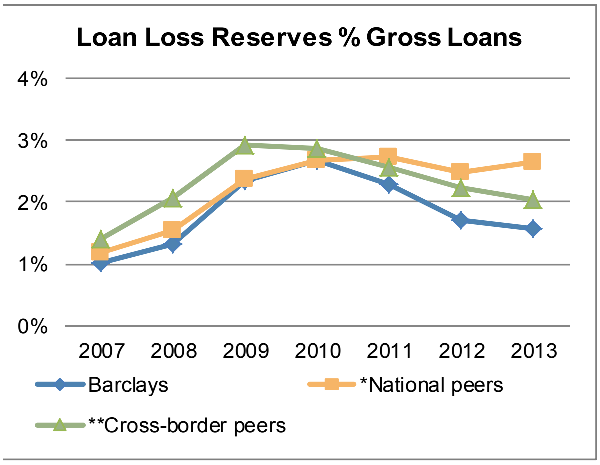

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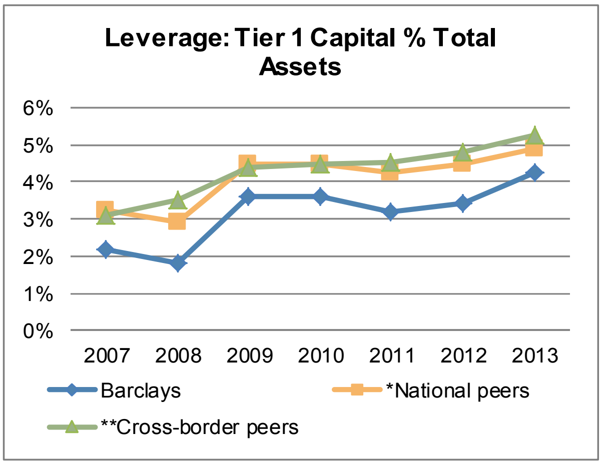


Source: SNL Financial, Scope Ratings

*National peers: Barclays, HSBC, Lloyds, RBS

**Cross-border peers: Bank of America Corp, Barclays, BNP Paribas, Citigroup Inc, Credit Suisse, Deutsche Bank, HSBC, JP Morgan Chase, Societe Generale, UBS

Selected Financial Information - Barclays plc

	2007	2008	2009	2010	2011	2012	2013	2014E	2015E
Balance Sheet summary (GBP billion)									
Assets									
Cash and balances with central banks	5.8	30.0	81.5	97.6	106.9	86.2	45.7	55.3	63.8
Interbank assets	42.0	49.4	42.7	40.2	49.8	43.0	39.6	37.6	36.9
Total securities	451.2	404.3	367.2	455.3	386.7	418.8	428.6	411.2	401.8
of which debt instruments	403.6	355.0	323.8	406.6	348.5	380.5	368.8	350.4	339.9
of which equity instruments	43.4	39.2	32.5	36.8	33.8	34.0	54.9	56.0	57.2
Derivatives	248.1	984.8	416.8	420.3	539.0	469.2	324.3	321.6	321.7
Gross customer loans	374.4	501.5	459.5	466.2	465.3	455.1	457.5	466.5	475.7
of which impaired loans	8.8	12.7	17.2	40.0	29.5	24.5	25.2	25.2	23.9
Total funded assets	979.1	1,084.9	975.5	1,084.1	1,034.2	1,025.6	991.6	990.9	998.1
Total Assets	**1,227.4**	**2,053.0**	**1,378.9**	**1,489.6**	**1,562.1**	**1,488.3**	**1,312.3**	**1,308.8**	**1,316.2**
Liabilities									
Interbank liabilities	92.3	116.5	77.9	79.3	92.1	78.6	56.2	50.6	48.0
Senior debt	393.0	437.5	451.6	523.7	438.7	431.3	373.1	354.5	336.7
Derivatives	248.3	968.1	403.4	405.5	527.9	462.7	320.6	318.0	318.1
Customer deposits	312.3	346.0	328.7	356.0	376.8	396.8	436.0	457.8	480.7
Subordinated debt + hybrid securities	18.2	29.8	25.8	28.5	24.9	24.0	21.7	21.7	22.8
Total Liabilities	**1,194.9**	**2,005.6**	**1,320.5**	**1,427.4**	**1,498.1**	**1,428.3**	**1,248.3**	**1,243.3**	**1,247.1**
Ordinary equity	23.3	33.0	47.3	50.9	54.4	50.6	53.3	55.0	58.4
Minority interests	9.2	10.8	11.2	11.4	9.6	9.4	8.6	8.6	8.6
Total Liabilities and Equity	**1,227.4**	**2,053.0**	**1,378.9**	**1,489.6**	**1,562.1**	**1,488.3**	**1,312.3**	**1,308.8**	**1,316.2**
Core Tier 1 Capital [1]	*16.7*	*24.4*	*38.4*	*42.9*	*43.1*	*38.4*	*40.4*	*42.0*	*43.9*
Income Statement summary (GBP billion)									
Net interest income	9.6	11.5	11.9	12.5	12.2	11.7	11.6		
Net fee & commission income	7.7	6.5	8.4	8.9	8.6	8.5	8.7		
Net trading income	4.9	1.8	7.1	9.4	9.8	4.1	7.2		
Operating Income	**23.0**	**21.2**	**29.2**	**31.5**	**31.2**	**24.9**	**27.9**	**28.9**	**29.8**
Operating expenses	13.5	13.4	16.7	19.6	20.3	21.0	20.5	20.8	20.7
Loan loss provision charges	2.8	5.4	8.1	5.7	5.6	3.3	3.1	3.1	3.0
Non-recurring items	0.3	3.5	7.0	0.2	1.0	0.3	-1.2	0.0	0.0
Pre-Tax Profit	**7.1**	**5.7**	**11.4**	**6.1**	**5.8**	**0.8**	**2.9**	**5.0**	**6.1**
Income tax	2.0	0.5	1.1	1.5	1.9	0.6	1.6	1.5	1.8
Net profit attributable to minority interests	0.7	0.9	0.9	1.0	0.9	0.8	0.8	1.3	1.6
Net Income Attributable to Parent	**4.4**	**4.4**	**9.4**	**3.6**	**2.9**	**-0.6**	**0.5**	**2.2**	**2.6**

Source: SNL Financial and Scope Ratings estimates. Scope's forecasts are based on publicly available information. Please refer to "Methodologies Used for this Report" for further details.
[1] CRD 4 basis from 2012 onwards

Ratios - Barclays plc

	2007	2008	2009	2010	2011	2012	2013	2014E	2015E
Funding/Liquidity									
Gross loans % Total deposits	119.9%	144.9%	139.8%	130.9%	123.5%	114.7%	104.9%	101.9%	99.0%
Total deposits % Total funds	38.3%	37.1%	37.2%	36.1%	40.4%	42.6%	49.0%	51.6%	54.0%
Wholesale funds % Total funds	61.7%	62.9%	62.8%	63.9%	59.6%	57.4%	51.0%	48.4%	46.0%
Asset Mix, Quality and Growth									
Gross loans % Funded assets	38.2%	46.2%	47.1%	43.0%	45.0%	44.4%	46.1%	47.1%	47.7%
Impaired loans % Gross loans	2.4%	2.5%	3.7%	8.6%	6.3%	5.4%	5.5%	5.4%	5.0%
Loan loss reserves % Impaired loans	32.7%	51.4%	62.5%	31.0%	35.8%	31.9%	28.8%	28.8%	30.4%
Gross loan growth (%)	24.5%	33.9%	-8.4%	1.5%	-0.2%	-2.2%	0.5%	5.3%	5.2%
Impaired loan growth (%)	104.7%	43.6%	35.2%	133.0%	-26.3%	-17.0%	2.8%	0.0%	-5.0%
Funded assets growth (%)	14.4%	10.8%	-10.1%	11.1%	-4.6%	-0.8%	-3.3%	-0.1%	0.7%
Earnings									
Net interest income % Revenues	41.7%	54.1%	40.9%	39.8%	39.1%	46.8%	41.6%		
Fees & commissions % Revenues	33.5%	30.6%	28.9%	28.2%	27.6%	34.3%	31.3%		
Trading income % Revenues	21.5%	8.6%	24.2%	30.0%	31.5%	16.7%	25.9%		
Other income % Revenues	3.4%	6.6%	6.1%	2.1%	1.8%	2.2%	1.2%		
Net interest margin (%)	1.2%	1.3%	1.3%	1.3%	1.2%	1.2%	1.2%		
Pre-provision Income % Risk-weighted assets (RWAs)	2.7%	1.8%	3.3%	3.0%	2.8%	1.0%	2.1%	1.9%	2.1%
Loan loss provision charges % Pre-provision income	29.1%	69.5%	64.7%	47.7%	51.2%	85.7%	41.6%	38.3%	33.3%
Loan loss provision charges % Gross loans (cost of risk)	0.8%	1.3%	1.7%	1.3%	1.2%	0.7%	0.7%	0.7%	0.7%
Cost income ratio (%)	58.4%	63.2%	57.2%	62.2%	64.9%	84.3%	73.6%	72.0%	69.5%
Net Interest Income / Loan loss charges (x)	3.4	2.1	1.5	2.2	2.2	3.5	3.8		
Return on average equity (ROAE) (%)	20.5%	15.6%	23.4%	7.3%	5.6%	-1.2%	1.0%	4.0%	4.7%
Return on average funded assets (%)	0.3%	0.3%	0.6%	0.2%	0.2%	0.0%	0.0%	0.1%	0.2%
Retained earnings % Prior year's book equity	10.5%	18.3%	26.9%	6.1%	4.3%	-2.7%	n/a	3.1%	3.4%
Pre-tax return on common equity tier 1 capital	42.3%	23.6%	29.6%	14.2%	13.4%	2.1%	7.1%	11.8%	13.8%
Capital and Risk Protection [1]									
Common equity tier 1 ratio (common equity tier 1 capital % RWAs)	4.7%	5.6%	10.0%	10.8%	11.0%	8.2%	9.3%	9.7%	10.0%
Tier 1 leverage ratio (%)	2.2%	1.8%	3.6%	3.6%	3.2%	3.4%	4.3%		
Median of tier 1 leverage ratio and common equity tier 1 ratio (%)	3.5%	3.7%	6.8%	7.2%	7.1%	5.8%	6.8%		
Total loss coverage (CET 1 capital + loan loss provisions) % RWAs	5.8%	7.6%	13.7%	14.5%	13.7%	11.9%	13.4%	11.3%	11.7%
Non-senior bailinable debt cushion (as % of total liabilities)	1.5%	1.7%	2.0%	2.0%	1.7%	1.7%	1.9%	1.9%	2.0%
Asset risk intensity (RWAs % total assets)	28.8%	21.1%	27.8%	26.7%	25.0%	26.0%	27.0%	33.2%	33.2%

Source: SNL Financial and Scope Ratings estimates. Scope's forecasts are based on publicly available information. Please refer to "Methodologies Used for this Report" for further details.
[1] CRD 4 basis from 2012 onwards

METHODOLOGIES USED FOR THIS REPORT

For the rating and analysis contents of this report Scope has used the following methodologies which were published on www.scoperatings.com:

"Bank Rating Methodology" (February 2014)

"Forecasting Bank Financials Methodology" (February 2014)

Forecasting bank financials: Forward-looking estimates are an important analytical tool underpinning Scope's bank ratings. These forecasts cover the current financial year (before final year-end figures are published by the bank) plus the forthcoming two years. Depending on the complexity of the bank being assessed, different forecasting tools will be used. For a majority of banks operating primarily commercial and retail banking franchises (loans and deposits) the analysis is underpinned by an **accounting** forecast of the balance sheet and profit and loss account. For more complex groups with multiple ranges of activities – notably those with material wholesale and investment banking operations – Scope uses an **analytical** forecast, relying on the bank's business-line reporting to come up with plausible estimates. For all banks Scope also include a **regulatory metrics** forecast, considering the growing importance of this aspect in bank analysis.

For complex banks, divisional data is used to forecast profit and loss accounts and basic divisional balance sheet metrics. For less complex banks, a line-by-line forecasting of major P&L elements is forecast.

For balance-sheet forecasts, Scope estimates of all major balance sheet lines, using the P&L estimates to complete the forecast of the capital/shareholders' equity line. This comprehensive methodology for estimating the balance sheet is used for all the banks in our universe, irrespective of size and complexity.

Lastly, our forecasts include assessments of the major regulatory metrics: Tier 1 and CET 1 (historically CT1), Leverage, Liquidity Coverage Ratio, and Net Stable Funding Ratio (the latter two when and if sufficient public information to compute them is available).

Scope will not aim to forecast financials when it considers the public disclosure of the bank as insufficient for a transparent and credible outcome.

All Scope's bank financial forecasts are based on public information. For its forecasts Scope will not use any non-public information or data, even if such information or data were provided by rated banks. Scope's forecasting process is transparent, with a detailed roadmap provided in its *"Forecasting bank financials"* methodology.

BBVA SA
Issuer Rating Report

SCOPE | A STABLE OUTLOOK
Financial Institutions

Overview

Scope Ratings assigns an Issuer Credit-Strength Rating (ICSR) of A and a short-term debt rating of S-1 to BBVA SA, both with a stable outlook. The ratings are based to a large extent on the strength and reliability of BBVA's retail and commercial banking franchises in several countries and on the strong market positioning in its main countries of operation.

The high degree of diversification has helped BBVA deliver significant profits, despite the stressed operating environment in Spain, and enabled it to generate capital organically. The bank has withstood harsh conditions, peaking with a collapse in its domestic real estate market and significant stress to funding markets and to domestic sovereign risk in 2011 and 2012. Throughout the period, the bank's capital base has kept growing.

The challenging macro environment in Spain continues to weigh negatively on the group's earnings capacity due to the continued high provisions required by a growing NPLs stock. However, the Spanish economy has started to improve, although from a very low base. The recovery, if sustained, should have a positive impact on asset quality in the coming years and help improve the sustainability of public debt, which remains a concern to us. We would underscore, however, that we do not automatically link BBVA's rating with the credit standing of the Spanish sovereign. These ratings are not applicable to unguaranteed subsidiaries of the rated parent.

Issuer Credit-Strength Rating (assigned on April 2, 2014)	**A**
Outlook	Stable
Senior Unsecured Debt	A
Short term debt rating (May 22, 2014)	S-1
Short term debt rating outlook	Stable

Unsolicited ratings with issuer participation.

Lead Analyst

Marco Troiano
m.troiano@scoperatings.com

Team Leader

Sam Theodore
s.theodore@scoperatings.com

Rating drivers (Summary)

The rating drivers, in decreasing order of importance in the rating assignment, are:

- (+) Retail-focused, globally-diversified revenue and earnings streams with strong market positions in several key markets (Spain, US Sunbelt, Mexico, Argentina, Chile, Venezuela, Colombia, Peru and Turkey).
- (−) Large exposure to Spanish credit and sovereign risk remains a key factor.
- (+) Significant improvement in capital and liquidity position in recent years.
- (−) Intervention by host or home regulators could limit intragroup capital and liquidity flows across geographies at times of stress.

Rating change drivers

Turnaround in Spanish asset quality and profitability. Despite early indications of a turnaround in the macro environment in Spain, NPLs remain high and loan loss charges are still keeping profitability depressed. A sustained improvement in the asset quality metrics and profitability of the Spanish business would be a significant positive change driver.

Significant worsening of Mexican earnings capacity and asset quality. BBVA group's profitability currently relies on Mexico contributing 86% of total pre-tax income in 2013. Should the earnings capacity and asset quality of the Mexican business be dented, the capital generation of BBVA could be impacted.

Further deterioration in Spain's fiscal metrics. A further increase in Spanish Government debt/GDP ratio or a failure to bring the deficit under control would negatively affect the economic value of BBVA's government loans and bond portfolio.

The positive effect of the forthcoming Banking Union. We note the increased regulatory convergence across EU banking systems, especially for firms within the euro area, as a factor materially attenuating the potential impact of the home sovereign situation on BBVA's credit fundamentals. We consider that the emergence later this year of a Banking Union (BU) for the euro area, underpinned by the Single Supervisory Mechanism (SSM) and the Single Resolution Mechanism (SRM), could be a positive rating driver to the extent that it will further de-link the credit standing of BBVA from that of its home sovereign. At this time, such an outcome is not yet certain, but the current steps towards the creation of the BU are encouraging.

Recent events

Q1 2014 results

On April 30, BBVA released its Q1 2014 report.

While year on year comparisons were impacted by unfavourable FX movements and by positive one offs in Q1 2013 (capital gains on the sale of the pension business in Mexico and insurance operations in Spain), underlying profitability trends were encouraging. At constant exchange rates, revenues increased 5% while costs only grew 4%. Group loan loss provisions declined, reflecting a stabilization in asset quality trends. Indeed, for the first time since beginning of the crisis, the non-performing asset ratio for the group declined (to 6.6% from 6.8% in Q4 2014), while coverage was stable at 60%.

At the end of March, the group had a CRD4 CET1 Ratio of 10.8% on a transitional basis and of 9.9% on a fully-loaded basis. The company also reported a fully loaded leverage ratio of 5.8%.

Monetization of DTAs

The Royal Decree-Law 14/2013 took effect on January 1, 2014. It allows Spanish banks to convert some deferred tax assets (DTAs) generated by time differences (arising from non-deductible provisions for loans and foreclosed assets, and by employee pension payments) into tax credits.

Tax credits are valuable assets that do not depend on future profitability, and therefore will no longer be deducted under CRD4 capital rules. According to management guidance, this measure had a positive impact of around 60-70 bps on BBVA's 9.8% fully-phased Common Equity Tier 1 ratio reported at year-end 2013.

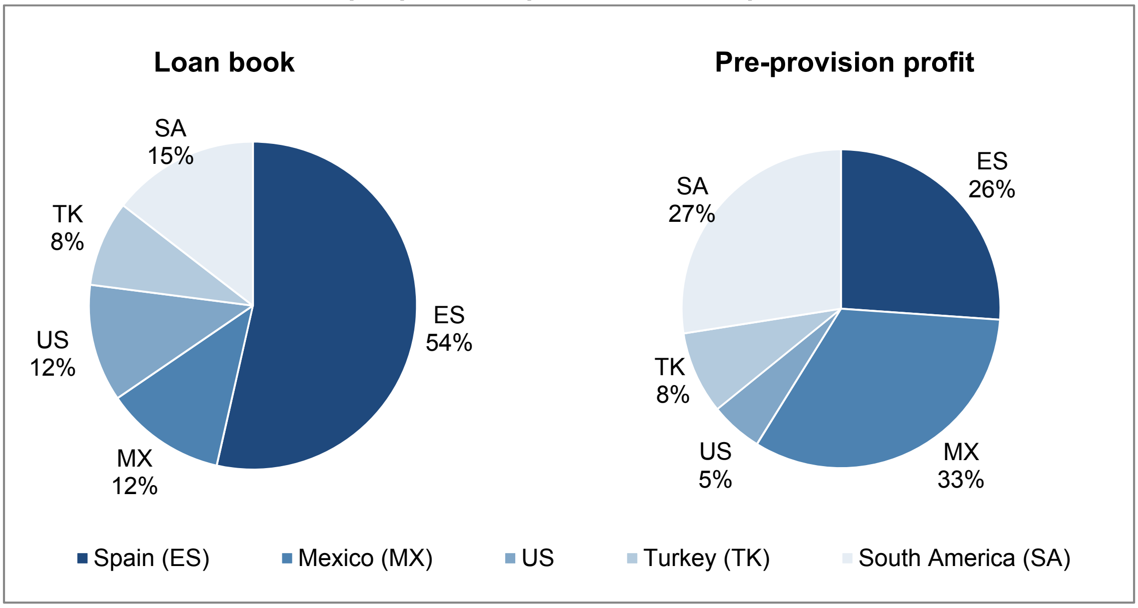
Rating drivers (Details)

1. Retail-focused, globally diversified revenue and earnings streams with strong market positions in several key markets (Spain, US Sunbelt, Mexico, Argentina, Chile, Venezuela, Colombia, Peru and Turkey).

BBVA offers predominantly retail banking services to customers in Europe, Asia and the Americas. In 2013, corporate and investment banking revenues accounted for 15% of the group's total revenues.

While the bulk of the bank's activity remains in Spain (Spanish assets still account for more than 50% of the total for the group), BBVA's emerging markets operations have helped the bank navigate the crisis that has engulfed its home country and still offer a good degree of business diversification. As shown in Chart 1, pre-provision profits from South America and Mexico accounted for 61% of the group's total.

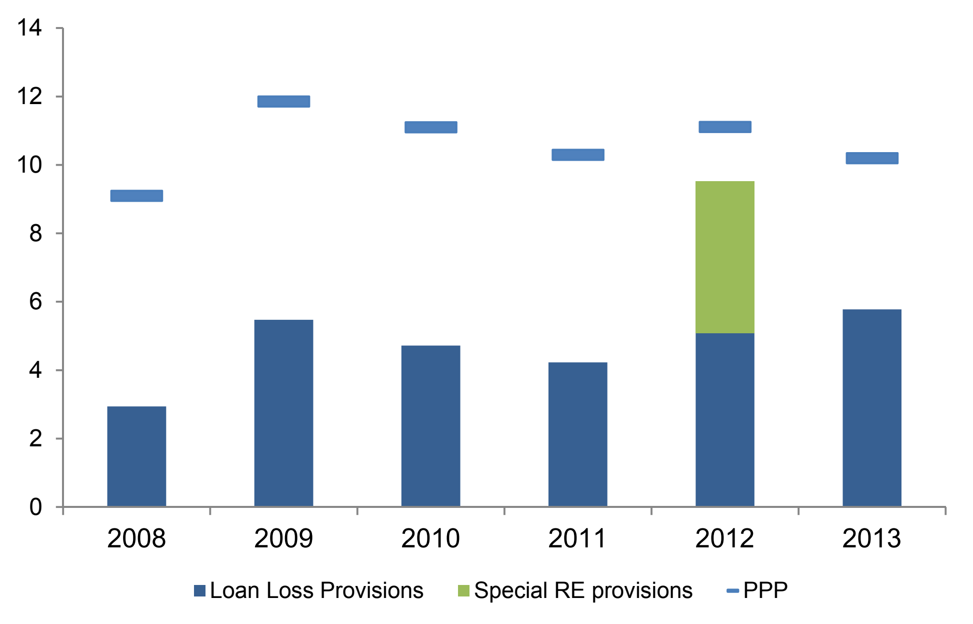
Chart 1: BBVA's loans and pre-provision profit divisional split, 2013



Source: Company data, Scope Ratings
Note: Turkey includes other loans in Europe and Asia. BBVA reports Eurasia as a single business division

During the past few years, the income stream from outside Spain has ensured that BBVA maintained a positive bottom line at a group level in most quarters. The only exception was Q4 2011, when the bank posted net losses driven by a large goodwill write-down in the US.

Chart 2: Pre-provision profit offers a first line of defense against asset quality shocks (EUR bn)



Source: Company data, Scope Ratings

2. Large exposure to Spanish credit and sovereign risk remains a key factor

Out of the group's balance sheet of approximately EUR 600bn, the Spanish segment accounts for EUR 314bn of total assets in Q1 2014, not including an additional EUR 20bn in real estate assets, which were recently separated and put in run-off mode.

The Spanish loan book, which comprises approximately EUR 175bn of loans, mainly consists of retail mortgages and business loans. It has experienced sustained asset quality deterioration in recent years, even if we exclude the troubled real estate developer loans. If we stress the Spanish loss assumptions, we note that an increase in the Spanish loan-loss ratio to 400 bps (from 142 bps in 2013) would wipe out group profits for the year.

Adding to the large loan book exposure, we note that BBVA had a EUR 53bn exposure to Spanish sovereign risk as of December 2013, or 152% of EBA Core Tier 1 capital (see Table 1), including bonds (EUR 30bn) and loans (EUR 23bn) and excluding exposures in the insurance companies (EUR 11bn). This risk concentration makes BBVA capital ratios sensitive to potential losses on Spanish sovereign debt. Indeed, for every 10% loss on Spanish sovereign debt, BBVA capital ratios would decline by c. 150 bps. In other words, a 30% loss rate in the event of default (or voluntary PSI) would translate into a EUR 16bn loss and leave BBVA with a 5.9% EBA CT1 ratio. That said, such sovereign losses are not our expected scenario, but rather a simplified exercise to assess the group's vulnerability to a tail risk. Our calculations do not include the tax implication of the eventual losses or management actions that could mitigate the capital impacts of such losses in a stressed scenario. A quarter of the exposure has a maturity of less than one year, which means that BBVA could materially reduce its exposure in a relatively short time by not rolling the paper. However, we caution that in periods of real stress and market closure, a large bank can, in fact, be asked to support the bond issuance of its home sovereign.

Table 1: BBVA's exposure to sovereign risk at year-end 2013

BBVA (EUR m)		CT1 Ratio assuming haircut of 0%	10%	20%	30%
Spanish sovereign exposure	53,253	10.8%	9.2%	7.5%	5.9%
% of Core Tier 1 capital (EBA)	152%				
Core Tier 1 (EBA)	35,038				
RWAs	323,605				

Source: Company data, Scope Ratings

The Spanish economy is recovering and we believe that the risk of a tail event for the Spanish sovereign has receded further since the ECB effectively backstopped it in the summer of 2012. However, we still see significant weakness due to fragile public finances (government deficit/GDP of 7.2% and public debt/GDP at 94.3% in 2013[1]) and the current account deficits accumulated during the past decade, which have left Spain with a net international investment deficit of close to 100% of GDP in 2013[2]- one of the highest in Europe.

3. Significant improvement in capital and liquidity position in recent years

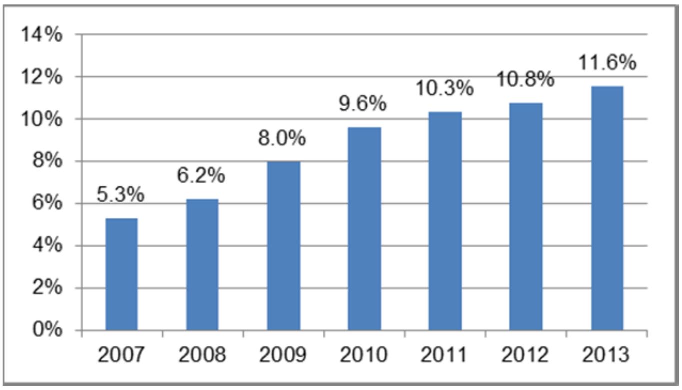
BBVA has significantly improved its capital and liquidity in recent years. On a Basel 2 basis, the group CT1 Ratio has gone from 5.3% in 2007 to 11.5% in 2013 (see Chart 3.a). The increase was driven primarily by profit generation, with limited capital raisings from asset divestments and RWA growth throughout most of the period.

On a CRD4 basis, BBVA reported a 9.9% fully loaded CET1 Ratio as of March 2014, including the positive impact from Royal Decree 14/2013 on deferred tax assets, as well as the partial divestment of CITIC.

Moreover, BBVA has already issued approximately EUR 2.6bn in CRD4 compliant AT1 instruments. These securities, equivalent to 0.8% of group RWAs, provide an additional protection buffer to senior bondholders.

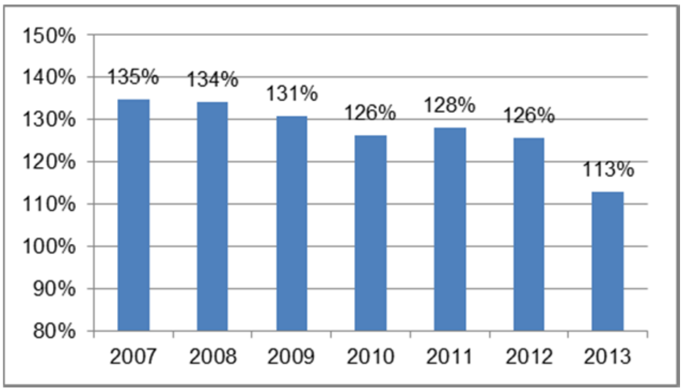
Similarly, BBVA has enhanced its funding profile. Deleveraging in Spain helped reduce the loan/deposit ratio to 113% in 2013 from 135% in 2007. Wholesale funding declined from 44% of total funds in 2007 to 35% in 2013.

Chart 3.a: BBVA Core Tier 1 Capital Ratio (Basel 2) evolution – 2007 - 2013



Source: Company data, Scope Ratings

Chart 3b: BBVA Gross Loan/Deposit ratio evolution – 2007-2013



Source: Company data, Scope Ratings

[1] Source: European Commission
[2] Spain's NIIP in 2013 was a negative 98% of GDP. Source: Eurostat

While BBVA does not disclose its CRD4 net stable funding ratio and liquidity coverage ratio, the bank has stated that it is compliant with the liquidity regulatory requirements and comfortable with its position in relation to the CRD4 liquidity framework. At the end of BBVA has repaid slightly over half of the EUR 30bn in LTRO loans initially taken out (including UNNIM).

4. Intervention by host or home regulators could limit intragroup capital and liquidity flows across geographies at times of stress

The recent financial crisis has shown that, in a period of stress, intragroup capital and liquidity mobility across geographies can significantly diminish, limiting a cross-border banking group's financial flexibility just when it needs it the most. Faced with such restrictions, some banking groups may take steps ranging from the listing of a minority stake to the disposal of the entire business in order to unlock capital from a subsidiary. The extent to which cross-border banking groups have at their disposal such alternatives represents a mitigation to this risk.

Conversely, we acknowledge that BBVA's subsidiarisation limits the risk of contagion between units. Indeed, we look favorably at cross-border banking organizations that display reassuring capital and liquidity metrics not only at the group level, but also at the subsidiary level. As of December 2013, BBVA's parent company had a CET1 ratio of 12.7% (calculated according to Bank of Spain rules).

Peer comparison

At Scope Ratings, we compare banks within peer groups at domestic and cross border levels.

BBVA's national peer group mainly comprises Santander, Bankia and Caixabank, although it also includes mid-sized banks such as Sabadell, Popular and Bankinter. While Santander and BBVA pursued an international expansion with the result that Spain now represents about one-quarter and one-half of their respective loan portfolios, the rest of their peers are largely domestic lenders.

At the cross border level, we compare BBVA with large and diversified retail banks, including Unicredit, KBC, Erste Bank, RBS, ING, Nordea, Danske Bank, Commerzbank and Raiffeisen, as well as Santander. The group is heterogeneous, but it shares a predominant weight of retail in the banks' business model and exposure to several developed and emerging markets. Several of the above names fall under the definition of systemically-important financial institutions and as such are required to carry additional capital buffers (1% in the case of BBVA).

In Spain, BBVA compares favorably with peers in terms of impaired loans ratio, due to its international diversification. BBVA's asset quality is in line with international peers in 2013.

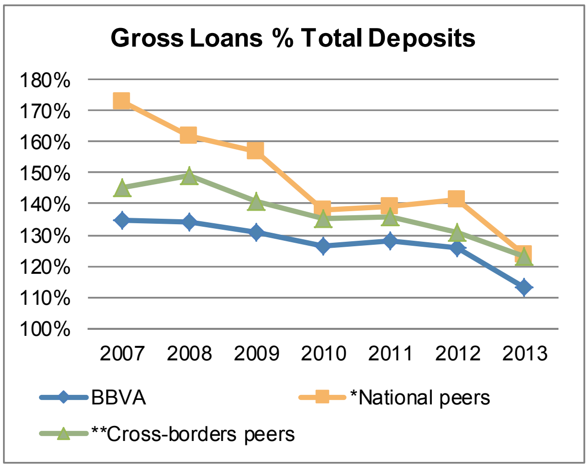
BBVA's profitability is amongst the highest in both peer groups. The difference with domestic peers is largely explained by the high provisions in Spain, which impact on group earnings is diluted in the case of BBVA. Compared with international peers, BBVA benefits from very high profitability in Mexico, which accounts for 29% of group revenues and 85% of group profits.

From a funding and liquidity perspective, BBVA has a lower loan-to-deposit ratio than both domestic and international peers.

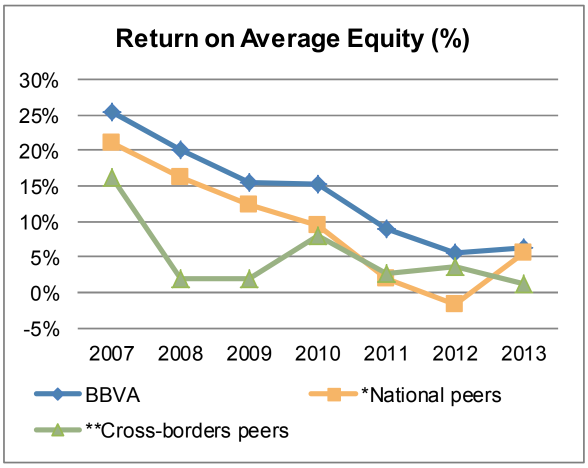
The strong and resilient group profitability has contributed to the strengthening of capital, although the Core Equity Tier 1 ratio under CRD4 (fully phased) is just below 10%, partly because of the very high risk intensity of BBVA's balance sheet (RWA/Assets of 54% in 2013). The leverage ratio is significantly better than those of its peers.

In time, BBVA's capital position could benefit from a convergence towards a more level playing field in Europe, especially in the area of RWA harmonization, where Spanish practices are particularly conservative.

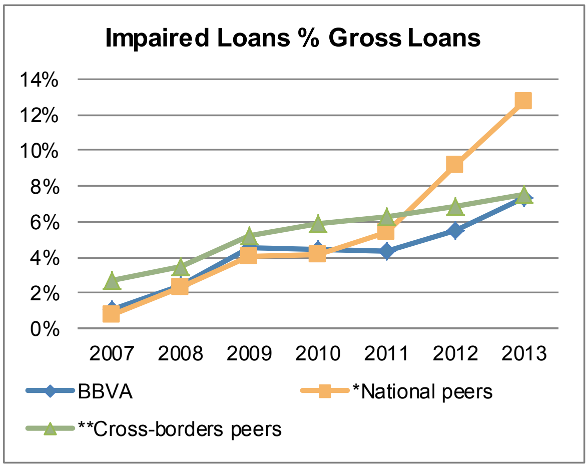
Peer Comparison - BBVA group



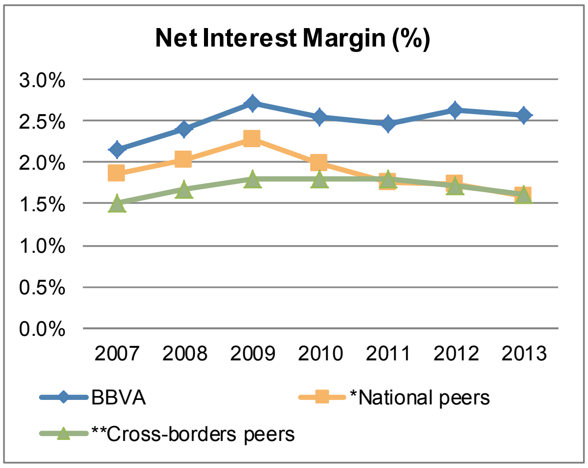
Source: SNL Financial, Scope Ratings



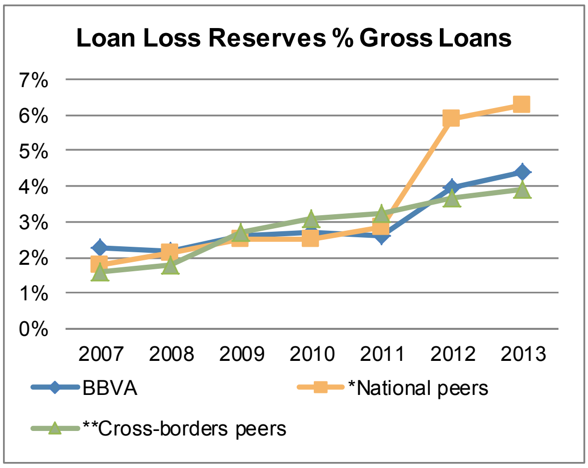
Source: SNL Financial, Scope Ratings



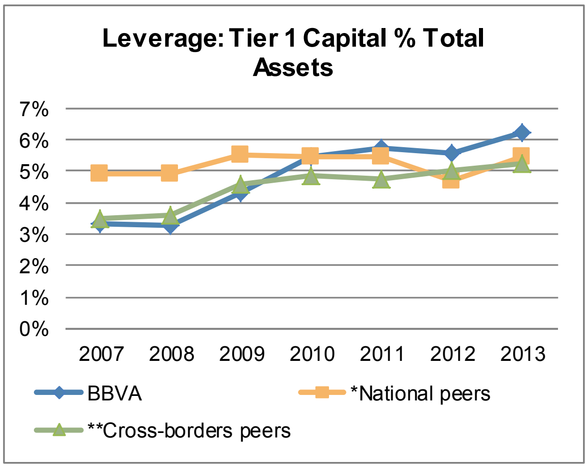
Source: SNL Financial, Scope Ratings



Source: SNL Financial, Scope Ratings



Source: SNL Financial, Scope Ratings



Source: SNL Financial, Scope Ratings

*National peers : Santander, BBVA, Caixabank, Bankia, Sabadell, Popular, Bankinter.
**Cross-border peers based on business model : Santander, BBVA, Unicredit, RBS, Erste Bank, RZB AG, Commerzbank, Nordea, KBC, Danske Bank, ING Bank.
Notes: Cross-border peer group averages exclude RZB in 2013

Selected Financial Information - BBVA group

	2007	2008	2009	2010	2011	2012	2013	2014E	2015E
Balance sheet summary (EUR billion)									
Assets									
Cash and balances with central banks	22.6	14.7	16.3	20.0	30.9	37.4	37.1	28.5	22.3
Interbank assets	21.0	33.9	22.2	23.6	26.1	26.5	24.2	24.9	25.7
Total securities	109.4	87.5	112.2	101.0	98.3	119.4	122.5	124.3	126.2
of which debt instruments	81.8	72.6	98.3	88.1	88.6	110.5	113.6	115.8	118.1
of which equity instruments	21.0	15.0	13.9	12.9	9.7	9.0	9.0	8.5	8.1
Derivatives	15.8	44.8	32.9	37.3	52.1	53.8	38.0	36.1	34.3
Gross customer loans	318.0	342.7	332.2	348.3	361.3	367.7	350.1	355.8	363.9
of which impaired loans	3.2	8.4	15.2	15.4	15.6	20.3	25.8	25.6	25.1
Total funded assets	482.9	501.1	504.8	517.9	548.3	585.5	561.5	562.1	567.7
Total Assets	**502.2**	**542.6**	**535.1**	**552.7**	**597.7**	**637.8**	**599.5**	**598.2**	**602.0**
Liabilities									
Interbank liabilities	88.1	66.8	70.3	68.2	92.5	106.5	87.7	70.2	56.2
Senior debt	83.0	104.2	99.9	85.2	81.9	87.2	65.5	66.8	68.1
Derivatives	19.3	41.5	30.3	34.8	49.4	52.3	38.0	36.1	34.3
Customer deposits	236.2	255.2	254.2	275.8	282.2	292.7	310.2	324.1	339.2
Subordinated debt + hybrid securities	15.7	17.0	17.9	17.4	15.4	11.8	10.6	10.6	10.6
Total Liabilities	**474.3**	**515.9**	**504.3**	**515.3**	**557.6**	**594.0**	**554.7**	**551.3**	**552.7**
Ordinary equity	27.1	25.7	29.3	35.9	38.2	41.4	42.4	44.5	46.9
Minority interests	0.9	1.0	1.5	1.6	1.9	2.4	2.4	2.4	2.4
Total Liabilities and Equity	**502.2**	**542.6**	**535.1**	**552.7**	**597.7**	**637.8**	**599.5**	**598.2**	**602.0**
Core Tier 1 Capital [1]	*16.1*	*17.6*	*23.2*	*30.1*	*34.2*	*35.5*	*37.5*	*39.6*	*42.0*
Income Statement summary (EUR billion)									
Net interest income	9.4	11.7	13.9	13.3	13.2	15.1	14.6	14.6	15.5
Net fee & commission income	4.7	4.5	4.4	4.0	4.0	4.4	4.4	4.4	4.7
Net trading income	2.7	1.6	1.5	1.8	1.5	1.8	2.5	2.5	1.8
Operating Income	**18.2**	**19.0**	**20.7**	**20.3**	**20.0**	**21.9**	**21.4**	**22.6**	**24.0**
Operating expenses	7.8	9.9	8.8	9.2	10.2	11.4	11.8	12.1	12.8
Loan loss provision charges	1.9	2.9	5.5	4.7	4.2	8.0	5.8	5.6	5.6
Non-recurring items	0.1	0.8	-0.6	0.0	-1.9	-0.4	-0.2	0.0	0.1
Pre-Tax Profit	**8.5**	**6.9**	**5.7**	**6.3**	**3.7**	**2.1**	**3.6**	**4.9**	**5.7**
Income tax	2.1	1.5	1.1	1.3	0.2	-0.3	0.6	1.2	1.4
Net profit attributable to minority interests	0.3	0.4	0.4	0.4	0.5	0.7	0.8	0.9	1.1
Net Income Attributable to Parent	**6.1**	**5.0**	**4.2**	**4.6**	**3.0**	**1.7**	**2.2**	**2.8**	**3.2**

Source: SNL Financial and Scope Ratings for historical figures. Scope's forecasts are based on publicly available information. Please refer to "Methodologies Used for this Report" for further details.
[1] Basel 2 basis

Ratios - BBVA group

	2007	2008	2009	2010	2011	2012	2013	2014E	2015E
Funding/Liquidity									
Gross loans % Total deposits	134.6%	134.3%	130.7%	126.3%	128.0%	125.6%	112.9%	109.8%	107.3%
Total deposits % Total funds	55.8%	57.6%	57.5%	61.8%	59.8%	58.7%	65.4%	68.7%	71.5%
Wholesale funds % Total funds	44.2%	42.4%	42.5%	38.2%	40.2%	41.3%	34.6%	31.3%	28.5%
Asset Mix, Quality and Growth									
Total loans % Funded assets	65.9%	68.4%	65.8%	67.2%	65.9%	62.8%	62.4%	63.3%	64.1%
Impaired loans % Gross loans	1.0%	2.4%	4.6%	4.4%	4.3%	5.5%	7.4%	7.2%	6.9%
Loan loss reserves % Impaired loans	220.2%	88.7%	57.4%	61.2%	60.1%	71.4%	59.5%	59.5%	59.5%
Gross loan growth (%)	20.9%	7.8%	-3.1%	4.8%	3.7%	1.8%	-4.8%	1.6%	2.3%
Impaired loan growth (%)	30.1%	157.8%	81.8%	1.1%	1.9%	29.7%	27.3%	-1.0%	-2.0%
Funded assets growth (%)	21.8%	3.8%	0.7%	2.6%	5.9%	6.8%	-4.1%	0.1%	1.0%
Earnings									
Net interest income % Revenues	51.8%	61.6%	67.2%	65.5%	65.7%	69.1%	68.3%	64.8%	64.6%
Fees & commissions % Revenues	26.0%	23.9%	21.4%	19.8%	20.1%	19.9%	20.7%	19.6%	19.7%
Trading income % Revenues	14.7%	8.2%	7.5%	9.0%	7.4%	8.1%	11.8%	11.2%	7.5%
Other income % Revenues	7.5%	6.4%	3.9%	5.7%	6.8%	3.0%	-0.8%	4.4%	8.2%
Net interest margin (%)	2.4%	2.6%	3.0%	2.9%	2.7%	3.0%	2.8%	2.9%	3.0%
Pre-provision Income % Risk-weighted assets (RWAs)	3.4%	3.2%	4.1%	3.5%	3.0%	3.2%	2.9%	3.2%	3.4%
Loan loss provision charges % Pre-provision income	18.4%	32.3%	46.2%	42.5%	43.2%	76.3%	60.4%	53.5%	49.6%
Loan loss provision charges % Gross loans (cost of risk)	0.7%	0.9%	1.7%	1.4%	1.2%	2.3%	1.7%	1.6%	1.6%
Cost income ratio (%)	43.1%	52.1%	42.7%	45.4%	51.2%	52.2%	55.3%	53.9%	53.2%
Net Interest Income / Loan loss charges (x)	5.0	4.0	2.5	2.8	3.1	1.9	2.5	2.6	2.8
Return on average equity (ROAE) (%)	25.2%	19.0%	15.3%	14.1%	8.1%	4.2%	5.3%	6.3%	7.0%
Return on average funded assets (%)	0.9%	0.7%	0.6%	0.6%	0.4%	0.2%	0.3%	0.3%	0.4%
Retained earnings % Prior year's book equity	16.2%	9.9%	10.0%	11.6%	5.4%	1.1%	4.0%	4.9%	5.4%
Pre-tax return on core tier 1 capital	52.7%	39.5%	24.7%	21.1%	10.8%	5.8%	9.5%	12.4%	13.6%
Capital and Risk Protection [1]									
Common equity tier 1 ratio (common equity tier 1 capital % RWAs)	5.3%	6.2%	8.0%	9.6%	10.3%	10.8%	11.6%	12.2%	12.8%
Tier 1 leverage ratio (%)	4.1%	4.1%	5.1%	6.0%	5.7%	5.6%	6.6%		
Median of tier 1 leverage ratio and core tier 1 ratio (%)	4.7%	5.2%	6.5%	7.8%	8.0%	8.2%	9.1%		
Total loss coverage (core tier 1 capital + loan loss provisions) % RWAs	7.6%	8.8%	11.0%	12.6%	13.2%	15.2%	16.2%	16.9%	17.4%
Non-senior bailinable debt cushion (as % of total liabilities)	3.3%	3.3%	3.5%	3.4%	2.8%	2.0%	1.9%		
Asset risk intensity (RWAs % total assets)	60.6%	52.2%	54.4%	56.7%	55.3%	51.6%	54.3%	54.3%	54.3%

Source: SNL Financial and Scope Ratings for historical figures. Scope's forecasts are based on publicly available information. Please refer to "Methodologies Used for this Report" for further details.
[1] Basel 2 basis

METHODOLOGIES USED FOR THIS REPORT

For the rating and analysis contents of this report, Scope has used the following methodologies which were published on www.scoperatings.com:

"Bank Rating Methodology" (February 2014)

"Forecasting Bank Financials Methodology" (February 2014)

Forecasting bank financials: Forward-looking estimates are an important analytical tool underpinning Scope's bank ratings. These forecasts cover the current financial year (before final year-end figures are published by the bank) plus the forthcoming two years. Depending on the complexity of the bank being assessed, different forecasting tools will be used. For a majority of banks operating primarily commercial and retail banking franchises (loans and deposits) the analysis is underpinned by an **accounting** forecast of the balance sheet and profit and loss account. For more complex groups with multiple ranges of activities – notably those with material wholesale and investment banking operations – Scope uses an **analytical** forecast, relying on the bank's business-line reporting to come up with plausible estimates. For all banks Scope also includes a **regulatory metrics** forecast, considering the growing importance of this aspect in bank analysis.

For complex banks, divisional data is used to forecast profit and loss accounts and basic divisional balance sheet metrics. For less complex banks, a line-by-line forecasting of major P&L elements is forecast.

For balance sheet forecasts, Scope estimates of all major balance sheet lines, using the P&L estimates to complete the forecast of the capital/shareholders' equity line. This comprehensive methodology for estimating the balance sheet is used for all the banks in our universe, irrespective of size and complexity.

Lastly, our forecasts include assessments of the major regulatory metrics: Tier 1 and CET 1 (historically CT1), Leverage, Liquidity Coverage Ratio, and Net Stable Funding Ratio (the latter two when and if sufficient public information to compute them is available).

Scope will not aim to forecast financials when it considers the public disclosure of the bank as insufficient for a transparent and credible outcome.

All Scope's bank financial forecasts are based on public information. For its forecasts Scope will not use any non-public information or data, even if such information or data were provided by rated banks. Scope's forecasting process is transparent, with a detailed roadmap provided in its *"Forecasting bank financials"* methodology.

BNP Paribas SA
Issuer Rating Report

A+ NEGATIVE OUTLOOK
Financial Institutions

Overview

On 2 July 2014 we downgraded the long-term ratings of BNP Paribas S.A. to A+ from AA-, thus concluding the review for possible downgrade initiated on 11 June 2014. The downgrade follows the announcement of a comprehensive legal and financial settlement regarding the review of certain USD transactions of BNP Paribas by US authorities and reflects our concerns regarding the impact of the settlement on the reputation and the track record of the banking group, with potentially negative ramifications for parts of its business franchise in the US market. These concerns also underpin the negative outlook on the long-term ratings.

While announcing this rating action, Scope reiterated that it continues to view BNP Paribas as a financially very strong banking group with a well-rounded business model and solid market positions in key geographies and activities.

These ratings apply to senior unsecured debt issued by BNP Paribas S.A. They are not applicable to unguaranteed debt issued by subsidiaries of BNP Paribas S.A.

Issuer Credit-Strength Rating (last changed 2 July 2014)	**A+**
Outlook	Negative
Senior unsecured debt	A+
Short term debt rating (May 22, 2014)	S-1
Short term debt rating outlook	Stable

Unsolicited ratings with issuer participation.

Lead Analyst

Jacques-Henri Gaulard
j-h.gaulard@scoperatings.com

Team Leader

Sam Theodore
s.theodore@scoperatings.com

Rating drivers (Summary)

The rating drivers, in decreasing order of importance in the rating assignment, are:

- (+) A well-diversified business and geographic mix, with exposure to different economies and businesses.
- (−) The settlement stemming from certain USD transactions has exposed severe failures in controls and processes within BNP Paribas's organization on top of giving rise to strict financial and business terms.
- (+) Extensive balance sheet restructuring that has reinforced capital (BNP Paribas's Basel 3 capital position is strong).
- (+) Ongoing efforts to reduce costs and increase efficiency; BNPP constantly endeavors to optimize its organization.
- (−) Average risk-weighted asset intensity (level of group RWAs as a percentage of total assets) compared with peers, although the gap is largely due to accounting differences.

Rating change drivers

Given BNPP's strong focus on the European banking market, a large acquisition in Europe would be a rating change driver, and not necessarily negative in the long term. We note that BNPP has thrived from acquisitions in countries such as Italy or Belgium, and that the ensuing diversification process has secured the stability of earnings.

The ability of BNP Paribas to squeeze more costs out of its “Simple and Efficient” program by 2016 would be a positive rating driver. The bank has successfully reduced its cost-income ratio over the decades from 62.7% in 2001, after the BNP and Paribas merger, to a low of 60.2% in 2007. The group recently revised the BNP Paribas “Simple & Efficient” program upwards, with cumulative recurring cost savings of EUR 2.8bn by 2016 versus EUR 2bn in the initial plan. This should reduce the group’s underlying cost-income ratio from 2013 levels of 66% to 63% by 2016. Assuming RWA growth of 3% per annum on full-year 2013 estimates and a cash dividend payout rising to its 45% target by 2016, supplementary post-tax earnings could thus rise by about EUR 1bn, or around 10bps of fully-phased Basel 3 CET1 ratio. The upward revision of the “Simple & Efficient” cost savings target is a tribute to the success of the program, even if the majority of the gains yet to be booked (EUR 2bn by 2016) will be invested in the business, i.e. up to EUR 1.4bn.

A sharp deterioration in the economic and political situation in France could significantly impact BNP Paribas’s credit standing, in our opinion. Although unlikely, this merits mention considering the current poor economic environment in France. In our opinion, renewed problems in the euro area should remain manageable given the bank’s ability to withstand the 2010-2012 crisis.

On 30 June 2014, BNP Paribas announced it had to plead guilty to conspiring to violate the International Emergency Economic Powers Act (IEEPA) and the Trading With the Enemy Act (TWEA). Considering the severe failures in controls and processes exposed by the settlement as well as the very public nature of the litigation – which was escalated at top French and US government levels, Scope Ratings decided to assign a negative outlook to BNP Paribas’s long-term ratings (on top of downgrading the ratings from AA- to A+). In particular, in light of the duration of the “publicized” aspects of the litigation (62 days between April 30 -the first time the extent of the litigation was flagged- and June 30th) Scope will pay particular attention to the impact of the settlement on the reputation and the track record of the banking group, with potentially negative ramifications for parts of its business franchise in the US market. Tangible evidence of underlying revenue sustainability over several quarters would be a decisive factor in revisiting the negative outlook.

Recent events

BNP Paribas’s Q1 2014 profits highlights are as follows:

- The revenue momentum has been somewhat weak at group level. Underlying group revenues were down 1.5% YoY reflecting decreases in emerging markets and the US (mostly foreign exchange impacts), while French and Italian retail banking revenues were virtually flat. Against this rather dull picture, Corporate & Investment Banking revenues held up well thanks to a stellar performance from the equities business, while investment solutions seems to have regained momentum, in particular net new asset growth.
- To offset this phenomenon, BNPP controlled the cost base successfully: operating expenses were down 1.2% year-on-year, which means that pre-provision profits were down by only 2%. As a result of this cost control, the underlying cost-income ratio of BNPP only increased by 20bps YoY, to 64.4%.
- Excluding the impact of a EUR 100m generic provision set aside for Eastern Europe, bad debt charges increased by 8%, to slightly less than EUR 1bn. The main driver of the increase was BNL, where the cost of risk stood at 185bps in Q1 2014. Even if the bank remains confident it will be able to bring the Italian cost of risk back to 100bps by 2016, it does not see any marked improvement in the next couple of quarters.
- Overall, the pre-tax profits of the bank fell by 5.6% YoY, to EUR 2.452bn which can be considered as a resilient performance even if the revenue momentum is yet to be seen. We are nonetheless encouraged by

the fact that even in what can be considered a dull quarter, BNPP still delivered 30bps of CET1 generation versus YE 2013.

2014-2016 Business Development Plan

On March 24, BNP Paribas presented its 2014-2016 Business Development Plan. In the course of the day, the group re-iterated the major principles underpinning its strategic vision and quantified its likely progress over the next three years. The bank confirmed its ambition to meet the targets of this plan in the press release that followed the US settlement. In our opinion, the three main takeaways of the Business Development Plan are as follows.

- The 2014-2016 plan demonstrates the ability of BNP Paribas to encompass change while remaining consistent with its long-term strategy. The group's strategy remains that of a European-based universal bank with four domestic markets (France, Belgium, Italy, Luxembourg) complemented by businesses well diversified by product (corporate and investment bank, asset and wealth management, securities services, insurance) and geographically (US retail banking, Turkey, Asia-Pacific). Another "stable" aspect of the strategy is the relentless search to maximize cross-selling between the different divisions and geographies of the bank, making BNP Paribas one of the very few institutions to lead a successful "one bank" strategy. The most recent development in this respect is the introduction of the successful private banking platform in the US and in Turkey, or the rollout of the "One Bank for Corporates" initiative throughout Europe. At the same time, the bank is open to change and innovation. BNP Paribas is currently reshuffling its various retail networks to change the branch format and turn the banking experience into a mix of advisory and digital capabilities. At the same time, BNP Paribas has launched Hellobank!, the first 100% digital mobile bank in Europe. The initiative was launched in 2013 in Germany, Belgium, France and Italy and has attracted 177,000 clients so far. The aim is for Hellobank! to reach 1.4m clients by 2017.
- The bank is pursuing convincing growth initiatives. In the course of its history, BNP Paribas has achieved growth either through external acquisitions or organically. Currently, considering all the regulatory changes undergone by the sector, as well as BNPP's G-SIFI status, it seems that the organic route is preferred - even if this does not prevent BNP Paribas from seizing acquisition opportunities when they arise (BGZ in Poland being one of the most recent examples). In this context, some of BNP Paribas's initiatives look extremely promising. In particular, the development plan of Asia Pacific has come off to a good start: in just one year the bank delivered close to 50% of the revenue growth target it had planned for the next four years. In Germany, BNP Paribas realized it was worth building a bank out of the twelve separate platforms previously in existence in the country. With the successful launch of Hellobank! in Germany, BNPP can now tap the retail deposit market as well. Turkey and Poland are also two countries where the bank is relying on increased cross-selling and market share gains in the future.
- BNP Paribas will not hesitate to use its balance sheet to secure growth. In the context of a Basel 3 CET1 target of 10%, and a long-term payout ratio of 45%, we estimate that the annual capital generation of the bank (i.e. its retained earnings) could come to between EUR 3bn and EUR 4.5bn over 2015-2016. Of this, around EUR 1.3bn-2bn will finance organic growth (securing 3% RWA growth while maintaining the CET1 ratio at 10%); while around EUR 1.7bn-2.5bn will qualify as "free cash flow" and will act as a "security buffer" or finance additional growth, either external or organic. Assuming a CET1 ratio of 10%, BNP Paribas can, in theory, increase its RWAs by about EUR 30bn to EUR 45bn per annum without denting its capital base. Although the bank is highly unlikely to do so, we find encouraging that it can put to use its strong balance sheet in its traditionally very stable and low-risk corporate banking business. This would allow the bank to regain some of the market share lost during the deleveraging of 2011-2012 and secure quality business in a market from which many international banks have withdrawn. So even if BNP Paribas still uses the "Originate to Distribute" model, its ability to put its balance sheet to good use is also quite reassuring. BNP Paribas' 8%+ funded asset growth CAGR target in Corporate Banking

would lead the bank to report, in 2016, broadly the same level of assets as in 2011 before the deleveraging – not exactly an aggressive target.

BNP Paribas also gave interesting disclosure on liquidity and capital planning. On the former, it stated that its Liquidity Coverage Ratio (LCR) at year-end 2013 was “above regulatory threshold” – meaning that the bank is already around 100%. On capital planning, BNPP is now gradually re-issuing Tier 2 instruments; it made its first issue since 2007, a EUR 1.5bn Tier 2 note due March 2026, on March 18.

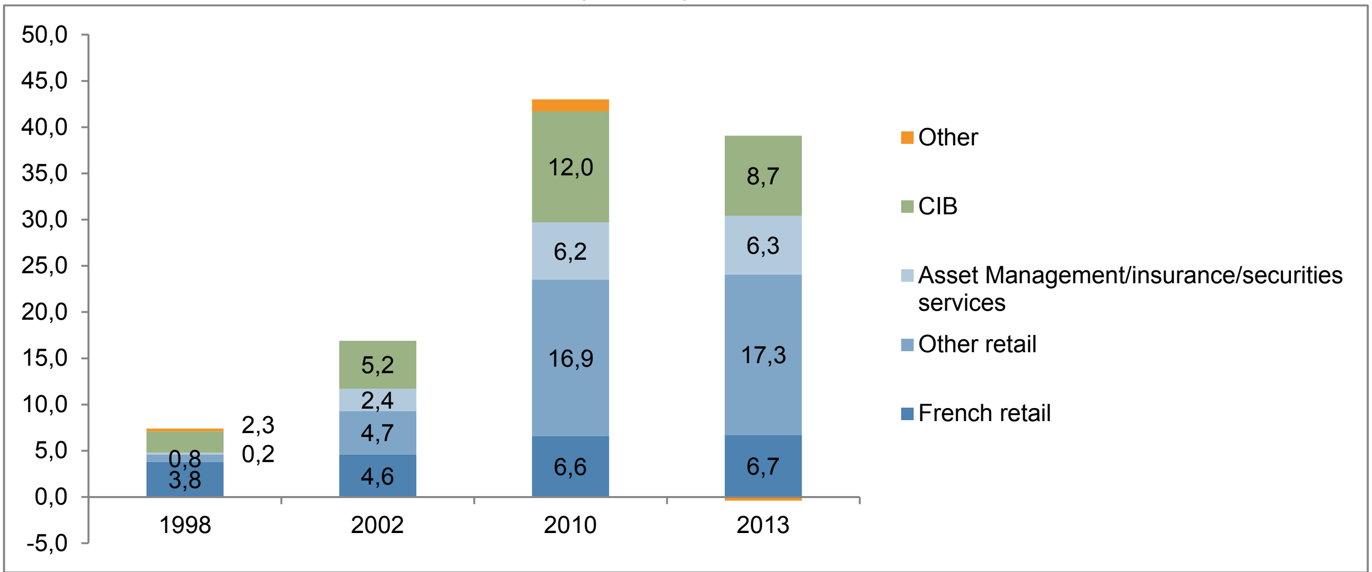
Rating drivers (Details)

1. A well-diversified business and geographic mix

BNP Paribas’s strength as a bank has always been its diversification, visible first and foremost at the **business line** level. Prior to its privatization in the 1990s, the old Banque Nationale de Paris (BNP) was essentially a French domestic retail business with traditional commercial banking operations and one subsidiary in the US: Bank of the West. Its merger with Paribas contributed multiple expertise in corporate and investment banking, as well as great franchises in personal finance, asset management, and securities services. Chart 1 below examines these trends by looking at the pre-tax earnings mix of the company in 1997, 2002 (post BNP Paribas merger), 2010 (post BNL and Fortis acquisitions) and 2013.

As seen in Chart 1, the different retail businesses of BNP Paribas experienced a quantum leap in 2002, with the addition of Paribas’ old Compagnie Bancaire business, and in 2006 and 2009 with the addition of the BNL and Fortis networks. Together, all retail banking operations represent between 55% and 62% of BNPP’s revenue mix over the cycle, while the weight of Corporate & Investment Banking (CIB) has traditionally been limited to 25-30%.

Chart 1: BNP Paribas revenue mix 1998-2013 (EUR bn)

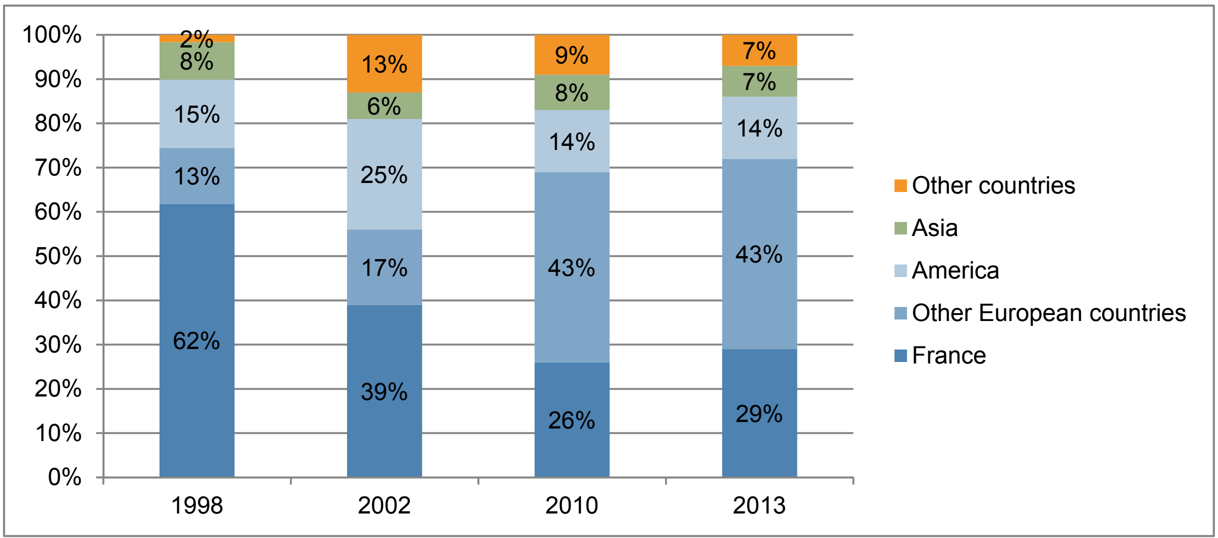


Source: Company data, Scope ratings estimates

BNP Paribas’s business mix is also well-diversified at **geographic** level**.** In our view, this priority given to diversification comes from the fact that during the 1994-1995 French recession, the old BNP managed to maintain acceptable financial fundamentals thanks to the earnings contribution of its subsidiary Bank of the West in the

United States. This positive experience with diversification probably shaped the resolutely European strategy launched by BNP Paribas in the 2000 decade, when the bank purchased BNL (2006) and Fortis (2009), thus gaining leadership positions in three other European countries (Italy, Belgium and Luxembourg). Looking at the geographic breakdown of the loan book for the same period as for Chart 1, we can see that the company's risk base is extremely well-diversified geographically.

Chart 2: Geographic breakdown of loan book at BNP Paribas, 1998-2013



Source: Company data, Scope ratings estimates

While the weight of France has declined over the years from more than 60% of the loan book to about 30% today, Western Europe has become the main contributor to the loan book. Of the 43% coming from Western Europe, the main contributors are Italy (12%) and Belgium & Luxembourg (14%).

2. A settlement stemming from certain USD transactions has exposed severe failures in controls and processes within BNP Paribas's organization on top of giving rise to strict financial and business terms

The downgrade of BNP Paribas's Long-Term ratings from AA- to A+ was underpinned by the settlement documents that were produced by the US Department of Justice and the District Court of the Southern District of New York. These documents exposed severe failures in controls and processes within BNP Paribas's organization.

The settlement also stroke us as imposing very strict terms to BNP Paribas (even if these terms are manageable), particularly in light of former litigations in the US involving European banks. Indeed, on top of a financial penalty of close to USD 9bn (of which the unreserved portion will lead to a charge of EUR 5.8bn in the Q2 2014 accounts), the bank has had to plead guilty to infringing various US laws we mention above. BNP Paribas will also have to accept a temporary suspension of one year, starting on 1 January 2015, on some USD-clearing activities, limited to one business line in certain locations.

Lastly, we note that the forthcoming EUR 5.8bn charge makes the capital position of BNP Paribas on a proforma Q1 2014 basis slightly less strong than peer average. However, the bank continues to display ample cash-generation capacity which should enable it to rebuild its CET1 ratio quickly (a level of around 10% is expected by the bank in Q2 2014 despite the settlement-related charges mentioned above).

3. Strong capital build-up

Of the European banks, BNP Paribas was among the most exposed to the new, tighter capital regime of Basel 3 as the bank had just purchased Fortis (2009) and had one of the largest balance sheets in the world at EUR 2trn. Since then, though, BNP Paribas has significantly reduced its RWAs and significantly increased its capital base. After one year during which the bank assessed the impact of the new capital rules, it decided to launch an aggressive adaptation plan in 2011 that significantly improved both its leverage and Basel 3 metrics (as shown in the table below).

Table 1: Leverage and capital metrics BNP Paribas (EUR bn except otherwise noted)

	2005	2006	2007	2008	2009	2010	2011	2012	2013
Tier 1 capital	28.8	34.4	39.2	41.8	62.9	68.5	71.0	75.2	66.6
Total Assets	1,258.0	1,440.0	1,694.0	2,076.0	2,058.0	1,998.0	1,965.0	1,907.0	1,800.1
Leverage ratio (%)	2.3%	2.4%	2.3%	2.0%	3.1%	3.4%	3.6%	3.9%	3.7%
RWAs (Basel 2, then Basel 2.5 from 2011 onwards)	378	463	533	535	621	601	614	552	560
CET1 ratio (%) (Basel 2, then Basel 2.5 from 2011 onwards)				5.4%	8.0%	9.2%	9.6%	11.7%	11.7%
RWA Basel 3 estimated							642	580	627
Published Basel 3 CET1 ratio (%)							7.4%	9.9%	10.3%
Implied Basel 3 CET1 (€bn)							47.5	57.4	64.9

Source: Company data, Scope ratings estimates

The adaptation plan meant selling a 28.7% stake in Klépierre, a property company initially in the Paribas dowry, deleveraging the corporate and investment banking business on around EUR 50bn of assets between September

2011 and December 2012, running-down EUR 8.5bn of non-core leasing outstanding since 2010, and running down the mortgage loan book of the Personal Finance division, now reclassified in the corporate center. Some of the revenue sluggishness experienced by the bank between 2011 and 2013 can be explained by this intense deleveraging effort.

4. Ongoing efforts to reduce costs and increase efficiency

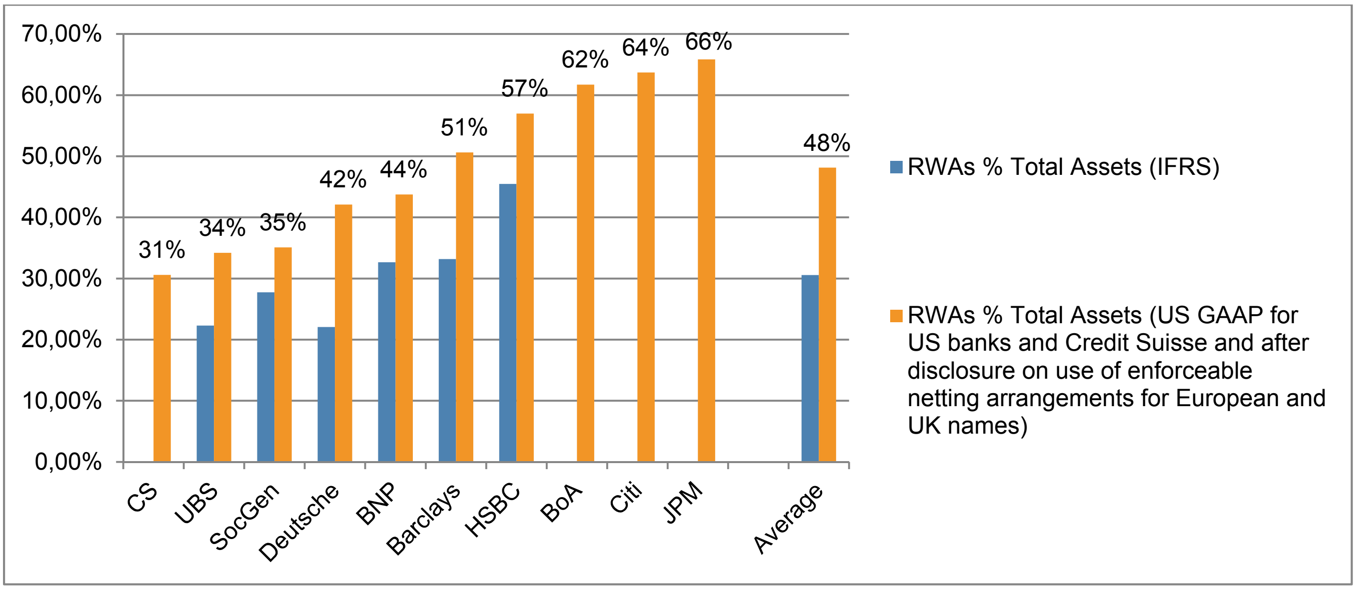
Optimization has always been at the forefront of BNP Paribas's priorities, ever since Banque Nationale de Paris was privatized in 1993 and started to improve the efficiency and the profitability of its loss-making French retail network. These efforts were pursued with the BNP-Paribas merger, leading the newly merged company to realize EUR 700m in costs synergies by September 2001, more than a year ahead of plan. The bank continued with a EUR 240m cost savings program in 2004 representing 2% of the cost base at that point, and EUR 250m in cost savings following the merger with BNL in February 2006, which was raised to EUR 270m later in the year. The acquisition of Fortis led to additional cost synergies, initially estimated at EUR 900m (mostly costs) in 2009 and then raised to EUR 1.2bn in December 2010 and EUR 1.5bn in December 2011. In December 2012, BNP Paribas announced the "Simple & Efficient" plan aimed at generating EUR 2bn in cost savings by 2015. As mentioned above, the success of this program prompted the bank to increase its cost savings targets from EUR 2bn to EUR 2.8bn.

5. Average risk-weighted assets intensity

French banks post among the lowest risk-weighted intensity of banks worldwide. In other words, the proportion of risk-weighted assets to assets remains low versus international peers.

However, the well-known accounting differences between IFRS and US GAAP tend to give a material advantage to US peers. To facilitate comparisons, IFRS 7 has requested banks reporting under IFRS to disclose both gross and net amounts of recognized financial assets and liabilities associated with master netting agreements and similar arrangements. Using the restatements provided by IFRS 7 enables a closer comparison between banks reporting under US GAAP and banks reporting under IFRS.

Chart 3: "Harmonized" Risk-Weighted Assets Intensity for selected European, UK and US banks – YE 2013



Source: Scope Ratings estimates, Company data

As we can see, the IFRS 7 restatements bring BNP Paribas much closer to the global peer group average of 48% (BNP Paribas reports an estimated "harmonized" IFRS 7-compliant, risk-weighted asset intensity of 44%, to be compared with a "reported" IFRS RWA intensity of 33%). BNPP's ratio does not stand among the best in the peer group but the bank's business mix is different from that of Bank of America or JP Morgan.

Assuming BNP Paribas moves its asset intensity to the peer group average of 48%, it would have to generate around EUR 4bn of extra capital, on our estimates, to maintain its Basel 3 CET1 target of 10%, from what would then be a level of 9.4%. We estimate BNP Paribas could reach this level in about a year of retained earnings.

Peer comparison

At Scope Ratings, we compare banks within peer groups at domestic and cross-border level.

Domestically, BNP Paribas is comparable to Société Générale, Crédit Agricole Group, BPCE and Crédit Mutuel Group.

Looking at the performance of BNP Paribas versus domestic peers, it is interesting to note that, on many metrics, the five rated banks show very similar rankings. This is particularly the case for liquidity metrics, since the loan-to-deposits ratio of all French banks is comprised between 110% and 130%, with BNPP ranking roughly in the middle of the pack.

In asset quality terms, French banks are clearly divided between domestically-biased and internationally-biased banks. The internationally-biased banks (BNP Paribas and SocGen) post higher impaired loans-to-total loans ratios, but the coverage ratios are homogenous.

In profitability terms, BNP Paribas benefits from very good pre-provision profitability. As a result, its ROE remains acceptable within the French peer group despite considerably higher levels of capital (although it has gone down in 2013 due to provisions for litigation).

The story is a bit different at cross-border level. Outside France, we have positioned BNP Paribas in the bucket of large universal banks operating in varied markets in varied geographies. This peer group includes Société

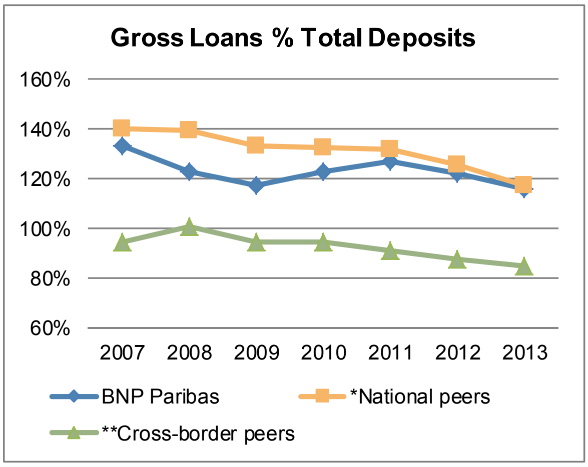
Générale, HSBC, Barclays, Deutsche, UBS and Credit Suisse, plus Citigroup, Bank of America and JP Morgan in the United States.

Overall, we find the positioning of BNP Paribas solid versus peers, particularly on the CET1 front where BNP Paribas has managed to close the gap with global peers.

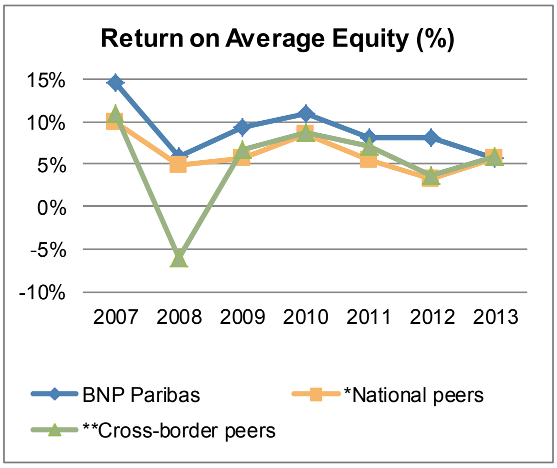
The bank's profitability is average overall, but with a notably better cost-income ratio than peers.

The only area where BNP Paribas has margin for improvement is on funding and liquidity, where it has a loan-to-deposits ratio of 116% as of year-end 2013 vs. a peer group average of 86%, and where the ratio of wholesale funds to total funds is also higher than peers. However, in this area BNP Paribas has posted the most impressive improvement of its peers since the crisis.

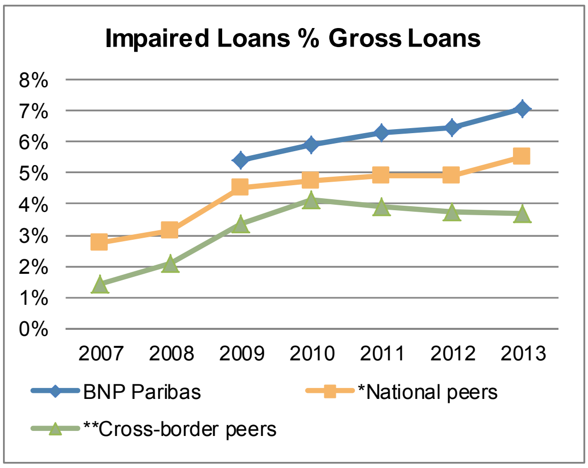
Peer Comparison - BNP Paribas group



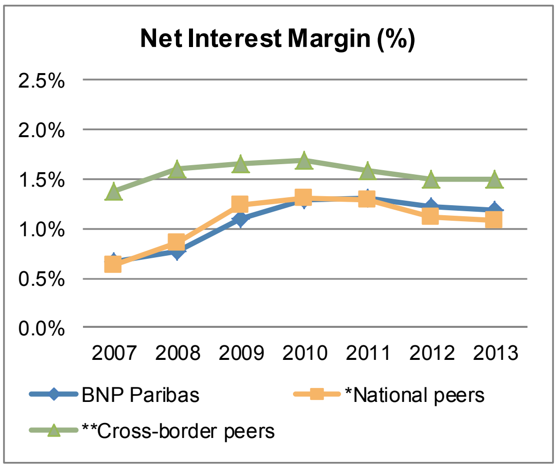
Source: SNL Financial, Scope Ratings



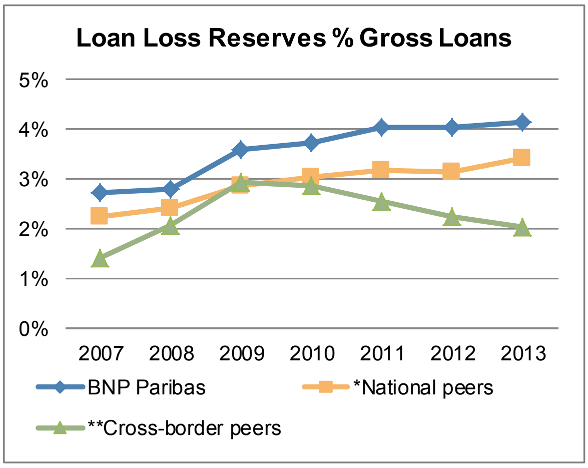
Source: SNL Financial, Scope Ratings



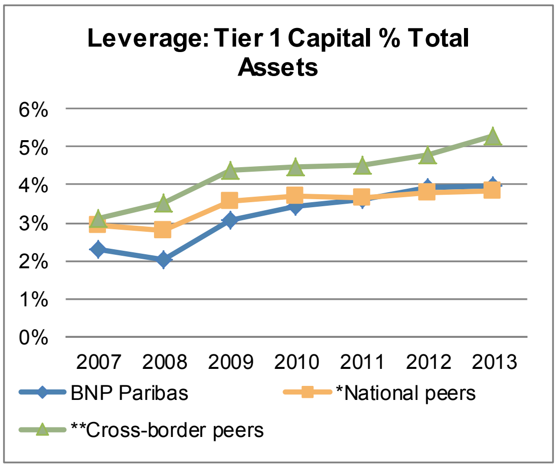
Source: SNL Financial, Scope Ratings



Source: SNL Financial, Scope Ratings



Source: SNL Financial, Scope Ratings



Source: SNL Financial, Scope Ratings

*National peers: BNP Paribas, Credit Agricole Group, Credit Mutuel Group, Groupe BCPE, Societe Generale
**Cross-border peers: Bank of America Corp, Barclays, BNP Paribas, Citigroup Inc, Credit Suisse, Deutsche Bank, HSBC, JP Morgan Chase, Societe Generale, UBS

Selected Financial Information - BNP Paribas group

	2007	2008	2009	2010	2011	2012	2013	2014E	2015E
Balance Sheet summary (EUR billion)									
Assets									
Cash and balances with central banks	18.5	39.2	56.1	33.6	58.4	103.2	101.1	105.8	127.6
Interbank assets	73.4	70.6	88.9	62.7	49.4	40.4	50.5	50.5	55.5
Total securities	817.0	768.3	696.3	717.1	571.0	554.7	583.1	601.7	621.2
of which debt instruments	650.5	664.8	579.3	588.5	477.1	432.9	443.8	452.7	461.8
of which equity instruments	166.6		117.0	128.6	93.9	121.8	139.2	149.0	159.4
Derivatives	238.8	574.0	371.1	355.5	465.7	430.7	313.5	321.7	331.8
Gross customer loans	460.5	509.2	702.4	707.9	694.4	658.3	644.3	656.6	675.5
of which impaired loans	14.2	16.4	38.4	42.1	43.7	42.5	45.4	44.5	43.6
Total funded assets	1,448.7	1,524.1	1,693.1	1,643.9	1,503.1	1,483.2	1,489.8	1,525.7	1,590.9
Total Assets	**1,694.5**	**2,075.6**	**2,057.7**	**1,998.2**	**1,965.3**	**1,907.2**	**1,800.1**	**1,844.1**	**1,919.3**
Liabilities									
Interbank liabilities	171.9	187.2	226.2	170.1	150.4	113.3	85.7	77.1	73.3
Senior debt	576.6		477.4	483.1	370.7	418.3	423.2	444.3	488.7
Derivatives	245.8	551.5	364.6	354.3	462.2	424.0	310.3	318.4	328.4
Customer deposits	346.7	414.0	604.9	580.9	546.3	539.5	557.9	569.1	580.4
Subordinated debt + hybrid securities	18.6	18.5	31.8	27.9	22.1	16.7	13.6	12.3	11.0
Total Liabilities	**1,635.1**	**2,016.6**	**1,977.4**	**1,912.5**	**1,879.7**	**1,813.2**	**1,709.0**	**1,749.8**	**1,821.7**
Ordinary equity	47.1	42.7	61.5	66.6	68.1	78.2	81.0	84.1	87.4
Minority interests	5.6	5.7	10.8	11.0	10.3	8.6	3.6	3.6	3.6
Total Liabilities and Equity	**1,694.5**	**2,075.6**	**2,057.7**	**1,998.2**	**1,965.3**	**1,907.2**	**1,800.1**	**1,844.1**	**1,919.3**
Core Tier 1 Capital [1]	*30.3*	*28.9*	*49.5*	*55.4*	*47.5*	*57.4*	*64.8*	*67.0*	*70.3*
Income Statement summary (EUR billion)									
Net interest income	9.7	13.5	21.0	24.1	24.0	21.7	20.6		
Net fee & commission income	6.3	5.9	7.5	8.5	8.4	7.5	7.2		
Net trading income	9.7	2.5	6.0	5.1	3.6	4.4	5.7		
Operating Income	**31.4**	**27.6**	**40.4**	**44.1**	**42.5**	**39.6**	**39.1**	**38.1**	**39.0**
Operating expenses	18.8	18.4	23.3	26.5	26.1	26.5	26.1	25.3	25.6
Loan loss provision charges	1.7	5.8	8.4	4.9	3.6	3.9	4.0	3.6	3.5
Non-recurring items	0.2	0.5	0.9	0.3	-3.0	1.7	-0.5	-0.8	-0.6
Pre-Tax Profit	**11.1**	**3.9**	**9.0**	**13.0**	**9.7**	**10.4**	**8.2**	**8.4**	**9.3**
Income tax	2.7	0.5	2.5	3.9	2.8	3.1	2.8	2.6	2.9
Net profit attributable to minority interests	0.5	0.4	0.6	1.3	0.8	0.8	0.6	0.6	0.7
Net Income Attributable to Parent	**7.8**	**3.0**	**5.8**	**7.8**	**6.1**	**6.6**	**4.8**	**5.2**	**5.7**

Source: SNL Financial and Scope Ratings for historical figures. Scope's forecasts are based on publicly available information. Please refer to "Methodologies Used for this Report" for further details.
[1] CRD 4 basis from 2011 onwards

Ratios - BNP Paribas group

	2007	2008	2009	2010	2011	2012	2013	2014E	2015E
Funding/Liquidity									
Gross loans % Total deposits	132.8%	123.0%	116.1%	121.9%	127.1%	122.0%	115.5%	115.4%	116.4%
BNP Paribas	30.9%	34.1%	44.9%	45.7%	49.8%	49.3%	51.3%	51.3%	50.0%
Wholesale funds % Total funds	69.1%	65.9%	55.1%	54.3%	50.2%	50.7%	48.7%	48.7%	50.0%
Asset Mix, Quality and Growth									
Gross loans % Funded assets	31.8%	33.4%	41.5%	43.1%	46.2%	44.4%	43.2%	43.0%	42.5%
Impaired loans % Gross loans	3.1%	3.2%	5.5%	5.9%	6.3%	6.4%	7.0%	6.8%	6.5%
Loan loss reserves % Impaired loans	88.0%	87.2%	50.5%	50.7%	64.1%	62.5%	58.7%	59.9%	61.1%
BNP Paribas	13.2%	10.6%	38.0%	0.8%	-1.9%	-5.2%	-2.1%	1.9%	2.9%
Impaired loan growth (%)	-9.6%	15.5%	134.0%	9.7%	3.8%	-2.8%	7.0%	-2.0%	-2.0%
Funded assets growth (%)	15.5%	5.2%	11.1%	-2.9%	-8.6%	-1.3%	0.4%	2.4%	4.3%
Earnings									
Net interest income % Revenues	30.9%	48.9%	52.1%	54.5%	56.5%	55.0%	52.6%		
Fees & commissions % Revenues	20.1%	21.2%	18.5%	19.2%	19.8%	19.0%	18.3%		
Trading income % Revenues	30.9%	9.1%	14.9%	11.6%	8.4%	11.2%	14.5%		
BNP Paribas	18.0%	20.7%	14.5%	14.7%	15.3%	14.8%	14.5%		
Net interest margin (%)	0.9%	1.1%	1.6%	1.7%	1.8%	1.8%	1.7%		
Pre-provision Income % Risk-weighted assets (RWAs)	2.4%	1.7%	2.7%	2.9%	2.7%	2.4%	2.3%	2.2%	2.3%
Loan loss provision charges % Pre-provision income	13.2%	62.5%	49.1%	27.7%	21.8%	29.7%	30.9%	28.1%	26.3%
Loan loss provision charges % Gross loans (cost of risk)	0.4%	1.2%	1.4%	0.7%	0.5%	0.6%	0.6%	0.6%	0.6%
Cost income ratio (%)	59.8%	66.6%	57.8%	60.1%	61.5%	67.1%	66.7%	66.4%	65.7%
Net Interest Income / Loan loss charges (x)	5.8	2.3	2.5	4.9	6.7	5.6	5.1		
Return on average equity (ROAE) (%)	17.0%	6.7%	11.2%	12.2%	9.0%	9.0%	6.1%	6.3%	6.7%
Return on average funded assets (%)	0.4%	0.1%	0.2%	0.3%	0.3%	0.3%	0.2%	0.2%	0.2%
Retained earnings % Prior year's book equity	10.6%	4.5%	9.5%	8.7%	6.9%	6.9%	3.8%	3.8%	3.9%
Pre-tax return on common equity tier 1 capital	36.5%	13.6%	18.2%	23.5%	20.3%	18.1%	12.6%	12.6%	13.2%
Capital and Risk Protection [1]									
Common equity tier 1 ratio (common equity tier 1 capital % RWAs)	5.7%	5.4%	8.0%	9.2%	7.4%	9.9%	10.3%	10.4%	10.5%
Tier 1 leverage ratio (%)	2.3%	2.0%	3.1%	3.4%	3.6%	3.9%	3.7%		
Median of tier 1 leverage ratio and common equity tier 1 ratio (%)	4.0%	3.7%	5.5%	6.3%	5.5%	6.9%	7.0%		
Total loss coverage (CET 1 capital + loan loss provisions) % RWAs	8.0%	8.1%	11.1%	12.8%	12.3%	15.2%	16.3%	15.9%	16.8%
Non-senior bailinable debt cushion (as % of total liabilities)	1.5%	1.4%	2.0%	1.9%	1.6%	1.3%	1.2%	1.1%	1.0%
Asset risk intensity (RWAs % total assets)	31.5%	25.8%	30.2%	30.1%	31.2%	28.9%	31.1%	34.8%	34.8%

Source: SNL Financial and Scope Ratings for historical figures. Scope's forecasts are based on publicly available information. Please refer to "Methodologies Used for this Report" for further details.
[1] CRD 4 basis from 2011 onwards

METHODOLOGIES USED FOR THIS REPORT

For the rating and analysis contents of this report, Scope has used the following methodologies which were published on www.scoperatings.com:

"Bank Rating Methodology" (February 2014)

"Forecasting Bank Financials Methodology" (February 2014)

Forecasting bank financials: Forward-looking estimates are an important analytical tool underpinning Scope's bank ratings. These forecasts cover the current financial year (before final year-end figures are published by the bank) plus the forthcoming two years. Depending on the complexity of the bank being assessed, different forecasting tools will be used. For a majority of banks operating primarily commercial and retail banking franchises (loans and deposits) the analysis is underpinned by an **accounting** forecast of the balance sheet and profit and loss account. For more complex groups with multiple ranges of activities – notably those with material wholesale and investment banking operations – Scope uses an **analytical** forecast, relying on the bank's business-line reporting to come up with plausible estimates. For all banks Scope also includes a **regulatory metrics** forecast, considering the growing importance of this aspect in bank analysis.

For complex banks, divisional data is used to forecast profit and loss accounts and basic divisional balance sheet metrics. For less complex banks, a line-by-line forecasting of major P&L elements is forecast.

For balance sheet forecasts, Scope estimates of all major balance sheet lines, using the P&L estimates to complete the forecast of the capital/shareholders' equity line. This comprehensive methodology for estimating the balance sheet is used for all the banks in our universe, irrespective of size and complexity.

Lastly, our forecasts include assessments of the major regulatory metrics: Tier 1 and CET 1 (historically CT1), Leverage, Liquidity Coverage Ratio, and Net Stable Funding Ratio (the latter two when and if sufficient public information to compute them is available).

Scope will not aim to forecast financials when it considers the public disclosure of the bank as insufficient for a transparent and credible outcome.

All Scope's bank financial forecasts are based on public information. For its forecasts Scope will not use any non-public information or data, even if such information or data were provided by rated banks. Scope's forecasting process is transparent, with a detailed roadmap provided in its *"Forecasting bank financials"* methodology.

BPCE SA
Issuer Rating Report

A+ STABLE OUTLOOK
Financial Institutions

Overview

Scope Ratings assigns an Issuer Credit-Strength Rating (ICSR) of A+ and a short-term debt rating of S-1 to BPCE SA, both with a stable outlook. These ratings reflect the strong improvement in the fundamentals of a group that was only put together in 2009 to avoid a full government bail-out of Natixis (NX), the listed subsidiary of Banques Populaires (BP) and Caisses d'Epargne (CE). In four years, the most recently created French banking group managed to create a strong culture and proper business standards out of very disparate components. At the same time, the ratings also reflect the somewhat less strong liquidity and funding metrics of the bank, which are in part a direct result of its checkered history.

The ratings on BPCE SA are based on Groupe BPCE's (BPCE) credit fundamentals and support. The A+ and S-1 ratings are not applicable to unguaranteed debt issued by subsidiaries of BPCE SA.

Issuer Credit-Strength Rating (assigned on April 2, 2014)	**A+**
Outlook	Stable
Senior unsecured debt	A+
Short term debt rating (May 22, 2014)	S-1
Short term debt rating outlook	Stable

Unsolicited ratings without issuer participation.

Lead Analyst

Jacques-Henri Gaulard
j-h.gaulard@scoperatings.com

Team Leader

Sam Theodore
s.theodore@scoperatings.com

Rating drivers (Summary)

The rating drivers, in decreasing order of importance in the rating assignment, are:

- (+) A strong franchise and a low-risk business model. The combination of two of the largest domestic retail franchises in France together with the powerful and de-risked Natixis product engine guarantee sustainable cash generation, which is strongly supportive of the rating.
- (+) The manner in which BPCE has considerably simplified its dual mutualist-listed structure and aligned the interests of all its components (Banques Populaires, Caisses d'Epargne, BPCE and Natixis) is very beneficial for bondholders: there is little friction between entities and no obstacle to free capital circulation within the group in the unlikely case of a major credit event.
- (−) The liquidity metrics of the company remain slightly less strong than French and international peers.
- (+) Natixis is now much more than just BPCE's corporate & investment banking arm. Its manufacturing capabilities in specialized financial services help raise the number of products per client in the retail networks, while BPCE's listed subsidiary also benefits from a highly profitable asset management division.
- (−) The overall profitability of the two large retail networks of the BPCE group (Banques Populaires and Caisses d'Epargne) is not where it should be versus French peers and considering the bank's large market shares.

Rating change drivers

In its 2014-2017 strategic plan, the bank is very discreet about its acquisition plans, except for EUR 1.5bn that are budgeted for the asset management division of Natixis. Excluding asset management, the objectives of the bank at an international level are less clear ("seize opportunistic developments internationally"). The equity market reach of Natixis as the listed entity of BPCE as well as its growing excess capital following the forthcoming IPO of credit insurer Coface could pave the way for a large non-domestic acquisition that could prove problematic to integrate.

The restructuring of the BPCE group occurred with no particular change to the geographic spread of the bank. On our estimates, France represented 78% of the total commitments of the group as of year-end 2013. Considering the extent of the bank's exposure to France, any sharp deterioration in the fundamentals of the French economy could negatively impact BPCE.

After four years of restructuring, we expect the capital build-up of the company to gather momentum, and we expect its Basel 3 core Tier 1 ratio to increase by 40bps per annum. The 12% Basel 3 CET1 target by 2017 is realistic and would rank BPCE among the best capitalized banks in Europe.

Recent events

BPCE reported very good Q1 2014 results, with net profits standing at EUR 866mn, up 16% versus Q1 2013. At the same time, the bank increased its CET1 ratio by 40bps to 10.8% and its leverage ratio stood close to 4%. All the asset quality metrics were satisfactory, and the good performance was spread across all divisions. The toxic assets portfolio (called "GAPC") is to be closed, since the remaining assets have been transferred to the wholesale division. The forthcoming IPO of Coface should accelerate the capital build-up of the group.

Another important event for BPCE was the bank's presentation of its 2014-2017 strategic plan last November. The new plan capitalizes on the success of the 2009-2013 "Together" plan, which was defended by the company and implemented throughout 2011 and 2012, despite the euro crisis, at a time when several French banks were dropping their strategic plans.

The new 2014-2017 strategic plan (called "Another way to grow") is quite innovative to the extent that priority is given to strengthening capital adequacy and transforming the bank's funding model. Contrary to many plans where funding, liquidity and capital are a means to an end, improving these metrics is the paramount priority at BPCE. Growing for the sake of growing is definitely not part of the plan. Indeed, the overall capital allocation at group level will remain stable with a priority on insurance and asset management (the latter being granted a budget of EUR 1.5bn in the course of the plan for acquisitions). At Natixis, new loan production will be done through the strict criteria of the "Originate to Distribute" (O2D) model, and parts of the loans will be sold to investors – Natixis will keep a portion on-balance sheet to ensure that its own interests and client interests are aligned. Lastly, the entire growth plan of the two retail networks will be based on increasing the number of products per client rather than increasing loan volumes; a goal we do not perceive as being very capital intensive either. BPCE's new plan strikes us as formalizing what it means to run a bank in a post-Basel 3 world.

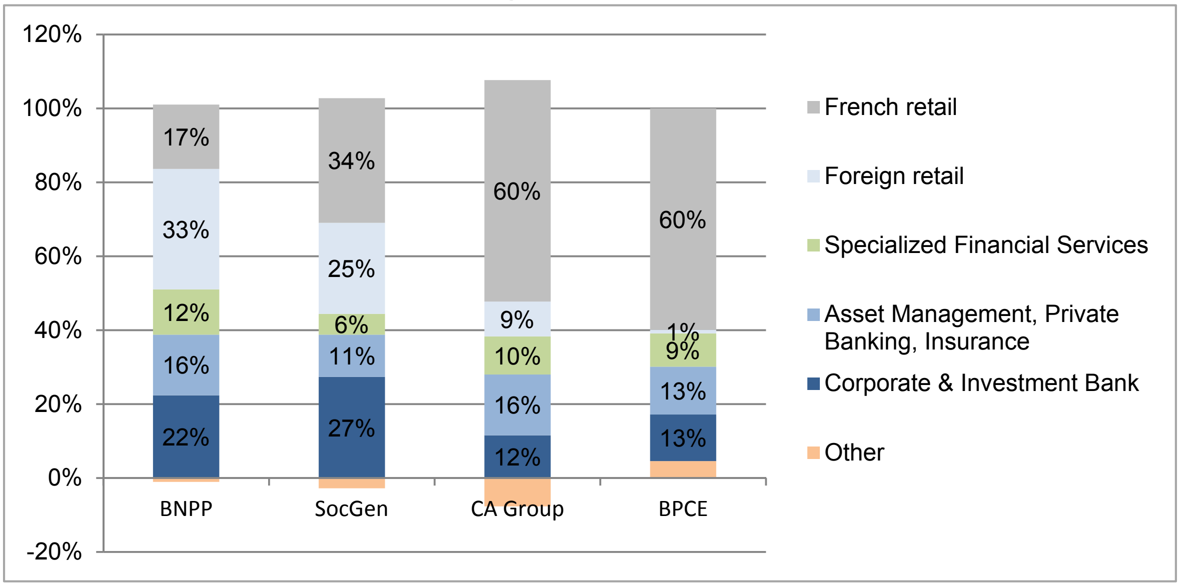
Rating drivers (Details)

1. A strong franchise and a low-risk business model

Over the past decade or so, French bank mergers involving mutualist banks did not result in combined entities that were as low-risk as their predecessor banks. The merger of BP and CE in 2009 was no exception, as the combination was mostly designed to shore up the financially troubled Natixis. But despite unfavorable odds, BPCE's new management was very good at (1) capitalizing on the strong domestic retail franchises of BP and CE, and (2) restructuring and de-risking Natixis, partly through a guarantee from BPCE on the subsidiary's toxic assets. The notional amount of toxic assets under guarantee represented EUR 52.8bn in Natixis' books as of Q1 2009; equivalent to 3.3x the proforma shareholder's equity of BPCE at year-end 2008. By December 2013, the toxic assets had fallen to EUR 7.6bn (less than 17% of BPCE's 2013 estimated tangible equity). The whole toxic assets division (known as GAPC) will be closed down by BPCE mid-2014. As for the quality of the franchises underpinning BPCE, Caisses d'Epargne is a well-established brand in France with a focus on household savings, while Banques Populaires specializes in servicing French small- and medium-sized companies. On top of these two networks, it is important to include Crédit Foncier de France (CFF), a mortgage lending specialist, and Banque Palatine (formerly San Paolo Bank (France), specialized in upper market corporate and retail clients). All of BPCE's networks claimed a market share of 21.4% of the sector's deposits and 20.6% of the loans, second only to Crédit Agricole-LCL (around 25% market share for loans and deposits).

The strength of the franchise combined with the restructuring of Natixis have led BPCE to benefit from a very low-risk business model compared with peers, as demonstrated in Chart 1 below, which looks at the revenue structures of four large French banks as of December 2013.

Chart 1: Revenue breakdown of four large French banks, 2013



Source: Scope Ratings research, Company data

Chart 1 shows that, with 13% of total revenues as of December 2013, the weight of the corporate and investment banking businesses remains very small in BPCE's revenue mix. But Natixis has become much more than a corporate & investment bank. BPCE's listed subsidiary comprises very stable businesses, such as the Specialized Financing entities and the Asset Management division. Natixis is also the product engine of the group. We believe that as CE and BP increase the number of products per client, Natixis will improve its revenues generated by the two networks, partly triggered by the fact that, from 2016 onwards, Natixis will be the exclusive provider of insurance products for the entire BPCE group following the termination of the manufacturing agreement between Caisse Nationale de Prévoyance (CNP) and BPCE. The weight of asset management should also increase on the back of the future acquisitions budgeted in Natixis' 2014-2017 strategic plan. As a result, the weight of the Corporate & Investment Banking (CIB) division could be diluted further and the business model could remain as low-risk as it is now.

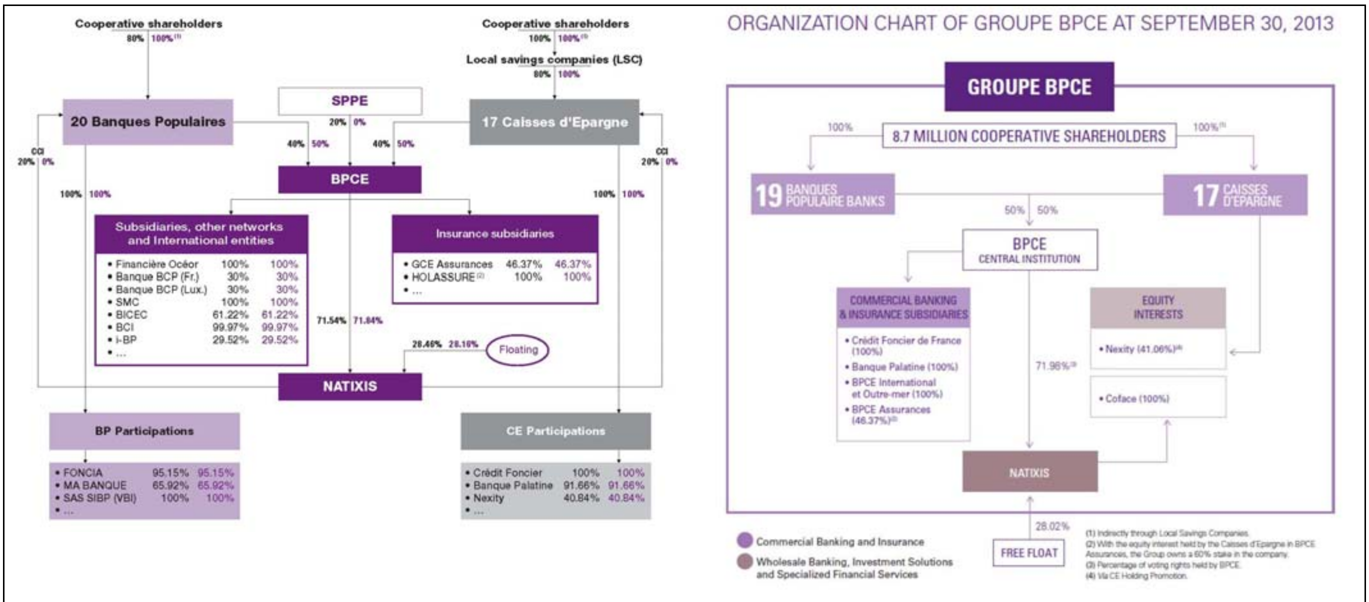
2. BPCE's corporate structure has been considerably simplified since 2009

Since the merger that created BPCE in 2009, the company's new management has made every effort to simplify a corporate structure that was too complicated and could be an obstacle to the free circulation of cash flows between different member banks.

The left part of Chart 2 shows the corporate structure as it was in December 2009. Back in 2009, BPCE was a complicated banking group, where the BPs and the CEs held an equal proportion of the capital of BPCE (20% of the company was by the French government at the time held), as well as 100% of two holding companies (BP Participations and CE Participations), to which each network had contributed its financial and other non-network-related equity stakes. In addition, BPCE owned 71% of the listed vehicle Natixis, and to complicate matters further, Natixis owned 20% of the capital of each network (BPs and CEs). The latter ownership enabled Natixis to be exposed to the French retail business.

In the course of the last four years, the group managed to collapse the vast majority of this structure by (1) bringing all the equity stakes up to BPCE – bar Coface (located at Natixis) and the property company Nexity (located at CE) - and closing the intermediary holding companies; (2) selling the majority of the non-strategic holdings (Société Marseillaise de Crédit, Foncia, equity stake in Volksbank International, own-account Private Equity, correlation derivatives portfolio, Eurosic) bar Coface (soon to be IPO'ed) and Nexity; and (3) through a very brave move, ending the BP, CE and Natixis cross-shareholding by having the BPs and the CEs agree to buy back the 20% of their capital held by Natixis. The right side of Chart 2 looks at the current corporate structure of BPCE.

Chart 2: BPCE's corporate structure –then (left) and now (right)



Source: Company data

It is clear that cash flows are now circulating more freely. From the very inception of the group, BPCE has centralized the long-term bond issues of the BPCE Group under its name (and Crédit Foncier's for long-dated bonds funding property projects). While BPs and CEs contribute the bulk of the group's cash generation, Natixis is the product engine of the BPs and the CEs as well as the group representative for businesses that the network cannot engage in (Corporate & Investment Banking, Asset Management). BPCE, as Central Body of the group, seems to be a "trusted intermediary" between the different banking cultures represented by all of the group's components. This is made easier, in our view, by the fact that BPCE is only a Central Body and does not double up as a listed vehicle or full-bodied bank. All the missions are well-defined.

The successful ability of all parties at BPCE to set aside their cultural differences is exemplified by the fact that back in 2009, when the group was created, two distinct share categories were issued: one for CE shareholders and one for BP shareholders in order to guarantee the parity between the two shareholders during the five years of an "incorporation period" that guaranteed that this equality between networks would continue in case of a capital increase, share cancellation, etc. But the company's general shareholders' meeting of December 20, 2012 decided to abolish the incorporation period. Instead, the meeting defined a system whereby shares can be freely transferred (after a pre-emptive right of each relevant network) from August 1, 2019.

3. Group liquidity has room for continued improvement

Considering what have been essentially strong achievements in business and governance standards, the liquidity metrics of Groupe BPCE offer room for improvement. On paper, the liquidity should look strong, since BPCE accumulates two big retail networks, with one in particular (CE) specialized in household savings. However, the loss-leader of CE's deposit offer, the Livret A (the only tax-free savings product in France) is essentially unavailable for liquidity purposes as it is transferred to Caisse des Dépôts (CDC) for social housing purposes. On top of this, Natixis is an amalgamation of wholesale-funded credit institutions, which were known at the time as "Institutions Financières Spécialisées". These companies could not, by law, receive deposits from the public. They were Crédit National, BFCE, Crédit Foncier de France – the addition of CDC's former investment bank (Ixis) to the whole did nothing to improve the situation – as it was also fully wholesale funded (on a balance sheet of around EUR 250bn). It must also be said that the group's communication on liquidity has not been as consistent as in other areas (although BPCE was the only French bank to acknowledge in writing that it had used the ECB's LTRO facilities).

Following a deep dive into the accounts of BPCE between 2009 and 2013, we found that the bank has significantly improved on its liquidity metrics but there is still room for improvement.

In Table 1 we have compiled some liquidity metrics by making the following restatements on the published accounts: (1) 65% of the Livret A deposits is assumed unavailable and transferred to CDC; and (2) the pool of assets of Compagnie de Financement Foncier segregated for covered bonds is also restated from the loan book. Making the second restatement is logical since the assets are "off" the "regular" funding circuit of BPCE and legally secured for covered bond holders. These restatements help explain why some of the metrics disclosed in Table 1 are different from the numbers reported by the bank in the "peer comparison", "selected information" and "ratios" tables below.

Table 1: Main restated liquidity metrics of BPCE

	2009	2010	2011	2012	2013
Loans % deposits	175.35%	142.71%	142.38%	133.42%	125.50%
Liquid assets % short-term funds	108.76%	106.74%	107.57%	134.03%	124.58%
Wholesale funds % total funds	59.23%	57.08%	58.88%	58.14%	53.17%
ST wholesale funds % total funds	36.03%	33.86%	36.37%	32.50%	33.93%
Deposits % total funds	40.74%	42.86%	41.12%	41.86%	46.83%
Loans % total assets	50.30%	43.76%	40.94%	41.31%	43.29%
Repos % ST wholesale funds	24.29%	31.13%	38.62%	53.20%	46.30%

Source: Company data, Scope Ratings estimates

The year 2009 gives a good idea as to what the non-restated loans-to-deposits ratio of BPCE would look like, i.e. prima facie a high dependency of the bank to wholesale funding, much higher than French and international peers.

Excluding the covered pool, the ratio declines to an acceptable but still high 125% in 2013. In the meantime, we note that the proportion of wholesale funds to total funds has remained at a high 53% (despite a mild decrease between 2012 and 2013) and that within this the proportion of repos has increased steadily from 24% in 2009 to 53% in 2012, before receding slightly in 2013. We believe that BPCE is in a transition as far as liquidity and funding are concerned. The bank has yet to complete the second phase of its transformation whereby the bulk of the corporate loans outstanding are repackaged and sold and/or syndicated away, while the long-term loans (property, local authorities) should be extensively refinanced as covered bonds. This is a very ambitious and credible strategy but it may take years before these efforts are plainly visible in the bank's balance sheet structure.

4. Natixis' dual role as product and growth engine

Between 2009 and 2013, Natixis managed to become indispensable to the proper functioning of BPCE Group as a product engine. During this time, its biggest achievement was bringing a close to EUR 900m in revenue synergies with BP and CE (around 4% of BPCE's revenues in 2013), basically increasing the equipment rate of the two networks in consumer finance, payments and, to a lesser extent, insurance. This role should increase in the future as the BP and CE networks still lag behind the rest of the French banking sector in several high-profile products such as insurance, factoring or payment processing. In insurance, the equipment targets should be made easier by the severance of the partnership with CNP, the historical life insurance partner of CE.

But Natixis will also have to be the growth engine of the group, through low-capital intensity businesses such as asset management, where the bank is Top 15 worldwide, and thanks to the O2D model, made credible and real as the bank has already announced two partnerships with insurance companies interested in the potential yield of the lending business (Ageas – 2012 and CNP – 2013).

5. The profitability of the BP and CE networks is not where it should be

Table 2: Comparative profitability of retail divisions in France (Year-end 2013)

	BP+CE	BNPP	SocGen	Reg Bks CA	LCL
Total revenues (EURm)	13,387	6,726	8,235	14,873	3,811
Cost-income ratio (%)	65.5%	65.3%	64.0%	54.0%	66.0%
Cost of risks (%)	0.34%	0.24%	0.66%	0.26%	0.34%
Estimated post-tax ROE (%)	8%	17%	13%	25%	22%
Net profits (EURm)	2,072	1,278	1,164	3,666	599

Source: Company data, Scope Ratings estimates

Table 2 compares the financial performances of BP and CE (combined) with the performances of other retail networks in France. Even if the ROEs are distorted by the different capital allocation methodologies of each network, it is clear that the BP and CE networks are among the least profitable of the peer group. The cost-income ratio remains higher than its peers and the cost of risks is simply average. If we compare the P&L of the BP and CE networks with Crédit Agricole's regional banks, we see that the revenue bases are not that different: EUR 14.9bn for the regional banks of Crédit Agricole and EUR 13.4bn for the combination of BP and CE. Despite a limited 11% difference in revenues, the difference in net profits is closer to 75%, showing that BPCE has a significant margin for improvement.

Peer comparison

At Scope ratings, we compare banks within peer groups at domestic and cross-border levels.

Domestically, BPCE is comparable to BNP Paribas, Société Générale, Crédit Agricole Group and Crédit Mutuel Group.

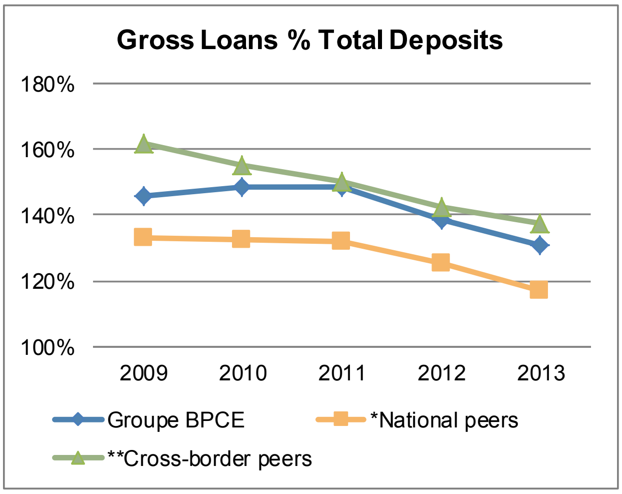
Looking at the performance of Groupe BPCE versus domestic peers, it is interesting to note that on many metrics the five rated banks show very similar rankings. This is particularly the case of liquidity metrics, since the loan-to-deposits ratios of all French banks are between 110% and 130%. BPCE displayed one of the highest loan-to-deposits ratios in 2013 of French banks, despite a major improvement since 2009 and the creation of the bank (the restated LTD ratio stood at 175% then). Other liquidity ratios show that BPCE still has room for improvement in this area, particularly regarding the weight of wholesale funding in total funding.

In asset quality terms, French banks are clearly divided between domestically-biased and internationally-biased banks. Among the former (CA Group, Crédit Mutuel and BPCE), BPCE shows impaired loans metrics which rank well among peers, with a coverage ratio within average levels.

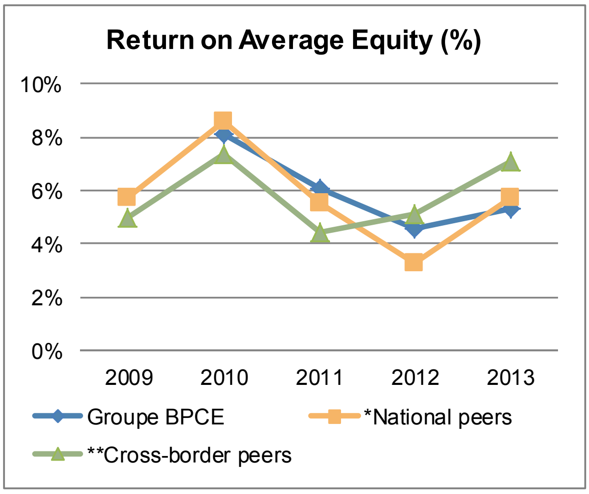
Looking outside France, we have positioned Groupe BPCE as a domestic pure play, together with banks such as Crédit Mutuel, CaixaBank, Lloyds or Rabobank.

Despite some of the problems mentioned above, BPCE’s relative position will look acceptable versus its international peers. The position of the bank appears better than average in terms of a loan-to-deposits ratio, but the weight of wholesale funding to total funding and the proportion of short-term wholesale funding remains higher than those of its peers. The capital position is decent though, and we believe that BPCE’s target of a CET1 ratio of 12% by 2017 is realistic and adequate considering the business model and risk profile of the group.

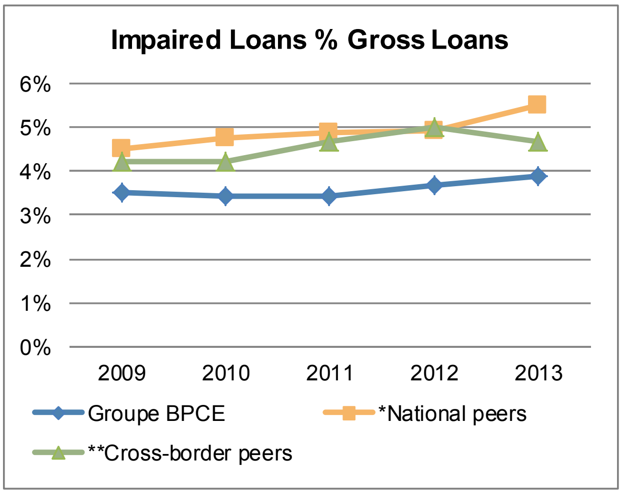
Peer Comparison - Groupe BPCE



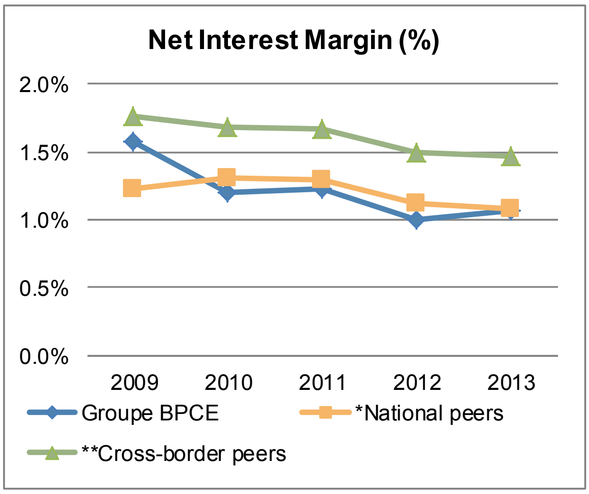
Source: SNL Financial, Scope Ratings



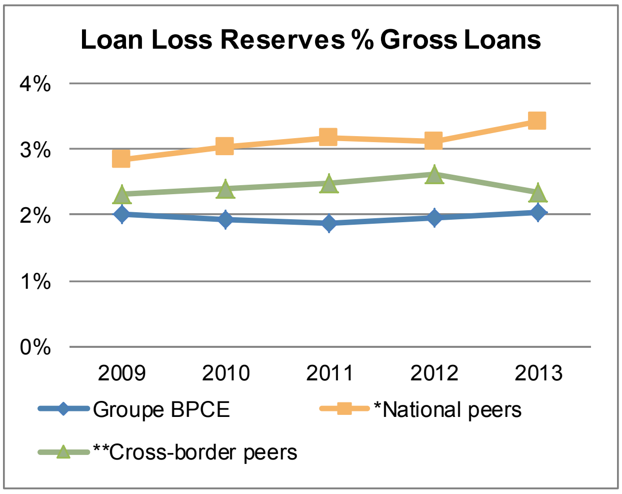
Source: SNL Financial, Scope Ratings



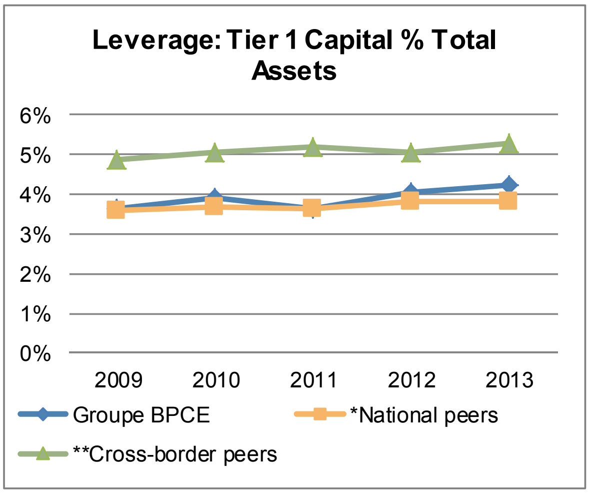
Source: SNL Financial, Scope Ratings



Source: SNL Financial, Scope Ratings



Source: SNL Financial, Scope Ratings



Source: SNL Financial, Scope Ratings

*National peers: BNP Paribas, Credit Agricole Group, Credit Mutuel Group, Groupe BCPE, Societe Generale
**Cross-border peers: Groupe BPCE, Credit Mutuel Group, Intesa, DNB ASA, Credit Agricole Group, CaixaBank, Sw edbank, Lloyds Banking group, Wells Fargo & Co., Rabobank Group

Notes: Cross-border peer group excludes Credit Mutuel Group in 2013 as w ell as Intesa for the Net Interest Margin and the Return on Average Equity. We use H1 2013 numbers as a 2013 proxy for Intesa on all other ratios

Selected Financial Information - Groupe BPCE

	2009	2010	2011	2012	2013	2014E	2015E
Balance Sheet summary (EUR billion)							
Assets							
Cash and balances with central banks	13.1	24.1	16.0	53.8	60.4	60.4	60.4
Interbank assets	147.7	143.7	141.7	129.5	108.4	110.5	113.9
Total securities	164.3	150.7	198.9	244.9	231.4	234.9	239.7
of which debt instruments	122.5	108.9	163.7	203.7	181.2	181.2	181.2
of which equity instruments	41.8	41.7	35.2	41.2	50.2	53.7	58.5
Derivatives	102.1	90.2	127.5	72.5	67.1	68.2	69.6
Gross customer loans	527.7	573.3	581.2	574.9	588.3	597.1	609.1
of which impaired loans	18.9	20.0	20.3	21.9	23.3	24.0	24.5
Total funded assets	918.6	954.5	1,012.1	1,077.9	1,058.9	1,089.6	1,121.5
Total Assets	**1,028.8**	**1,048.4**	**1,138.4**	**1,147.5**	**1,123.5**	**1,155.3**	**1,188.5**
Liabilities							
Interbank liabilities	116.3	106.5	118.7	111.5	88.9	90.7	93.4
Senior debt	276.8	292.3	332.3	366.9	293.6	293.6	293.6
Derivatives	110.2	94.0	126.3	69.6	64.6	65.6	67.0
Customer deposits	369.8	394.3	399.0	430.5	458.3	485.8	510.1
Subordinated debt + hybrid securities	15.0	13.8	12.0	10.0	10.5	9.4	8.5
Total Liabilities	**981.0**	**997.1**	**1,089.5**	**1,093.2**	**1,065.3**	**1,094.3**	**1,124.4**
Ordinary equity	34.7	41.2	41.9	47.0	47.8	50.6	53.8
Minority interests	3.8	4.0	3.7	3.8	6.8	6.8	6.8
Total Liabilities and Equity	**1,028.8**	**1,048.4**	**1,138.4**	**1,147.5**	**1,123.5**	**1,155.3**	**1,188.5**
Core Tier 1 Capital [1]	*28.5*	*33.1*	*26.0*	*38.7*	*42.5*	*45.3*	*48.4*
Income Statement summary (EUR billion)							
Net interest income	12.8	12.2	12.5	11.0	11.5	11.8	12.4
Net fee & commission income	7.0	7.4	7.4	7.3	7.7	8.2	8.7
Net trading income	0.4	2.0	1.0	2.3	2.1	2.1	2.2
Operating Income	**25.5**	**24.0**	**23.8**	**22.6**	**23.2**	**24.2**	**25.3**
Operating expenses	19.7	16.1	15.9	15.9	16.1	16.7	17.3
Loan loss provision charges	4.8	2.1	2.3	2.6	2.2	2.2	2.2
Non-recurring items	0.0	-0.1	-0.9	0.0	0.0	0.0	0.0
Pre-Tax Profit	**-0.4**	**5.7**	**4.7**	**3.7**	**4.9**	**5.3**	**5.9**
Income tax	-0.3	1.7	1.6	1.4	1.9	2.1	2.3
Net profit attributable to minority interests	-0.6	0.4	0.3	0.2	0.3	0.3	0.4
Net Income Attributable to Parent	**0.5**	**3.6**	**2.7**	**2.1**	**2.7**	**2.8**	**3.1**

Source: SNL Financial and Scope Ratings for historical figures. Scope's forecasts are based on publicly available information.
Please refer to "Methodologies Used for this Report" for further details.
[1] CRD 4 basis from 2011 onwards

Ratios - Groupe BPCE

	2009	2010	2011	2012	2013	2014E	2015E
Funding/Liquidity							
Gross loans % Total deposits	146.3%	148.8%	148.9%	136.6%	131.4%	125.8%	122.1%
Total deposits % Total funds	47.0%	48.5%	46.1%	46.7%	53.6%	55.0%	56.1%
Wholesale funds % Total funds	53.0%	51.5%	53.9%	53.3%	46.4%	45.0%	43.9%
Asset Mix, Quality and Growth							
Gross loans % Funded assets	58.9%	61.5%	58.7%	54.6%	56.9%	56.1%	55.5%
Impaired loans % Gross loans	3.5%	3.4%	3.4%	3.7%	3.9%	3.9%	3.9%
Loan loss reserves % Impaired loans	69.8%	66.1%	63.4%	60.5%	59.4%	57.7%	56.6%
Gross loan growth (%)	-	8.9%	1.3%	-1.1%	2.5%	1.5%	2.0%
Impaired loan growth (%)	-	-7.1%	6.1%	10.9%	12.7%	-4.1%	-3.4%
Funded assets growth (%)	-	-74.6%	15.2%	16.6%	42.9%	-43.7%	-24.3%
Earnings							
Net interest income % Revenues	50.0%	50.7%	52.5%	48.7%	49.7%	49.0%	49.1%
Fees & commissions % Revenues	27.4%	30.9%	31.3%	32.4%	33.2%	33.9%	34.3%
Trading income % Revenues	1.5%	8.5%	4.1%	10.1%	9.1%	8.8%	8.6%
Other income % Revenues	21.2%	9.9%	12.1%	8.7%	7.9%	8.3%	8.0%
Net interest margin (%)	1.6%	1.5%	1.4%	1.2%	1.2%	1.3%	1.3%
Pre-provision Income % Risk-weighted assets (RWAs)	1.4%	2.0%	2.0%	1.7%	1.7%	1.8%	1.8%
Loan loss provision charges % Pre-provision income	84.0%	26.4%	29.2%	39.2%	31.3%	29.7%	26.5%
Loan loss provision charges % Gross loans (cost of risk)	0.9%	0.4%	0.4%	0.4%	0.4%	0.4%	0.4%
Cost income ratio (%)	77.4%	66.8%	66.7%	70.7%	69.5%	69.0%	68.5%
Net Interest Income / Loan loss charges (x)	2.6	5.8	5.4	4.2	5.2	5.3	5.9
Return on average equity (ROAE) (%)	-	9.6%	6.5%	4.8%	5.6%	5.7%	6.0%
Return on average funded assets (%)	-	0.3%	0.2%	0.1%	0.2%	0.2%	0.2%
Retained earnings % Prior year's book equity	-	10.5%	6.5%	5.1%	5.7%	5.9%	6.2%
Pre-tax return on common equity tier 1 capital	-	17.3%	18.0%	9.7%	11.5%	11.6%	12.1%
Capital and Risk Protection [1]							
Common equity tier 1 ratio (common equity tier 1 capital % RWAs)	6.9%	8.1%	6.6%	8.8%	10.4%	10.8%	11.2%
Tier 1 leverage ratio (%)	3.7%	3.9%	3.6%	4.1%	3.8%		
Median of tier 1 leverage ratio and common equity tier 1 ratio (%)	5.3%	6.0%	5.1%	6.4%	7.1%		
Total loss coverage (CET 1 capital + loan loss provisions) % RWAs	10.1%	11.4%	10.0%	13.6%	13.8%	14.1%	14.4%
Non-senior bailinable debt cushion (as % of total liabilities)	2.4%	2.0%	1.4%	1.2%	1.3%	1.2%	1.1%
Asset risk intensity (RWAs % total assets)	40.0%	38.8%	34.1%	33.2%	32.8%	36.4%	36.4%

Source: SNL Financial and Scope Ratings for historical figures. Scope's forecasts are based on publicly available information.
Please refer to "Methodologies Used for this Report" for further details. *[1] CRD 4 basis from 2011 onwards*

METHODOLOGIES USED FOR THIS REPORT

For the rating and analysis contents of this report, Scope has used the following methodologies which were published on www.scoperatings.com:

"Bank Rating Methodology" (February 2014)

"Forecasting Bank Financials Methodology" (February 2014)

Forecasting bank financials: Forward-looking estimates are an important analytical tool underpinning Scope's bank ratings. These forecasts cover the current financial year (before final year-end figures are published by the bank) plus the forthcoming two years. Depending on the complexity of the bank being assessed, different forecasting tools will be used. For a majority of banks operating primarily commercial and retail banking franchises (loans and deposits) the analysis is underpinned by an **accounting** forecast of the balance sheet and profit and loss account. For more complex groups with multiple ranges of activities – notably those with material wholesale and investment banking operations – Scope uses an **analytical** forecast, relying on the bank's business-line reporting to come up with plausible estimates. For all banks Scope also includes a **regulatory metrics** forecast, considering the growing importance of this aspect in bank analysis.

For complex banks, divisional data is used to forecast profit and loss accounts and basic divisional balance sheet metrics. For less complex banks, a line-by-line forecasting of major P&L elements is forecast.

For balance sheet forecasts, Scope estimates of all major balance sheet lines, using the P&L estimates to complete the forecast of the capital/shareholders' equity line. This comprehensive methodology for estimating the balance sheet is used for all the banks in our universe, irrespective of size and complexity.

Lastly, our forecasts include assessments of the major regulatory metrics: Tier 1 and CET 1 (historically CT1), Leverage, Liquidity Coverage Ratio, and Net Stable Funding Ratio (the latter two when and if sufficient public information to compute them is available).

Scope will not aim to forecast financials when it considers the public disclosure of the bank as insufficient for a transparent and credible outcome.

All Scope's bank financial forecasts are based on public information. For its forecasts Scope will not use any non-public information or data, even if such information or data were provided by rated banks. Scope's forecasting process is transparent, with a detailed roadmap provided in its *"Forecasting bank financials"* methodology.

Commerzbank AG
Issuer Rating Report

BBB+ POSITIVE OUTLOOK
Financial Institutions

Overview

Scope Ratings assigns an Issuer Credit-Strength Rating (ICSR) of BBB+ and a short-term debt rating of S-2 to Commerzbank AG (CZ), both with a positive outlook. The ratings reflect the fact that the bank has now restructured and is running under more normal operating, profitability and prudential metrics. It also reflects the still high risk profile of the bank's non-core portfolio and CZ's problematic financial track record since its merger with Dresdner Bank in 2009. Our positive outlook reflects the fact that the bank is on the right de-risking track and that the continuous run-down of CZ's non-core portfolio at or below the revised EUR 75bn target by 2016 (versus current levels of EUR 102bn) is likely to improve further the bank's credit quality.

The BBB+ and S-2 ratings apply to senior unsecured debt issued by Commerzbank AG. However, the ratings do not apply to unguaranteed debt issued by subsidiaries of Commerzbank AG.

Issuer Credit-Strength Rating (assigned on April 2, 2014)	**BBB+**
Outlook	Positive
Senior unsecured debt	BBB+
Short term debt rating (May 22, 2014)	S-2
Short term debt rating outlook	Positive
Unsolicited ratings with issuer participation.	

Lead Analyst

Jacques-Henri Gaulard
j-h.gaulard@scoperatings.com

Team Leader

Sam Theodore
s.theodore@scoperatings.com

Rating drivers (Summary)

The rating drivers, in decreasing order of importance in the rating assignment, are:

- (+) The de-risking of the bank is on track.
- (−) …but the risk profile of the bank's non-core portfolio remains high.
- (+) The business model of the restructured Commerzbank is attractive…
- (−) …but securing revenue growth in German retail banking will take some time.
- (+) The balance sheet metrics of the bank have improved significantly since 2008.
- (−) Commerzbank's track record since its merger with Dresdner Bank in 2008 has been problematic.

Rating change drivers

Any tangible evidence that Commerzbank is successfully pursuing its de-risking through a consistent reduction of its non-core asset portfolio would be a materially positive rating change driver, underpinning our current positive outlook.

Even if the domestic retail activities of Commerzbank in Germany are currently showing signs of recovery and volume improvement, revenue growth levels remain low. Considering the cost reduction undergone by CZ since 2008, any sign of revenue increase would have a material impact on the bank's operating leverage and therefore on cash generation and the ability to better absorb the negative cash flow of the non-core portfolio.

So far, the improvement in Commerzbank's credit fundamentals is closely linked to improving market conditions and better asset valuations. Any deterioration in market fundamentals could, in our view, have a material impact on CZ's credit metrics and on the value of its non-core assets portfolio. This is particularly true considering that, up to now, CZ's core business has merely covered the costs of the non-core portfolio.

Recent events

The Q1 2014 results of Commerzbank confirmed the steady progress in risk profile reductions, with the non-core assets (NCA) portfolio falling by EUR 14bn quarter on quarter (and 29% year-on-year) to EUR 102bn as of March 31, 2014. Out of the EUR 14bn decrease, EUR 9bn can be attributed to the transfer of high-quality liquid assets (HQLAs as per LCR definition) from the NCA portfolio to the liquidity portfolio in the core bank. These instruments will largely mature before YE 2016, and will help the bank comply with its liquidity ratios without having to acquire them externally. The continuous increase in the number of new customers in the retail business (+43, 000 quarter-on-quarter) and a mild increase in loan volumes at the Mittelstand division remain encouraging signs for Commerzbank.

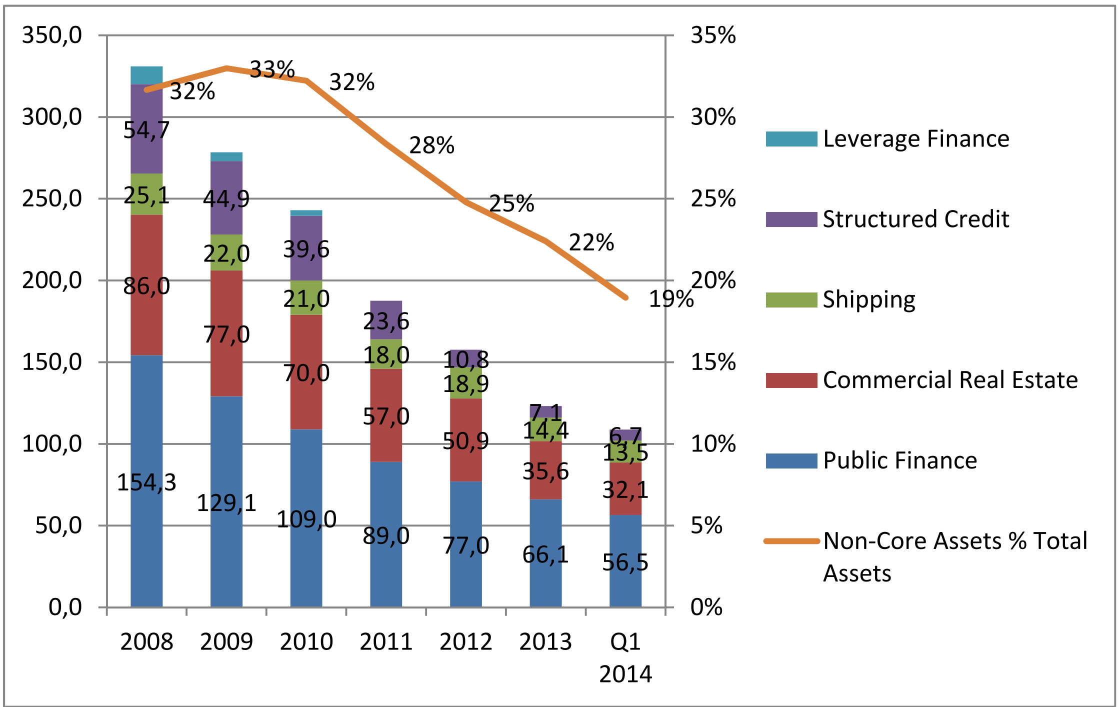
At the time of its Q1 2014 reporting, Commerzbank announced the sale of the bulk of its US commercial real estate loan book, with a total volume of EUR 830m representing RWAs of EUR 390m, to various American financial investors. This transaction is another sign of the appetite of market participants for Commerzbank's risky assets.

Rating drivers (Details)

1. The de-risking of the bank is on track

In order to compare Commerzbank's Non-Core Assets (NCAs) over a long period of time, we have slightly restated the definition given by CZ of NCAs to add back the nominal value of the structured credit portfolio, which, until 2012 was included in the "Portfolio Restructuring Unit" and was distinct of the then-NCA division. Until 2010, we maintained the conduits and other asset-backed exposures among the non-core assets, but took them out from 2011 onwards as their value did not change and they increasingly represented securitization of German Mittelstand receivables – definitely a core business, in our view. The de-risking of Commerzbank is detailed on Chart 1.

Chart 1: Restated Non-Core Assets portfolio of Commerzbank, 2008-2013 (in EUR bn)



Source: Scope Ratings estimates, Company

As seen, the reduction of Commerzbank's risk profile is not a recent phenomenon: it began the year after the merger announcement with Dresdner Bank. The asset reduction was in response to the state aid-related requirements of the European Commission after the EUR 18.2bn support granted by the German government in November 2008 and January 2009 (note that the 2008 numbers on the chart above are proforma of this merger). At the time and among other generally mild requests, the EC asked Commerzbank to sell Eurohypo before the end of 2014, as the vast majority of the NCAs disclosed above (except for the structured credit portfolio and the leverage finance business) were located at Eurohypo.

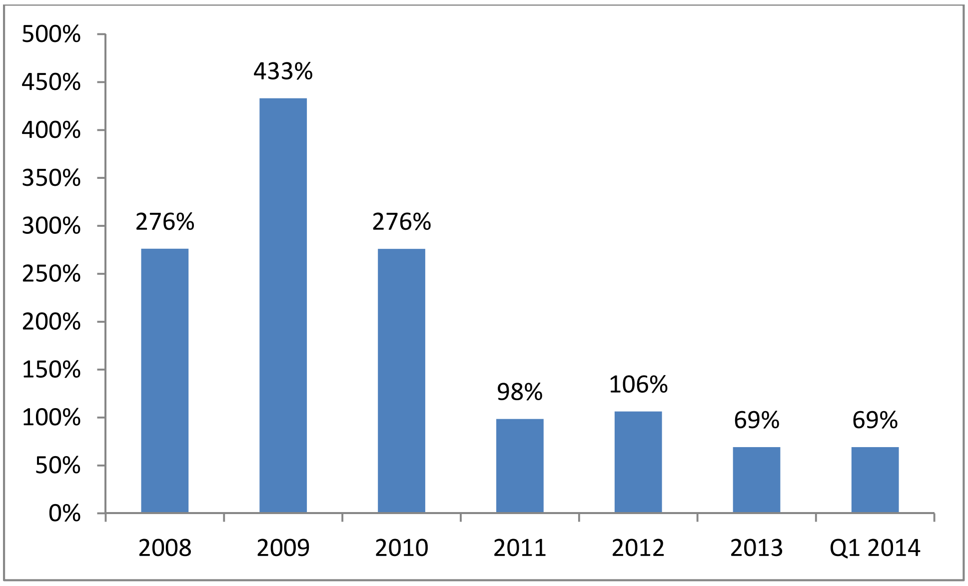
Between 2008 and Q1 2014, the "enlarged" NCA portfolio of Commerzbank declined sharply from EUR 331bn in 2008 to EUR 109bn, including the structured credit portfolio. Each year, Commerzbank has reduced its NCAs by an average of 18%, representing a decline of 67% (or more than EUR 200bn) since 2008. Interestingly enough, as a percentage of the total assets of the group, Chart 1 shows that the reduction became only more pronounced from 2011 onwards. Between 2008 and 2010, NCAs represented around one-third of the total assets of the bank. This number dropped to 25% in 2012 and 19% in Q1 2014. The NCA portfolio has therefore contracted steadily throughout the years, even if the EC requirement has changed somewhat: since Eurohypo eventually proved difficult to sell, the CRE subsidiary of CZ now has to be run down. This does not really change the nature of CZ's de-risking, but slows down the process considerably.

2. The risk profile of the bank's non-core portfolio remains high

We have stress-tested the non-core portfolio of Commerzbank by making the following very severe assumptions, which we clearly do not expect to materialize: (1) we used the defaulted exposure of each sub-portfolio (shipping and CRE), assuming a probability of default of 100% and a loss-given default of 100% – a theoretical worst-case scenario, (2) we have added supplementary losses corresponding to 20% of the remaining exposure to peripheral sovereigns (on the Public Finance Portfolio) and (3) we have added another 20% loss on the total structured credit portfolio.

We compare the sum of (1), (2) and (3) to the CET1 capital of the bank (under Basel 3 standards from 2012 onwards). We are therefore comparing a very severe stress loss with the most conservative definition of capital we can use. Chart 2 gives some revealing answers.

Chart 2: Stress-tested expected loss of Commerzbank from NCAs as a % of CET 1 capital



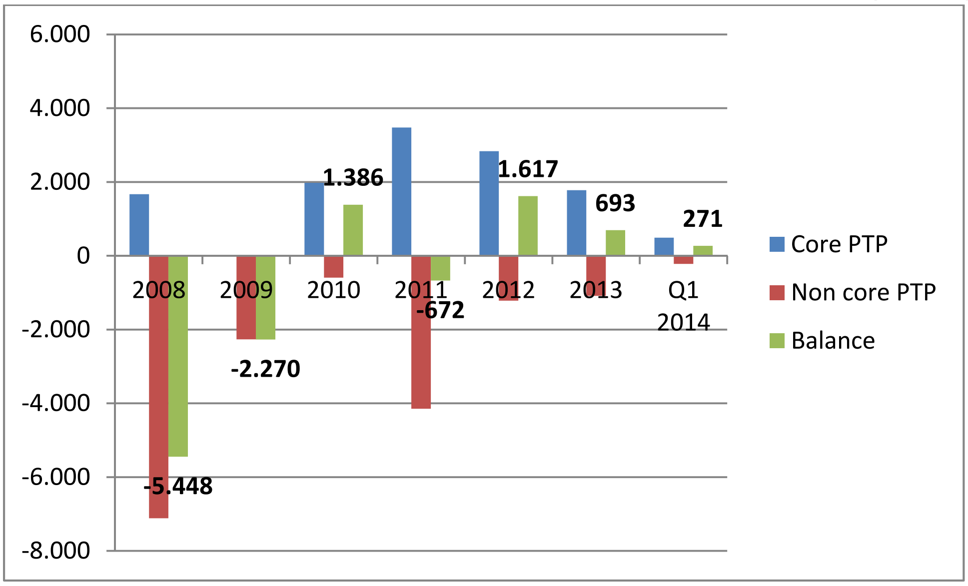
Source: Scope Ratings estimates, Company data

Under this very conservative stress scenario, the gross expected stress losses fall sharply, from a peak of EUR -37bn at year-end 2009 to EUR -12.8bn at the end of Q1 2014. This compares to CET1 capital which, at its lowest, was EUR 8.5bn in 2009 (excluding silent participations) and is now EUR 19.7bn under fully-phased Basel 3 standards.

This stress test does not include the specific and generic loan loss provisions held by Commerzbank against its default NCA portfolio. If we deduct them from the stress losses, we end up with a maximum net stress loss of EUR 9.4bn, representing 48% of CZ's CET1 capital. Our stress test does not take the collateral received by the bank into account, although it represents a significant portion of the bank's credit protection.

Assuming CZ benefits from the cash generation of its other businesses and has to report the losses in one calendar year, we reckon that the impact of the stress loss on the bank's estimated 2014 fully-phased Basel 3 Core Equity 1 tier capital would stand at 277bps. This would bring the CET1 ratio of Commerzbank down to 6.4%, on our estimates. While this scenario may be quite extreme, a comparison of the cash generation of CZ's core business (German domestic retail banking + Mittelstand banking + Polish retail banking + capital markets + corporate center) with the pre-tax losses generated by the non-core business shows that the pre-tax profits of the core businesses can just about absorb the pre-tax losses of the non-core business (see Chart 3). This, in our view, justifies a cautiously optimistic view of Commerzbank's credit quality. We note that the bank itself forecasts cumulative pre-tax operating losses of EUR 2.9bn on its NCA portfolio between 2013 and 2016.

Chart 3: Pre-tax profit of Commerzbank: core business vs. non core (EUR m)



Source: Company data, Scope Ratings estimates

3. The business model of the restructured Commerzbank is attractive

In many ways, the strategy that Commerzbank presented to the market after its merger with Dresdner in 2009 has not materially changed since. The idea remains as compelling as ever: build a Germany-centered universal bank with a strong focus on the Mittelstand and private clients, supported by a de-risked and scaled down investment bank. Commerzbank can serve its corporate client base internationally through an extensive network of 60 offices in 50 countries (with a strong density in Asia) and a 70% stake in mBank (formerly BRE), the third-largest bank in Poland.

Commerzbank's strategy is clear and well articulated, but its execution has been fundamentally delayed by three major problems:

1. The deterioration of Eurohypo's credit quality from 2008 onwards, which triggered significant losses that have been at the core of the company's problems over the last six years.
2. The European sovereign bond crisis of 2011-2012, which put more pressure on the asset quality of the bank's public finance portfolio.
3. The management of the German government silent participation of EUR 16.4bn, which was only reimbursed almost five years after the government's first intervention in November 2008.

Now that Commerzbank's management team is less distracted by the effects of the crisis than before, the bank can start executing a "One Bank" strategy, which is not dissimilar to the strategy followed by successful European peers. The interactions between the divisions are indeed quite obvious:

- Between the private customer business and the Mittelstand division for the servicing of very small SMEs (with turnover of less than EUR 2.5m).

- Between the Mittelstand division and the capital markets business for the latter to provide “quasi” investment banking services to the mid/ large caps of the Mittelstand division (with turnover of EUR 25m or more).
- Between the Mittelstand division, mBank and the international network of Commerzbank for serving German exporters and importers.

A key challenge for the bank remains regaining market share in its core German retail market and translating this into revenues.

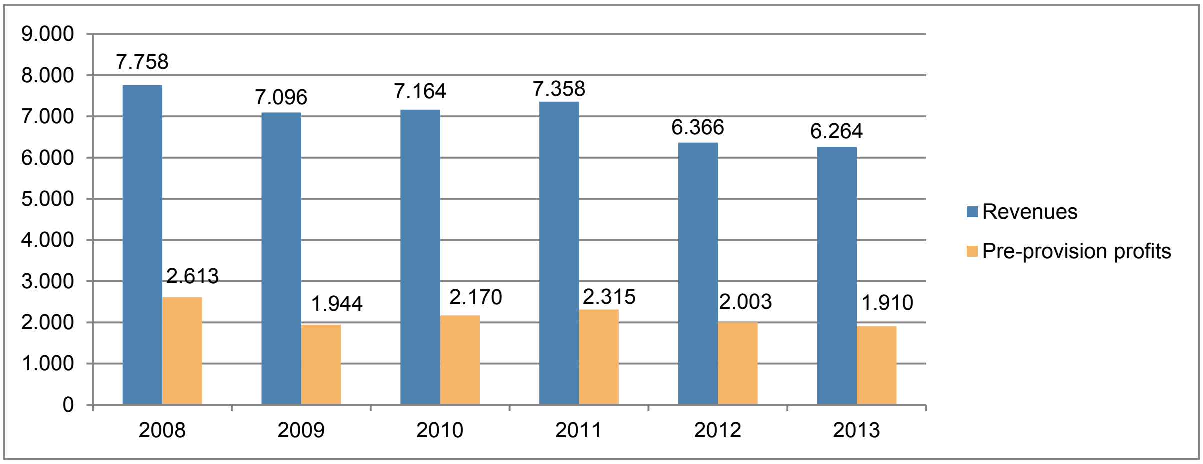
4. Securing revenue growth in German retail banking will take some time

While the business model of Commerzbank provides many competitive advantages, it is hampered by the structure of the German banking system.

The breakdown of the German banking sector in three very different and distinct pillars is already well known. Because a significant portion of the banks are not-for-profit organizations or mutualist structures where share “ownership” does not give any right to the net assets of the bank, profitability has never really been an end-objective for these banks. On the contrary, the priority has always been to fuel the German economic growth under good pricing conditions through the financing of the German Mittelstand. This phenomenon has positively contributed to the strength of the German economy but has also contributed, in our opinion, to the relative financial weakness of German banks versus some European peers. As a result, the larger banks – private and Landesbanken alike – had to look for more substantial revenue growth outside Germany and/or outside the “traditional” retail banking business, which is penalized by very low margins and a high break-even point. Deutsche Bank’s solution was to build a global investment bank. Commerzbank initially pursued the same approach, but following the bank’s withdrawal from investment banking in 2005, it chose the strategy of becoming a large player in global commercial real estate lending and mortgage-backed securities by buying Eurohypo in 2005.

Post-crisis, Commerzbank is refocusing on Germany where its challenge is to develop in a very competitive market. We are encouraged by the increase in new clients in the Private Customer division as well as the loan growth in the Mittelstandbank division. Revenues seem to have bottomed out.

Chart 4: Revenues and pre-provision profits of Commerzbank’s German retail business (Private Clients + Mittelstandbank, EUR m)



Source: Company data, Scope Ratings estimates

As Chart 4 demonstrates, since the proforma numbers of the new Commerzbank post merger with Dresdner in 2008, German retail revenues have dropped by a compound annual growth rate (CAGR) of 4% per annum. Pre-provision profits shrank by 6% during the same time period, still an acceptable figure since Commerzbank reduced its German retail costs by about EUR 0.8bn between 2008 and 2013, while revenues were contracting by EUR 1.5bn.

5. The balance sheet metrics of the bank have improved significantly since 2008

As 2008 is the first year for which proforma accounts of the new Commerzbank-Dresdner combination are available, we have traced the balance sheet history of the newly-merged bank as of then.

Table 1 shows the progress of the balance sheet metrics of the new group.

Table 1: Table 1: Commerzbank – key balance sheet metrics

	2008	2009	2010	2011	2012	2013
Loans % deposits	130.08%	133.10%	124.70%	116.15%	104.78%	88.96%
Liquid assets % short-term funds	69.08%	110.79%	125.09%	150.94%	162.26%	207.92%
Wholesale funds % total funds	56.90%	56.70%	53.99%	47.55%	44.65%	37.23%
Short-term wholesale funds % total funds	28.22%	33.87%	32.69%	27.13%	27.40%	23.19%
Deposits % total funds	43.10%	43.30%	46.01%	52.45%	55.35%	62.77%
Loans % total assets	39.80%	41.72%	43.45%	44.82%	43.80%	44.75%
Tangible equity % total assets	1.64%	2.70%	3.28%	3.18%	3.63%	4.14%
Tangible equity (ex-silent participation) % total assets	0.86%	0.67%	1.01%	2.78%	3.26%	4.14%

Source: Company data, Scope Ratings estimates

As we can see, Commerzbank has, over the years, considerably improved its liquidity and funding profile. From a loan-to-deposit ratio of 130% in 2008, this metric has been steadily brought down to 89% in 2013. The proportion of liquid assets to short-term funds has also increased significantly – from a point where the bank was a net short-term borrower (proforma 2008) to a situation where the excess of liquid assets over short-term funds reached about EUR 110bn in 2013 on our estimates – i.e. the equivalent of the entire short-term debt outstanding at year-end 2013.

The capital level of the bank has also improved, pursuant to the capital increases and balance sheet reduction efforts of the bank over the years. In the five years since the trough of 2009, the ratio of tangible equity to total assets has almost been multiplied by five.

To conclude, Table 1 pictures a bank which, after having been in a crisis situation, now looks very good versus European peers.

6. Commerzbank's track record since 2008 has been problematic

A key factor holding our rating at its level is Commerzbank's problematic track record since the merger with Dresdner Bank was announced in 2008. The recent positive three quarters come after 19 very difficult quarters since Q4 2008. The two key stakeholder groups of the bank, investors and clients, had good reason to be disappointed by the bank's performance between 2009 and H1 2013.

- **Investors**: As Commerzbank was poorly capitalized when it was bailed out by the German government in 2008-2009, the bank had to spend the better part of 2009 to 2013 looking to exchange the government's silent participation against fresh common equity capital, which led to a material dilution for shareholders. As for hybrid investors, the intervention of the government meant that several preferred dividends had to be suspended; in particular, Eurohypo Capital Funding Trust I and II. Last November the bank did, in fact, repay the dividends that had been suspended between 2010 and 2013. In addition, during the crisis several issues were called or exchanged for common equity at deep discount to par, the January 2011 exchange in particular.

- **Clients**: Because of the combination of events described above – sub-prime crisis, merger integration, government bail-in and euro sovereign crisis – the bank could not really focus on customer satisfaction until the end of 2012. A combined sustained period of low interest rates and the structural problems of the German banking market led to a decrease in the revenues of the German retail business (see Chart 4 above).

On all these aspects Commerzbank has started to turn the corner. With regard to **Investors**, it could be argued that since the last capital increase was announced in March 2013 the bank has been able to start again with "a clean slate" and its performance with investors should be judged from the moment the silent participation was fully repaid. With regard to **Clients**, Commerzbank has been very clear that it needed to regain trust and modernize the bank as far as the Private Customer division is concerned. Since the bank "rebooted" its offering and services in 2012, it has seen an increase in client accounts, market share (particularly in construction financing) and customer loyalty. At year-end 2013, Commerzbank's Private Customer division registered 245,000 new customers, a trend that accelerated towards the end of the year and was confirmed in Q1 2014.

Peer comparison

Of the banks rated by Scope, Commerzbank can be compared with Deutsche Bank in Germany. However, given their different business models, only limited valid conclusions can be drawn from such a comparison.

On a cross-border basis, we have positioned Commerzbank in the bucket of banks with a strong domestic market and a material foothold abroad. This peer group includes Unicredit, BBVA, Santander and selected Nordic banks. Commerzbank's foreign activities are of a more limited scope than those of its large cross-border peers, being to a large extent focused on its successful Polish bank. BRE (recently rebranded mBank), which is the third-largest bank in Poland, contributed around 9% of Commerzbank's revenues in 2013 and 15% of pre-provision profits. It is a very stable cash contributor to Commerzbank's business mix.

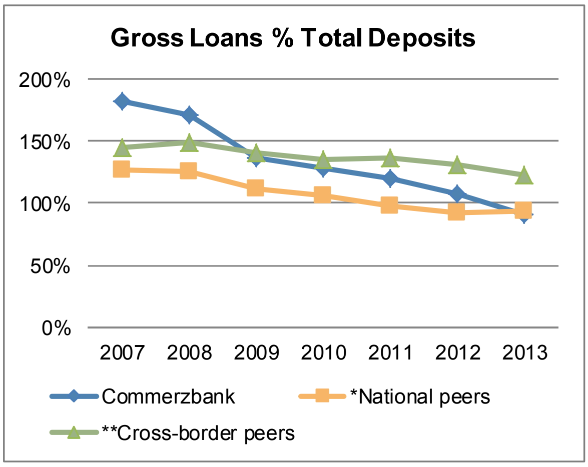
The progress of Commerzbank in terms of liquidity versus cross-border peers has been impressive over the years and the loan-to-deposit ratio of the company is now best-in-class after trailing behind at the start of the crisis. The group has also normalized and lowered its proportion of wholesale funding so that the bank stands particularly well among a rather large peer group.

The bank's capital position is also improving, even if it is not quite at the same level as those of its cross-border peers.

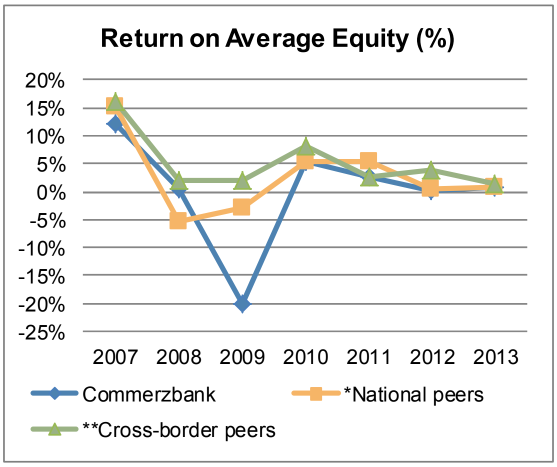
In asset quality terms, the bank has an acceptable level of impaired loans to total loans, but the coverage remains low versus peers. This is due to the mortgage-driven features of CZ's loan book, meaning the bank makes up in collateral what it does not charge in provisions.

The drawback of all the balance sheet restructuring lies in the profitability metrics: the bank has a lower margin and a higher cost-income ratio than its peers.

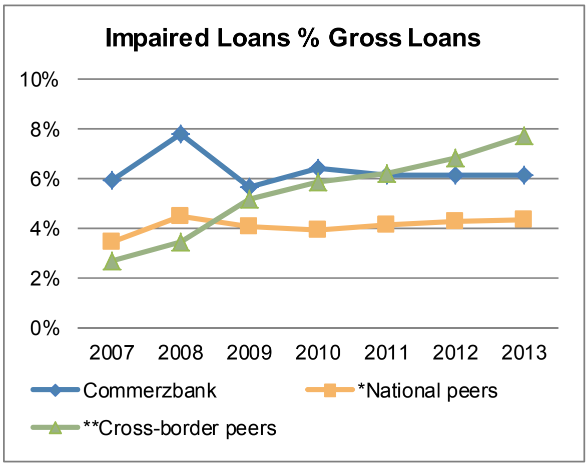
Peer Comparison - Commerzbank group



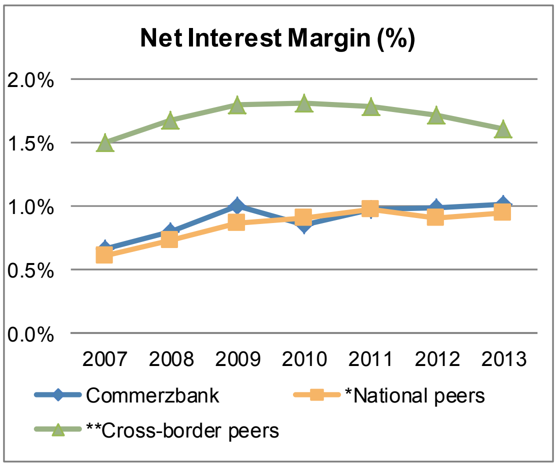
Source: SNL Financial, Scope Ratings



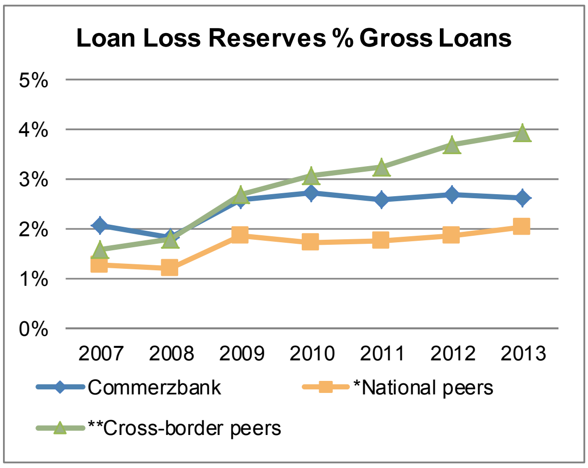
Source: SNL Financial, Scope Ratings



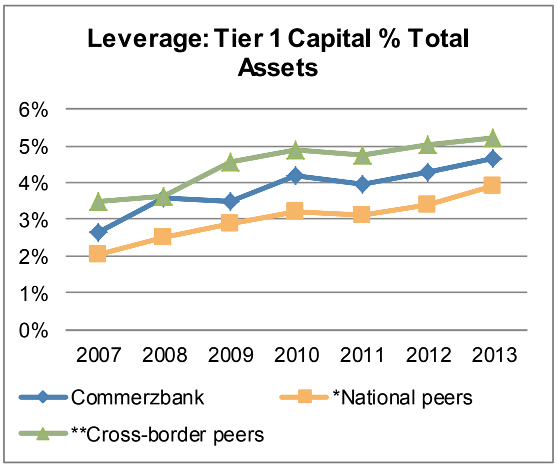
Source: SNL Financial, Scope Ratings



Source: SNL Financial, Scope Ratings



Source: SNL Financial, Scope Ratings



Source: SNL Financial, Scope Ratings

*National peers: Commerzbank, Deutsche Bank

**Cross-border peers based on business model : Santander, BBVA, Unicredit, RBS, Erste Bank, RZB AG, Commerzbank, Nordea, KBC, Danske Bank, ING Bank

Notes: Cross-border peer group averages exclude RZB in 2013

Selected Financial Information - Commerzbank group

	2007	2008	2009	2010	2011	2012	2013	2014E	2015E
Balance Sheet summary (EUR billion)									
Assets									
Cash and balances with central banks	5.2	6.6	10.3	8.1	6.1	15.8	12.4	21.0	28.8
Interbank assets	74.0	63.0	106.7	110.6	87.8	88.0	87.5	87.5	89.3
Total securities	166.4	153.6	173.1	160.5	127.5	127.6	120.1	120.8	123.9
of which debt instruments	150.4	144.1	157.8	145.6	114.5	107.3	97.7	97.7	99.7
of which equity instruments	15.0	8.7	11.9	13.9	11.7	19.4	21.5	22.1	23.2
Derivatives	73.0	103.5	183.6	128.8	128.9	112.7	69.5	68.3	68.0
Gross customer loans	291.6	290.4	362.0	337.2	304.4	286.0	253.0	245.6	240.6
of which impaired loans	17.1	22.7	20.5	21.6	18.7	17.6	15.6	14.8	14.0
Total funded assets	536.1	512.0	654.4	614.7	523.5	517.7	478.2	479.9	487.6
Total Assets	**616.5**	**625.2**	**844.1**	**754.3**	**661.8**	**636.0**	**549.7**	**550.1**	**557.5**
Liabilities									
Interbank liabilities	125.1	128.5	140.6	137.6	98.5	110.2	77.7	77.7	79.2
Senior debt	205.6	165.8	171.4	140.4	111.5	84.5	69.7	62.7	59.6
Derivatives	80.4	113.3	189.7	139.6	138.3	118.3	71.5	70.2	69.9
Customer deposits	159.2	170.2	264.6	262.8	255.3	265.8	276.5	284.8	293.3
Subordinated debt + hybrid securities	14.5	15.0	19.9	17.1	15.5	13.9	13.7	13.7	13.7
Total Liabilities	**600.3**	**605.4**	**817.5**	**725.6**	**637.0**	**609.7**	**522.7**	**522.8**	**529.4**
Ordinary equity	15.1	11.0	8.8	10.7	21.4	23.1	26.0	26.4	27.1
Minority interests	1.0	0.7	0.6	0.8	0.7	0.9	1.0	1.0	1.0
Total Liabilities and Equity	**616.5**	**625.2**	**844.1**	**754.3**	**661.8**	**636.0**	**549.7**	**550.1**	**557.5**
Core Tier 1 Capital [1]	*13.3*	*11.2*	*7.3*	*9.6*	*20.8*	*17.7*	*19.4*	*19.8*	*20.5*
Income Statement summary (EUR billion)									
Net interest income	4.0	4.7	7.2	7.1	6.7	6.5	6.1	0.0	0.0
Net fee & commission income	3.2	2.8	3.8	3.6	3.5	3.2	3.2	0.0	0.0
Net trading income	1.0	-1.1	-0.6	2.1	-1.7	0.1	0.0	0.0	0.0
Operating Income	**8.5**	**6.6**	**10.6**	**12.6**	**9.8**	**9.9**	**9.5**	**9.2**	**9.4**
Operating expenses	5.5	5.2	9.3	8.7	7.9	7.1	6.9	6.8	6.8
Loan loss provision charges	0.5	1.8	4.2	2.5	1.4	1.6	1.8	1.6	1.4
Non-recurring items	0.0	0.0	-1.0	0.0	0.0	-0.3	-0.5	0.0	0.0
Pre-Tax Profit	**2.5**	**-0.4**	**-4.7**	**1.4**	**0.5**	**0.9**	**0.2**	**0.7**	**1.2**
Income tax	0.6	-0.5	0.0	-0.1	-0.2	0.8	0.1	0.3	0.4
Net profit attributable to minority interests	0.0	0.1	-0.1	0.1	0.1	0.1	0.1	0.1	0.1
Net Income Attributable to Parent	**1.9**	**0.0**	**-4.5**	**1.4**	**0.6**	**0.0**	**0.1**	**0.4**	**0.7**

Source: SNL Financial and Scope Ratings for historical figures. Scope's forecasts are based on publicly available information. Please refer to "Methodologies Used for this Report" for further details.
[1] CRD 4 basis from 2012 onwards

Ratios - Commerzbank group

	2007	2008	2009	2010	2011	2012	2013	2014E	2015E
Funding/Liquidity									
Gross loans % Total deposits	183.2%	170.6%	136.8%	128.3%	119.2%	107.6%	91.5%	86.2%	82.0%
Total deposits % Total funds	31.6%	34.9%	43.1%	45.7%	52.8%	55.7%	63.2%	64.9%	65.8%
Wholesale funds % Total funds	68.4%	65.1%	56.9%	54.3%	47.2%	44.3%	36.8%	35.1%	34.2%
Asset Mix, Quality and Growth									
Gross loans % Funded assets	54.4%	56.7%	55.3%	54.8%	58.2%	55.3%	52.9%	51.2%	49.4%
Impaired loans % Gross loans	5.9%	7.8%	5.7%	6.4%	6.2%	6.1%	6.2%	6.0%	5.8%
Loan loss reserves % Impaired loans	47.2%	24.6%	47.6%	43.6%	41.7%	42.6%	45.2%	47.1%	48.6%
Gross loan growth (%)	-1.2%	-0.4%	24.6%	-6.9%	-9.7%	-6.0%	-11.5%	-2.9%	-2.0%
Impaired loan growth (%)	34.7%	32.2%	-9.4%	5.2%	-13.1%	-6.2%	-11.5%	-5.0%	-5.0%
Funded assets growth (%)	-0.5%	-4.5%	27.8%	-6.1%	-14.8%	-1.1%	-7.6%	0.4%	1.6%
Earnings									
Net interest income % Revenues	47.1%	71.4%	67.5%	55.8%	68.9%	65.4%	64.9%		
Fees & commissions % Revenues	37.0%	43.0%	35.5%	28.8%	35.8%	32.7%	33.9%		
Trading income % Revenues	11.8%	-17.3%	-5.8%	16.3%	-17.1%	1.1%	0.2%		
Other income % Revenues	4.1%	2.8%	2.8%	-1.0%	12.4%	0.8%	1.0%		
Net interest margin (%)	0.8%	0.9%	1.3%	1.2%	1.2%	1.3%	1.3%		
Pre-provision Income % Risk-weighted assets (RWAs)	1.3%	0.4%	0.5%	1.5%	0.8%	1.3%	1.3%	1.1%	1.2%
Loan loss provision charges % Pre-provision income	16.0%	128.8%	311.2%	63.4%	71.7%	57.6%	71.2%	68.7%	52.0%
Loan loss provision charges % Gross loans (cost of risk)	0.2%	0.6%	1.3%	0.7%	0.4%	0.6%	0.7%	0.7%	0.6%
Cost income ratio (%)	64.9%	78.5%	87.3%	68.8%	80.7%	72.0%	72.8%	74.2%	72.4%
Net Interest Income / Loan loss charges (x)	8.4	2.6	1.7	2.8	5.0	4.0	3.4		
Return on average equity (ROAE) (%)	13.1%	0.0%	-45.8%	14.6%	4.0%	-0.2%	0.3%	1.5%	2.7%
Return on average funded assets (%)	0.2%	0.0%	-0.5%	0.2%	0.1%	0.0%	0.0%	0.1%	0.1%
Retained earnings % Prior year's book equity	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	1.5%	2.7%
Pre-tax return on common equity tier 1 capital	18.9%	-3.6%	-63.4%	14.2%	2.4%	4.9%	1.2%	3.7%	6.1%
Capital and Risk Protection [1]									
Common equity tier 1 ratio (common equity tier 1 capital % RWAs)	5.6%	3.3%	2.6%	3.6%	8.8%	7.6%	9.0%	9.2%	9.4%
Tier 1 leverage ratio (%)	2.6%	3.6%	3.5%	4.2%	4.0%	4.3%			
Median of tier 1 leverage ratio and common equity tier 1 ratio (%)	4.1%	3.5%	3.1%	3.9%	6.4%	5.9%			
Total loss coverage (CET 1 capital + loan loss provisions) % RWAs	9.0%	5.0%	6.1%	7.1%	12.1%	12.1%	13.8%	12.4%	12.5%
Non-senior bailinable debt cushion (as % of total liabilities)	2.4%	3.8%	4.4%	4.6%	2.8%	2.7%	2.6%	2.6%	2.6%
Asset risk intensity (RWAs % total assets)	38.4%	54.1%	33.2%	35.5%	35.8%	32.7%	34.7%	39.3%	39.3%

Source: SNL Financial and Scope Ratings for historical figures. Scope's forecasts are based on publicly available information. Please refer to "Methodologies Used for this Report" for further details.
[1] CRD 4 basis from 2012 onwards

METHODOLOGIES USED FOR THIS REPORT

For the rating and analysis contents of this report, Scope has used the following methodologies which were published on www.scoperatings.com:

"Bank Rating Methodology" (February 2014)

"Forecasting Bank Financials Methodology" (February 2014)

Forecasting bank financials: Forward-looking estimates are an important analytical tool underpinning Scope's bank ratings. These forecasts cover the current financial year (before final year-end figures are published by the bank) plus the forthcoming two years. Depending on the complexity of the bank being assessed, different forecasting tools will be used. For a majority of banks operating primarily commercial and retail banking franchises (loans and deposits) the analysis is underpinned by an **accounting** forecast of the balance sheet and profit and loss account. For more complex groups with multiple ranges of activities – notably those with material wholesale and investment banking operations – Scope uses an **analytical** forecast, relying on the bank's business-line reporting to come up with plausible estimates. For all banks Scope also includes a **regulatory metrics** forecast, considering the growing importance of this aspect in bank analysis.

For complex banks, divisional data is used to forecast profit and loss accounts and basic divisional balance sheet metrics. For less complex banks, a line-by-line forecasting of major P&L elements is forecast.

For balance sheet forecasts, Scope estimates of all major balance sheet lines, using the P&L estimates to complete the forecast of the capital/shareholders' equity line. This comprehensive methodology for estimating the balance sheet is used for all the banks in our universe, irrespective of size and complexity.

Lastly, our forecasts include assessments of the major regulatory metrics: Tier 1 and CET 1 (historically CT1), Leverage, Liquidity Coverage Ratio, and Net Stable Funding Ratio (the latter two when and if sufficient public information to compute them is available).

Scope will not aim to forecast financials when it considers the public disclosure of the bank as insufficient for a transparent and credible outcome.

All Scope's bank financial forecasts are based on public information. For its forecasts Scope will not use any non-public information or data, even if such information or data were provided by rated banks. Scope's forecasting process is transparent, with a detailed roadmap provided in its *"Forecasting bank financials"* methodology.

Crédit Agricole SA
Issuer Rating Report

SCOPE — A POSITIVE OUTLOOK — Financial Institutions

Overview

Scope Ratings assigns Crédit Agricole SA an Issuer Credit-Strength Rating (ICSR) of A with a positive outlook, and a short-term debt rating of S-1 with a stable outlook. The ratings on Crédit Agricole SA are based on Crédit Agricole Group's (CA Group) credit fundamentals and support. The A and S-1 ratings are not applicable to unguaranteed debt issued by subsidiaries of Crédit Agricole SA.

These ratings reflect the benefits of the banking group's de-risking and return to its domestic retail roots, while leveraging on its size and expertise in savings products businesses (asset management and insurance). They also reflect the difficulty related to the status of the Organe Central (Central Body) Crédit Agricole SA, which is at the same time network head and listed holding company. As a result, the communication channels between the regional banks and CASA were tested during the European crisis. Our positive outlook reflects the possible change in relationship between CASA and the regional banks, which, if clear and properly executed, could materially improve the governance of the group.

Issuer Credit-Strength Rating (assigned on April 2, 2014)	**A**
Outlook	Positive
Senior unsecured debt	A
Short term debt rating (May 22, 2014)	S-1
Short term debt rating outlook	Stable

Unsolicited ratings with issuer participation.

Lead Analyst

Jacques-Henri Gaulard
j-h.gaulard@scoperatings.com

Team Leader

Sam Theodore
s.theodore@scoperatings.com

Rating drivers (Summary)

The rating drivers, in decreasing order of importance in the rating assignment, are:

- (+) After the 11 difficult years that followed on the IPO of CASA, CA Group has now de-risked and returned to its domestic retail roots.
- (+) CA Group can benefit from the ample cash generation of its very strong franchises in retail banking and bancassurance in France, where its number one market position seems very secure, and in asset management in Europe (through Amundi).
- (−) We believe that the governance structure of the group has shown its limits, with constant push-pull pressures between CASA (Central Body) and the regional banks. This tension peaked during the crisis and in our view raised questions about the ability of the group to react effectively in an adverse situation.
- (+) After years of restructuring and deleveraging, the group is now in a position to build strong capital levels over the next two to three years.

Rating change drivers

In our view, the biggest hurdle to a higher rating for CA Group remains its current structure, in which the group's Central Body is also a listed vehicle with its own market-driven priorities. We believe that the recent crisis and its consequences have led the group to re-assess its modus operandi. Our outlook reflects our belief that the group is aware of this problem and is currently working towards a clearer group structure with well-defined responsibilities. A higher level of clarity and proper execution could lead to a higher rating.

As the group has reverted to its French roots (Italy and to a lesser extent Poland remaining the only material foreign markets), any further sharp deterioration in the fundamentals of the French economy could negatively impact the revenues and the credit quality of CA Group, considering its entrenchment in its core market.

Recent events

Q1 2014 results

CA Group reported very strong results in Q1 2014.

In a dull French economic environment, the bank reported net profits of EUR 1.4bn, up 14.8% Year-on-Year.

This result was supported by a strong performance from the regional banks' retail network and, perhaps more surprisingly, by the corporate and investment bank – which showed very resilient results despite a difficult environment. This division managed to report a 3.2% revenue growth year-on-year driven by strong income from securitization and treasury (even if the CFO added during the results' call that these businesses had benefitted from a EUR 100m-150m non-recurring revenue tailwind). Without this one-off effect, the performance of CA Group's CIB division would still have been slightly better than peers.

The corporate centre (excluding own credit and DVA) displayed much improved results, partly due to a better hedging of inflation risk but the bank expects this phenomenon to even out by the end of the year so that the yearly guidance for the net profits of CASA's corporate centre remains at EUR -2bn

The group's capital metrics have improved since the end of 2013. CA Group reported a fully-phased CET1 ratio of 11.7% by the end of March 2014, while CASA's ratio improved 50bps QoQ, to 9%. The group's CRD4 leverage ratio stood at 3.8% at the end of March 2014.

Strategic Plan 2014-2016

On March 20, Crédit Agricole presented its 2014-2016 strategic plan, which strikes us as being very detailed and significantly more focused than the previous plan. It is also interesting to note that the group gives balance sheet metrics targets, which we find paradoxically more demanding than the profitability targets, all very reasonable. Scope's 2015 earnings forecasts for CA Group follow the overall trajectory of the group's own estimates. CA Group targets net profits of more than EUR 6.5bn in 2016 – Scope expects EUR 5.9bn in 2015.

For 2016, CA Group intends to focus on four pillars of development:

- Innovate and transform the retail business in France to better serve customers and strengthen the bank's leadership in France. Since CA Group has the largest retail network in France, it is easy to understand why the bank will try to develop both the brick-and-mortar branches and the online/digital channels. Considering the geographic spread of the bank, however, an overly aggressive reduction of the branch network would be risky. We believe that the bank has fully appreciated this challenge in its development plan.
- Step up the revenue synergies across the group. This strategic pillar, which consists in generating EUR 850m in additional group synergies by 2016, is quite demanding. Credit Agricole is known for its ability to exploit

cross-divisional synergies, in particular between life insurance and retail; in 2013 CA Group generated a total of EUR 7.2bn in total synergies, more than 20% of Group revenues. However the targets rely on increasing the weight of non-life insurance sales in the networks and boosting the weight of specialized financial services product engines in the network's offering – both of which are less developed than life insurance.

- Achieve focused growth in Europe. The objective of CA Group is to increase its revenues generated in Europe (excluding France) by a combined 12% to EUR 7.6bn by 2016. This aspect of the plan may prove somewhat optimistic, considering that the group expects the revenues generated by its Italian subsidiary Cariparma (CA Group's largest exposure abroad) to grow by a CAGR of 5% per annum. This growth rate would be underpinned by market share gains linked to the withdrawal of some local players, as well as the fact that, according to CA Group management, Cariparma uses no carry trade whatsoever, which may benefit the bank when interest rates increase.
- Invest in human resources, strengthen group efficiency and mitigate risks. Between now and 2016, CA Group intends to invest EUR 3.7bn to support business development and improve operational efficiency; generate EUR 950m of costs savings enabling a 2% fall in the group's cost-income ratio by 2016; and maintain strong risk metrics in asset quality, liquidity and funding, and market risks.

CA Group also disclosed interesting information on liquidity and on capital planning. On the former, it reported a Liquidity Coverage Ratio (LCR) of 80%+ at YE 2013, and is targeting a level above 100% at year-end 2014. With regard to the Net Stable Funding Ratio (NSFR), the group acknowledged the penalizing impact of repos in the ratio's calculation and announced a target of 100% by year-end 2016.

On the latter, the group confirmed that it would issue more than EUR 4bn of AT1 products between 2014 and 2016, so as to offset the regulatory grandfathering of older Tier 1 notes by 10% a year (EUR 0.9bn per annum, EUR 3.6bn in total over 2013-2016). The bank intends to capitalize on market opportunities to strengthen the financial structure and prepay hybrid Basel 2.5 instruments. It added that it does not plan to issue Tier 2 between 2014 and 2016.

Rating drivers (Details)

1. Back to domestic retail roots

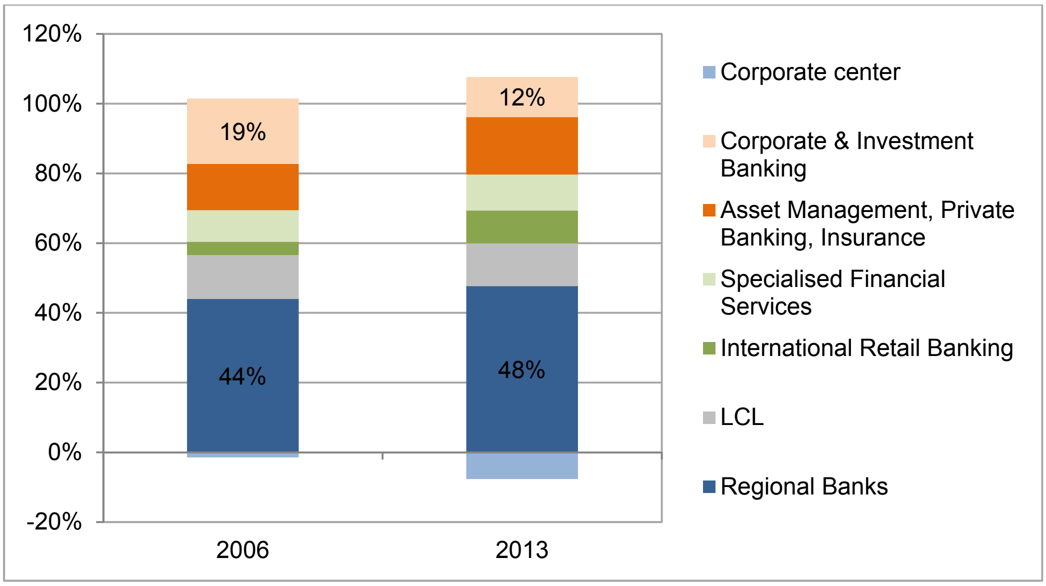
The history of Crédit Agricole Group can be divided into in three different periods. Between the creation of the first local banks in 1894 and the creation of the Fédération Nationale de Crédit Agricole in 1945, CA Group built its business alongside its mutualist structure. Between 1959 and 1991, CA Group's lending restrictions were progressively lifted. Lastly, in 2001, the Central Body CNCA (renamed CASA) became listed, enabling CASA to launch a very ambitious growth strategy. Initially, the objective of CASA's listing was to enable the group to take part in French domestic consolidation and have an opportunity to buy Crédit Lyonnais (the acquisition was effective in 2003). But between 2005 and 2009, CA Group diversified aggressively into investment banking (essentially through organic growth from 2005 onwards); retail banking in Italy (acquisition of Cariparma and Friuladria in 2007, of Carispe and 96 branches from Intesa in 2010); Greece (acquisition of Emporiki in 2006) and Spain (20% of Bankinter acquired in 2007-2008); brokerage (Newedge, 2008); consumer credit (Agos Ducato, 2008); and asset management (SGAM in 2009).

The combination of the 2007-2009 financial crisis and the 2011-2012 EU sovereign crisis led Crédit Agricole to disengage and retrench. This move proved very costly, raising questions about the strategy of the past six to seven years. It generated losses of around EUR 8.3bn between 2007 and 2012 on the toxic assets stemming from the financial crisis, in addition to a EUR 5.5bn loss in 2011-2012 on Emporiki; EUR 1.1bn representing the cost of the

"Private Sector Initiative" in Greece; as well as a combined EUR 6.6bn of goodwill impairment on various assets and on disposals – including Emporiki and investment banking assets.

Things have changed though, and at year-end 2013 the revenue breakdown of CA Group was much sounder than in 2006, at the peak of the bank's development in investment banking.

Chart 1: Revenue breakdown of CA Group, 2006-2013



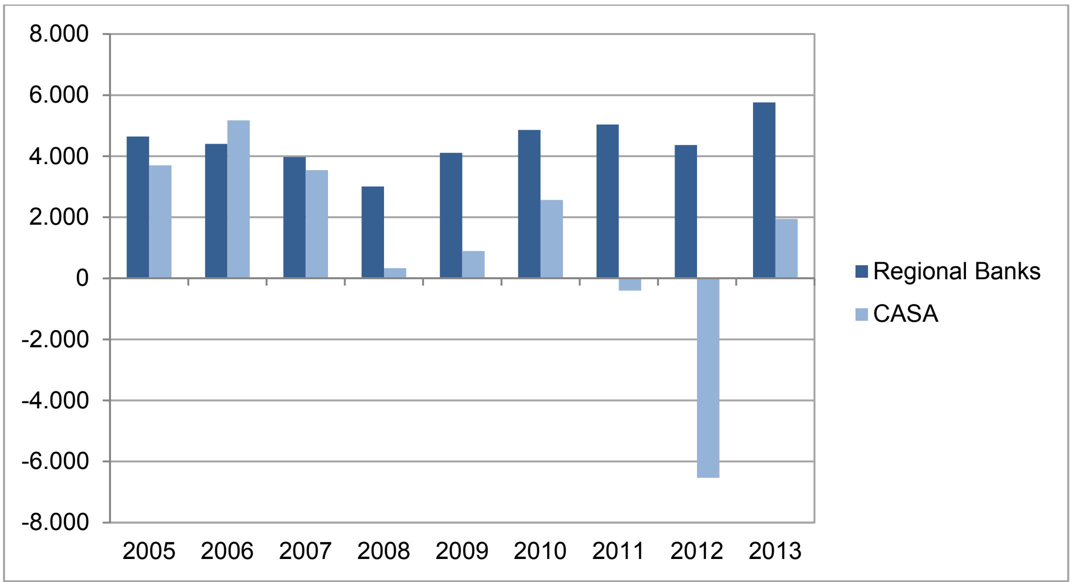
Source: Scope estimates, company data

As a group consolidating the regional banks and CASA, and therefore netting out all the intra-group entries, CA Group was never as dependent on Corporate & Investment Banking (CIB) as CASA alone was. Indeed, CA Group fully integrates 100% of the results of the regional banks, representing around EUR 14-15bn of revenues, instead of the 25% equity-accounted income consolidated by CASA, representing around EUR 1bn in an associates line. However, notwithstanding the enlarged perimeter of CA Group, the weight of French retail banking increased from 44% to 48% of group revenues between 2006 and 2013, while that of CIB fell by 7% to 12%. The weight of all retail businesses stood at 80% in 2013 versus 69% in 2006. When asset management, insurance and private banking are added, it could be argued that "lower-risk" revenues make up more than 95% of CA Group's revenues. This is a good sign indicating that CA Group is back to its domestic retail roots.

2. A strong franchise in domestic retail and in savings management

CA Group's regional banks network is the largest in France. Fed by the business of 2,483 local banks spread throughout more than 7,000 branches servicing 21 million clients (about a third of the total French population), the regional banks represent a loan market share of around 19% (21% for individuals). Deposit market shares are very similar. If we add the contribution of LCL, the market share of CA Group in French retail is close to 25%. Chart 2 compares the pre-tax profits of the regional banks' network with the pre-tax profits of CASA, both just excluding taxes and income from associates. As Chart 2 shows, between 2005 and 2007, CASA managed to match the profitability of the regional banks. But the financial crisis cut into the profits of CASA, and in 2012 the profits of the group's regional banks, large as they were, proved insufficient to offset the losses of CASA. This phenomenon led to CA Group posting its first-ever loss.

Chart 2: Regional banks vs. CASA pre-tax profits (excluding associates), 2005-2013 (EUR m)



Source: Company data, Scope estimates

The Savings Management and Insurance division is the second-largest contributor to CA Group's net profit. Within it, life insurance is a natural product engine for the regional banks, manufacturing life insurance products for the retail network. Outside the network, Amundi, the asset management arm of the CA Group, has gained a global critical mass following the merger of CAAM with SGAM in 2009 and is very successful. We believe that Amundi may, in fact, be the only lasting success of the 2005-2009 development years. CA Group refers to it as the ninth-largest asset manager in the world and the largest in Europe (source: IPE "Top 400 global asset managers active in the European marketplace") with assets under management of EUR 777bn as of year-end 2013. On top of external distribution, Amundi also acts as a product engine for the regional banks, LCL and Société Générale, which currently owns 25% of Amundi.

3. Limits of the current governance structure

Because of the hybrid nature of Credit Agricole SA (both listed vehicle and Central Body as defined by the French Monetary and Financial Code, articles I511-30 and I511-31), we believe that the relationships between the different stakeholders of the group are perfectible. We base this on the following considerations:

- The regional banks and CASA have a vertical parent-daughter relationship, but also a horizontal cross-guarantee/guarantor relationship.
- Due to its Central Body status, CASA has a supervisory function for the regional bank network, while at the same time being majority-owned by the regional banks through SAS Rue La Boétie.

These first two points are common to every other mutualist group in France. In addition, CA Group presents some specific features:

- The internal funding mechanisms within Crédit Agricole Group are complex.
  - Each regional bank holds a current account with CASA, which records the financial movements resulting from internal financial transactions within the group.

- Funds held in special savings accounts (like the Livret A passbook savings account) are collected by the regional banks on behalf of CASA. These funds are required to be transferred to the latter.
- The regional banks also collect savings funds on behalf of CASA. Special savings accounts and term deposits are transferred back to the regional banks through “advances” (loans) to the regional banks, with a view to funding their medium and long-term loans. Currently CASA transfers back to the regional banks 50% of the funds collected in the form of advances. These “mirror advances” have maturity and interest rates precisely matching those of the savings funds received, and regional banks are free to use them at their discretion. Margins from deposits that have not been retroceded are split equally between CASA and the regional banks (since January 1, 2004). Also, since January 1, 2004, 50% of the new loans distributed by the regional banks and falling within the field of application of financial relations between CASA and the regional banks may be refinanced by advances from CASA negotiated at market rates.
- As a listed company, CASA also needs to meet the needs of institutional and retail equity investors (in minority but historically above 40% of CASA’s capital), which do not necessarily have the same priorities as the regional banks (majority shareholders).
- At the time of its IPO, CASA bought a 25% stake in the regional banks in the form of non-voting shares (*certificats coopératifs d’investissement*). This technique gave CASA exposure to the earnings of the regional banks, but did little to simplify the complexity of the relationship between CASA and the regional banks.

These factors inherently create a raft of different prerogatives and responsibilities, which can create difficulties in the channels of communication.

In our opinion, the worsening of the euro crisis from the summer 2011 together with the withdrawal of US money market funds from the short-term funding of European banks put pressure on CASA’s liquidity. In fact, CA Group put together an “adaptation plan” revealed on 28 September 2011 that seemed somewhat one-sided. As a result of this strategic change, CASA ended up disposing of a significant chunk of its investment bank, reducing its corporate loan book, writing off a large portion of the goodwill accumulated during the expansion years and, finally, selling the Greek bank Emporiki after considerable losses. Prima facie, the “adaptation plan” was announced at group level and included liquidity measures taken group-wide but, in reality, the vast majority of the efforts were made at CASA level. Specifically, if we assume that about half of the EUR 22bn funding reduction achieved by the domestic retail networks was due to the decline in the loan-to-deposits ratio of LCL, this would mean that 83% of the reduction in group funding needs and 100% of the group RWA reductions were attributable to CASA and CASA affiliates.

CA Group’s corporate governance issues are also illustrated by the way the group communicates on capital. Despite the fact that the regulator looks at CA Group, and not CASA, to analyze the capital and the liquidity of Crédit Agricole, a lot of details are devoted to the regulatory capital of CASA, the group’s listed entity. We are also surprised by the time and effort spent by the group on a complex intra-group capital enhancement operation (Switch), which then disappears at the consolidated group level, just for the purpose of boosting CASA’s capital ratios.

Overall, the rejuvenated business model of Crédit Agricole Group as revealed at the presentation of the Strategic Plan 2014-2016 would be helped by clarifying responsibilities between the group’s different participants, provided this clarification is convincing and properly executed. The multiplication of intra-group financial flows and intra-group corporate responsibilities could be simplified, so that the group can fully deliver on its very convincing strategy.

4. Capital build-up of CA Group expected to gain momentum

As a result of the de-risking of CA Group and its return to its domestic retail roots, we expect the bank to build a strong capital base over the next two to three years. The group's principal cash generators are the regional banks. As these are not managed via ROE targets or dividend yield, Scope expects a significant accumulation of capital at group level. In its capital planning exercise, CASA's CFO detailed the major Basel 3 estimates, most recently when presenting the 2014-2016 strategic plan. CA Group is targeting a fully-phased Core Equity Tier 1 ratio of 11% at the end of 2013 (achieved), 12% at the end of 2014, 13% at the end of 2015 and 14% at the end of 2016. The group claims that this will be reached through earnings generation and asset sales/identified balance sheet management. We cannot estimate the type of assets that CA Group will sell, especially since CASA has already disposed of numerous assets, but we can estimate the level of the CET1 ratio under conservative retained earnings and asset growth estimates. This is the aim of Table 1, together with an estimate of the "lowest possible" leverage ratio, i.e. assuming Total Tier 1 capital divided by all-grossed-up IFRS total assets. Therefore, the ratio cannot possibly be calculated in a more conservative manner.

Under these circumstances, we are comfortable with CA Group's capital levels. In fact, CA Group should post the highest capital levels of French banks in 2015E, at 12.5% CET1, roughly 200bps ahead of BNP Paribas. Our forecasts assume that CA Group will fall about 50bps short of its 2015 CET1 targets, but this could be explained by the fact that our forecasts include no further disposals and gives the bank no credit for any management action as detailed in the 2014-2016 strategic plan. We note that, on a pure organic basis, our CET1 estimates are roughly in line with the bank's targets.

As for the leverage ratio, the five large French banks are already materially above the 3% CRD 4-defined minimum in 2013.

In addition, the regulator looks at Crédit Agricole's regulatory capital from a group perspective and not at CASA level. The advantage is that this presents the regulatory capital in a more favorable light as all intra-group deductions and associated RWAs are not included in the calculation of the ratio at group level.

Table 1: Relative capital build-up of the five rated French banks

	2011		2012		2013		2014E		2015E	
	CET1 (%)	T1 LR (%)	CET1 (%)	T1 LR (%)	CET1 (%)	T1 LR (%)	CET1 (%)	T1 LR (%)	CET1 (%)	T1 LR (%)
Crédit Mutuel	12.0%	4.6%	12.0%	4.4%	14.2%	5.6%	NA	NA	NA	NA
BPCE	6.6%	3.6%	8.8%	4.1%	10.4%	3.6%	10.8%	NA	11.2%	NA
BNP Paribas	7.4%	3.6%	9.9%	3.9%	10.3%	3.7%	10.4%	NA	10.5%	NA
Crédit Agricole Group	7.2%	3.3%	9.3%	3.1%	11.2%	3.8%	11.8%	NA	12.5%	NA
Société Générale	6.1%	3.2%	8.1%	3.2%	10.0%	3.5%	10.3%	NA	10.4%	NA

Source: Scope estimates, company data

Peer comparison

At Scope Ratings, we compare banks within peer groups at domestic and cross-border level.

In France, Crédit Agricole Group is comparable to BNP Paribas, Société Générale, BPCE and Crédit Mutuel Group.

Looking at the performance of CA Group versus domestic peers, we note that, on many metrics, the five rated banks show similar rankings. This is particularly the case of liquidity metrics, since the loan-to-deposits ratio of all French banks falls between 110% and 130%. CA Group has significantly improved this metric over the years and is now well-positioned among its domestic peers.

In asset quality terms, French banks are clearly divided between domestically-biased and internationally-biased banks. Among the former (CA Group, Crédit Mutuel and BPCE), Crédit Agricole shows impaired loans metrics that rank among the best of its peers. The loan loss coverage ratio of CA Group is also the best among rated French banks.

The capital metrics of the group have improved as a result of the 60% reduction in the gross present value of derivatives reported on balance sheet thanks to the application of IAS 32, which increases the possibility of derivatives netting.

Outside France, we have positioned CA Group in the bucket of mostly domestic institutions. This peer group includes Lloyds, Rabobank, Intesa and Swedbank among others.

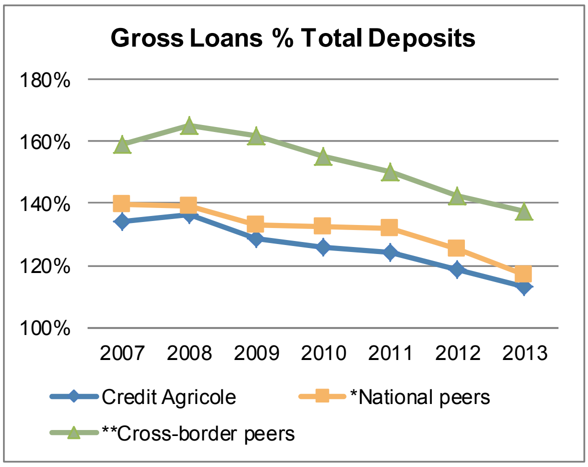
CA Group's position among peers can be said to evolve rapidly. Ten years ago, CA Group would have been considered a pure retail bank. Five years ago, the expansion into investment banking and the positions reached by CASA could have warranted a place among the large universal banks. Today, CA Group is back among the mostly domestic European retail banks.

Overall, CA Group looks well compared with peers. At 113% in 2013, its loan-deposit ratio compares well with its peers. The other liquid indicators look good and are improving, which is not surprising considering the significant efforts made by the group in 2011-2012.

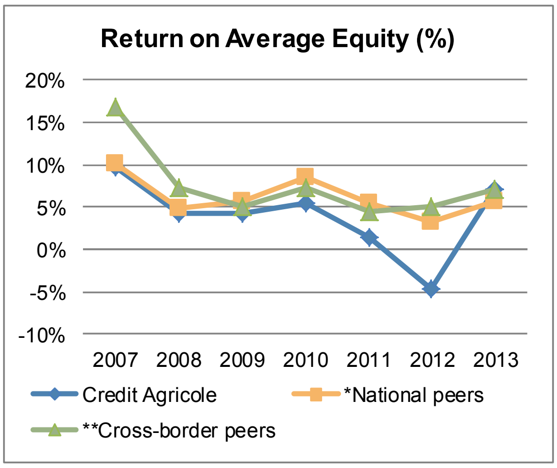
In asset quality terms, CA Group also shows metrics consistent with its leading position in the French market: much better than most internationally, but slightly lower than the metrics of Nordic banks. The coverage ratio of CA Group at the international level ranks among the best. On average, Crédit Agricole's profitability metrics are in line compared with peers, as demonstrated by the ROE comparative in our peer group charts.

Regarding leverage, the ratio of CA Group is still at the lower-end of international peers despite the bank's progress in 2013, and the risk-asset intensity remains low (only one Nordic banks shows lower ratios). This is a problem common to all French banks but, in the case of CA Group, it causes us less concern considering the group's low risk profile.

Peer Comparison - Credit Agricole Group



Source: SNL Financial, Scope Ratings



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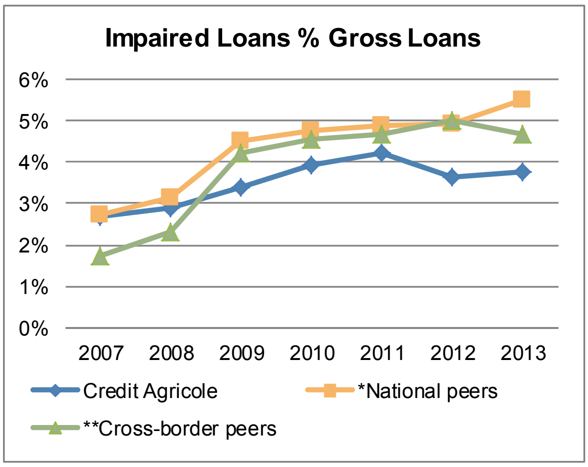
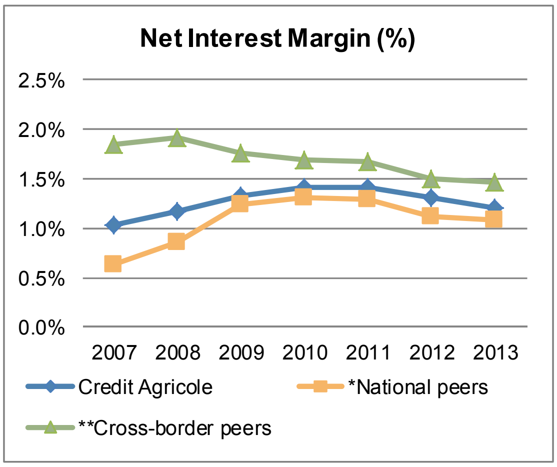


Source: SNL Financial, Scope Ratings



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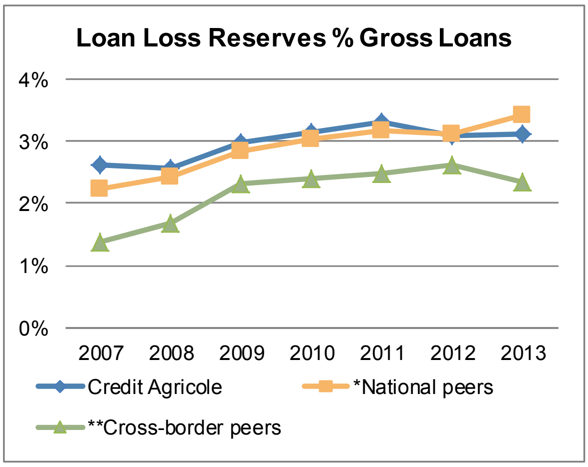

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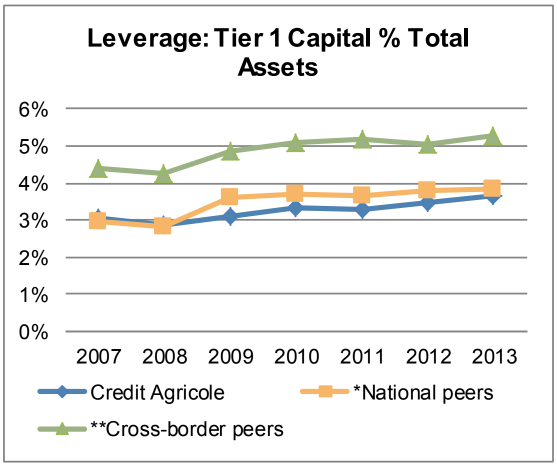


Source: SNL Financial, Scope Ratings

*National peers: BNP Paribas, Credit Agricole Group, Credit Mutuel Group, Groupe BCPE, Societe Generale
**Cross-border peers: Groupe BPCE, Credit Mutuel Group, Intesa, DNB ASA, Credit Agricole Group, CaixaBank, Sw edbank, Lloyds Banking group, Wells Fargo & Co., Rabobank Group

Notes: Cross-border peer group excludes Credit Mutuel Group in 2013 as w ell as Intesa for the Net Interest Margin and the Return on Average Equity. We use H1 2013 numbers as a 2013 proxy for Intesa on all other ratios.

Selected Financial Information - Credit Agricole Group

	2007	2008	2009	2010	2011	2012	2013	2014E	2015E
Balance Sheet summary (EUR billion)									
Assets									
Cash and balances with central banks	21.8	52.5	37.5	31.7	31.4	46.1	71.6	94.5	132.8
Interbank assets	86.3	78.7	90.2	101.8	102.8	117.3	93.7	94.6	96.5
Total securities	499.5	410.1	433.4	447.2	407.8	501.6	485.6	489.2	476.9
of which debt instruments	399.5	351.0	336.4	349.7	325.6	429.7	360.9	360.9	342.8
of which equity instruments	70.9	31.3	58.4	56.0	41.8	38.5	37.9	39.8	43.8
Derivatives	187.6	401.0	282.4	266.3	392.8	477.0	190.7	191.3	190.7
Gross customer loans	645.0	717.4	747.7	776.6	827.1	758.8	731.3	731.3	738.2
of which impaired loans	17.5	20.8	25.2	30.9	34.9	27.7	27.7	27.7	27.4
Total funded assets	1,356.0	1,391.6	1,415.1	1,470.3	1,491.5	1,531.0	1,516.9	1,544.1	1,578.8
Total Assets	**1,540.9**	**1,784.0**	**1,693.8**	**1,730.8**	**1,879.5**	**2,008.0**	**1,706.3**	**1,734.1**	**1,768.1**
Liabilities									
Interbank liabilities	151.9	150.8	113.9	124.2	126.8	110.0	104.6	104.6	104.6
Senior debt	328.8	300.0	282.9	273.9	233.3	294.5	310.9	314.0	317.1
Derivatives	184.9	392.4	278.7	260.6	388.0	477.0	189.4	190.0	189.4
Customer deposits	485.7	527.9	577.9	623.3	666.7	639.0	648.0	654.5	667.6
Subordinated debt + hybrid securities	22.5	31.6	34.1	33.0	33.1	28.1	26.6	26.6	26.6
Total Liabilities	**1,470.9**	**1,715.0**	**1,619.1**	**1,653.4**	**1,802.8**	**1,931.9**	**1,624.7**	**1,647.7**	**1,676.8**
Ordinary equity	64.8	63.7	68.8	71.5	70.7	70.8	76.3	81.0	86.0
Minority interests	5.2	5.3	5.9	6.0	6.1	5.3	5.4	5.4	5.4
Total Liabilities and Equity	**1,540.9**	**1,784.0**	**1,693.8**	**1,730.8**	**1,879.5**	**2,008.0**	**1,706.3**	**1,734.1**	**1,768.1**
Core Tier 1 Capital [1]	*42.4*	*42.2*	*45.8*	*49.6*	*40.0*	*47.8*	*60.7*	*65.4*	*70.4*
Income Statement summary (EUR billion)									
Net interest income	13.9	18.0	21.3	22.4	23.0	23.1	21.5		
Net fee & commission income	9.5	9.3	10.8	10.8	10.7	9.0	8.9		
Net trading income	8.5	-8.5	5.0	4.7	0.2	5.4	4.6		
Operating Income	**30.3**	**29.6**	**31.8**	**33.4**	**39.4**	**31.9**	**31.2**	**31.7**	**32.7**
Operating expenses	20.3	20.4	19.7	20.9	21.9	21.0	19.7	19.9	19.9
Loan loss provision charges	3.2	5.5	7.0	5.2	10.1	5.0	4.0	3.6	3.6
Non-recurring items	1.5	0.5	0.2	-0.1	-1.3	0.2	0.2	0.0	0.0
Pre-Tax Profit	**8.2**	**3.9**	**4.8**	**6.6**	**4.0**	**-1.4**	**7.7**	**8.2**	**9.2**
Income tax	1.7	1.0	1.8	2.5	2.9	2.3	2.2	2.6	2.9
Net profit attributable to minority interests	0.5	0.5	0.3	0.5	0.3	0.1	0.4	0.4	0.4
Net Income Attributable to Parent	**6.0**	**2.5**	**2.7**	**3.6**	**0.8**	**-3.7**	**5.1**	**5.3**	**5.9**

Source: SNL Financial and Scope Ratings for historical figures. Scope's forecasts are based on publicly available information. Please refer to "Methodologies Used for this Report" for further details.
[1] CRD 4 basis from 2011 onwards

Ratios - Credit Agricole Group

	2007	2008	2009	2010	2011	2012	2013	2014E	2015E
Funding/Liquidity									
Gross loans % Total deposits	132.8%	135.9%	129.4%	124.6%	124.0%	118.7%	112.8%	111.7%	110.6%
Total deposits % Total funds	49.1%	52.3%	57.3%	59.1%	62.9%	59.6%	59.4%	59.5%	59.8%
Wholesale funds % Total funds	50.9%	47.7%	42.7%	40.9%	37.1%	40.4%	40.6%	40.5%	40.2%
Asset Mix, Quality and Growth									
Gross loans % Funded assets	47.6%	51.6%	52.8%	52.8%	55.5%	49.6%	48.2%	47.4%	46.8%
Impaired loans % Gross loans	2.7%	2.9%	3.4%	4.0%	4.2%	3.7%	3.8%	3.8%	3.7%
Loan loss reserves % Impaired loans	62.6%	81.9%	108.5%	53.8%	78.7%	84.5%	82.5%	82.5%	82.5%
Gross loan growth (%)	20.7%	15.1%	9.4%	12.1%	11.2%	-1.7%	2.7%	6.7%	7.7%
Impaired loan growth (%)	7.6%	18.9%	21.3%	22.3%	13.1%	-20.6%	0.0%	0.0%	-1.0%
Funded assets growth (%)	8.0%	2.6%	1.7%	3.9%	1.4%	2.6%	-0.9%	1.8%	2.2%
Earnings									
Net interest income % Revenues	46.0%	60.9%	66.9%	67.0%	58.3%	72.5%	68.9%		
Fees & commissions % Revenues	31.5%	31.4%	33.8%	32.3%	27.2%	28.2%	28.5%		
Trading income % Revenues	28.0%	-28.8%	15.7%	14.1%	0.4%	17.1%	14.7%		
Other income % Revenues	-5.4%	36.5%	-16.3%	-13.4%	14.1%	-17.8%	-12.1%		
Net interest margin (%)	1.3%	1.5%	1.8%	1.8%	1.8%	1.8%	1.7%		
Pre-provision Income % Risk-weighted assets (RWAs)	1.6%	1.5%	2.2%	2.1%	3.4%	2.3%	2.4%	2.2%	2.3%
Loan loss provision charges % Pre-provision income	31.8%	59.9%	58.0%	41.6%	57.6%	45.7%	34.8%	30.7%	28.1%
Loan loss provision charges % Gross loans (cost of risk)	0.5%	0.8%	1.0%	0.7%	1.3%	0.6%	0.6%	0.5%	0.5%
Cost income ratio (%)	67.2%	69.1%	62.0%	62.6%	55.6%	65.8%	63.1%	62.5%	60.9%
Net Interest Income / Loan loss charges (x)	4.4	3.3	3.0	4.3	2.3	4.6			
Return on average equity (ROAE) (%)	9.7%	3.8%	4.1%	5.1%	1.1%	-5.3%	7.0%	6.7%	7.0%
Return on average funded assets (%)	0.3%	0.1%	0.1%	0.2%	0.0%	-0.2%	0.2%	0.2%	0.2%
Retained earnings % Prior year's book equity	n/a	n/a	n/a	n/a	n/a	n/a	7.0%	6.2%	6.1%
Pre-tax return on common equity tier 1 capital	19.4%	9.2%	10.6%	13.4%	9.9%	-2.9%	12.7%	12.6%	13.1%
Capital and Risk Protection [1]									
Common equity tier 1 ratio (common equity tier 1 capital % RWAs)	6.7%	6.9%	8.5%	8.4%	7.2%	9.3%	11.2%	11.8%	12.5%
Tier 1 leverage ratio (%)	3.0%	2.9%	3.1%	3.3%	3.3%	3.1%	4.4%		
Median of tier 1 leverage ratio and common equity tier 1 ratio (%)	4.9%	4.9%	5.8%	5.9%	5.3%	6.2%	7.8%		
Total loss coverage (CET 1 capital + loan loss provisions) % RWAs	8.5%	9.6%	13.6%	11.2%	12.9%	14.8%	17.5%	16.0%	16.5%
Non-senior bailinable debt cushion (as % of total liabilities)	1.5%	1.8%	2.1%	2.0%	1.8%	1.5%	1.6%	1.6%	1.6%
Asset risk intensity (RWAs % total assets)	40.9%	34.5%	31.8%	34.2%	27.8%	23.9%	28.0%	31.9%	31.9%

Source: SNL Financial and Scope Ratings for historical figures. Scope's forecasts are based on publicly available information. Please refer to "Methodologies Used for this Report" for further details.
[1] CRD 4 basis from 2011 onwards

METHODOLOGIES USED FOR THIS REPORT

For the rating and analysis contents of this report Scope has used the following methodologies which were published on www.scoperatings.com:

"Bank Rating Methodology" (February 2014)

"Forecasting Bank Financials Methodology" (February 2014)

Forecasting bank financials: Forward-looking estimates are an important analytical tool underpinning Scope's bank ratings. These forecasts cover the current financial year (before final year-end figures are published by the bank) plus the forthcoming two years. Depending on the complexity of the bank being assessed, different forecasting tools will be used. For a majority of banks operating primarily commercial and retail banking franchises (loans and deposits) the analysis is underpinned by an **accounting** forecast of the balance sheet and profit and loss account. For more complex groups with multiple ranges of activities – notably those with material wholesale and investment banking operations – Scope uses an **analytical** forecast, relying on the bank's business-line reporting to come up with plausible estimates. For all banks Scope also include a **regulatory metrics** forecast, considering the growing importance of this aspect in bank analysis.

For complex banks, divisional data is used to forecast profit and loss accounts and basic divisional balance sheet metrics. For less complex banks, a line-by-line forecasting of major P&L elements is forecast.

For balance-sheet forecasts, Scope estimates of all major balance sheet lines, using the P&L estimates to complete the forecast of the capital/shareholders' equity line. This comprehensive methodology for estimating the balance sheet is used for all the banks in our universe, irrespective of size and complexity.

Lastly, our forecasts include assessments of the major regulatory metrics: Tier 1 and CET 1 (historically CT1), Leverage, Liquidity Coverage Ratio, and Net Stable Funding Ratio (the latter two when and if sufficient public information to compute them is available).

Scope will not aim to forecast financials when it considers the public disclosure of the bank as insufficient for a transparent and credible outcome.

All Scope's bank financial forecasts are based on public information. For its forecasts Scope will not use any non-public information or data, even if such information or data were provided by rated banks. Scope's forecasting process is transparent, with a detailed roadmap provided in its *"Forecasting bank financials"* methodology.

Banque Fédérative du Crédit Mutuel SA
Issuer Rating Report

SCOPE | A STABLE OUTLOOK
Financial Institutions

Overview

Scope Ratings assigns an Issuer Credit-Strength Rating (ICSR) of A and a short-term debt rating of S-1 to Banque Fédérative du Crédit Mutuel, both with a stable outlook. These ratings reflect the stable and well-established retail franchise and overall strong fundamentals of the bank and its much-improved liquidity. At the same time, the ratings also reflect the less-clear governance of the firm and the geographical divide within the group, which give Crédit Mutuel much less of a unified structure than its French mutualist peers.

The ratings on Banque Fédérative du Crédit Mutuel (BFCM) are based on Crédit Mutuel Group's (CMut) credit fundamentals and support. Caisse Centrale du Crédit Mutuel (CCCM) has delegated its capital markets functions to BFCM, thence the assignment of our ratings to BFCM. However, the A and S-1 ratings is not applicable to unguaranteed debt issued by subsidiaries of BFCM.

Issuer Credit-Strength Rating (assigned on April 2, 2014)	**A**
Outlook	Stable
Senior unsecured debt	A
Short term debt rating (May 22, 2014)	S-1
Short term debt rating outlook	Stable

Unsolicited ratings without issuer participation.

Lead Analyst

Jacques-Henri Gaulard
j-h.gaulard@scoperatings.com

Team Leader

Sam Theodore
s.theodore@scoperatings.com

Rating drivers (Summary)

The rating drivers, in decreasing order of importance in the rating assignment, are:

- (+) A very strong franchise. The Crédit Mutuel and CIC networks together hold the third largest market share in French loans and deposits.
- (−) The governance of CMut is perfectible and has grown more and more complex with time.
- (+) The balance sheet of the bank is low-risk, and its capital base strong.
- (+) Crédit Mutuel has made few, but always smart, acquisitions over the years.

Rating change drivers

(↑) Any improvement in the governance process of Crédit Mutuel should be a positive development. So far, the bank has managed to cut costs and optimize resources by joining 11 regional banks within the so-called "CM11-CIC" group, the largest by far. Any further concentration of regional banks would, in our view, help strengthen the unity and cohesion of the group further.

(↓) Even if quite remote, an acceleration of the divide within the Crédit Mutuel Group could bring Crédit Mutuel Arkéa (the combination of the Britany, South-West and Massif Central federations) to leave the group. Crédit Mutuel Arkéa strikes us as being fully autonomous from the rest of the group; therefore an operational break-up would not create massive business disruption.

Recent events

CMut Group reported its FY 2013 results on March 6. Crédit Mutuel Group reported yearly net profits of EUR 2.651bn, up 23.3% on 2012. These good numbers were driven by a 4.8% growth in revenues coupled with flat operating expenses, leading to a 17% increase in pre-provision profits. Loan loss charges are up 10.4% to EUR 1.384m, and correspond to a group cost of risk of 39bps. The non-performing loan ratio increased to 4.4% (versus 3.95% in 2012), and CMut maintained its NPL coverage ratio at 66.1%.

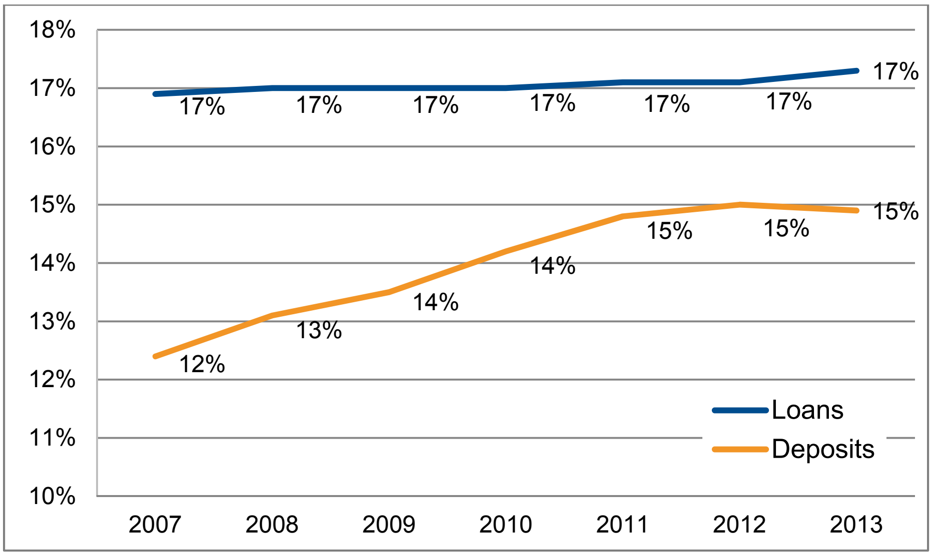
Rating drivers (Details)

1. A very strong franchise

There are three different aspects to Crédit Mutuel's business that strike us as quite special versus other French banks:

1. The two main networks of the group (the regional banks of Crédit Mutuel and the regional banks of the CIC group) represent the third largest market share in loans and deposits in France (Chart 1). Interestingly, while CMut's market shares in loans have not changed materially over the years, the bank has nonetheless increased its weight in deposits. The market share gap between loans and deposits has significantly narrowed over the last 6-7 years.

Chart 1: Loan and Deposit market shares – Crédit Mutuel Group



Source: Company data

2. In bancassurance, Assurances Crédit Mutuel ranks among the first bancassurers in France (together with Crédit Agricole's Prédica). The difference between the two groups is that Crédit Mutuel has been more successful in non-life insurance (where the bank is number one in France).

3. The main competitive advantage of Crédit Mutuel versus its French peers has been its long-standing focus on technology. This leadership is expressed at two levels: first electronic and digital banking, where the product includes an integrated mobile phone network offering, and also alarm systems through the subsidiary EPS, number one in France. Second, the bank is first in electronic payments in France with 2 billion transactions registered by affiliated retailers in 2012.

2. The governance of Crédit Mutuel is perfectible

2.1. In theory, a complex but comprehensible structure

The governance of Crédit Mutuel has become quite complex over the years and the different corporate and organizational layers make the identification of responsibility more difficult to assess.

The current problems can be traced back to the origins of the group itself. Technically, the first Crédit Mutuel in France was created in 1893 in the Lyon region. Progressively though, the western side of France quickly became the most important location of Crédit Mutuel local banks, while at the same time the first Crédit Mutuel banks were founded in German-occupied Alsace. As a result, from 1918 onwards, the Crédit Mutuel franchise has been built up independently and quite strongly in two different French regions. After forty years of co-existence, the unified Crédit Mutuel Group as we know it today was created in 1958 with the foundation of a Central Body for the whole group, the Confédération Nationale du Crédit Mutuel.

Up until today, CMut Group seems to play by the same rules as other comparable mutualist networks in France. The role of the Central Body and the rules of internal support are both defined in the Monetary and Financial Code, articles l511-30 and l511-31. According to these articles, the central body of a mutualist organization must "maintain the cohesion of the network it belongs to, and ensure that the operations of affiliated banks are in order. To this end, the central body is expected to take every necessary step, in particular to guarantee the liquidity and solvency of all the affiliates and of the network as a whole".

CMut is divided into 18 regional groups. Each regional group includes:

- Local banks, collecting deposits and granting loans with high delegation powers.
- Regional banks (owned by local banks).
- A regional Federation, i.e. a not-for-profit organization defining the strategy and implementing the controls of the whole regional group.

According to article r511-3 of the Monetary and Financial Code, "the ACPR[1] can, for the benefit of mutualist groups and after receiving the opinion of the central body, deliver a collective agreement to a regional bank for the benefit of this bank and all the local banks that are affiliated to this regional bank, provided that the liquidity and solvency of these local banks are guaranteed as a result of this affiliation".

As a result, there are two levels of internal support: regional and national; we assume that solvency and liquidity issues need to be sorted out at a regional level before being escalated to the level of the Confédération Nationale.

The Confédération Nationale du Crédit Mutuel is the central body of the whole group (including the 2,000-odd local banks and the 18 regional groups). The regional federations are all affiliated to Confédération Nationale. The Confédération Nationale sits at the top of the hierarchy. It is also a not-for-profit organization. The Confédération Nationale represents CMut vis-à-vis the authorities and is responsible for defending and promoting its interests. The Confédération Nationale also oversees the proper operations of its affiliated banks, supervises the regional groups and ensures the overall cohesion of the network.

Along the Confédération Nationale, at the top level, there is the Caisse Centrale du Crédit Mutuel (or CCCM), the central financing bank. It manages treasury for the regional groups and organizes the pooling of Crédit Mutuel's financial resources. Its capital is jointly owned by the regional banks.

[1] The French banking regulator, or Autorité de Contrôle Prudentiel et de Résolution

2.2. In practice, the build-up of powerful decentralized franchises

Because of the principle of “collective agreement” as authorized by Article r511-3 of the Monetary and Financial Code, the regional groups can actually operate and pretty much thrive on a stand-alone basis, as solvency and liquidity are guaranteed at regional and local levels. This also means that it can be tempting, particularly for regional banks that have been used to their independence, to build up their own product engines, their own subsidiaries and their own bond issue programs. As a result, CMut has for many years seen the proliferation of many different competing entities operating in the same business line, but in different regions. As of year-end 2012, the annual report of Crédit Mutuel listed three property subsidiaries, three equipment leasing companies, three property leasing companies, three consumer credit subsidiaries, four insurance companies, seven private equity companies and four asset management companies.

Faced with such duplications, the most powerful regional banks have tried to consolidate by encouraging “Interfederal Groups” to bring together shared services, common funding and liquidity, common purchasing, partnerships, etc. The Crédit Mutuel Centre-Est Europe (CMCEE) was born of the merger of three regional groups in the east of France.

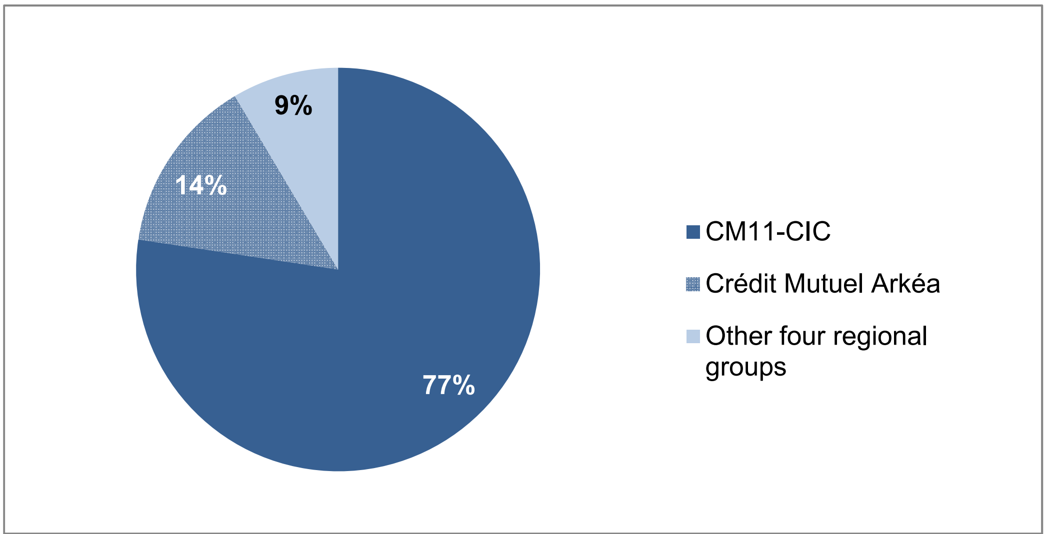
Between 1993 and 2012, the CMCEE (now renamed Caisse Fédérale de Crédit Mutuel - CFCM) joined forces with 10 other regional federations to become the CM11-CIC Group. CM11-CIC is an interregional group gathering 11 out of the 18 regional groups of Credit Mutuel. This means, in practice, that all these 11 Federations have agreed to consider CFCM as their Regional Bank. It also means that the “collective agreement” ruling the liquidity and the solvency of CM11-CIC now happens between CFCM (as central body), the 11 Federations and their corresponding local banks.

On the other side of the country, Crédit Mutuel de Bretagne has tried to build a competing alternative to the growing CM11-CIC. Crédit Mutuel de Bretagne, Crédit Mutuel du Sud-Ouest and Crédit Mutuel Massif Central have created Crédit Mutuel Arkéa in 2002, built on the same principles (even if on a much smaller scale) as CM11-CIC.

As a result, there are now only four Regional Groups that are organized “independently” from the two large interfederal groups: Crédit Mutuel Nord Europe, Crédit Mutuel Océan, Crédit Mutuel Maine-Anjou Basse-Normandie and Crédit Mutuel Antilles-Guyane.

As can be seen on Chart 2, CM11-CIC represents 77% of the assets of the whole Crédit Mutuel versus 14% for Arkéa and 9% for the rest of the group.

Chart 2: Breakdown of total assets of CMut Group (by big regional group)



Source: company data

2.3. As a result, a more complex cash circulation between entities

As a result of this extremely decentralized organization, the main risk attached to CMut would be frictions with regard to the cash circulation from one group to another in case of solvency and/or liquidity problems.

Things may be further complicated by the attributes of CCCM; in theory, the financing arm of the group and a pillar of the "third level" of Crédit Mutuel governance, together with the Confédération Nationale. We note that with time, CCCM has passed a lot of its prerogatives to BFCM, the financing arm of CM11-CIC, despite the expected "neutral" qualities of CCCM. Indeed, since 2002 and 2005, the back office and front office functions of CCCM have been delegated to BFCM. The capital markets activities of CCCM have also been delegated to BFCM. To quote from the CCCM annual report: "on the different markets, CCCM now only appears as an issuer of CDs and as deposit borrower; everything else is done internally within the Crédit Mutuel Group. The increase of the CM-CIC entity from CM5-CIC to CM10-CIC and then CM11-CIC has seen the traditional franchise of CCCM collapse. BFCM is now substituting for CCCM as lender/borrower to/from the regional banks".

This paragraph shows another sign of the growing decentralization of CMut and the fact that national solvency and liquidity firewalls are being increasingly dealt with at local levels, which could create a problem in the unlikely case of a credit event.

3. The balance sheet of Crédit Mutuel Group is strong

To sum up:

- The weight of derivatives in the group's balance sheet is extremely limited (around 1% of total assets).
- The weight of repos in the group's funding is extremely limited (never more than 5% of total funding over the last six years).
- The capital metrics of the company are among the strongest in France. The fully-phased Basel 3 leverage ratio in particular stood at 5.6% at year-end 2013. The fully-phased Basel 3 CET1 ratio amounted to 14.2%, which is at the top of the peer group both in France and abroad.

- Lastly, even if perfectible, the liquidity metrics of CMut have significantly improved over the last years, as demonstrated by Table 1 below. In particular, the loans-to-deposits ratio has gone down (partly as a result of the increasing reliance by Crédit Mutuel on covered bond issues) and the weight of wholesale funds as a percentage of total funding has gone down as well. This is positive, but in our view, the group's liquidity and funding remain to some extent a work in progress. Even if 2013 numbers are not fully available yet, it is our understanding that the loans-to-deposit ratio has fallen by another five percentage points in 2013.

Table 1: Liquidity and funding metrics of CMut

	2006	2007	2008	2009	2010	2011	2012
Loans % deposits	165.50%	173.98%	167.77%	152.13%	146.97%	132.90%	124.07%
Liquid assets % short-term funds	88.40%	78.86%	59.32%	63.67%	63.09%	63.00%	77.31%
Wholesale funds % total funds	59.39%	62.38%	58.25%	51.84%	47.89%	44.87%	43.03%
ST wholesale funds % total funds	42.81%	48.88%	49.25%	42.43%	37.89%	34.13%	31.38%
Deposits % total funds	40.49%	37.60%	41.18%	47.84%	52.09%	55.06%	56.89%
Loans % total assets	45.61%	45.90%	48.35%	50.08%	52.00%	50.16%	46.64%
Repos % ST wholesale funds	0.00%	1.15%	1.09%	2.86%	4.87%	2.33%	1.00%

Source: Company data, Scope Ratings estimates

4. The acquisition policy of the group has been smart

Compared with other French banks, Crédit Mutuel made fewer, but wiser, acquisitions.

Following the acquisition of CIC by BFCM in 1998, which enabled CMut to participate fully in the domestic consolidation of the French banking sector, Crédit Mutuel launched into a series of opportunistic acquisitions. Although few and far between, these acquisitions were sensible and made at a reasonable cost. At year-end 2012, the bank reported around EUR 4.852bn of goodwill. As a matter of comparison, goodwill stood at EUR 14.7bn for CA Group in 2012 (after a peak at more than EUR 20.5bn in 2008), EUR 10.6bn for BNP Paribas, EUR 5.2bn for Société Générale (following a peak at EUR 7.4bn in 2010), and EUR 4.3bn for Groupe BPCE (EUR 5.7bn in 2009). It is interesting to note that BFCM (belonging to CM11-CIC) is the vehicle that carried most of the major acquisitions since 1998 (CIC, also a part of the CM11-CIC sub-group, bought the minority stakes in Banque Marocaine du Commerce Extérieur and BPM in Italy). Interestingly, where all French banks favored either Italy and Greece or an expansion in Central & Eastern Europe, CMut chose Germany, France and consumer lending.

- In June 2008, BFCM acquired 100% of the subsidiary of the Spanish Banco Popular in France (18 branches in the Paris area, the southeast and the southwest).
- In November 2008, BFCM acquired 51% of the capital of Cofidis, the captive consumer credit operation of the retail group 3 Suisses. The acquisition enabled Cofidis to launch into outside partnerships and Crédit Mutuel to expand in Spain, Portugal, Belgium, Italy, Czech Republic, Slovakia and Hungary.
- In December 2008, BFCM acquired 100% of the capital of Citibank Germany (soon to be renamed Targobank). The entity then had 300 branches and 3.4 million clients. On top of the intrinsic qualities of the Citi franchise in Germany, the acquisition enabled CMut to benefit from the Citi retail IT structure.
- In 2012, Crédit Mutuel Nord Europe bought Citibank Belgium (442,000 clients and 34 branches) while Assurances Crédit Mutuel purchased the Spanish Agrupacio Mutua.

Adding the net profits of the different acquisitions (including CIC) and comparing them to the goodwill of the bank gives a 2012 yearly return of more than 15%; way above the cost of capital.

Peer comparison

At Scope Ratings, we compare banks within peer groups at domestic and cross-border levels.

Domestically, Crédit Mutuel Group is comparable to BNP Paribas, Société Générale, Crédit Agricole Group and BPCE.

Looking at the performance of CMut versus domestic peers, it is interesting to note that on many metrics the five rated banks show very similar rankings. This is particularly the case of liquidity metrics, since the loans-to-deposits ratio of all French banks is comprised between 110% and 130%. CMut displayed one of the highest loans-to-deposits ratios of French banks in 2012, despite a major improvement since 2007, when the LTD ratio of the bank was around 170%.

In asset quality terms, French banks are clearly divided between domestically-biased and internationally-biased banks. Among the former (CA Group, Crédit Mutuel and BPCE), CMut shows impaired loans metrics that rank well among peers, with a coverage ratio within average levels.

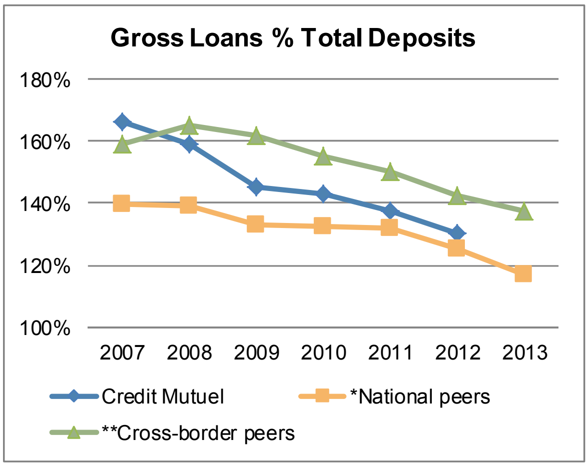
It is worth noting that Crédit Mutuel has been leading the French banks profitability pack together with BNP Paribas. This is due to a low cost of risks versus peers.

At an international level, we have positioned Crédit Mutuel as a domestic pure play, together with banks such as Lloyds, Rabobank and Intesa.

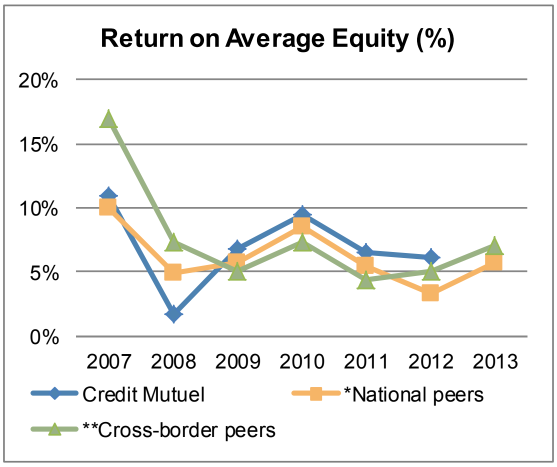
Considering the high quality of CMut's balance sheet, it is not surprising to see the bank significantly outperform European peers. Even on the loans-to-deposits ratio, which was the problematic metric of the bank, CMut is best in class among European peers in 2012 (despite the standards of the peer group on this particular ratio not being particularly high). The asset quality metrics are also good. As for leverage, at 5.6% in 2013, we believe the bank to be extremely well-positioned.

Overall, we find the financial fundamentals of Crédit Mutuel quite solid, but we are worried by the evolving governance of the group, which we consider far from satisfactory.

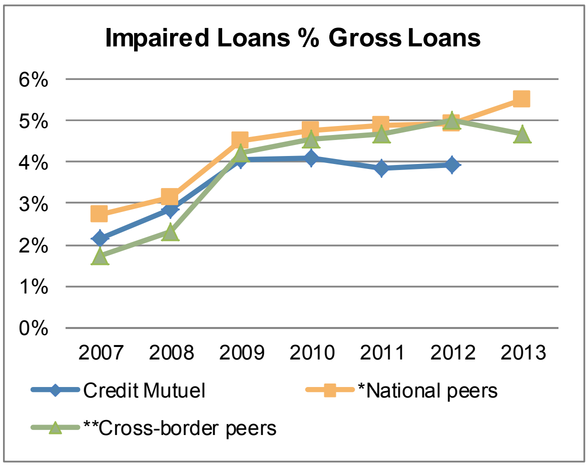
Peer Comparison - Credit Mutuel Group



Source: SNL Financial, Scope Ratings



Source: SNL Financial, Scope Ratings



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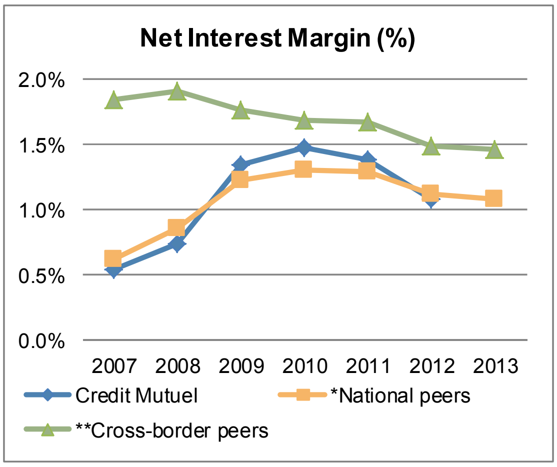
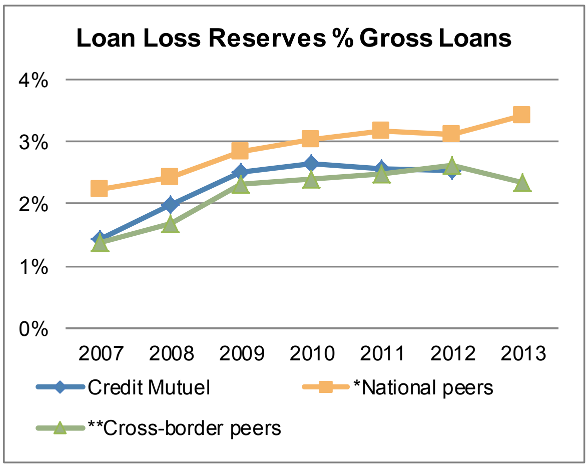
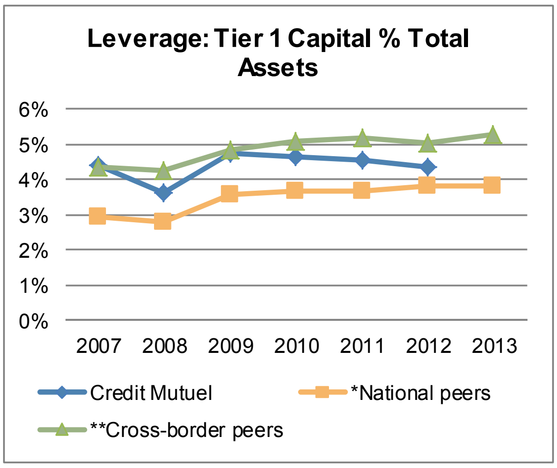


Source: SNL Financial, Scope Ratings



Source: SNL Financial, Scope Ratings



Source: SNL Financial, Scope Ratings

*National peers: BNP Paribas, Credit Agricole Group, Credit Mutuel Group, Groupe BCPE, Societe Generale
**Cross-border peers: Groupe BPCE, Credit Mutuel Group, Intesa, DNB ASA, Credit Agricole Group, CaixaBank, Sw edbank, Lloyds Banking group, Wells Fargo & Co., Rabobank Group

Notes: Cross-border peer group excludes Credit Mutuel Group in 2013 as w ell as Intesa for the Net Interest Margin and the Return on Average Equity. We use H1 2013 numbers as a 2013 proxy for Intesa on all other ratios.

Selected Financial Information - Credit Mutuel Group

	2007	2008	2009	2010	2011	2012	2013	2014E	2015E
Balance Sheet summary (EUR billion)									
Assets									
Cash and balances with central banks	8.3	18.1	10.7	8.7	8.6	16.3	n/a	n/a	n/a
Interbank assets	49.9	48.7	44.3	47.5	46.8	59.6	n/a	n/a	n/a
Total securities	179.7	158.8	164.4	165.4	161.6	167.8	n/a	n/a	n/a
of which debt instruments	145.7	132.4	130.0	131.1	128.2	131.2	n/a	n/a	n/a
of which equity instruments	32.6	25.3	34.4	34.2	33.3	36.6	n/a	n/a	n/a
Derivatives	9.8	13.8	6.4	4.0	5.3	6.7	n/a	n/a	n/a
Gross customer loans	288.5	314.2	327.8	340.6	354.5	362.8	n/a	n/a	n/a
of which impaired loans	6.3	9.0	13.3	14.0	13.7	14.3	n/a	n/a	n/a
Total funded assets	543.1	566.4	569.9	584.7	598.3	638.9	n/a	n/a	n/a
Total Assets	**553.3**	**581.7**	**579.0**	**591.3**	**605.2**	**645.2**	**n/a**	**n/a**	**n/a**
Liabilities									
Interbank liabilities	86.5	84.9	67.3	54.1	56.8	50.6	n/a	n/a	n/a
Senior debt	134.1	138.2	121.4	126.3	119.7	123.7	n/a	n/a	n/a
Derivatives	10.2	15.4	9.2	6.6	6.9	6.3	n/a	n/a	n/a
Customer deposits	173.3	197.6	225.7	238.6	258.3	278.0	n/a	n/a	n/a
Subordinated debt + hybrid securities	6.5	8.6	7.4	8.1	7.4	6.7	n/a	n/a	n/a
Total Liabilities	**526.4**	**556.7**	**548.4**	**557.9**	**570.8**	**606.8**	**n/a**	**n/a**	**n/a**
Ordinary equity	26.4	24.7	29.6	32.3	33.4	37.4	n/a	n/a	n/a
Minority interests	0.4	0.4	1.0	1.1	1.0	1.0	n/a	n/a	n/a
Total Liabilities and Equity	**553.3**	**581.7**	**579.0**	**591.3**	**605.2**	**645.2**	**n/a**	**n/a**	**n/a**
Core Tier 1 Capital [1]	*24.4*	*21.1*	*24.8*	*24.9*	*25.2*	*25.3*	*n/a*	*n/a*	*n/a*
Income Statement summary (EUR billion)									
Net interest income	2.7	4.0	7.4	8.2	7.8	6.3		n/a	n/a
Net fee & commission income	2.7	2.6	3.3	3.6	3.4	3.3		n/a	n/a
Net trading income	2.7	0.1	0.5	0.2	-0.2	1.2		n/a	n/a
Operating Income	**10.6**	**9.0**	**13.6**	**14.8**	**14.1**	**14.4**	**15.3**	**n/a**	**n/a**
Operating expenses	6.5	6.7	8.4	8.9	9.0	9.6	9.7	n/a	n/a
Loan loss provision charges	0.2	1.9	2.4	1.6	1.8	1.2	1.4	n/a	n/a
Non-recurring items	0.0	0.0	0.0	0.0	0.1	0.0	0.0	n/a	n/a
Pre-Tax Profit	**3.9**	**0.4**	**2.7**	**4.2**	**3.4**	**3.5**	**4.2**	**n/a**	**n/a**
Income tax	1.1	0.0	0.9	1.1	1.1	1.3	1.5	n/a	n/a
Net profit attributable to minority interests	0.1	0.0	0.1	0.1	0.1	0.1	0.1	n/a	n/a
Net Income Attributable to Parent	**2.7**	**0.4**	**1.8**	**2.9**	**2.1**	**2.2**	**2.7**	**n/a**	**n/a**

Source: SNL Financial and Scope Ratings for historical figures. Scope's forecasts are based on publicly available information. Please refer to "Methodologies Used for this Report" for further details.
[1] CRD 4 basis from 2012 onwards

Ratios - Credit Mutuel Group

	2007	2008	2009	2010	2011	2012	2013	2014E	2015E
Funding/Liquidity									
Gross loans % Total deposits	166.4%	159.0%	145.3%	142.8%	137.3%	130.5%	n/a	n/a	n/a
Total deposits % Total funds	43.3%	46.0%	53.5%	55.9%	58.4%	60.6%	n/a	n/a	n/a
Wholesale funds % Total funds	56.7%	54.0%	46.5%	44.1%	41.6%	39.4%	n/a	n/a	n/a
Asset Mix, Quality and Growth									
Gross loans % Funded assets	53.1%	55.5%	57.5%	58.3%	59.2%	56.8%	n/a	n/a	n/a
Impaired loans % Gross loans	2.2%	2.9%	4.0%	4.1%	3.9%	4.0%	n/a	n/a	n/a
Loan loss reserves % Impaired loans	65.7%	69.1%	62.2%	64.6%	66.1%	64.4%	n/a	n/a	n/a
Gross loan growth (%)	28.0%	8.9%	4.3%	3.9%	4.1%	2.3%	n/a	n/a	n/a
Impaired loan growth (%)	-3.8%	43.6%	47.7%	5.6%	-2.1%	4.5%	n/a	n/a	n/a
Funded assets growth (%)	14.0%	4.3%	0.6%	2.6%	2.3%	6.8%	n/a	n/a	n/a
Earnings									
Net interest income % Revenues	25.3%	44.3%	54.2%	55.3%	55.0%	44.1%			
Fees & commissions % Revenues	25.4%	29.2%	24.5%	24.3%	23.8%	22.8%			
Trading income % Revenues	25.9%	1.1%	3.9%	1.5%	-1.2%	8.1%			
Other income % Revenues	23.4%	25.4%	17.4%	19.0%	22.4%	25.0%			
Net interest margin (%)	0.6%	0.8%	1.5%	1.6%	1.5%	1.2%			
Pre-provision Income % Risk-weighted assets (RWAs)	2.4%	1.1%	2.5%	2.8%	2.4%	2.5%	n/a	n/a	n/a
Loan loss provision charges % Pre-provision income	5.2%	83.1%	45.8%	27.9%	35.4%	25.7%	n/a	n/a	n/a
Loan loss provision charges % Gross loans (cost of risk)	0.1%	0.6%	0.8%	0.5%	0.5%	0.3%	n/a	n/a	n/a
Cost income ratio (%)	61.3%	74.2%	61.3%	60.5%	64.0%	66.9%	n/a	n/a	n/a
Net Interest Income / Loan loss charges (x)	12.5	2.1	3.1	5.0	4.3	5.2			
Return on average equity (ROAE) (%)	10.8%	1.7%	6.7%	9.4%	6.5%	6.1%	n/a	n/a	n/a
Return on average funded assets (%)	0.3%	0.1%	0.2%	0.3%	0.2%	0.2%	n/a	n/a	n/a
Retained earnings % Prior year's book equity	11.4%	1.7%	7.4%	9.8%	6.6%	6.4%	n/a	n/a	n/a
Pre-tax return on common equity tier 1 capital	4.7%	-0.2%	3.5%	4.6%	4.5%	5.2%	n/a	n/a	n/a
Capital and Risk Protection [1]									
Common equity tier 1 ratio (common equity tier 1 capital % RWAs)	14.0%	10.5%	11.7%	12.1%	12.0%	12.0%	14.2%	n/a	n/a
Tier 1 leverage ratio (%)	4.4%	3.6%	4.7%	4.7%	4.6%	4.3%	5.6%		
Median of tier 1 leverage ratio and common equity tier 1 ratio (%)	9.2%	7.0%	8.2%	8.4%	8.3%	8.2%	9.9%		
Total loss coverage (CET 1 capital + loan loss provisions) % RWAs	16.4%	13.5%	15.6%	16.5%	16.3%	17.9%	n/a	n/a	n/a
Non-senior bailinable debt cushion (as % of total liabilities)	1.2%	1.5%	1.3%	1.5%	1.3%	1.1%	n/a	n/a	n/a
Asset risk intensity (RWAs % total assets)	31.4%	34.7%	36.6%	34.7%	34.8%	30.0%	n/a	n/a	n/a

Source: SNL Financial and Scope Ratings for historical figures. Scope's forecasts are based on publicly available information. Please refer to "Methodologies Used for this Report" for further details.
[1] CRD 4 basis from 2012 onwards

METHODOLOGIES USED FOR THIS REPORT

For the rating and analysis contents of this report, Scope has used the following methodologies which were published on www.scoperatings.com:

"Bank Rating Methodology" (February 2014)

"Forecasting Bank Financials Methodology" (February 2014)

Forecasting bank financials: Forward-looking estimates are an important analytical tool underpinning Scope's bank ratings. These forecasts cover the current financial year (before final year-end figures are published by the bank) plus the forthcoming two years. Depending on the complexity of the bank being assessed, different forecasting tools will be used. For a majority of banks operating primarily commercial and retail banking franchises (loans and deposits) the analysis is underpinned by an **accounting** forecast of the balance sheet and profit and loss account. For more complex groups with multiple ranges of activities – notably those with material wholesale and investment banking operations – Scope uses an **analytical** forecast, relying on the bank's business-line reporting to come up with plausible estimates. For all banks Scope also includes a **regulatory metrics** forecast, considering the growing importance of this aspect in bank analysis.

For complex banks, divisional data is used to forecast profit and loss accounts and basic divisional balance sheet metrics. For less complex banks, a line-by-line forecasting of major P&L elements is forecast.

For balance sheet forecasts, Scope estimates of all major balance sheet lines, using the P&L estimates to complete the forecast of the capital/shareholders' equity line. This comprehensive methodology for estimating the balance sheet is used for all the banks in our universe, irrespective of size and complexity.

Lastly, our forecasts include assessments of the major regulatory metrics: Tier 1 and CET 1 (historically CT1), Leverage, Liquidity Coverage Ratio, and Net Stable Funding Ratio (the latter two when and if sufficient public information to compute them is available).

Scope will not aim to forecast financials when it considers the public disclosure of the bank as insufficient for a transparent and credible outcome.

All Scope's bank financial forecasts are based on public information. For its forecasts Scope will not use any non-public information or data, even if such information or data were provided by rated banks. Scope's forecasting process is transparent, with a detailed roadmap provided in its *"Forecasting bank financials"* methodology.

Credit Suisse AG
Issuer Rating Report

SCOPE A+ NEGATIVE OUTLOOK
Financial Institutions

Overview

Scope Ratings assigns Credit Suisse AG an Issuer Credit-Strength Rating (ICSR) of A+ with a negative outlook, and a short-term debt rating of S-1 with a stable outlook. These ratings reflect the bank's successful restructuring as well as its well-balanced business model. The ratings also reflect the fact that leverage remains more elevated compared to domestic and international peers. The negative outlook follows the recently-announced settlement regarding all US cross-border matters. Scope will monitor the consequence of a guilty plea on the reputation of the bank, on the evolving behavior of its counterparties, and ultimately on its overall franchise. The A+ and S-1 ratings apply to senior unsecured debt issued by Credit Suisse AG. However, the ratings are not applicable to unguaranteed debt issued by subsidiaries of Credit Suisse AG.

On June 24, 2014 Scope Ratings assigned long-term ratings of A+ with Negative outlook and a short-term rating of S-1 with Stable outlook to Credit Suisse Group AG, which is the holding company of Credit Suisse AG. In rating the holding company at the same level as the operating bank, Scope pointed at the highly integrated structure of the Credit Suisse Group, financially, operationally and strategically. To support its rating action and explain the analytical rationale behind it Scope has published a detailed report on Credit Suisse Group AG, which supplements this issuer report.

Issuer Credit-Strength Rating	**A+**
Outlook	Negative
Senior unsecured debt	A+
Short term debt rating (May 22, 2014)	S-1
Short term debt rating outlook	Stable

Unsolicited ratings with issuer participation.

Lead Analyst

Jacques-Henri Gaulard
j-h.gaulard@scoperatings.com

Team Leader

Sam Theodore
s.theodore@scoperatings.com

Rating drivers (Summary)

The rating drivers, in decreasing order of importance in the rating assignment, are:

- (+) The very resilient private banking and wealth management division is proving to be a highly efficient cash cow throughout the cycle.
- (+) The successful redeployment of the investment bank has reduced risk and volatility.
- (−) The bank's Tier 1 leverage ratio remains decidedly lower than peers, despite a strong improvement in risk-weighted metrics.
- (+) A strong management team, which has helped the bank weather the crisis and has been successfully renewed over the years.
- (+) The weight of two very thorough and proactive public authorities (SNB and FINMA) in the field of financial stability and bank supervision in Switzerland.

Rating change drivers

Beware too much restructuring. To date, Credit Suisse has successfully managed to reduce the absolute size of its investment bank without harming its franchise or profitability. However, the recently announced build-up of two non-strategic units (one in the Private Banking & Wealth Management division (PBWM), the other in the Investment Bank (IB)) could at some point begin to damage the franchise of Credit Suisse. So far, we believe that the restructuring of the Rates business away from non-Basel 3 compliant and capital intensive positions, together with the decision of CS Group to exit 83 countries to rationalize its private banking setup, has proven successful. Nevertheless, further pressure from shareholders for supplementary cuts could, in our view, harm the bank and the proper functioning of its integrated model.

The recent success of CS Group's Private Banking business is associated more with the efficiency gains made by combining the asset management and the private bank and integrating Clariden Leu than with significant asset and revenue growth. For too long, CS Group's strategy in Wealth Management has been limited to waiting for interest rates to increase and for the Swiss franc to weaken. We believe that between H2 2009 and 2011, the bank lost much of the momentum it had gained during the crisis years. In our view, any initiative enabling CS Group to reposition the Private Bank towards higher growth clients and geographies would be positive for the stability of the bank's cash generation.

The settlement of the US cross-border matters has led Credit Suisse AG to plead guilty to one count of conspiracy. The impact of this plea on the counterparts and clients of Credit Suisse is still largely unknown, even if the bank has been very reassuring that there had been no material impact on the business at this stage. Our view on this matter underpins the negative outlook on Credit Suisse's long-term ratings.

Recent events

On April 16 Credit Suisse reported a very solid set of Q1 2014 numbers. Particularly encouraging were the CHF 10.6bn net new money flow numbers in the Wealth Management Clients (WMC) business, representing a net new asset growth rate of 5%. This represents more than half of the total net new assets reported by WMC for the whole of 2013. Private Banking margins remain stable at 104bps (versus Q4 2013) due the persistently negative impact of a low interest rates environment. However, thanks to significant efficiency gains, the cost-income ratio of WMC fell eight percentage points YoY. As a result of a positive operating leverage, the pre-tax profits of WMC were up 27% YoY.

Considering the poor operating environment, the results of the Investment Banking (IB) business are satisfactory. To be sure, fixed-income sales and trading revenues are down 25% YoY but strong performance from the rest of the business means that total IB revenues are down 13% only YoY. The continuous restructuring of this business has successfully contributed, in our view, to reduce the volatility of Credit Suisse's revenues. IB pre-tax profits are down more sharply YoY (-36%) but this largely reflects a new way of booking compensation (through lower deferrals and a more important reliance on full-year estimated profits – rather than on an estimated bonus pool).

The look-through Basel 3 CET1 ratio of Credit Suisse has remained flat QoQ, at 10%. This is due to operational risk add-ons and model changes. We estimate that these must have cost the bank more than 50bps of CET1 in the course of the quarter. Underlying "business-driven" RWAs were flat QoQ. Credit Suisse's Tier 1 leverage ratio increased 20bps quarter-on-quarter to 3.2%, but remains low versus international peers.

On May 20, Credit Suisse announced a comprehensive and final settlement regarding all outstanding US cross-border matters. On top of the guilty plea we mention above, Credit Suisse agreed to pay USD 2.815bn (or CHF 2.510bn). The bank had already provisioned around CHF 895m on this matter in its accounts, which means that net of existing provisions, Credit Suisse will have to recognize an after-tax charge of CHF 1,598m, to be booked in the second quarter of 2014. If the charge arising from the settlement had been applied at the end of Q1 2014, the look-through Basel 3 CET1 ratio of Credit Suisse would have been 9.3% instead of 10%. The bank intends to reduce its RWAs to or below the level of YE 2013 as well as take other capital actions, including the sale of surplus real-estate and other non-core assets. These measures alone should be enough to take Credit Suisse's CET1 ratio back to 10% by YE 2014. The company makes no reference to the leverage ratio, but we estimate that with the CHF 1.6bn charge, the leverage ratio of CS would decline from 3.21% to 3.07%.

Credit Suisse Group AG rating rationale

On June 24, 2014 Scope Ratings assigned long-term ratings of A+ with Negative outlook and a short-term rating of S-1 with Stable outlook to Credit Suisse Group AG, which is the holding company of Credit Suisse AG. In its bank rating methodology, Scope indicates that [it] "may potentially rate the Holding Company (HC) [of a banking group] at the same level it would rate the main operating bank. This will be the case as long as there are no grounds to estimate that, in a stress scenario, the creditors of the HC would be treated differently from the creditors of the operating bank".

Keeping in mind this methodological context, the rating of Credit Suisse Group AG is based on the following factors:

- Credit Suisse Group is a very integrated banking group with centralized treasury functions, where intra-group items play a large part in the funding and the capitalization of the group as a whole. As a result, we believe that the vast majority of Credit Suisse Group's consolidated capital is located at holding company level, offering a significant degree of protection for investors.
- Since the FINMA privileges the Single Point of Entry (or SPE) method of resolution, we believe that Credit Suisse Group AG will play an increasingly important part in the loss absorption capability of the group as a whole. Credit Suisse Group AG has already raised (or explicitly guaranteed) more than CHF 7.5bn of loss-absorbing capital instruments (versus CHF 3.75bn only for the bank). We estimate that by the end of the Basel 3 transition period (YE 2018) the vast majority of Credit Suisse's senior debt will be issued at Credit Suisse Group AG level and no more by Credit Suisse AG.
- The decreasing importance of Credit Suisse AG is likely to be compounded by the fact that a new Swiss legal entity will be created out of Credit Suisse AG's balance sheet. Considering the likelihood of ample deposit funding in this Swiss subsidiary, we believe that Credit Suisse AG will be slightly less operationally important for Credit Suisse as a whole than it used to be.
- More generally, we believe that the combination of Credit Suisse Group AG – Credit Suisse AG – Swiss legal subsidiary should be considered as a whole in the resolution process. Credit Suisse Group AG holds the vast majority of group capital (and soon a large portion of its bailinable debt), Credit Suisse AG hosts a large majority of the cash and the Swiss subsidiary hosts the deposit base (and also a very large and stable section of group profits). As a result, it is probable that in the unlikely case of resolution, these three Swiss-based entities would end up narrowly linked and considered as one by the regulator.

The rationale for the rating on Credit Suisse Group AG is explained in our research report "Credit Suisse Group AG: the last line of defence is also the better one" dated June 2014.

Rating drivers (Details)

1. The very resilient private banking and wealth management division is proving to be a highly efficient cash cow throughout the cycle

Over the years, Credit Suisse has benefitted from the reliability of a very solid private banking division, which has on average represented about 33%-35% of CS Group's pretax profit. Table 1 shows the main metrics of the division.

Table 1: Private Banking metrics – Credit Suisse

	2007	2008	2009	2010	2011	2012	2013	Q1 2014
Wealth management PTP (CHF m)	3,865	2,509	2,898	2,528	1,446	2,021	2,059	578
Net new money (CHF bn)	50.2	42.2	35.3	45.3	37.4	19.0	18.9	10.6
Gross margin (bps)	115	115	131	120	122	114	107	104

Source: Company data

The apparent volatility of the results is deceptive.

Despite a sharp fall in net profits, the division had to reposition the business in the context of:

1. Pronounced de-risking of the client base (around 28-30% of client assets have been invested in cash since 2010).
2. Retreat from Swiss-neighboring offshore markets (Germany, France, Italy) leading to pronounced outflows from these countries in 2012-2013.
3. Persistently low interest rates weighing on gross margins and a strong Swiss franc that penalized the P&L (as a large portion of revenues is labelled in USD while the bulk of the cost base is CHF-denominated).
4. Re-orientation of the business towards Ultra-High Net Worth Individuals (UHNWIs) and Asia-Pacific, which feature higher growth but lower margins than other sections of the franchise.
5. Restructuring of the international network leading to the closure of 83 offices in countries where Credit Suisse did not believe it had enough critical mass to service HNWIs profitably. This included the sale of the onshore German business to ABN AMRO.

As a result of the points above, the division's profitability reached a trough in 2011; even if it still accounted for one-third of the group's profits. However, the restructuring of the division – recently combined with the Asset Management IT platform – and the re-orientation of the franchise should soon bear fruit. Indeed, the profitability of Wealth Management improved again in 2012 and stabilized in 2013.

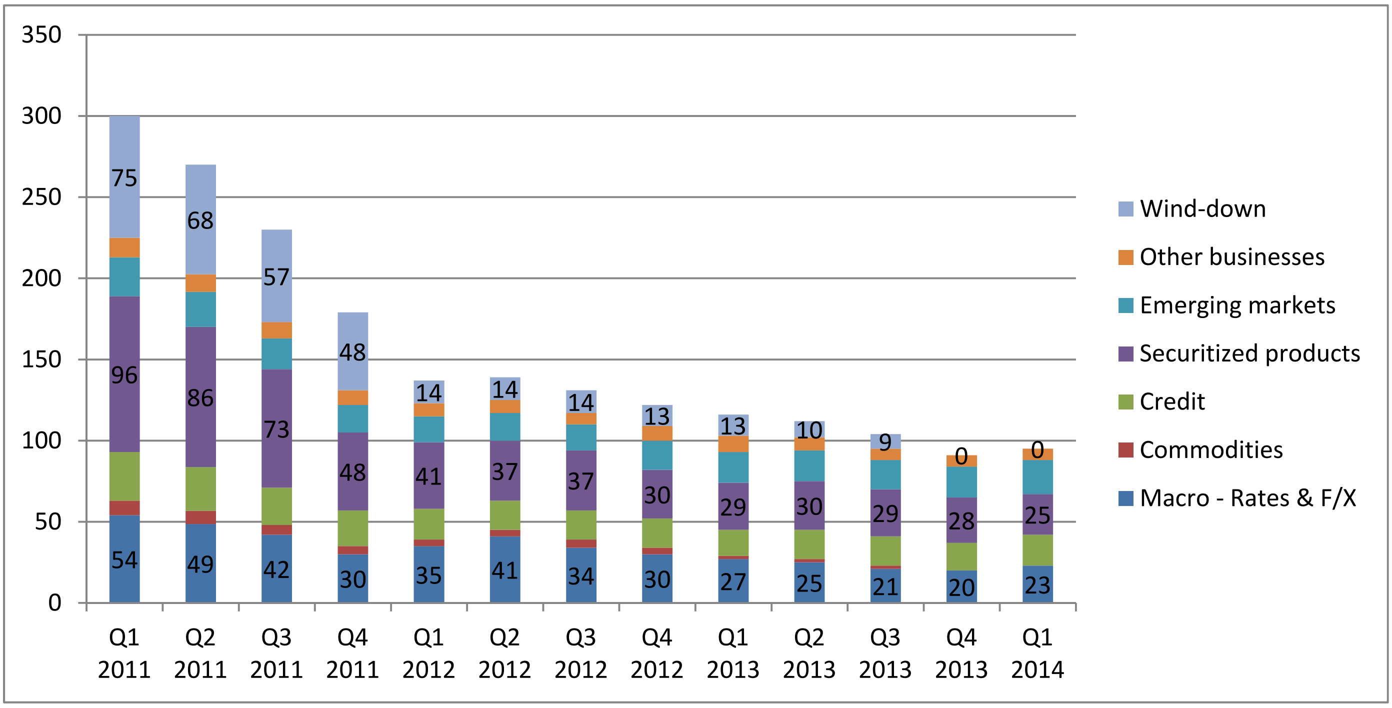
The Q1 2014 metrics are encouraging since, on top of the net new money growth mentioned above, the bank spent some time on its initiatives in the UHNWI market, in particular the lending business – significantly higher margin (100+bps) than the usual gross margin in this segment (around 50bps). In Q1 2014, Credit Suisse lent CHF 2.2bn to its UHNW clients, bringing the bank's loan outstanding to this client base to CHF 31bn.

2. The investment bank has been successfully redeployed without damage to the franchise

While some of its peers have deliberately taken an aggressive stance on reducing investment banking exposure, Credit Suisse has, in our view, been more cautious. Indeed, it is very difficult to assess the impact of too aggressive a reduction in a given business considering the hazards of such de-risking for integrated banks. CS has therefore taken a decisive, but measured approach to reducing its investment banking (IB) exposure, and we believe that so far it has been successful.

In pure capital generation terms, Chart 1 shows the magnitude of CS Group's efforts.

Chart 1: RWA reduction in the FICC business (USD bn)

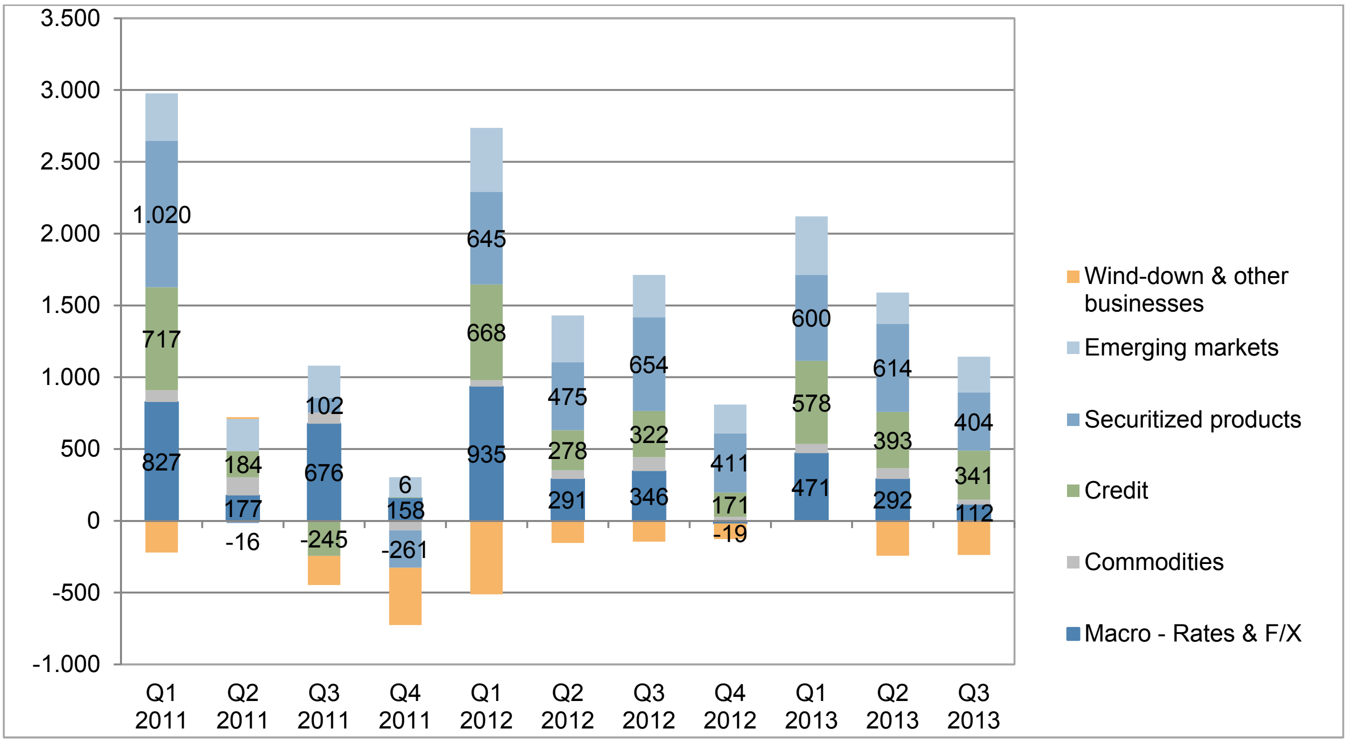


Source: Company data, Scope Ratings estimates

Based on our estimates, the RWAs of the investment bank's Fixed Income, Currency & Commodities (FICC) division dropped from USD 300bn in Q1 2011 to USD 95bn at the end of Q1 2014. This is a fall of more than two-thirds in three years. As seen on the chart, the bank has been extremely efficient in getting rid of its "wind-down" businesses, essentially consisting of long-dated, unsecured trades representing a reduction of USD 75bn until Q4 2013. The USD 71bn decline in securitized products' RWAs is also quite impressive, reflecting the bank's full exit from CMBS origination and a major reduction in RMBS inventories. Looking at this chart, it seems intuitively natural to think that the profitability of the FICC business would in fact fall. However, if anything, the revenue trends of the IB seem now less volatile than they used to be (Chart 2).

Looking at Chart 2, even a high-level examination shows that from Q2 2012 onwards the volatility of Credit Suisse's FICC results has abated significantly. Unsurprisingly, wind-down businesses report consistently negative revenues, but it is encouraging to see macro revenues (composed of global rates and forex) come under control. Over the six quarters between Q2 2012 and Q3 2013, macro revenues did not peak above USD 471m (in Q1 2013) – even if they still experienced one quarter of negative revenues in Q4 2012. Despite a very aggressive reduction in inventories, securitized products have demonstrated remarkably resilient revenues since Q1 2012, as has the credit business, much more under control. In this context, the last three quarterly results of the investment bank have shown progress on the stabilization of the IB franchise and the reduction of its volatility. This adds another layer of security in a rapidly de-risking business.

Chart 2: Revenue volatility of Credit Suisse's Fixed Income revenues (USD m)



Source: Company data, Scope Ratings estimates

Unfortunately, it is not possible to update the series on Chart 2 as the break-up of Credit Suisse between "strategic" and "non-strategic" businesses has rendered Q4 2013 and Q1 2014 comparisons with the above impossible. However, we believe that Chart 2 is a very good and recent example of the de-risking trends at Credit Suisse, which should be amplified by the transfer of the previous "wind-down" businesses to the non-strategic division of the investment bank.

3. The leverage ratio remains lower than peers

Since June 2012 and the announcement of its capital measures, Credit Suisse has accelerated the build-up of its capital base under Basel 3. As Table 2 demonstrates, the progress on the risk-weighted asset side has been spectacular.

Table 2: Swiss CET1 Basel 3 and leverage ratio of Credit Suisse (%)

	2011	2012	2013	Q1 2014
Common equity Tier 1 (%)	3.51%	6.69%	10.00%	10.00%
Tier 1 leverage ratio (%)	-	2.39%	2.96%	3.21%

Source: Scope Ratings estimates, Company data

Indeed, in less than two years the CET1 ratio of the bank has almost trebled, from 3.5% to 10%.

However, the Tier 1 leverage ratio (comprising all loss-absorbing capital) has remained somewhat weak at slightly above 3%, despite a 34% improvement since 2012. The bank cannot be criticized for not shedding assets in absolute terms. A quick look at the balance sheet and its pre-crisis levels shows that total US GAAP assets fell from a peak of CHF 1,360bn in 2007 to CHF 1,031bn in 2009 and CHF 873bn in 2013. However, the problem is that since CS reports under US GAAP and therefore uses netted positions for its derivatives, it has to account for considerable add-ons in its asset base when reporting its "exposure" (the denominator of the leverage ratio in Switzerland). Since the beginning of 2013, the total exposure number of Credit Suisse has decreased by less than 13%, at CHF 1,124bn in Q1 2014 (versus CHF 1,290bn as of Q1 2013). We reckon that retained earnings will help CS add 33bps to its leverage ratio by 2015. Taking into account CS's objective to bring the total exposure to CHF 1,000bn in the long-term could add another cumulative 44bps and almost raise the bank to a Tier 1 leverage ratio of 4%. However, this is unlikely to happen before 2015.

The leverage problem also raises the issue of the risk asset intensity of the bank. Under Basel 3, the ratio of RWAs to assets of CS Group stands at about 31% as of year-end 2013, which is considerably lower than international peers (using IFRS 7 to harmonize total assets definition between banks reporting under different accounting standards). This raises the issue of the bank's internal modelling and the appropriate calibration of risk by RWAs.

4. CS Group's management has successfully resisted the impact of the 2007-2008 financial crisis and has promoted a talented new generation of bankers

On the whole, CS Group's management team has remained stable over the last decade. This can be attributed to the fact that the bank did not have recourse to public money during the crisis, and was able to fund itself externally without too much difficulty. This in turn stems from the fact that between 2002 and 2005, CS Group faced its own crisis linked to the insurance company Winterthur, purchased by Credit Suisse in 1997. The disposal of the company in 2006 as well as an insightful de-risking of the investment bank prior to the 2007-2008 crisis protected the bank against a surfeit of financial woes and gave it the enviable status of "crisis winner" until the end of H1 2009. The bank's financial performance then sagged a bit until Q3 2011, at which point CS Group announced the redeployment of its strategy, shifting the Private Bank strategy towards UHNWIs and platform sharing with asset management. At the same time, CS Group started to exit capital-intensive and high-risk positions in its investment bank, particularly in Fixed Income.

The repositioning of the bank continued with the capital initiatives announced in July 2012. Even if these measures were directed by the Swiss National Bank (SNB, see below), they were very diligently executed and CS Group was able to exponentially increase its capital level in less than 18 months.

In the new phase of its restructuring disclosed in Q3 2013, CS announced the creation of two non-strategic units, one for the PBWM division and one for the IB. These units are purportedly not redirected to the corporate center, so as to secure the "experience and focus" of the divisional managers. The perimeter of these units does not strike us as too aggressive.

5. The weight of two very thorough and proactive public authorities (SNB and FINMA) in the field of financial stability and bank supervision in Switzerland

Following the financial crisis that brought another large bank to the brink of collapse, the Swiss financial authorities took steps to enhance the supervision of banks, in particular of the two large institutions that are critical in Switzerland as their banking assets represent five times the country's GDP. The respective prerogatives (and joint work) of the Swiss National Bank (SNB) and FINMA (Financial Regulator) are defined in the February 23, 2010 Memorandum of Understanding in the field of financial stability.

The following steps have been successfully taken since the crisis:

1. SNB and FINMA have managed to speedily insert Too Big To Fail (TBTF) and systematically-relevant specific legislation into the 1934 Banking Act and the 1972 Ordinance on banks. The most important conclusions of Basel 3 rules and their Swiss interpretation on minimum capital levels and liquidity as well as the recommendations of the Financial Stability Board (FSB) on TBTF have all been incorporated in the domestic regulation. For capital and liquidity, the Swiss Federal Council has written two specific ordinances (on June 1 and November 30, 2012) following and sometimes going beyond Basel 3 recommendations. All key measures have been in force since January 2013.
2. On top of this extensive legislative effort, both SNB and FINMA have maintained a very close monitoring of the two large systemically-relevant banks and have taken action when they perceived that they needed to strengthen some aspects of their financial fundamentals.

In the case of Credit Suisse, the SNB had been very public and very vocal in its June 2012 stability report. In a rather unusual move that started in the executive summary of the report, the SNB recommended that “Credit Suisse significantly expand its loss-absorbing capital during the current year”. This recommendation was repeated five more times in the course of a 24-page report. This proved effective as less than a month later Credit Suisse announced its CHF 15.3bn capital restructuring plan.

Peer comparison

At Scope ratings, we compare banks within peer groups at domestic and cross-border levels.

Of the banks rated by Scope, Credit Suisse can only be compared to UBS in Switzerland. Since both banks are part of the same global peer group of large universal banks operating in varied markets, we do not feel we have to focus specifically on the domestic comparison.

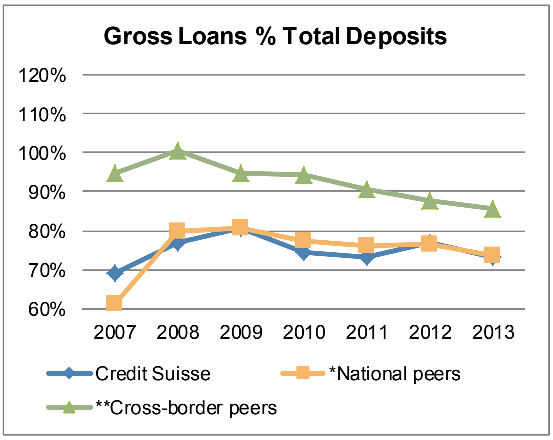
We will therefore focus on the global peer group including BNP Paribas, Société Générale, HSBC, Barclays, Deutsche and UBS plus Citigroup, Bank of America and JP Morgan in the United States.

Overall, we find Credit Suisse’s positioning solid, starting with a much fitter balance sheet than several years ago, particularly in light of the changes the bank underwent over the years. First, the bank reduced its total assets by 36% between 2007 and 2013 in one of the very best performances of its peers, even if the US GAAP total assets do not include the add-ons requested by the FINMA for the calculation of the leverage ratio.

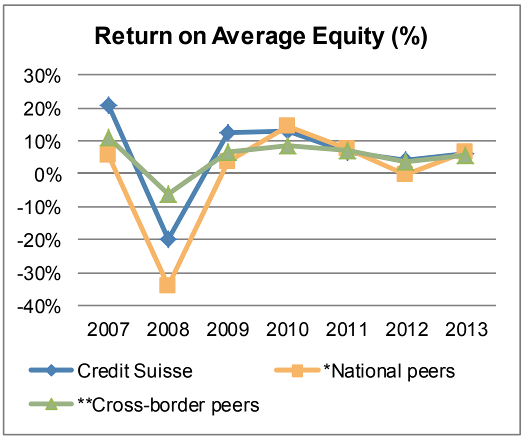
The liquidity of the bank also remains very satisfactory versus peers, with lower wholesale funding, increased deposits and still comfortable excess deposits versus loans. The asset quality metrics of CS are also sound and its performance is below par only with regards to cost metrics. But this is a phenomenon shared by the two large Swiss banks.

Lastly, even if prima facie the leverage ratio and the asset risk intensity of the bank look good, they are both flattered by the netting of derivatives. On a comparable basis and versus peers, Credit Suisse posts a weak leverage ratio and a low level of RWAs to assets. These metrics are the only serious concerns marring an otherwise satisfactory credit picture.

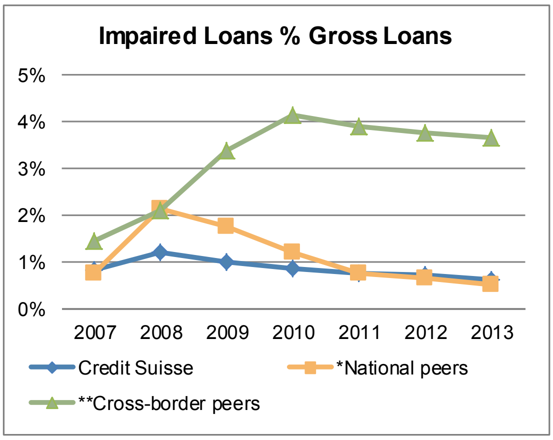
Peer Comparison - Credit Suisse Group



Source: SNL Financial, Scope Ratings



Source: SNL Financial, Scope Ratings



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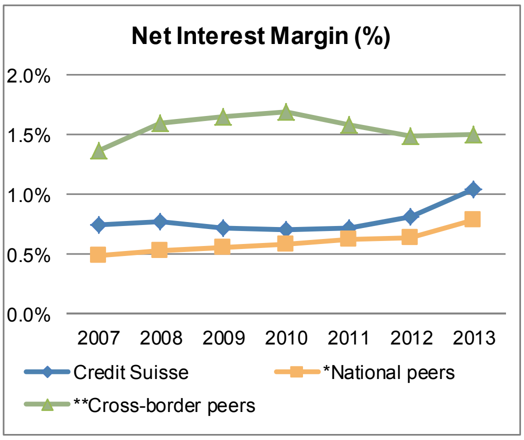

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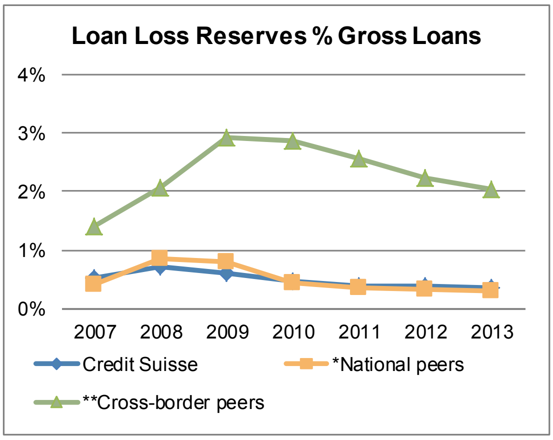
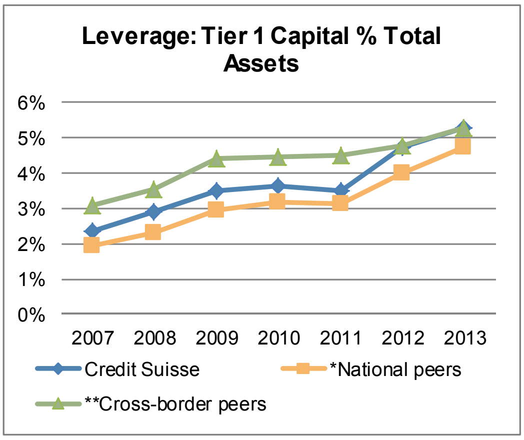


Source: SNL Financial, Scope Ratings



Source: SNL Financial, Scope Ratings

*National peers: Credit Suisse, UBS

**Cross-border peers: Bank of America Corp, Barclays, BNP Paribas, Citigroup Inc, Credit Suisse, Deutsche Bank, HSBC, JP Morgan Chase, Societe Generale, UBS

Selected Financial Information - Credit Suisse Group

	2007	2008	2009	2010	2011	2012	2013	2014E	2015E
Balance Sheet summary (CHF billion)									
Assets									
Cash and balances with central banks	38.5	90.0	51.9	65.5	110.6	61.8	68.7	82.4	102.3
Interbank assets	13.4	10.3	9.1	7.0	7.6	7.5	5.7	5.7	5.7
Total securities	799.5	574.8	556.5	561.4	509.1	449.2	391.2	384.7	392.5
of which debt instruments	521.4	436.2	384.7	389.5	391.2	323.2	275.0	261.3	261.3
of which equity instruments	248.8	127.5	152.6	150.5	100.9	111.8	103.6	110.8	118.6
Derivatives	99.6	108.6	57.2	50.5	56.3	37.1	33.7	33.4	33.9
Gross customer loans	232.1	229.0	230.6	214.3	229.0	237.6	243.7	243.7	246.1
of which impaired loans	1.9	2.7	2.3	1.9	1.7	1.7	1.5	1.5	1.5
Total funded assets	1,281.5	1,075.5	973.7	972.9	987.0	883.6	835.9	841.9	871.0
Total Assets	**1,360.7**	**1,170.4**	**1,031.4**	**1,032.0**	**1,049.2**	**924.3**	**872.8**	**878.5**	**908.1**
Liabilities									
Interbank liabilities	90.9	58.2	36.2	37.5	40.1	31.0	23.1	23.1	23.1
Senior debt	461.4	379.4	334.1	340.6	341.2	281.8	223.3	223.3	245.6
Derivatives	79.2	94.8	57.7	59.1	62.1	40.7	36.9	36.5	37.2
Customer deposits	335.5	297.0	286.7	287.6	313.4	308.3	333.1	339.8	346.5
Subordinated debt + hybrid securities	18.5	25.6	24.6	23.2	24.2	17.7	21.0	18.9	17.0
Total Liabilities	**1,300.8**	**1,123.1**	**983.1**	**989.0**	**1,008.1**	**882.0**	**825.6**	**829.6**	**857.3**
Ordinary equity	43.2	32.3	37.5	33.3	33.7	35.5	42.2	43.9	45.8
Minority interests	16.6	14.9	10.8	9.7	7.4	6.8	5.0	5.0	5.0
Total Liabilities and Equity	**1,360.7**	**1,170.4**	**1,031.4**	**1,032.0**	**1,049.2**	**924.3**	**872.8**	**878.5**	**908.1**
Core Tier 1 Capital [1]	*30.1*	*22.5*	*24.0*	*26.6*	*13.0*	*19.0*	*26.6*	*28.3*	*30.3*
Income Statement summary (CHF billion)									
Net interest income	8.4	8.5	6.9	6.5	6.4	7.2	8.1		
Net fee & commission income	16.5	12.5	11.8	11.9	11.0	11.3	11.5		
Net trading income	6.1	-9.9	12.2	9.3	5.0	1.2	2.7		
Operating Income	**36.9**	**7.0**	**31.3**	**29.2**	**24.2**	**22.2**	**24.1**	**26.7**	**27.9**
Operating expenses	22.9	20.8	22.7	21.8	20.5	19.8	19.8	20.7	21.3
Loan loss provision charges	0.2	0.8	0.5	-0.1	0.2	0.2	0.2	0.0	0.0
Non-recurring items	0.0	0.0	0.0	0.0	0.0	0.0	0.0	-0.9	-0.9
Pre-Tax Profit	**13.7**	**-15.4**	**8.2**	**7.5**	**3.5**	**2.2**	**4.2**	**5.1**	**5.7**
Income tax	1.2	-4.6	1.8	1.5	0.7	0.5	1.3	1.5	1.7
Net profit attributable to minority interests	4.7	-2.6	-0.3	0.8	0.8	0.3	0.6	0.8	0.9
Net Income Attributable to Parent	**7.8**	**-8.2**	**6.7**	**5.1**	**2.0**	**1.3**	**2.3**	**2.8**	**3.1**

Source: SNL Financial and Scope Ratings for historical figures. Scope's forecasts are based on publicly available information. Please refer to "Methodologies Used for this Report" for further details.
[1] Basel 3 basis from 2011 onwards

Ratios - Credit Suisse Group

	2007	2008	2009	2010	2011	2012	2013	2014E	2015E
Funding/Liquidity									
Gross loans % Total deposits	69.2%	77.1%	80.4%	74.5%	73.1%	77.1%	73.2%	71.7%	71.0%
Total deposits % Total funds	37.0%	39.1%	42.1%	41.7%	43.6%	48.3%	55.5%	56.2%	54.8%
Wholesale funds % Total funds	63.0%	60.9%	57.9%	58.3%	56.4%	51.7%	44.5%	43.8%	45.2%
Asset Mix, Quality and Growth									
Gross loans % Funded assets	18.1%	21.3%	23.7%	22.0%	23.2%	26.9%	29.2%	28.9%	28.3%
Impaired loans % Gross loans	0.8%	1.2%	1.0%	0.9%	0.8%	0.7%	0.6%	0.6%	0.6%
Loan loss reserves % Impaired loans	63.4%	60.1%	60.7%	54.6%	53.0%	53.3%	58.4%	58.4%	58.4%
Gross loan growth (%)	15.7%	-1.4%	0.7%	-7.1%	6.8%	3.8%	2.6%	0.0%	1.0%
Impaired loan growth (%)	-8.7%	40.0%	-15.7%	-18.9%	-7.8%	0.6%	-13.9%	0.0%	0.0%
Funded assets growth (%)	7.1%	-16.1%	-9.5%	-0.1%	1.5%	-10.5%	-5.4%	0.7%	3.4%
Earnings									
Net interest income % Revenues	22.9%	122.4%	22.0%	22.4%	26.5%	32.2%	33.6%		
Fees & commissions % Revenues	44.8%	179.5%	37.6%	40.8%	45.2%	50.9%	47.6%		
Trading income % Revenues	16.7%	-141.7%	38.8%	31.9%	20.7%	5.4%	11.4%		
Other income % Revenues	15.7%	-60.2%	1.6%	4.9%	7.5%	11.5%	7.4%		
Net interest margin (%)	1.1%	1.1%	1.0%	1.0%	0.9%	1.0%	1.3%		
Pre-provision Income % Risk-weighted assets (RWAs)	4.5%	-5.4%	3.9%	3.4%	1.5%	1.1%	1.6%	2.2%	2.4%
Loan loss provision charges % Pre-provision income	1.7%	-5.9%	5.9%	-1.1%	5.0%	7.2%	3.9%	0.0%	0.0%
Loan loss provision charges % Gross loans (cost of risk)	0.1%	0.4%	0.2%	0.0%	0.1%	0.1%	0.1%	0.0%	0.0%
Cost income ratio (%)	62.1%	298.6%	72.4%	74.6%	84.6%	89.3%	82.2%	77.5%	76.3%
Net Interest Income / Loan loss charges (x)	35.2	10.5	13.6	-82.8	34.4	42.1	48.6		
Return on average equity (ROAE) (%)	17.9%	-21.8%	19.3%	14.4%	5.8%	3.9%	6.0%	6.5%	7.0%
Return on average funded assets (%)	0.4%	-0.5%	0.4%	0.3%	0.1%	0.1%	0.2%	0.2%	0.2%
Retained earnings % Prior year's book equity	11.3%	-19.3%	13.6%	9.5%	2.1%	3.4%	3.4%	4.0%	4.5%
Pre-tax return on common equity tier 1 capital	45.6%	-68.4%	34.3%	28.0%	26.6%	11.5%	15.9%	18.1%	18.9%
Capital and Risk Protection [1]									
Common equity tier 1 ratio (common equity tier 1 capital % RWAs)	9.7%	8.8%	10.8%	12.2%	3.5%	6.7%	10.0%	10.6%	10.9%
Tier 1 leverage ratio (%)	2.5%	2.8%	3.1%	3.4%	3.7%	4.8%	3.9%		
Median of tier 1 leverage ratio and common equity tier 1 ratio (%)	6.1%	5.8%	7.0%	7.8%	3.6%	5.7%	7.0%		
Total loss coverage (CET 1 capital + loan loss provisions) % RWAs	10.0%	9.4%	11.5%	12.6%	5.8%	8.9%	10.3%	10.9%	11.2%
Non-senior bailinable debt cushion (as % of total liabilities)	1.4%	2.3%	2.5%	2.3%	2.4%	2.0%	2.5%	2.3%	2.0%
Asset risk intensity (RWAs % total assets)	22.9%	22.0%	21.5%	21.2%	23.0%	24.3%	30.5%	30.5%	30.5%

Source: SNL Financial and Scope Ratings for historical figures. Scope's forecasts are based on publicly available information. Please refer to "Methodologies Used for this Report" for further details.
[1] Basel 3 basis from 2011 onwards

METHODOLOGIES USED FOR THIS REPORT

For the rating and analysis contents of this report Scope, has used the following methodologies which were published on www.scoperatings.com:

"Bank Rating Methodology" (February 2014)

"Forecasting Bank Financials Methodology" (February 2014)

Forecasting bank financials: Forward-looking estimates are an important analytical tool underpinning Scope's bank ratings. These forecasts cover the current financial year (before final year-end figures are published by the bank) plus the forthcoming two years. Depending on the complexity of the bank being assessed, different forecasting tools will be used. For a majority of banks operating primarily commercial and retail banking franchises (loans and deposits) the analysis is underpinned by an **accounting** forecast of the balance sheet and profit and loss account. For more complex groups with multiple ranges of activities – notably those with material wholesale and investment banking operations – Scope uses an **analytical** forecast, relying on the bank's business-line reporting to come up with plausible estimates. For all banks Scope also includes a **regulatory metrics** forecast, considering the growing importance of this aspect in bank analysis.

For complex banks, divisional data is used to forecast profit and loss accounts and basic divisional balance sheet metrics. For less complex banks, a line-by-line forecasting of major P&L elements is forecast.

For balance sheet forecasts, Scope estimates of all major balance sheet lines, using the P&L estimates to complete the forecast of the capital/shareholders' equity line. This comprehensive methodology for estimating the balance sheet is used for all the banks in our universe, irrespective of size and complexity.

Lastly, our forecasts include assessments of the major regulatory metrics: Tier 1 and CET 1 (historically CT1), Leverage, Liquidity Coverage Ratio and Net Stable Funding Ratio (the latter two when and if sufficient public information to compute them is available).

Scope will not aim to forecast financials when it considers the public disclosure of the bank as insufficient for a transparent and credible outcome.

All Scope's bank financial forecasts are based on public information. For its forecasts Scope will not use any non-public information or data, even if such information or data were provided by rated banks. Scope's forecasting process is transparent, with a detailed roadmap provided in its *"Forecasting bank financials"* methodology.

Deutsche Bank AG
Issuer Rating Report

A- POSITIVE OUTLOOK
Financial Institutions

Overview

Scope Ratings assigns Deutsche Bank AG an Issuer Credit-Strength Rating (ICSR) of A- with a positive outlook, and a short-term debt rating of S-1 with a stable outlook. These ratings reflect the somewhat challenged business model of the company at a time when increased capital constraints and the US regulatory overhaul make it very costly for a "global universal bank" to operate as efficiently as before the crisis. To mitigate this factor, we acknowledge the improvement of the bank's earnings mix through the acquisition of Postbank between 2008 and 2010, as well as the cross-cycle resilience of the investment bank's revenue streams despite very difficult current operating conditions. The positive rating outlook is based on the significantly enhanced capital position of the bank following its recently-announced EUR 8bn capital raising.

The A- and S-1 ratings apply to senior unsecured debt issued by Deutsche Bank AG. However, the ratings are not applicable to unguaranteed debt issued by subsidiaries of Deutsche Bank AG.

Issuer Credit-Strength Rating (assigned on April 2, 2014)	**A-**
Outlook	Positive
Senior unsecured debt	A-
Short term debt rating (May 22, 2014)	S-1
Short term debt rating outlook	Stable
Unsolicited ratings with issuer participation.	

Lead Analyst

Jacques-Henri Gaulard
j-h.gaulard@scoperatings.com

Team Leader

Sam Theodore
s.theodore@scoperatings.com

Rating drivers (Summary)

The rating drivers, in decreasing order of importance in the rating assignment, are:

- (−) A somewhat challenged business model.
- (+) Despite recent market share erosion in a limited number of areas, the resilience of Deutsche's debt sales & trading revenues has been impressive.
- (+) The acquisition of Postbank has boosted the domestic retail component of Deutsche's earnings.

Rating change drivers

- Any strategic initiative aimed at strengthening the link between the investment bank and the other areas of the group would, in our view, increase the cohesion of the bank and therefore strengthen its business model. We are encouraged by some of the initiatives that have been announced with the capital raising, such as harmonizing the coverage of multinational corporations throughout the group

- Deutsche Bank has just announced an EUR 8bn capital raising exercise, which in our opinion should put to rest the market concerns on the capitalization level of the bank. Proforma core equity Tier 1 of 11.8% and CRD4/CR leverage ratio of 3.1% show a material improvement of capital metrics. Scope will analyze the extent to which the increased levels of capital enable Deutsche to evolve its business model without the fear of insufficient capital preventing the implementation of relevant strategic steps. Deutsche can seize these opportunities (1) in its core fixed income market (where a lot of European competitors have retrenched) and (2) in looking for closer integration in its different businesses.

Considering the recently-announced capital raising effort, it is not yet clear whether Deutsche Bank will pursue its EUR 250bn deleveraging program (of which EUR 134bn remain to be achieved by 2015). This program may be necessary to achieve the bank's 2015 3.5% leverage ratio target. As a result, if this program continues, it is difficult to predict the level at which the bank will be able to stabilize its fixed income margin (defined as Fixed Income, Currency & Commodities (FICC) revenues as a % total estimated FICC assets). Considering that fixed income revenues account for about 25% of Deutsche's group revenues, the bank's ability (or lack thereof) to maintain its fixed income margin on a sharply declining asset base could have a significant impact on the credit rating of the bank.

Recent events

Deutsche Bank announced good Q1 2014 considering the poor operating environment. The much-observed debt sales & trading revenues were down 10% year-on-year (-16% when restated from the special commodities group, transferred to the non-core unit in Q1 2014). Irrespective of the restatement, these trends compare well with international peers. Deutsche reported consolidated net attributable profits of EUR 1.1bn, down 34% on Q1 2013, despite revenues only being down 10% YoY. Overall firm revenues held up well but costs were only down 2% QoQ. Costs were inflated by (1) EUR 310m implementation costs to achieve the "Operational Excellence" (OpEx) efficiency program launched in 2012 and (2) the persistent surge in the cost of doing business triggered by increasing regulatory demands. Year-on-Year, Deutsche has increased compliance staff by 50 and has doubled compliance IT budget. Loan loss charges decreased by about 30% but from an already low level in Q1 2013, so this did little to move the dial.

On April 28 (the eve of Q1 results publication), Deutsche Bank announced its first CRD 4-compliant Additional Tier 1 capital issuance. The bank announced on May 20 that it finally raised EUR 3.5bn in aggregate. These AT1 notes take the form of participatory notes with temporary write-down at a trigger level of 5.125% phase-in Common Equity Tier 1 capital ratio. The AT1 Notes have been issued with attached warrants, excluding shareholders' pre-emptive rights. These warrants have been detached by a single subscriber and have no relevance for the AT1 investor.

Rating drivers (Details)

1. A somewhat challenged business model

Deutsche has acknowledged the fact that its chosen business model is facing challenges going forward, particularly in the next 12 to 15 months. Deutsche's co-CEO stated publicly in the recent past that "the most challenging business model is the one that Deutsche has adopted". Indubitably, being a global universal bank with a strong investment banking bias in a post-crisis world entails a lot of hurdles, commercial, financial and regulatory alike.

The challenges are expressed at three levels:

- Geographically: Speaking in pure investment banking terms, "being global" means being strong in the US. Indeed, the US investment banking fee pool remains the largest in the world: out of a global fee pool of close to USD 82.7bn as of December 31, 2013 (source: Thomson Reuters), the US represents 57% of the total, more than twice the total of Europe. As it happens, Deutsche has built a significant market position in US investment banking over the years, with a joint No. 1 position in US fixed income trading and a corresponding US market share of 10.9% as of September 30, 2013, down from 12.2% at year-end 2012 (source Greenwich Associates).

Protecting this US market share proved challenging as in February 2014 the Federal Reserve Board published final rules to strengthen the oversight of US operations of foreign banks. According to the Board, a foreign banking organization with USD 50bn or more in US non-branch assets will be required to organize its US subsidiaries under a single US intermediate holding company (IHC). These IHCs will be submitted to the same risk-based and leverage capital standards applicable to US bank holding companies. They will also have to meet enhanced liquidity requirements, conduct stress tests and hold a buffer of highly liquid assets.

In 2011, Deutsche's bank holding company in the US reported assets of USD 355bn as of December 31, 2011, shareholders' equity of USD 4.8bn and tangible equity of USD -0.6bn. The bank therefore needed to strengthen its capital base in the US, but it also had plenty of time to alter its US structure and make it compliant with regulation. According to the bank's CFO, Deutsche plans to reduce its balance sheet in the US from USD 400bn (as of year-end 2013) to USD 300bn, partly by reallocating some businesses away from the US, and partly by reducing the size of some operations. This is the case when part of the client base is not using the bank's other, more profitable offerings.

- By product: the second big challenge faced by Deutsche Bank with regard to its global model is the fact that the bank has built up and nurtured a dominant position in fixed income. The bank is number 1 in fixed income trading worldwide with a market share of 10% as of year-end 2013, down from 10.7% at year-end 2012 (source: Greenwich Associates). This is a commendable performance but we believe that two recent trends have challenged the sustainability of fixed income revenues. First, on the capital front: the capital necessary to sustain banks' securitization activities has increased with Basel 3. Combined with the capital necessary to maintain high inventory levels of fixed income products on-balance sheet, this has challenged the returns of FICC businesses globally. Second, the shift of OTC derivatives towards standardized clearing platforms is bound to negatively impact FICC margins. These market trends are obviously not specific to Deutsche Bank but they are critical for Deutsche considering its size in this business. We note that between 2012 and 2013, the market share of the largest two fixed income players globally (Deutsche and Barclays) has fallen from a combined 20.5% to 19.2% (source: Greenwich Associates).

- In integration terms: we also note that, unlike some other global universal banks, Deutsche has been late in launching a systematic "one bank" program as its Swiss or French peers have done. To be sure, the bank has taken note of these problems and announced in its Q3 2013 financial report an aligned and integrated commercial banking coverage for "Mittelstand" companies in Germany, through a joint-venture between the Global Transaction Banking (GTB) and the PCB (Private & Commercial Banking) divisions. The coverage of 11,500 German SMEs is to be transferred to this new joint venture. More needs to be done though and we believe that Deutsche can be even more specific with regard to the quantification of its cross-divisional synergies.

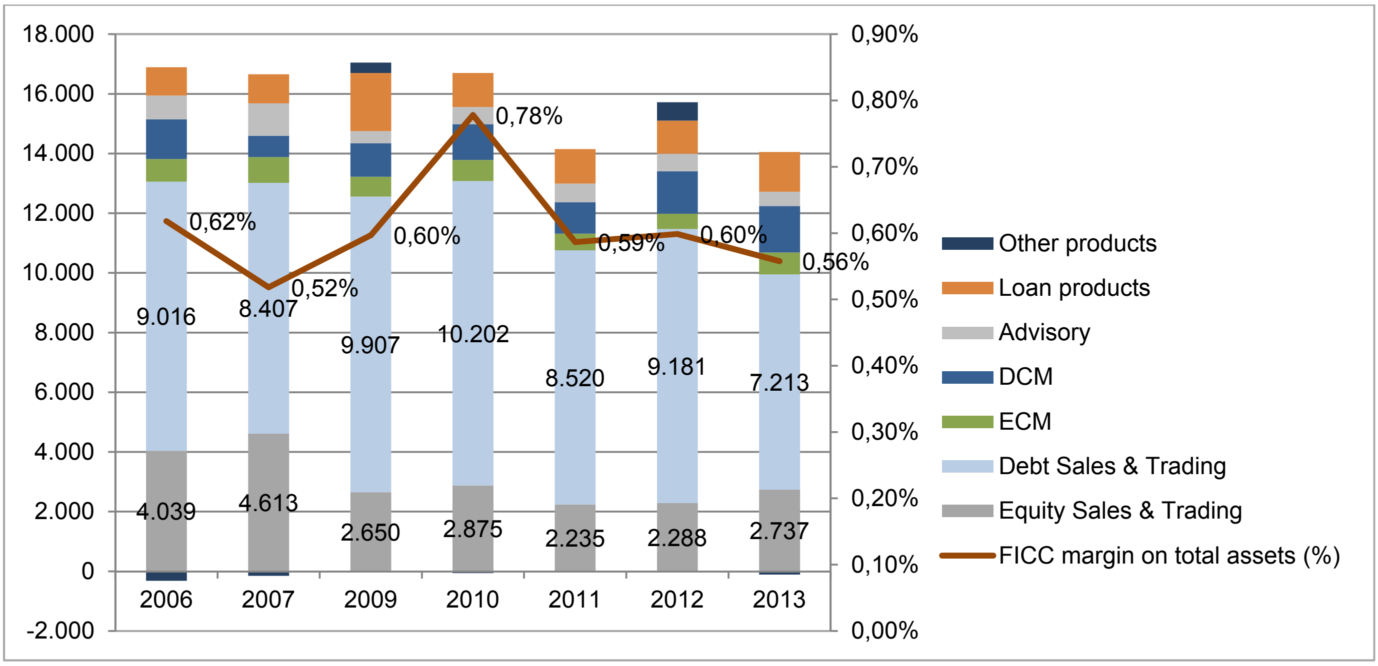
The uncertainty surrounding some divisions is also a concern. The AWM (Asset & Wealth Management) division has been a structural underperformer for years, to the point that Deutsche considered disposing of all the non-German parts of its Asset Management division in a thorough business review that lasted between November 2011 and June 2012. It seems that the inability of Deutsche to dispose of these businesses led the bank to rethink its strategy in order to reduce the number of low-margin mandates and focusing on Ultra High Net Worth Individuals (UHNWIs) – the latter being an extremely competitive market, in our view. Achieving lasting success in this division will be difficult: although 2013 was a record year based on pre-tax profits, this is partly due to the reallocation of the Corporate Banking & Securities (CB&S) passive third-party business to the AWM division back in 2012.

The last doubtful aspect about the business model lies in the fact that Deutsche seems to have taken some questionable decisions under pressure. To many market participants, Deutsche appeared to be a "crisis winner". The bank showed resilience and composure during the 2007-2008 financial crisis, it didn't tap government money, it gained market share and proved a very efficient consolidator through the purchase of Postbank between 2008 and 2010 to reinforce its stable cash generation. While initially Deutsche used this hard-earned status to expand its market share, the group changed strategy towards the beginning of Q2 2013. Deutsche announced (1) a EUR 3bn capital raising in April; and (2) an extensive EUR 250bn deleveraging exercise two months later. In its Q3 2013 results presentation the company communicated hat this deleveraging would generate a negative recurring pre-tax profit impact of EUR 450-500m per annum, and one-off costs of EUR 600m. However, we believe that to support a further EUR 134bn decline in assets while maintaining its gross fixed-income margin, the annual loss of FICC revenues could stand at another EUR 1bn from year-end 2013 levels, considering that between 2012 and 2013, a EUR 325bn fall in total CB&S assets corresponded to a drop in underlying FICC revenues of around EUR 2bn. It is unclear to us as to whether Deutsche will pursue its deleveraging program in light of its recent capital raising.

2. The investment banking earnings of Deutsche Bank have been remarkably resilient

Chart 1 demonstrates the resilience of Deutsche's investment banking revenues by sub-segment at two levels. We excluded 2008 in order to keep the scale of the chart readable, and we also excluded GTB from the picture to show only the theoretically most volatile parts of the investment bank.

Chart 1: The resilience of Deutsche's investment banking revenues 2006-2013 (excl. 2008) in EUR m and %



Source: Company data, Scope Ratings estimates

First, looking at the left axis, we note that between 2006 and 2013, there has been only an 18% difference between peak and trough Corporate Banking & Securities (CB&S) underlying revenues, despite quite volatile market conditions. Looking at the average revenues during the period, the peak (recorded in 2009) was only 8% higher than the average, while the 2013 trough was less than 12% below that average. Clearly the debt sales & trading business has been the main contributor to the bank's CB&S revenues and has helped the bank weather a structural decline in its equity trading revenues, triggered in part by the closure of Deutsche's equity prop desk at the end of 2008. This therefore raises the question of the sustainability of Deutsche's debt sales & trading revenues. The line graph scaled on the right side of the chart gives a mitigating answer: compared with total assets (including the gross present value of derivatives), Deutsche has mostly managed to maintain its gross FICC margin in a tight range comprised between 56bps and 62bps. 2007 and 2010 were the only trough and peak exceptions in what seems to have been a very resilient business. This was achieved while Deutsche's investment banking assets fell from EUR 1.79trn in 2007 to EUR 1.11trn in 2013 and is encouraging in light of the further planned balance sheet reduction. However, the mitigating part of the line graph on Chart 2 is that the 2013 FICC revenues have shown for the first time a clear correlation between balance sheet reduction and margin erosion, which was not the case between 2011 and 2012, when CB&S assets fell by EUR 117bn but FICC revenues increased by almost EUR 700m.

We have chosen not to update Chart 1 with Q1 2014 numbers simply because Fixed income revenues are very cyclically biased towards the beginning of the year, and therefore annualizing Q1 debt sales and trading revenues would lead to the wrong conclusion. However, assuming that Q1 2014 FICC revenues represent the same proportion of annual revenues as they did last year (37%), then estimated annual 2014 FICC revenues would stand at EUR 6.576bn, a 9% fall versus 2013 – but considering the fall in investment banking assets, the gross margin would stand at 0.59%, a 4bps increase on 2013. This early indicator on margin would be encouraging but at the same time the correlation between decreasing assets and decreasing revenues would be confirmed, However, we believe it is still too early in the year to draw firm conclusions on the profitability trends of the FICC business for 2014.

3. The Postbank acquisition has partially rebalanced Deutsche's earnings profile

Deutsche's acquisition of a majority stake in Postbank in 2010 was actually one of the last steps taken by the company to boost the stability of its earnings, although we have seen that the CB&S earnings were hardly in need of stabilization. It followed on the acquisition of norisbank and Berliner Bank in 2006, and the purchase in 2010 of a further 2.8% stake in Hua Xia, the 13th largest bank in continental China, bringing Deutsche's equity stake in the company to 19.9% (Deutsche had taken an initial 14% stake in 2005). In 2008, Deutsche Post sold 29.75% of its subsidiary Postbank to Deutsche Bank, and at the end of 2010 Deutsche Bank could fully consolidate Postbank with a stake of about 51%. Deutsche declared an ownership of 94.1% as of September 5, 2012. The acquisition enabled the Deutsche Bank-Postbank combination to become the undisputable Number 1 retail institution among private banks in Germany with a client base of 24 million, way above runner-up Commerzbank (11 million), but significantly below the leaders Sparkassen (combined client base of 50 million) and the cooperative banks (30 million).

Table 1 shows that while the acquisition of Postbank was a commercial success, it was not a total game changer for Deutsche's business mix.

Table 1: Deutsche Bank's revenue and pre-tax earnings mix 2006-2013

	2006	2007	2009	2010	2011	2012	2013
Retail revenues % Total	18%	19%	20%	19%	32%	28%	29%
Retail PTP % Total (ex CC and NCOU) [1]	13%	16%	11%	13%	30%	28%	29%
CB&S + GTB Revenues % total group revenues	67%	64%	71%	64%	52%	58%	55%
CB&S + GTB PTP % Group (ex CC and NCOU)	76%	71%	91%	79%	59%	69%	60%

[1] 2012 and 2013 numbers are restated from CtAs and PPAs.
Source: Company data, Scope Ratings estimates

To be clear, the table ignores the weight of the non core unit (NCOU) and of the corporate center (CC), to focus on the combined pre-tax profits and revenues of the four operating divisions: CB&S, GTB, AWM and PBC (Private & Business Clients, the divisional name of the retail business).

We have combined GTB and CB&S to be able to duplicate a typical “Corporate & Investment Bank” division at another bank. Indeed, around 74% of GTB’s revenues as of December 31, 2011 are composed of trade finance and cash management, which would typically be part of the responsibilities of a corporate bank at another institution.

Keeping this in mind, the weight of the retail bank experienced a quantum leap between 2010 and 2011, with retail revenues jumping from 19% to 32% of group revenues, while the weight of pre-tax profits would rise from 13% to 30% (while the PTP of the investment bank declined in the same period from 79% to 59%). The retail bank has broadly maintained this level of relative profitability since then, versus 60% for the combination of GTB and CB&S.

Peer comparison

At Scope ratings, we compare banks within peer groups at domestic and cross-border level.

Of the banks rated by Scope, Deutsche Bank can only be compared to Commerzbank in Germany and only limited valid conclusions can be drawn from the comparison of these two institutions, considering their different business models. However, the performance of their domestic retail businesses (if we include Commerzbank’s Mittelstandbank division in its Private Customers division) is broadly similar in profitability terms.

On a cross-border basis, we have included Deutsche in a peer group comprising BNP Paribas, Société Générale, HSBC, Barclays, UBS and Credit Suisse plus Citigroup, Bank of America and JP Morgan in the United States.

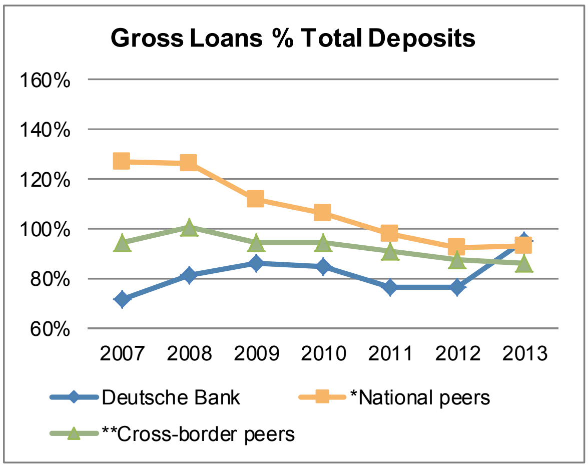
Traditionally, Deutsche Bank has compared itself with US peers rather than European peers. This reflected the importance of the investment bank in the bank’s mix as well as the willingness to succeed in US investment banking. Deutsche has been among the most successful European banks in this respect.

To a large extent, Deutsche has driven its own strategy by comparing itself with the US benchmark “crisis winner” of the peer group, JP Morgan. There is a point to make that the retail-driven acquisitions of 2006-2010 were intended to shift Deutsche’s earnings mix towards more stable businesses and to achieve a 40/60 earnings mix (60 representing CIB) similar to JP Morgan. This is also what drove the EUR 3bn capital increase last year, so that Deutsche could reach the benchmark CET1 ratio of 10%.

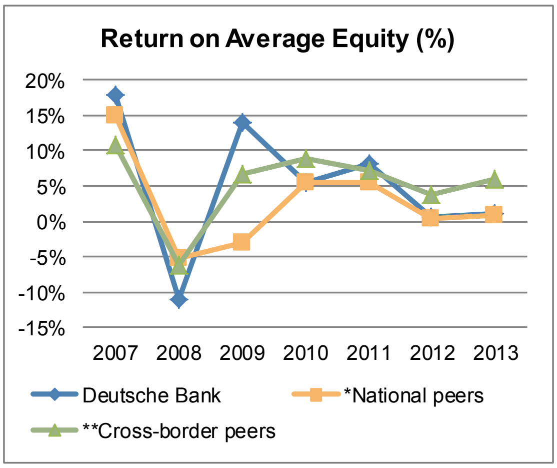
However, Deutsche cannot really rival its benchmark yet in terms of profitability, for example on ROE or the cost-income ratio. Deutsche also remains sub-standard in leverage terms. Much of this has to do with the fact that the JP Morgan’s US domestic commercial and retail business is far more profitable than the equivalent business of Deutsche, reflecting the structurally different nature of retail banking in Germany vs. the US.

Within Europe, competitors in France, Switzerland and the UK show better leverage metrics and – at the margin – better CET1 metrics. The bank’s profitability versus European peers is low and its cost-income ratio is also at the bottom quintile.

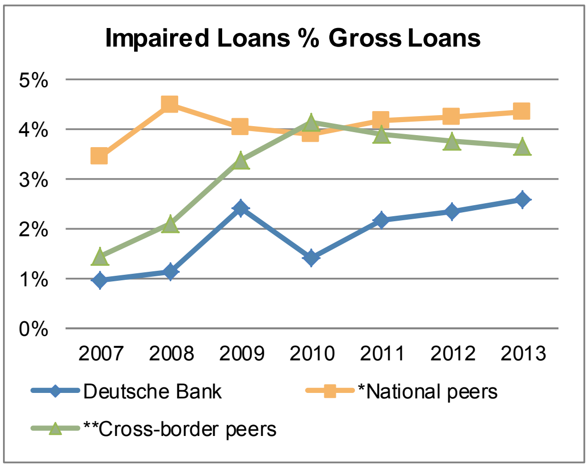
Peer Comparison - Deutsche Bank group



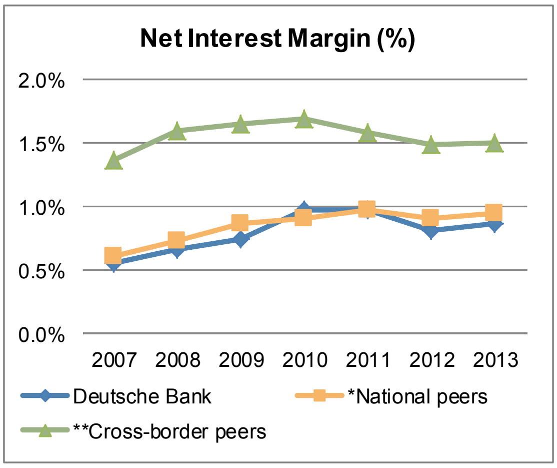
Source: SNL Financial, Scope Ratings



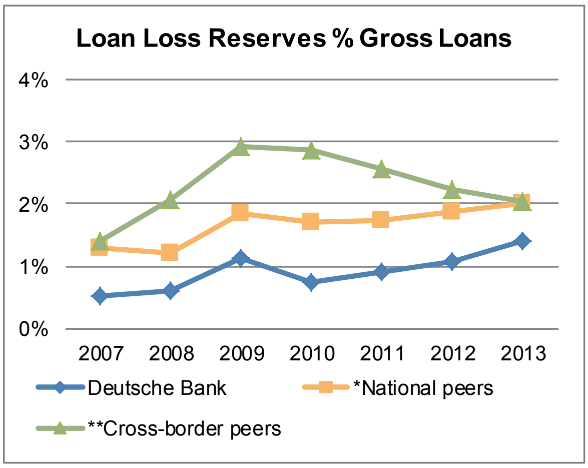
Source: SNL Financial, Scope Ratings



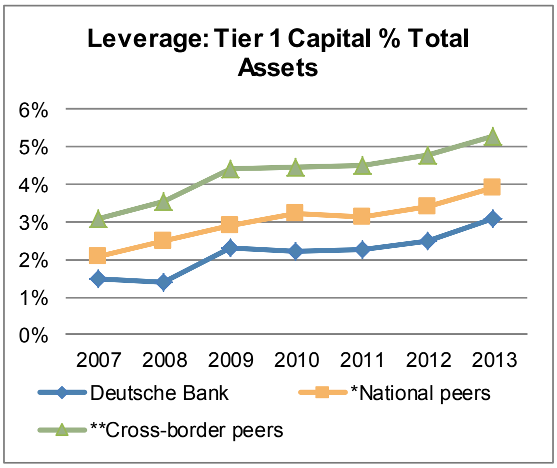
Source: SNL Financial, Scope Ratings



Source: SNL Financial, Scope Ratings



Source: SNL Financial, Scope Ratings



Source: SNL Financial, Scope Ratings

*National peers: Commerzbank, Deutsche Bank
**Cross-border peers: Bank of America Corp, Barclays, BNP Paribas, Citigroup Inc, Credit Suisse, Deutsche Bank, HSBC, JP Morgan Chase, Societe Generale, UBS

Selected Financial Information - Deutsche Bank group

	2007	2008	2009	2010	2011	2012	2013	2014E	2015E
Balance Sheet summary (EUR billion)									
Assets									
Cash and balances with central banks	8.6	9.8	9.3	17.2	15.9	27.9	17.2	430.4	413.6
Interbank assets	21.6	64.7	47.2	100.4	162.0	120.6	101.4	96.4	91.5
Total securities	1,181.8	417.1	402.2	498.1	478.4	512.6	455.7	23.3	22.1
of which debt instruments	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
of which equity instruments	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Derivatives	184.5	1,234.0	603.2	666.3	867.1	776.7	508.6	483.1	459.0
Gross customer loans	327.4	323.6	298.6	453.4	464.0	443.3	396.6	377.2	358.7
of which impaired loans	3.1	3.7	7.2	6.3	10.1	10.3	10.1	9.9	9.7
Total funded assets	1,411.5	1,016.1	919.9	1,251.8	1,320.5	1,265.9	1,127.4	1,075.5	1,026.4
Total Assets	**1,925.0**	**2,202.4**	**1,500.7**	**1,905.6**	**2,164.1**	**2,022.3**	**1,611.4**	**1,535.3**	**1,463.2**
Liabilities									
Interbank liabilities	0.0	0.0	0.0	0.0	0.0	0.0	114.2	108.5	103.0
Senior debt	704.3	385.5	349.2	442.5	433.4	376.6	317.0	301.2	286.1
Derivatives	513.5	1,186.3	580.8	653.8	843.6	756.3	484.0	459.8	436.8
Customer deposits	457.9	395.6	344.2	534.0	601.7	577.2	413.6	392.9	373.3
Subordinated debt + hybrid securities	14.5	17.9	18.2	24.6	19.8	20.9	19.5	18.5	17.6
Total Liabilities	**1,885.7**	**2,170.5**	**1,462.7**	**1,855.3**	**2,109.4**	**1,968.0**	**1,556.4**	**1,478.6**	**1,404.7**
Ordinary equity	37.9	30.7	36.6	48.8	53.4	54.0	54.7	56.5	58.3
Minority interests	1.4	1.2	1.3	1.5	1.3	0.2	0.2	0.2	0.2
Total Liabilities and Equity	**1,925.0**	**2,202.4**	**1,500.7**	**1,905.6**	**2,164.1**	**2,022.3**	**1,611.4**	**1,535.3**	**1,463.2**
Core Tier 1 Capital [1]	*22.7*	*21.5*	*23.8*	*30.0*	*36.3*	*31.3*	*34.0*	*35.8*	*37.6*
Income Statement summary (EUR billion)									
Net interest income	8.8	12.5	12.5	15.6	17.4	16.0	14.8		
Net fee & commission income	12.3	9.7	8.9	10.7	11.5	11.4	12.3		
Net trading income	8.2	-8.5	7.7	3.7	3.8	6.3	4.2		
Operating Income	**30.9**	**15.2**	**29.1**	**30.7**	**34.2**	**33.3**	**31.5**	**30.2**	**29.8**
Operating expenses	21.2	17.9	19.7	22.8	25.6	28.5	27.0	25.0	23.4
Loan loss provision charges	0.9	2.0	3.6	1.4	1.9	1.7	2.1	0.9	0.8
Non-recurring items	0.0	0.0	0.0	0.0	-0.5	-0.4	-0.4	0.0	0.0
Pre-Tax Profit	**8.7**	**-5.7**	**5.2**	**4.0**	**5.4**	**0.8**	**1.5**	**4.2**	**5.6**
Income tax	2.2	-1.8	0.2	1.6	1.1	0.5	0.8	1.5	2.0
Net profit attributable to minority interests	0.0	-0.1	0.0	0.0	0.2	0.1	0.0	0.0	0.1
Net Income Attributable to Parent	**6.5**	**-3.8**	**5.0**	**2.3**	**4.1**	**0.3**	**0.7**	**2.7**	**3.6**

Source: SNL Financial and Scope Ratings for historical figures. Scope's forecasts are based on publicly available information. Please refer to "Methodologies Used for this Report" for further details.
[1] CRD 4 basis from 2012 onwards

Ratios - Deutsche Bank group

	2007	2008	2009	2010	2011	2012	2013	2014E	2015E
Funding/Liquidity									
Gross loans % Total deposits	71.5%	81.8%	86.7%	84.9%	77.1%	76.8%	95.9%	96.0%	96.1%
Total deposits % Total funds	38.9%	49.5%	48.4%	53.3%	57.0%	59.2%	47.9%	47.9%	47.9%
Wholesale funds % Total funds	61.1%	50.5%	51.6%	46.7%	43.0%	40.8%	52.1%	52.1%	52.1%
Asset Mix, Quality and Growth									
Gross loans % Funded assets	23.2%	31.8%	32.5%	36.2%	35.1%	35.0%	35.2%	35.1%	34.9%
Impaired loans % Gross loans	1.0%	1.1%	2.4%	1.4%	2.2%	2.3%	2.6%	2.6%	2.7%
Loan loss reserves % Impaired loans	78.9%	78.7%	64.7%	78.4%	62.7%	68.9%	78.0%	79.6%	81.2%
Gross loan growth (%)	26.5%	0.3%	-6.0%	56.7%	4.6%	-1.8%	-7.6%	-0.9%	-0.7%
Impaired loan growth (%)	-2.2%	17.1%	95.6%	-12.3%	59.5%	2.6%	-1.9%	-2.0%	-2.0%
Funded assets growth (%)	18.6%	-28.0%	-9.5%	36.1%	5.5%	-4.1%	-10.9%	-4.6%	-4.6%
Earnings									
Net interest income % Revenues	28.6%	82.2%	42.8%	50.8%	51.1%	47.9%	47.2%		
Fees & commissions % Revenues	39.7%	64.3%	30.6%	34.8%	33.8%	34.2%	39.1%		
Trading income % Revenues	26.6%	-55.8%	26.4%	12.0%	11.1%	19.0%	13.4%		
Other income % Revenues	5.0%	9.3%	0.2%	2.4%	4.0%	-1.1%	0.3%		
Net interest margin (%)	2.8%	3.3%	3.3%	3.4%	2.9%	2.6%	2.7%		
Pre-provision Income % Risk-weighted assets (RWAs)	3.0%	-0.9%	3.4%	2.3%	2.2%	1.4%	1.3%	1.5%	1.8%
Loan loss provision charges % Pre-provision income	9.0%	-69.8%	38.3%	17.6%	22.8%	35.7%	47.9%	18.0%	12.6%
Loan loss provision charges % Gross loans (cost of risk)	0.3%	0.6%	1.2%	0.4%	0.4%	0.4%	0.5%	0.2%	0.2%
Cost income ratio (%)	68.4%	118.4%	67.7%	74.4%	75.1%	85.6%	85.9%	82.9%	78.4%
Net Interest Income / Loan loss charges (x)	10.0	6.4	3.5	11.2	9.0	9.3	7.0		
Return on average equity (ROAE) (%)	18.3%	-11.2%	14.8%	5.4%	8.1%	0.5%	1.2%	4.9%	6.3%
Return on average funded assets (%)	0.3%	-0.2%	0.3%	0.1%	0.2%	0.0%	0.0%	0.2%	0.2%
Retained earnings % Prior year's book equity	12.8%	-10.9%	14.7%	4.4%	7.0%	-1.0%	-0.2%	3.2%	3.2%
Pre-tax return on common equity tier 1 capital	38.5%	-26.7%	21.9%	13.3%	14.8%	2.6%	4.3%	11.9%	15.0%
Capital and Risk Protection [1]									
Common equity tier 1 ratio (common equity tier 1 capital % RWAs)	6.9%	7.0%	8.7%	8.7%	9.5%	7.8%	9.7%	10.2%	10.7%
Tier 1 leverage ratio (%)	1.5%	1.4%	2.3%	2.2%	2.3%	1.5%	2.1%		
Median of tier 1 leverage ratio and common equity tier 1 ratio (%)	4.2%	4.2%	5.5%	5.4%	5.9%	4.7%	5.9%		
Total loss coverage (CET 1 capital + loan loss provisions) % RWAs	7.7%	7.9%	10.4%	10.1%	11.2%	9.6%	12.0%	12.5%	13.0%
Non-senior bailinable debt cushion (as % of total liabilities)	0.8%	0.8%	1.2%	1.3%	0.9%	1.1%	1.3%	1.3%	1.3%
Asset risk intensity (RWAs % total assets)	17.1%	14.0%	18.2%	18.2%	17.6%	16.5%	21.7%	22.8%	23.9%

Source: SNL Financial and Scope Ratings for historical figures. Scope's forecasts are based on publicly available information. Please refer to "Methodologies Used for this Report" for further details.
[1] CRD 4 basis from 2012 onwards

METHODOLOGIES USED FOR THIS REPORT

For the rating and analysis contents of this report Scope has used the following methodologies which were published on www.scoperatings.com:

"Bank Rating Methodology" (February 2014)

"Forecasting Bank Financials Methodology" (February 2014)

Forecasting bank financials: Forward-looking estimates are an important analytical tool underpinning Scope's bank ratings. These forecasts cover the current financial year (before final year-end figures are published by the bank) plus the forthcoming two years. Depending on the complexity of the bank being assessed, different forecasting tools will be used. For a majority of banks operating primarily commercial and retail banking franchises (loans and deposits) the analysis is underpinned by an **accounting** forecast of the balance sheet and profit and loss account. For more complex groups with multiple ranges of activities – notably those with material wholesale and investment banking operations – Scope uses an **analytical** forecast, relying on the bank's business-line reporting to come up with plausible estimates. For all banks Scope also include a **regulatory metrics** forecast, considering the growing importance of this aspect in bank analysis.

For complex banks, divisional data is used to forecast profit and loss accounts and basic divisional balance sheet metrics. For less complex banks, a line-by-line forecasting of major P&L elements is forecast.

For balance-sheet forecasts, Scope estimates of all major balance sheet lines, using the P&L estimates to complete the forecast of the capital/shareholders' equity line. This comprehensive methodology for estimating the balance sheet is used for all the banks in our universe, irrespective of size and complexity.

Lastly, our forecasts include assessments of the major regulatory metrics: Tier 1 and CET 1 (historically CT1), Leverage, Liquidity Coverage Ratio, and Net Stable Funding Ratio (the latter two when and if sufficient public information to compute them is available).

Scope will not aim to forecast financials when it considers the public disclosure of the bank as insufficient for a transparent and credible outcome.

All Scope's bank financial forecasts are based on public information. For its forecasts Scope will not use any non-public information or data, even if such information or data were provided by rated banks. Scope's forecasting process is transparent, with a detailed roadmap provided in its *"Forecasting bank financials"* methodology.

HSBC Holdings plc
Issuer Rating Report

AA- STABLE OUTLOOK
Financial Institutions

Overview

Scope Ratings assigns an Issuer Credit Strength Rating (ICSR) of AA- and a short-term debt rating of S-1+ to HSBC Holdings plc, both with Stable outlooks. The ratings are based on the Group's very diverse and unique business franchise, which generates robust earnings. This has enabled HSBC to maintain strong liquidity and capital positions during the financial crisis despite having to deal with large losses in its US consumer finance business. Nonetheless, the Group's size and complexity means that it is more vulnerable to operational, governance and internal control risks. With its broad-based focus on emerging markets, HSBC is also more exposed to the potential volatility inherent in these markets.

The ratings also apply to senior unsecured and short-term debt issued by HSBC Bank plc but not to unguaranteed debt issued by any other direct or indirect subsidiaries of HSBC Holdings plc.

Issuer Credit-Strength Rating (assigned April 2, 2014)	**AA-**
Outlook	Stable
Senior unsecured debt	AA-
Short term debt rating (May 22, 2014)	S-1+
Short term debt rating outlook	Stable

Unsolicited ratings without issuer participation.

Lead Analyst

Pauline Lambert
p.lambert@scoperatings.com

Team Leader

Sam Theodore
s.theodore@scoperatings.com

Rating drivers (Summary)

The rating drivers, in decreasing order of importance in the rating assignment, are:

- (+) A highly diversified business in terms of activity and geography, supporting a unique market position.
- (+) Ability to generate robust and sustainable earnings even in difficult markets.
- (+) Strong liquidity and capital positions.
- (−) Vulnerable to regulatory, governance and internal control risks due to the Group's size and complexity.
- (−) Exposed to material pockets of emerging market risks.

Rating change drivers

Failure to address compliance and conduct issues. In December 2012, HSBC entered into agreements with US and UK authorities regarding past inadequate compliance with anti-money laundering and sanctions laws. According to these agreements, the Group must take remedial measures within various specified time periods. Failure to comply could lead to further prosecution or a divestiture of US operations.

Continued progress in simplifying the business and increasing global standards across the Group. Since 2011, HSBC's strategy has been focused on implementing global standards and streamlining processes and procedures. Progress has been made but there is more to do, particularly in the areas of risk, compliance and business de-risking. These goals remain a part of the Group's strategy through 2016.

Change in the risk appetite of the Group. With the large exception of the acquisition of Household Finance, a US sub-prime and credit card company, in 2003, the Group has a reputation for being relatively conservative in its management style. The Group characterizes its risk culture as being "conservative and control-based." We would view negatively a change in management ethos that increases the risk profile of the Group (e.g. a material reduction in the Group's liquidity position or a significant increase in riskier capital markets activities).

Ability to successfully manage evolving regulatory requirements. In particular, the Group may be impacted by evolving UK regulations regarding the ring-fencing of personal and small business activities, as well as where capital should sit within the banking group (e.g. subsidiary vs. holding company).

Recent events

Q1 2014 results

For the three months ending March 31, 2014, HSBC reported an attributable profit of USD 5.2bn, down from USD 6.4bn in the prior year period, primarily due to lower gains from disposals and reclassifications. Notably, results in Q1 2013 included a USD 1.1bn accounting gain from the reclassification of Industrial Bank as a financial investment. Underlying profit before tax was USD 6.6bn, compared to USD 7.6bn in Q1 2013. Excluding the impact of significant items, underlying revenues decreased 2%, with declines in Global Banking and Markets due to subdued client activity and in Retail Banking and Wealth Management as employee incentives for selling specific products were removed. Management believes that this will improve the quality of future earnings and limit potential misconduct costs. Meanwhile, excluding significant items, operating expenses increased 2% due in part to continued investment in global standards, risk and compliance as well as inflation. Loan impairment charges fell over 30% to USD 0.8bn, driven by reductions in the US run-off portfolio.

The Group's CRD 4 fully loaded CET1 ratio was nearly unchanged at 10.8% (2013: 10.9%). The slight decline was due primarily to increased RWAs (up USD 122bn) as CRD 4 and certain PRA Loss Given Default floors relating to corporate and banking exposures in Asia and Europe were adopted. HSBC disclosed that its Pillar 2A guidance is currently 1.5% of RWA, with at least 0.9% to be met with CET1 capital by January 2015. In addition, management stated that to cover potential short-term volatility from FX movements, they could envision a management capital buffer of 50bps. However, as they are still awaiting further clarity on various capital requirements, the Group does not feel that it is in a position to further define its management capital buffer.

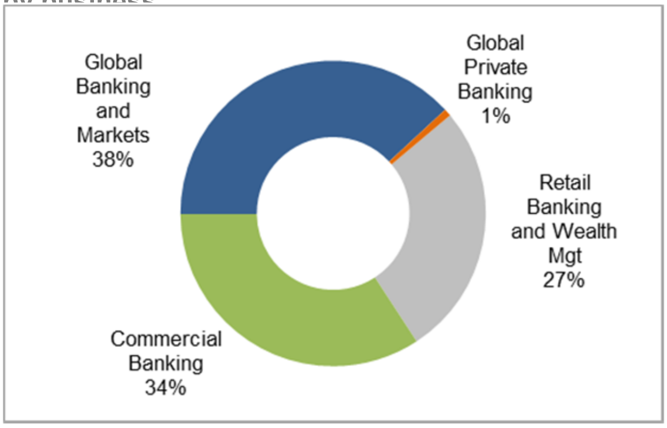
Rating drivers (Details)

1. A highly diversified business in terms of activity and geography, supporting a unique market position

The Group's stated objective is to become the world's leading international bank. Its home markets, the UK and Hong Kong, together with 20 other priority growth markets, account for over 90% of profit before tax. In addition, HSBC operates in network markets which serve to complement the international network. The Group states that its combined presence in home, priority growth and network markets covers around 85-90% of all international trade and financial flows. The Group aims to serve clients as they grow from small enterprises into large and international corporates. Further, HSBC targets opportunities in retail banking arising from social mobility and wealth creation in faster growing markets.

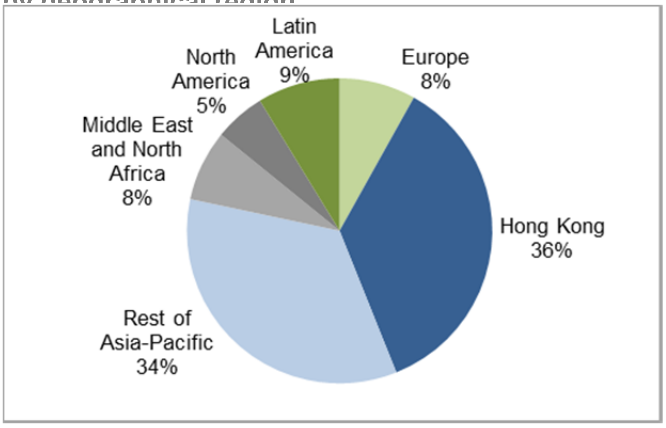
The Group has a matrix management structure, which includes global businesses, geographic regions and global functions. Over half of earnings are derived from more stable retail and commercial banking activities. Within Global Banking and Markets, the Group derives a significant portion of earnings from less volatile and client related businesses such as payments and cash management and trade and receivables finance. Also included in this division is the Group's Treasury portfolio, called Balance Sheet Management.

Chart 1: 2013 profit before tax (USD 22.6bn) by business



Source: Company data, Scope Ratings

Chart 2: 2013 profit before tax (USD 22.6bn) by geographical region



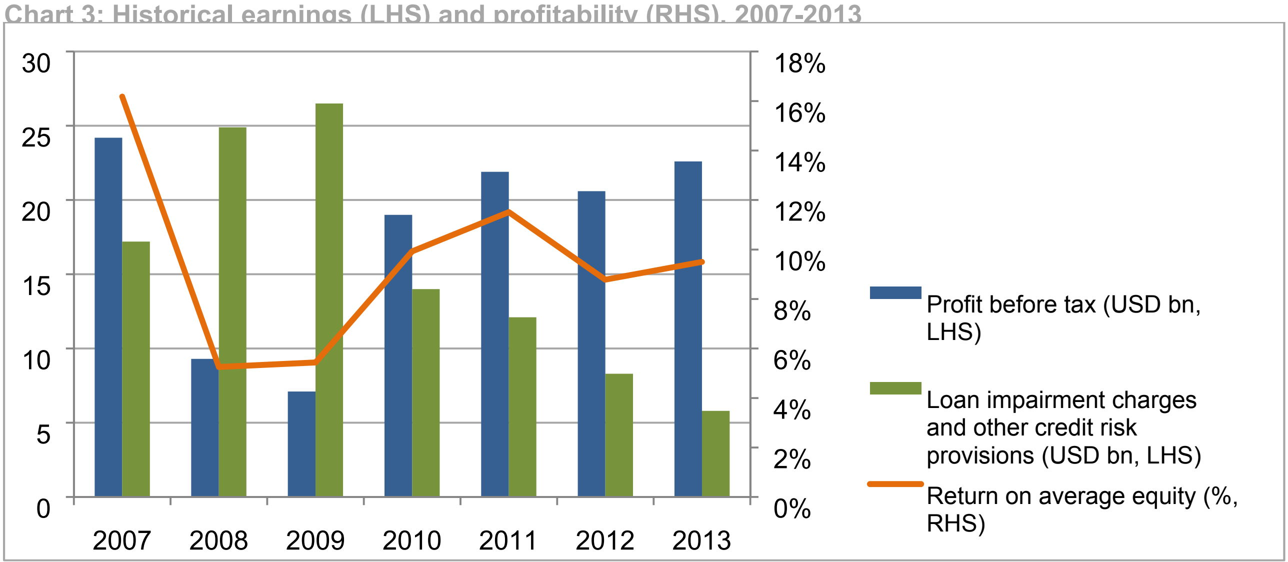
Source: Company data, Scope Ratings

2. Ability to generate sustainable and robust earnings even during difficult markets

The Group's extremely diverse business continues to generate strong earnings, which have enabled it to weather the financial crisis well, and positions it favourably in a changed banking environment. HSBC has not been immune to costs related to UK customer redress, restructuring and US consumer and real estate problems, but earnings have been sufficiently robust to absorb these costs.

HSBC remained profitable in 2008/2009 despite absorbing large impairments and losses in its US businesses. In 2009, management admitted that it had been a mistake to acquire Household Finance and placed most of the US consumer lending business into run-off. The US real estate related legacy portfolio is expected to decline to USD 20bn in 2016, from USD 30bn at year-end 2013 (2012: USD 39bn). At year-end 2013, the Global Banking and Markets business also had a legacy credit portfolio of USD 26bn RWAs (mortgage-backed securities and other asset-backed securities). While not a large component of total assets, these legacy assets remain a drag on Group performance.

Chart 3: Historical earnings (LHS) and profitability (RHS), 2007-2013



Source: Company data, Scope Ratings

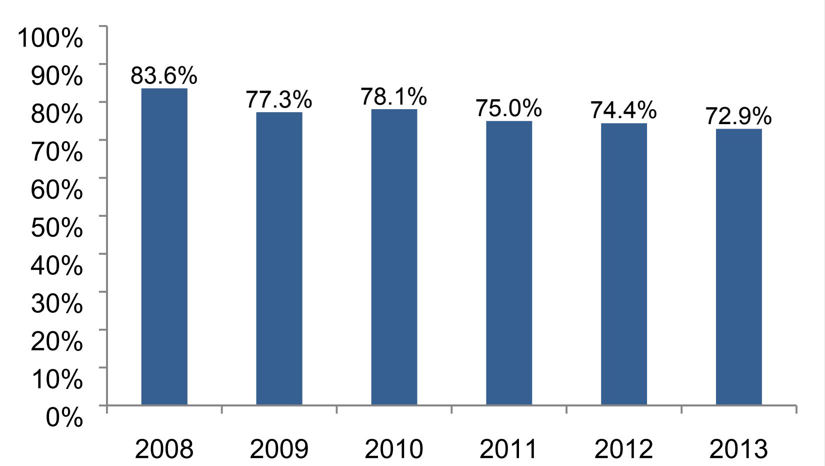
3. Strong liquidity and capital positions

HSBC Holdings plc, the holding company of the Group, does not provide core funding to any subsidiary, nor does it act as a lender of last resort. Further, HSBC has a legal-entity based Group structure, with subsidiaries operating under their own boards of directors as separately capitalized entities. This type of structure is particularly pertinent in times of stress as national regulators may prevent the free movement of liquidity and capital.

The Group's liquidity and funding risk management framework requires liquidity to be managed by operating entities on a stand-alone basis with no implicit reliance on the Group or central banks. Two key measures are used to monitor and control liquidity and funding risks. The advances-to-core funding ratio (i.e. loan-to-deposit ratio) is used to monitor the structural long-term funding position and the stressed coverage ratio, based on Group-defined stress scenarios, is used to monitor resilience to severe liquidity stresses. Each operating entity is expected to comply with its respective limit for the advances-to-core funding ratio and to maintain a positive stressed cash flow position out to three months.

The three principal entities of the Group, HSBC UK, The Hong Kong and Shanghai Banking Corporation and HSBC USA, account for 66% of the Group's customer accounts. The reported advances-to-core funding ratios for these entities were 100%, 72% and 85%, respectively, at year-end 2013. And the reported stressed three-month coverage ratios were 109%, 114% and 110%, respectively. At Group level, the reported advances-to-core funding ratio was 72.9%.

Chart 4: Customer advances-to-core funding ratio 2008-2013 (%)



Source: Company data, Scope Ratings

HSBC currently manages its capital position to meet an internal target of CRD 4 CET1 ratio greater than 10%. The Group continues to generate capital and is well positioned compared with peers on both a capital and a leverage basis. At year-end 2013, the estimated CET1 ratio under CRD 4 was 10.9%, up from 9.5% at year-end 2012. Further, the estimated leverage ratio was 4.4% excluding instruments that will be ineligible for inclusion after the Basel 3 transitional period.

4. Vulnerable to regulatory, governance and internal control risks due to the Group's size and complexity

As part of its 2011 strategic objectives, the Group simplified its structure to focus on 22 home and priority markets, created four global businesses, established 11 global functions and implemented the 8x8 programme. Nonetheless, HSBC remains large and complex and requires skilled management. The Group's strategic priorities for 2014-2016 are to continue implementing global standards (particularly in risk and compliance) and streamlining processes and procedures to generate a further USD 2-3bn in cost savings. These two priorities are considered equally important to the third strategic priority which is to further grow the business and dividends.

HSBC faces regulatory sanctions and fines related to business conduct and financial crime. In December 2012, the Group entered into agreements with US and UK authorities regarding inadequate compliance with anti-money laundering and sanctions laws. According to the US Justice Department, HSBC failed to monitor significant volumes of wire transfers and purchases of US dollars from HSBC Mexico. Among other agreements, the Group entered into two- and five-year deferred prosecution agreements and made payments totalling USD 1.9bn. Further, various entities of the Group no longer meet the requirements for financial holding company status and must obtain prior approval from US authorities before engaging in new activities or acquiring control of any new financial subsidiary. If remedial measures, including the establishment of an effective compliance risk management program, are not taken in a timely manner, the Group may be subject to further prosecution or may be required to divest its US businesses.

Like other UK banks, HSBC has incurred costs for customer redress programmes related to payment protection insurance, interest rate derivatives and wealth management (2013: USD 1.2bn, 2012: USD 2.3bn). In addition, it is the subject of ongoing investigations into the setting of LIBOR and other benchmark interest and foreign-exchange rates. Other ongoing legal proceedings concern Household International, Madoff and US residential mortgage foreclosure practices.

Another regulatory risk is that, in periods of extreme stress, the mobility of capital and liquidity across geographies within a group can significantly diminish, limiting a cross-border banking group's financial flexibility at a time when it needs it most. Mitigating factors to this would be the extent to which cross-border banking groups incorporate this risk in their business and financial strategies and can take management actions to increase financial flexibility at short notice. In this context, we look favourably on cross-border banking organizations that display reassuring capital and liquidity metrics not only at group level, but also at subsidiary level. We believe that HSBC has been aware of this potential risk for some time and that its financial management would be able to address this.

5. Exposed to material pockets of emerging market risks

For the last few years, HSBC has focused its investments in "faster growing priority markets", of which more than half can be considered as emerging markets. These include Indonesia, Mainland China, Vietnam, India, Malaysia, Argentina, Mexico, Brazil and Egypt. While these operations are significant contributors to the Group's geographic diversity and earnings, they also expose HSBC to emerging market risks. Compared with other large and diversified banking groups focused on more developed and stable markets, HSBC would be more at risk to potential shocks (e.g., a slowdown in China, political instability in the Middle East or a currency crisis) and changes in investor sentiment regarding emerging markets. In its outlook, management stated that it "anticipates greater volatility in 2014 and choppy markets as adjustments are made to changing economic circumstances and sentiment."

Peer comparison

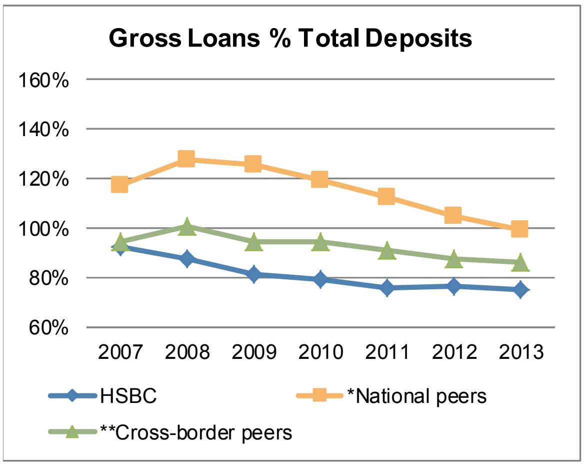
Within the UK, HSBC is among the top four players that dominate the market. However, the Group cannot be easily compared to the other UK banks due to the breadth and scale of its operations. Lloyds and RBS are primarily UK focused retail and commercial banks and continue to be partly owned by the UK government.

Internationally, we compare HSBC to other large universal banks with both retail/commercial and wholesale/investment banking activities. That said, HSBC is somewhat different from its international peers as well, in the sense that it has extensive activities in numerous retail markets across geographies and investment banking activities on a global scale. In that, perhaps its closest peers are Citigroup and BNP Paribas.

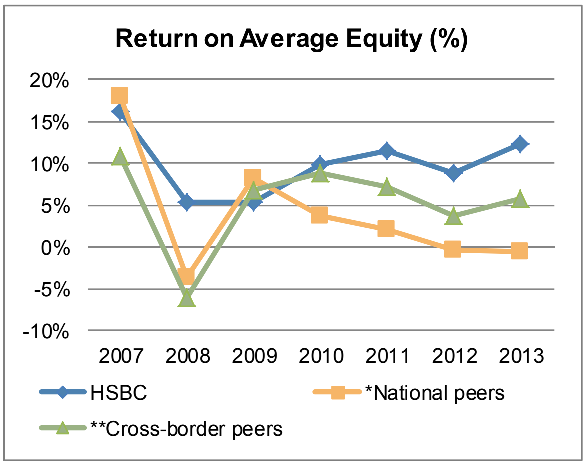
HSBC compares well among both domestic and international peers with respect to liquidity and leverage. 2013 year-end metrics included a leverage ratio of 4.4%% on an end-point PRA-adjusted basis and a CRD 4 CET1 ratio of 10.9%. There is low reliance on wholesale funding, liquid assets are of high quality and the loan-deposit ratio is well below 100%. Profitability (ROAE and ROARWA) has improved since 2009 and is consistently above peer averages, supported by one of the lowest cost-income ratios.

With regard to asset quality, HSBC is generally in line with cross-border peers but much better than national peers. The impaired loan ratio was 3.2% at year-end 2013. Impairments are relatively low in the Group's Asian businesses but are higher for the Latin American, European and North American businesses. The impaired loan ratio has continued to decline as the legacy US portfolio is run-off and the US housing market improves.

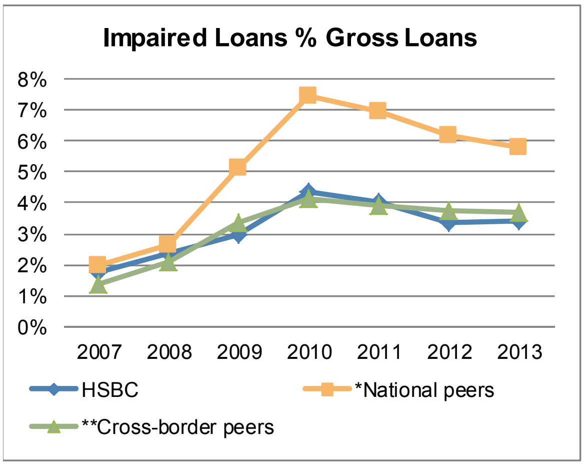
Peer Comparison - HSBC Holdings plc



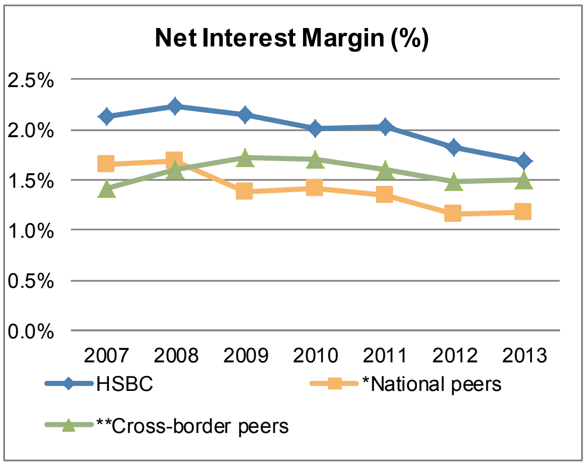
Source: SNL Financial, Scope Ratings



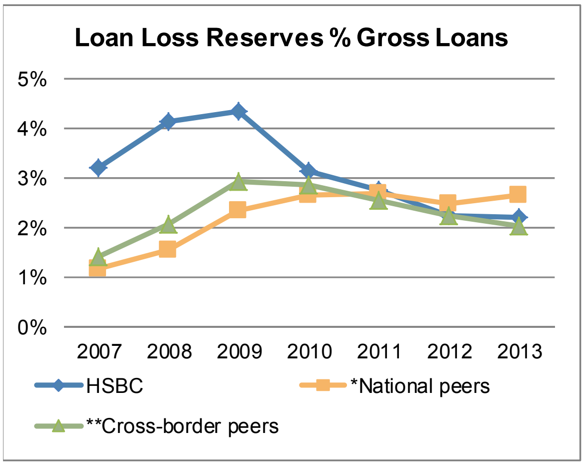
Source: SNL Financial, Scope Ratings



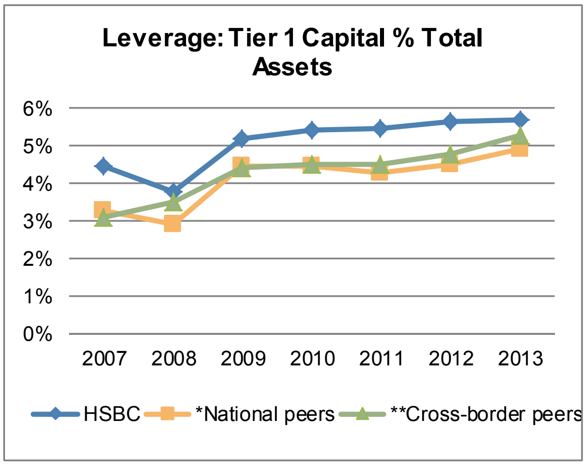
Source: SNL Financial, Scope Ratings



Source: SNL Financial, Scope Ratings



Source: SNL Financial, Scope Ratings



Source: SNL Financial, Scope Ratings

*National peers: HSBC, Barclays, Lloyds, RBS

**Cross-border peers: Bank of America Corp, Barclays, BNP Paribas, Citigroup Inc, Credit Suisse, Deutsche Bank, HSBC, JP Morgan Chase, Societe Generale, UBS

Selected Financial Information - HSBC Holdings plc

	2007	2008	2009	2010	2011	2012	2013	2014E	2015E
Balance Sheet summary (USD billion)									
Assets									
Cash and balances with central banks	21.8	52.4	60.7	57.4	129.9	141.5	166.6	191.7	238.2
Interbank assets	347.8	233.1	264.7	285.1	264.8	238.2	245.5	250.4	257.9
Total securities	594.3	603.2	695.6	709.1	656.5	716.4	739.5	734.2	722.9
of which debt instruments	500.9	557.0	622.4	624.1	590.5	621.6	617.9	611.7	599.5
of which equity instruments	84.1	40.1	59.4	66.5	46.1	68.3	98.7	100.7	102.7
Derivatives	187.9	494.9	250.9	260.8	346.4	357.5	282.3	283.2	283.3
Gross customer loans	1,116.0	1,078.4	1,025.7	1,072.6	1,038.9	1,141.3	1,151.7	1,163.0	1,174.4
of which impaired loans	19.6	25.4	30.6	46.9	41.6	38.7	36.4	37.2	36.8
Total funded assets	2,170.9	2,040.4	2,116.8	2,196.0	2,210.2	2,333.7	2,397.0	2,432.1	2,486.0
Total Assets	**2,354.3**	**2,527.5**	**2,364.5**	**2,454.7**	**2,555.6**	**2,692.5**	**2,671.3**	**2,707.3**	**2,761.3**
Liabilities									
Interbank liabilities	199.8	173.9	171.8	155.9	169.1	176.3	179.3	181.0	182.9
Senior debt	343.7	261.3	240.2	244.3	234.1	226.6	214.8	204.1	193.9
Derivatives	183.4	487.1	247.6	258.7	345.4	358.9	274.3	275.2	275.3
Customer deposits	1,206.6	1,235.0	1,264.9	1,359.9	1,377.8	1,491.2	1,540.8	1,571.6	1,618.8
Subordinated debt + hybrid securities	52.4	53.2	54.9	57.2	52.2	51.0	50.9	51.4	52.4
Total Liabilities	**2,218.9**	**2,427.2**	**2,228.8**	**2,299.8**	**2,389.5**	**2,509.4**	**2,480.9**	**2,507.7**	**2,551.4**
Ordinary equity	128.2	90.1	124.8	140.4	151.5	168.0	174.6	183.0	191.7
Minority interests	7.3	6.6	7.4	7.2	7.4	7.9	8.6	8.6	8.6
Total Liabilities and Equity	**2,354.3**	**2,527.5**	**2,364.5**	**2,454.7**	**2,555.6**	**2,692.5**	**2,671.3**	**2,707.3**	**2,761.3**
Core Tier 1 Capital [1]	*90.9*	*80.3*	*106.3*	*116.1*	*122.5*	*122.5*	*132.5*	*140.9*	*149.6*
Income Statement summary (USD billion)									
Net interest income	37.8	42.6	40.7	39.4	40.7	37.7	35.5		
Net fee & commission income	22.0	20.0	17.7	17.4	17.2	16.4	16.4		
Net trading income	17.0	11.7	7.2	9.5	11.0	6.5	11.6		
Operating Income	**80.5**	**84.4**	**68.3**	**70.9**	**75.7**	**65.3**	**66.0**	**65.9**	**67.0**
Operating expenses	39.0	38.5	34.3	37.6	41.1	42.8	38.5	36.8	37.0
Loan loss provision charges	17.3	26.0	26.8	14.1	12.3	8.7	6.0	6.5	6.6
Non-recurring items	0.0	0.0	0.0	0.0	0.0	7.0	1.1	0.0	0.0
Pre-Tax Profit	**24.2**	**9.3**	**7.1**	**19.0**	**21.9**	**20.6**	**22.6**	**22.5**	**23.3**
Income tax	3.8	2.8	0.4	4.8	3.9	5.3	4.8	5.6	5.8
Net profit attributable to minority interests	1.3	0.8	0.9	1.0	1.1	1.3	1.6	1.6	1.7
Net Income Attributable to Parent	**19.1**	**5.7**	**5.8**	**13.2**	**16.8**	**14.0**	**16.2**	**15.3**	**15.9**

Source: SNL Financial and Scope Ratings for historical figures. Scope's forecasts are based on publicly available information. Please refer to "Methodologies Used for this Report" for further details.
[1] CRD 4 basis from 2012 onwards

Ratios - HSBC Holdings plc

	2007	2008	2009	2010	2011	2012	2013	2014F	2015F
Funding/Liquidity									
Gross loans % Total deposits	92.5%	87.3%	81.1%	78.9%	75.4%	76.5%	74.7%	74.0%	72.5%
Total deposits % Total funds	66.9%	71.5%	72.9%	74.5%	74.9%	76.4%	77.3%	78.0%	78.7%
Wholesale funds % Total funds	33.1%	28.5%	27.1%	25.5%	25.1%	23.6%	22.7%	22.0%	21.3%
Asset Mix, Quality and Growth									
Gross loans % Funded assets	51.4%	52.9%	48.5%	48.8%	47.0%	48.9%	48.0%	47.8%	47.2%
Impaired loans % Gross loans	1.8%	2.4%	3.0%	4.4%	4.0%	3.4%	3.2%	3.2%	3.1%
Loan loss reserves % Impaired loans	182.4%	175.7%	145.7%	71.9%	68.5%	66.3%	63.7%	62.5%	63.1%
Gross loan growth (%)	15.7%	-3.4%	-4.9%	4.6%	-3.1%	9.9%	5.7%	5.2%	5.2%
Impaired loan growth (%)	42.1%	29.5%	20.7%	53.1%	-11.3%	-7.0%	-5.8%	2.0%	-1.0%
Funded assets growth (%)	23.4%	-6.0%	3.7%	3.7%	0.6%	5.6%	2.7%	1.5%	2.2%
Earnings									
Net interest income % Revenues	46.9%	50.4%	59.6%	55.7%	53.7%	57.7%	53.8%		
Fees & commissions % Revenues	27.3%	23.7%	25.9%	24.5%	22.7%	25.2%	24.9%		
Trading income % Revenues	21.1%	13.8%	10.6%	13.4%	14.6%	9.9%	17.6%		
Other income % Revenues	4.6%	12.0%	4.0%	6.4%	9.1%	7.2%	3.7%		
Net interest margin (%)	2.1%	2.2%	2.1%	2.0%	2.0%	1.8%	1.7%		
Pre-provision Income % Risk-weighted assets (RWAs)	3.7%	4.0%	3.0%	3.0%	2.9%	2.0%	2.3%	2.4%	2.4%
Loan loss provision charges % Pre-provision income	41.6%	56.6%	78.9%	42.6%	35.5%	38.8%	21.9%	22.5%	22.2%
Loan loss provision charges % Gross loans (cost of risk)	1.7%	2.5%	2.7%	1.4%	1.2%	0.8%	0.5%	0.6%	0.6%
Cost income ratio (%)	48.4%	45.6%	50.2%	53.1%	54.3%	65.5%	58.3%	55.9%	55.2%
Net Interest Income / Loan loss charges (x)	2.2	1.6	1.5	2.8	3.3	4.3	5.9		
Return on average equity (ROAE) (%)	16.2%	5.2%	5.4%	9.9%	11.5%	8.8%	9.5%	8.6%	8.5%
Return on average funded assets (%)	0.6%	0.2%	0.2%	0.4%	0.5%	0.4%	0.5%	0.4%	0.4%
Retained earnings % Prior year's book equity	7.2%	0.1%	-0.6%	4.5%	6.2%	4.6%	5.8%	4.8%	4.8%
Pre-tax return on common equity tier 1 capital	26.6%	11.6%	6.7%	16.4%	17.9%	16.9%	17.0%	16.0%	15.6%
Capital and Risk Protection [1]									
Common equity tier 1 ratio (common equity tier 1 capital % RWAs)	8.1%	7.0%	9.4%	10.5%	10.1%	9.5%	10.9%	11.4%	11.9%
Tier 1 leverage ratio (%)	4.5%	3.8%	5.2%	5.4%	5.5%	5.6%	5.9%		
Median of tier 1 leverage ratio and common equity tier 1 ratio (%)	6.3%	5.4%	7.3%	8.0%	7.8%	7.6%	8.4%		
Total loss coverage (CET 1 capital + loan loss provisions) % RWAs	11.3%	10.9%	13.3%	13.6%	12.5%	13.2%	12.8%	13.3%	13.8%
Non-senior bailinable debt cushion (as % of total liabilities)	2.4%	2.3%	2.6%	2.8%	2.5%	2.3%	2.3%	2.4%	2.4%
Asset risk intensity (RWAs % total assets)	47.7%	45.4%	47.9%	44.9%	47.3%	41.7%	40.9%	45.5%	45.5%

Source: SNL Financial and Scope Ratings for historical figures. Scope's forecasts are based on publicly available information. Please refer to "Methodologies Used for this Report" for further details.
[1] CRD 4 basis from 2012 onwards

METHODOLOGIES USED FOR THIS REPORT

For the rating and analysis contents of this report Scope has used the following methodologies which were published on www.scoperatings.com:

"Bank Rating Methodology" (February 2014)

"Forecasting Bank Financials Methodology" (February 2014)

Forecasting bank financials: Forward-looking estimates are an important analytical tool underpinning Scope's bank ratings. These forecasts cover the current financial year (before final year-end figures are published by the bank) plus the forthcoming two years. Depending on the complexity of the bank being assessed, different forecasting tools will be used. For a majority of banks operating primarily commercial and retail banking franchises (loans and deposits) the analysis is underpinned by an **accounting** forecast of the balance sheet and profit and loss account. For more complex groups with multiple ranges of activities – notably those with material wholesale and investment banking operations – Scope uses an **analytical** forecast, relying on the bank's business-line reporting to come up with plausible estimates. For all banks Scope also include a **regulatory metrics** forecast, considering the growing importance of this aspect in bank analysis.

For complex banks, divisional data is used to forecast profit and loss accounts and basic divisional balance sheet metrics. For less complex banks, a line-by-line forecasting of major P&L elements is forecast.

For balance-sheet forecasts, Scope estimates of all major balance sheet lines, using the P&L estimates to complete the forecast of the capital/shareholders' equity line. This comprehensive methodology for estimating the balance sheet is used for all the banks in our universe, irrespective of size and complexity.

Lastly, our forecasts include assessments of the major regulatory metrics: Tier 1 and CET 1 (historically CT1), Leverage, Liquidity Coverage Ratio, and Net Stable Funding Ratio (the latter two when and if sufficient public information to compute them is available).

Scope will not aim to forecast financials when it considers the public disclosure of the bank as insufficient for a transparent and credible outcome.

All Scope's bank financial forecasts are based on public information. For its forecasts Scope will not use any non-public information or data, even if such information or data were provided by rated banks. Scope's forecasting process is transparent, with a detailed roadmap provided in its *"Forecasting bank financials"* methodology.

ING Bank NV
Issuer Rating Report

A STABLE OUTLOOK
Financial Institutions

Overview

Scope Ratings assigns an Issuer Credit-Strength Rating (ICSR) of A and a short-term debt rating of S-1 to ING Bank NV, both with a Stable outlook.

The ratings of ING Bank NV are driven by its relatively strong and resilient retail and commercial banking franchise in the Benelux region. The Bank has continued to be profitable despite restructuring, impairments on financial assets and elevated credit costs. Notably, ING Bank remains part of ING Groep NV and will continue to be impacted by restructuring at the group level. The Group is in a period of transition as it is divesting all of its insurance and investment management businesses (nearly half of assets). If implemented as agreed with the European Commission, the Group will be comprised primarily of banking operations from 2015/2016 onwards.

We highlight that the ratings are not applicable to unguaranteed debt issued by subsidiaries of ING Bank NV as well as debt issued by ING Groep NV.

Issuer Credit-Strength Rating (assigned April 2, 2014)	**A**
Outlook	Stable
Senior unsecured debt	A
Short term debt rating (May 22, 2014)	S-1
Short term debt rating outlook	Stable

Unsolicited ratings without issuer participation.

Lead Analyst

Pauline Lambert
p.lambert@scoperatings.com

Team Leader

Sam Theodore
s.theodore@scoperatings.com

Rating drivers (Summary)

The rating drivers, in decreasing order of importance in the rating assignment, are:

- (+) Strong retail and commercial banking franchise in the Benelux.
- (+) Funding and capital have improved to satisfactory levels.
- (+) Good progress made on restructuring plan and “Back to Basics” program.
- (−) Performance likely to be hampered by costs related to further restructuring.

Rating change drivers

Completion of required restructuring. The Group is in the process of fully separating its banking and insurance operations (including investment management) as part of the restructuring required by the European Commission in order to gain approval for the aid it received from the Dutch State in 2008/2009. The remaining insurance operations account for about 15% of Group assets. In November 2012, the Group amended the terms of the restructuring plan, extending the deadline for completion to end-2018 from end-2013. The ability to do so will depend on market conditions and evolving regulatory requirements. The Group also needs to repay EUR 683m in principal plus EUR 342m in interest and premiums to the Dutch State. Successful completion would lend further credibility to management and allow it to focus fully on managing its banking operations.

Change in business strategy leading to an increase in riskier investment banking activities. Since 2009, ING Bank has refocused its financial markets activities in areas where it has the strongest franchises and where it can support its clients as a universal bank. We would view negatively a change in strategy and business model that increases the risk profile of the Bank.

Sustained earnings generation that enables ING Bank to meet its capital and leverage targets (fully loaded CRD4 CET1 ratio above 10% and leverage ratio about 4%). Retained earnings have been negatively impacted by restructuring costs, impairments on financial assets and repayments to the Dutch State. We would view positively a reduction in these costs so that earnings can be retained to further bolster the capital position.

Meaningful deterioration in asset quality. About 40% of the loan portfolio is exposed to the relatively weak economic environment in the Netherlands. Credit costs are currently elevated but adequately covered by earnings. For 2013, the reported non-performing loan ratio was 2.8%, while credit costs accounted for approximately one-third of pre-provision income. We would view negatively a meaningful increase in credit costs or a poor outcome in the upcoming asset quality review.

Recent events

Q1 2014 results

For the three months ending March 31, 2014, ING Group reported a net loss of EUR 1.9bn compared to a net profit of EUR 1.9bn in the prior year period. Results were negatively impacted by EUR 2bn in losses related to the deconsolidation of Voya (formerly ING USA) and a charge of EUR 1.1bn for making the Dutch closed defined benefit pension plan financially independent. On an underlying basis, the net result was EUR 988m.

ING Bank generated an underlying net result of EUR 830m, up slightly from EUR 809m in the prior year period. Net lending increased by EUR 5.1bn, excluding the impact of FX, the deconsolidation of ING Vysya Bank and asset transfers. Most divisions saw net lending growth, except for Retail Netherlands and Real Estate Finance. Risk costs were EUR 468m, decreasing year-over-year as well as from Q4 2013. However, management expects risk costs to remain elevated in Retail Banking Netherlands and noted that while risk costs in Commercial Banking were continuing their downtrend trend, there can be quarterly volatility. Meanwhile, the NPL ratio remained stable at 2.8%.

Due to its systemic importance in the Netherlands, the Dutch Central Bank in April 2014 announced that it intends to impose an additional capital buffer requirement of 3% of RWAs for ING Bank, to be phased in between 2016 and 2019. At Q1 2014, ING Bank already met this requirement with a CRD4 fully loaded CET1 ratio of 10.1%.

Strategy update

On March 31, 2014, the Group provided a strategy update for ING Bank. With Group restructuring at an end stage and repayment to the Dutch State nearly complete, management said that they are now “in a position to look ahead to the future of ING Bank – to Think Forward.” The strategy entails becoming the primary bank for more customers by increasing the share of payment accounts in Retail Banking and with anchor products such as lending and transaction services in Commercial Banking. The Bank also detailed how it plans to proceed based on its current market positioning in various geographic markets – classified as Market Leaders, Challengers and Growth Markets.

Financial targets were also updated under Ambition 2017. The Bank intends to grow the loan book by approximately 4% per year and the balance sheet by approximately 3%, funded primarily through customer deposits. In addition, with new lending focused on SMEs and consumer lending, the resulting more diversified lending mix is expected to lead to a higher net interest margin of 150-155 bps by 2017. Management maintained a ROE target of 10% to 13% from 2015. After full repayment to the Dutch State, ING also intends to resume dividend payments in 2015, with an eventual target payout ratio above 40%. Further, management confirmed a fully-loaded CRD4 CET1 ratio target above 10% and introduced a leverage ratio target of about 4%, subject to final regulations.

Rating drivers (Details)

1. Strong retail and commercial banking franchise in the Benelux

ING Bank has stated that it intends to be predominantly a European bank with leading positions in stable home markets, as well as a leading commercial bank in the Benelux with a strong position in Central and Eastern Europe. The units of ING Direct will also be developed into more full-service banking models.

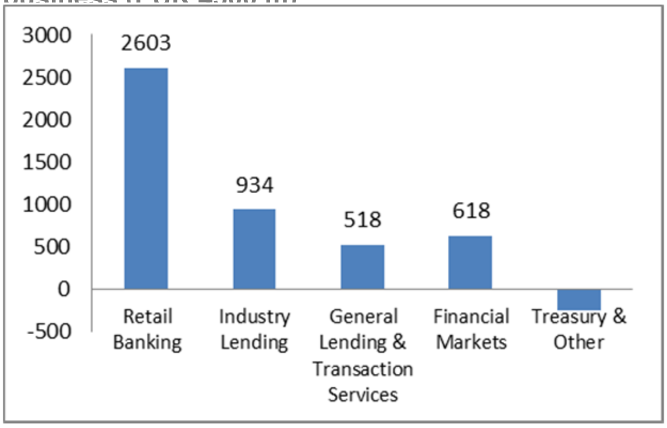
ING Bank operates as a universal bank in the Netherlands and Belgium, where it is the number two and three bank, respectively. In the Netherlands, ING Bank holds market shares of 22% in mortgages, 19% in savings, 28% in payments and 30% in SMEs. Further, through ING Direct, the Bank is a leading direct player with operations in Germany, Australia, France, Italy, and Spain. In Germany, it is the third largest private retail bank by number of retail customers, after Deutsche Bank/Postbank and Commerzbank. These operations are generally low cost and have been a good source of customer deposits.

Operations are split between Retail Banking and Commercial Banking, accounting for approximately 60% and 40% of earnings, respectively. Within Retail Banking, over 70% of the loan portfolio is comprised of residential mortgages.

Within Commercial Banking, Industry Lending, which comprises structured finance and real estate finance, is the largest contributor to income. ING Bank is among the top ten players in structured finance globally, with a particular focus on industries such as oil and gas, metals and mining, power and infrastructure and transportation. Financial Markets comprises trading and sales businesses. Over the last few years, this business has been refocused in light of regulatory changes, with the income contribution declining by more than half. For example, in 2012, the Strategic Trading Platform was discontinued and the international cash equities business outside the Benelux was closed.

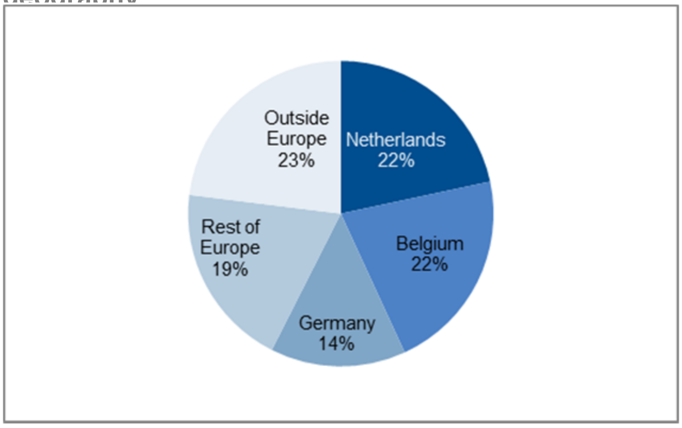
ING Bank has consistently generated profits, even in 2008 and 2009 when net profit was EUR 772m and EUR 684m, respectively. For 2013, ING Bank reported net profit of EUR 3bn.

Chart 1: 2013 underlying result before tax by business (EUR 4300 m)



Source: Company data, Scope Ratings

Chart 2: 2013 underlying result before tax by geography



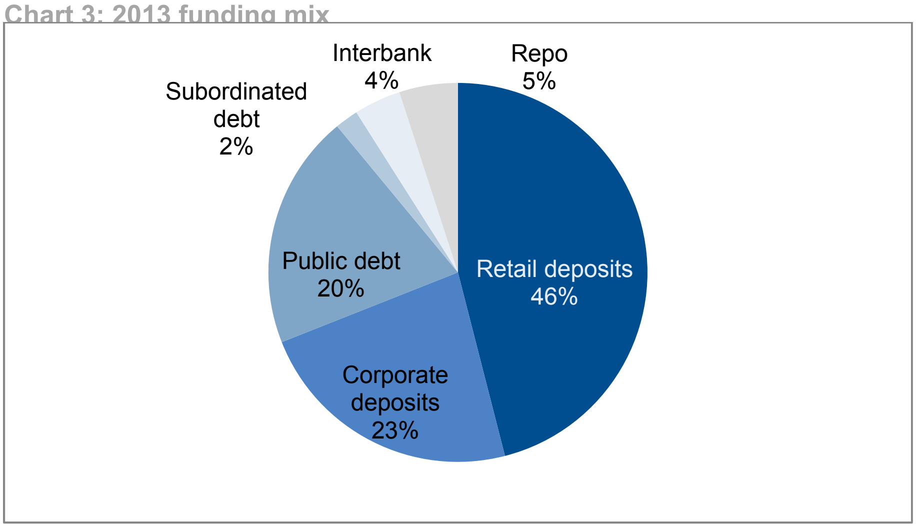
Source: Company data, Scope Ratings

2. Funding and capital have improved to satisfactory levels

Over the last few years, ING Bank has worked to reduce risks and optimize its balance sheet. Its funding profile has improved and capital has been strengthened. Customer deposits are the largest component of funding, supported by continued deposit gathering. The reported loan-to-deposit ratio has steadily declined since 2011 and was 111% at year-end 2013 (2011: 121%). From 2010 to 2011, there was an increase in the loan-to-deposit ratio as the deposits of ING Direct USA were transferred to assets/liabilities held for sale.

The maturity profile of debt has been extended and the reliance on short-term funding from banks has been reduced. Since 2009, interbank funding has declined from EUR 84bn to EUR 27bn at year-end 2013. At the same time, long-term funding has increased from EUR 65bn to EUR 101bn. ING Bank aims for LCR and NSFR ratios above 100% in 2015. At year-end 2013, ING Bank reported that its LCR was above 100% (Sep 2011: 90%) and that its eligible asset buffer stood at EUR 180bn.

Chart 3: 2013 funding mix



Source: Company data, Scope Ratings

Further, ING Bank has reduced investments, trading, repo and interbank positions while increasing the proportion of assets derived from lending. In particular, the balance sheet of the banking operations have been combined with that of ING Direct and deposits from ING Direct are now better matched by own originated assets. From 2008 to 2012, gross loans as a percentage of funded assets increased from 70% to over 75%.

In Q4 2012, the planned de-risking of the investment portfolio was completed. The Bank incurred EUR 601m in losses on its bond holdings with positions in covered bonds, ABS securities and real estate investments being reduced. The investment portfolio is now maintained for liquidity purposes. At year-end 2013, the breakdown of the EUR 97bn investment portfolio was as follows: 58% government bonds, 19% covered bonds, 15% financial and corporate bonds and 8% asset-backed securities. Only 4% of government bond holdings are related to higher risk sovereigns.

At year-end 2013, ING Bank reported a pro-forma fully loaded CRD4 CET1 ratio of 10% and a leverage ratio of 3.9%. The capital position has steadily improved due to lower RWAs and retained earnings. This improvement has come about even as ING Bank has upstreamed dividends to the Group to repay the Dutch State and to unwind the guarantee facility covering 80% of the Group's Alt-A mortgage securities portfolio.

3. Good progress made on restructuring plan and "Back to Basics" program

In April 2009, the Group announced its "Back to Basics" program with the goals of strengthening financials to navigate through the crisis, simplifying the Group and reinforcing franchises in focus markets. Over the last four years, the Group has made good progress in achieving these objectives. Banking and insurance have been operating separately since 2011, various divestments have been made and insurance businesses have been strengthened to operate as standalone businesses. Group double leverage continues to decline and was EUR 3.8bn in Q1 2014 (2012: EUR 7bn). The Group estimates that the remainder is largely covered by the market value of the remaining 43% stake in Voya (formerly ING USA), the 10% stake in SulAmerica, pre-IPO investments and the intended IPO of NN Group.

The Group has also reduced its reliance on State support, repaying in instalments the EUR 10bn capital injection (via core Tier 1 securities) it received from the Dutch State in 2008. Sources of repayment have come from a rights issue as well as earnings. In March 2014, the Group repaid another EUR 1.2bn to the Dutch State. The Group intends to repay the fourth and last payment of EUR 1.0bn in May 2015. In addition, in December 2013, the Group and the Dutch State unwound the back-up facility on Alt-A mortgage securities, reducing RWA by EUR 2bn.

As regards to divestments required by the European Commission, the second tranche of ING US was sold in October 2013, reducing the stake to 57%. In March 2014, the Group further reduced its stake in Voya to approximately 43%. The retained minority stake is now accounted for as an associate under equity accounting. This had a negative after-tax P&L impact of EUR 2bn in the Group's Q1 2014 results but no impact on the capital position of ING Bank.

Following the sale of ING Life Korea completed in December 2013, Asian insurance divestments are effectively completed. Lastly, NN Group (formerly ING Insurance and ING Life Japan) are preparing for a base case IPO in 2014. ING Group will inject EUR 800m into NN Group to finalize its capital structure. Meanwhile, ING Group has secured EUR 1.3bn in pre-IPO investments in NN Group.

4. Performance likely to be hampered by costs related to further restructuring

While the bulk of the remaining restructuring relates to the insurance operations, the banking operations will not be unaffected. In February 2014, the Group reached an agreement to make its Defined Benefits Pension Fund financially independent. This will facilitate the IPO of NN Group and the Group will be released from future financial obligations arising out of the fund. The removal of the pension asset on the Group's balance sheet resulted in an after-tax P&L charge of EUR 1.1bn in 1Q 2014 (EUR 0.7bn attributed to ING Bank and EUR 0.4bn to NN Group). This charge negatively impacted ING Bank's CRD4 phased-in CET1 ratio by 1%.

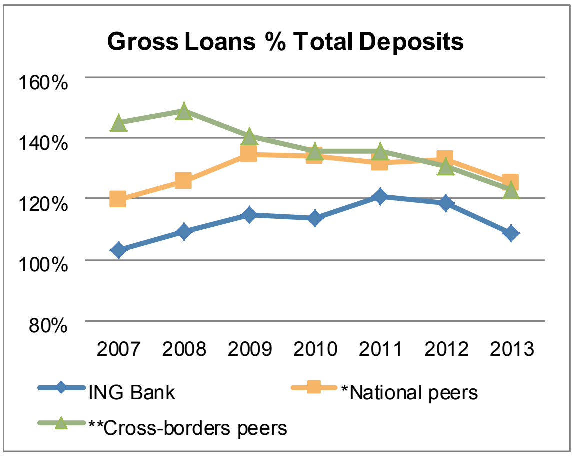
Further, the profitability of the insurance operations has been weaker than the banking operations, generating net losses between 2008 and 2010. In 2013, the insurance operations generated a net result of EUR 201m. Consequently, it is earnings from ING Bank which are upstreamed to the Group in order to repay State aid. The repayment to the Dutch State in March 2014 was funded by a dividend from ING Bank and lead to a 40bp reduction in ING Bank's CET1 ratio. Moreover, dividends from ING Bank have been used to reduce the Group's double leverage. During the period from 2011 to 2013, ING Bank has upstreamed approximately EUR 8bn of capital to the Group.

Peer comparison

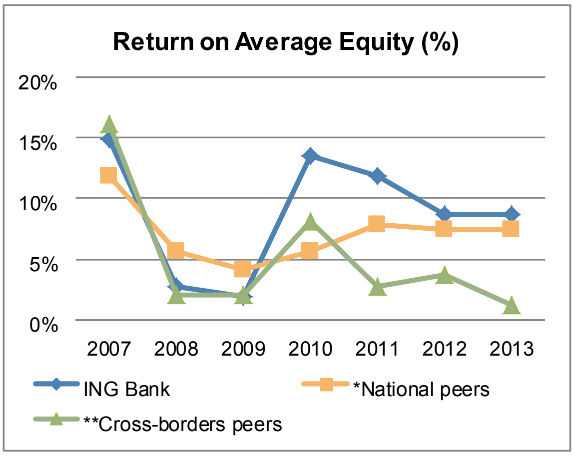
In light of ING Bank's number two position in the Netherlands, it makes sense to compare it to the other major domestic players such as Rabobank and ABN Amro. Unlike these two, ING Bank benefits from greater regional geographic diversification due to its significant operations in Belgium, Luxembourg and Germany. About 40% of the loan portfolio is domestic while international operations further contribute to ING Bank's funding mix via customer deposits. While ING Bank has nearly repaid the Dutch State, ABN Amro remains state-owned. Meanwhile, Rabobank did not require any State aid and maintains a stronger capital position.

At Scope Ratings, ING Bank is included within the peer group of international retail banks. This peer group includes banks such as KBC, Unicredit, Santander, BBVA, Nordea and Commerzbank. Overall, ING Bank compares relatively well to peers in terms of its liquidity and funding profile, asset quality and profitability. We do note that the level of provisions as a percentage of loans is low compared to peers at around 1%. This is somewhat offset by the high level of collateralization. Approximately 80% of the portfolio consists of secured lending such as mortgages, leasing and structured finance. The one area where ING Bank has historically been weaker is in terms of capital and leverage although this has improved and is now in line in with peers. At year-end 2013, ING Bank reported a pro-forma fully loaded CRD4 CET1 ratio of 10%, with a leverage ratio of 3.9%.

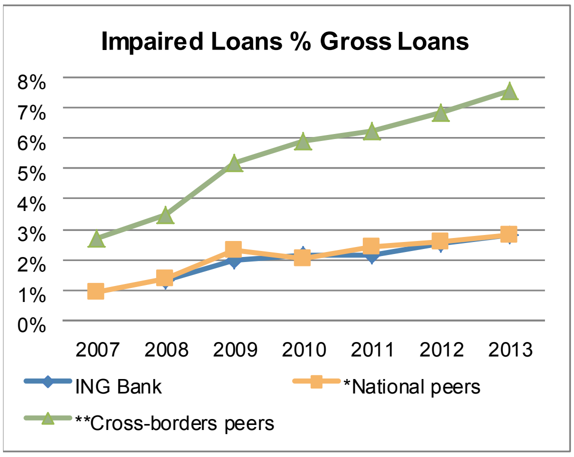
Peer Comparison - ING Bank NV



Source: SNL Financial, Scope Ratings



Source: SNL Financial, Scope Ratings



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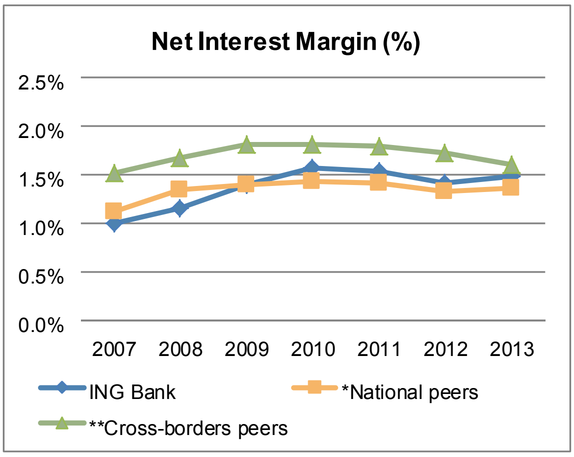
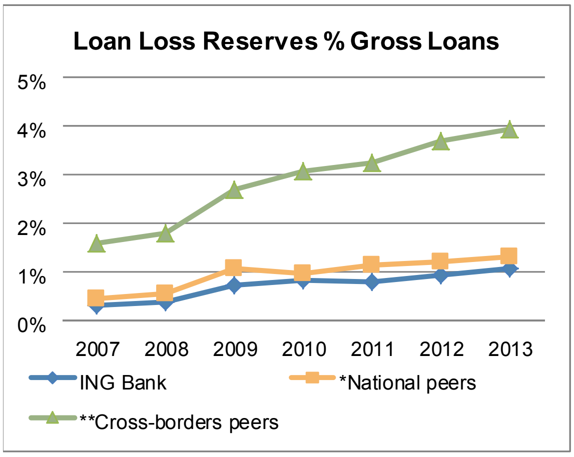


Source: SNL Financial, Scope Ratings



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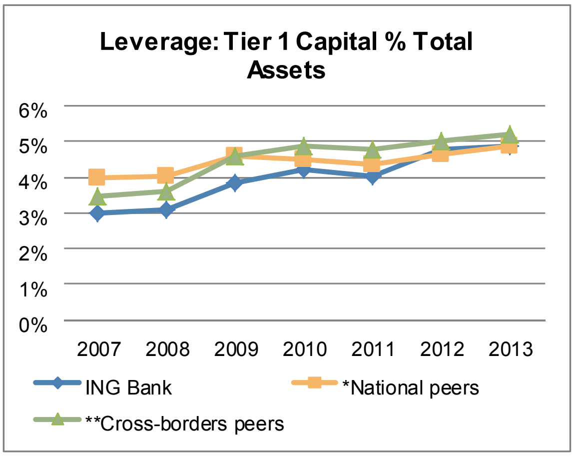


Source: SNL Financial, Scope Ratings

*National Peers : ING Bank, ABN AMRO, Rabobank.

**Cross-border peers based on business model : Santander, BBVA, Unicredit, RBS, Erste Bank, RZB AG, Commerzbank, Nordea, KBC Group, Danske Bank, ING Bank.

Notes: Cross-border peer group averages exclude RZB in 2013

Selected Financial Information - ING Bank NV

	2007	2008	2009	2010	2011	2012	2013	2014E	2015E
Balance Sheet summary (EUR billion)									
Assets									
Cash and balances with central banks	9.8	18.2	12.6	9.5	28.1	15.4	11.9	4.9	-1.2
Interbank assets	48.9	48.4	43.4	51.8	45.3	39.1	43.0	43.9	44.7
Total securities	216.1	181.2	136.8	146.6	107.1	104.6	113.0	114.3	115.6
of which debt instruments	201.0	177.2	130.6	138.4	101.4	97.2	98.5	99.4	100.4
of which equity instruments	15.1	4.0	6.2	8.2	5.8	7.4	14.6	14.9	15.2
Derivatives	35.8	82.5	50.1	51.4	69.2	64.2	37.2	37.9	38.9
Gross customer loans	642.9	661.0	598.7	642.7	626.7	585.2	565.8	577.0	594.2
of which impaired loans	0.0	8.6	12.0	13.8	13.4	14.9	15.9	15.9	15.6
Total funded assets	960.0	945.3	825.1	875.5	887.0	768.0	748.5	754.4	767.3
Total Assets	**994.1**	**1,034.7**	**882.1**	**933.1**	**961.2**	**836.1**	**787.6**	**794.3**	**808.3**
Liabilities									
Interbank liabilities	167.0	152.3	84.2	72.9	72.2	38.7	27.3	25.9	24.6
Senior debt	77.2	106.7	131.2	152.3	151.8	154.1	142.1	139.3	136.5
Derivatives	34.1	89.4	57.0	57.6	74.2	68.1	39.2	39.9	41.0
Customer deposits	626.8	604.1	520.7	565.0	518.7	481.5	508.2	518.4	533.9
Subordinated debt + hybrid securities	18.8	23.4	22.7	22.3	19.5	17.5	15.7	14.1	13.4
Total Liabilities	**966.9**	**1,010.6**	**850.9**	**898.0**	**926.1**	**798.6**	**753.9**	**758.9**	**770.6**
Ordinary equity	25.5	22.9	30.2	34.5	34.4	36.7	32.8	34.5	36.7
Minority interests	1.7	1.2	1.0	0.6	0.7	0.8	1.0	1.0	1.0
Total Liabilities and Equity	**994.1**	**1,034.7**	**882.1**	**933.1**	**961.2**	**836.1**	**787.6**	**794.3**	**808.3**
Core Tier 1 Capital [1]	*23.4*	*24.9*	*26.0*	*30.9*	*31.7*	*31.7*	*30.1*	*31.8*	*34.0*
Income Statement summary (EUR billion)									
Net interest income	9.0	11.3	12.8	13.6	13.6	12.2	12.0		
Net fee & commission income	2.9	2.9	2.7	2.6	2.5	2.1	2.2		
Net trading income	1.3	0.0	0.1	1.0	0.6	0.7	1.0		
Operating Income	**14.5**	**14.4**	**15.2**	**17.8**	**17.1**	**14.7**	**15.3**	**15.2**	**15.5**
Operating expenses	10.0	10.3	9.7	9.7	9.4	9.7	8.7	8.5	8.5
Loan loss provision charges	0.2	3.7	4.5	1.9	2.4	2.2	2.3	2.3	2.0
Non-recurring items	0.1	0.2	0.0	0.3	0.2	1.6	0.0	-2.1	-1.0
Pre-Tax Profit	**4.5**	**0.5**	**0.5**	**6.0**	**5.3**	**4.3**	**4.2**	**2.3**	**3.9**
Income tax	0.8	-0.2	0.0	1.4	1.2	1.1	1.1	0.6	1.0
Net profit attributable to minority interests	0.1	-0.1	-0.1	0.1	0.1	0.1	0.1	0.0	0.1
Net Income Attributable to Parent	**3.6**	**0.8**	**0.7**	**4.5**	**4.0**	**3.1**	**3.1**	**1.7**	**2.8**

Source: SNL Financial and Scope Ratings for historical figures. Scope's forecasts are based on publicly available information. Please refer to "Methodologies Used for this Report" for further details.
[1] CRD 4 basis from 2012 onwards

Ratios - ING Bank NV

	2007	2008	2009	2010	2011	2012	2013	2014F	2015F
Funding/Liquidity									
Gross loans % Total deposits	100.0%	111.7%	116.4%	114.1%	121.5%	118.8%	111.3%	n/a	n/a
Total deposits % Total funds	70.4%	68.1%	68.6%	69.5%	68.0%	69.6%	73.3%	74.3%	75.4%
Wholesale funds % Total funds	29.6%	31.9%	31.4%	30.5%	32.0%	30.4%	26.7%	25.7%	24.6%
Asset Mix, Quality and Growth									
Gross loans % Funded assets	67.0%	69.9%	72.6%	73.4%	70.7%	76.2%	75.6%	76.5%	77.4%
Impaired loans % Gross loans	0.0%	1.3%	2.0%	2.1%	2.1%	2.6%	2.8%	2.8%	2.6%
Loan loss reserves % Impaired loans	0.0%	30.4%	36.7%	37.7%	41.3%	36.9%	38.6%	38.6%	39.4%
Gross loan growth (%)	15.5%	2.8%	-9.4%	7.3%	-2.5%	-6.6%	-3.3%	2.0%	3.0%
Impaired loan growth (%)	0.0%	0.0%	39.5%	15.0%	-2.9%	11.6%	6.7%	0.0%	-2.0%
Funded assets growth (%)	10.4%	-1.5%	-12.7%	6.1%	1.3%	-13.4%	-2.5%	0.8%	1.7%
Earnings									
Net interest income % Revenues	62.2%	78.4%	83.9%	76.5%	79.4%	83.1%	78.2%		
Fees & commissions % Revenues	20.1%	20.1%	17.6%	14.8%	14.6%	14.5%	14.6%		
Trading income % Revenues	9.2%	0.0%	0.6%	5.4%	3.5%	4.9%	6.2%		
Other income % Revenues	8.5%	1.5%	-2.1%	3.3%	2.5%	-2.5%	0.9%		
Net interest margin (%)	1.0%	1.3%	1.5%	1.7%	1.7%	1.6%	1.7%		
Pre-provision Income % Risk-weighted assets (RWAs)	1.1%	1.2%	1.6%	2.5%	2.3%	1.7%	2.2%	2.2%	2.2%
Loan loss provision charges % Pre-provision income	4.4%	88.6%	82.5%	24.0%	30.9%	42.7%	34.7%	34.4%	28.9%
Loan loss provision charges % Gross loans (cost of risk)	0.0%	0.6%	0.7%	0.3%	0.4%	0.4%	0.4%	0.4%	0.3%
Cost income ratio (%)	69.0%	71.3%	64.0%	54.7%	54.7%	65.6%	56.8%	55.4%	55.3%
Net Interest Income / Loan loss charges (x)	45.4	3.1	2.8	7.0	5.7	5.7	5.2		
Return on average equity (ROAE) (%)	15.3%	3.2%	2.6%	13.9%	11.6%	8.8%	8.8%	5.0%	7.9%
Return on average funded assets (%)	0.3%	0.1%	0.1%	0.3%	0.3%	0.3%	0.3%	0.1%	0.2%
Retained earnings % Prior year's book equity	-3.1%	3.0%	2.1%	4.9%	5.5%	0.5%	8.4%	5.1%	6.5%
Pre-tax return on common equity tier 1 capital	19.1%	2.1%	1.9%	19.4%	16.7%	13.6%	14.1%	7.3%	11.4%
Capital and Risk Protection [1]									
Common equity tier 1 ratio (common equity tier 1 capital % RWAs)	5.8%	7.3%	7.8%	9.6%	9.6%	10.4%	10.0%	10.5%	11.0%
Tier 1 leverage ratio (%)	3.0%	3.1%	3.9%	4.2%	4.0%	4.8%	4.9%		
Median of tier 1 leverage ratio and common equity tier 1 ratio (%)	4.4%	5.2%	5.8%	6.9%	6.8%	7.6%	7.4%		
Total loss coverage (CET 1 capital + loan loss provisions) % RWAs	5.8%	8.0%	9.1%	11.2%	11.3%	12.2%	12.0%	12.5%	13.0%
Non-senior bailinable debt cushion (as % of total liabilities)	1.9%	2.3%	2.7%	2.5%	2.1%	2.2%	2.1%	1.9%	1.7%
Asset risk intensity (RWAs % total assets)	40.5%	33.2%	37.7%	34.4%	34.4%	33.3%	35.9%	38.2%	38.2%

Source: SNL Financial and Scope Ratings for historical figures. Scope's forecasts are based on publicly available information. Please refer to "Methodologies Used for this Report" for further details.
[1] CRD 4 basis from 2012 onwards

METHODOLOGIES USED FOR THIS REPORT

For the rating and analysis contents of this report Scope has used the following methodologies which were published on www.scoperatings.com:

"Bank Rating Methodology" (February 2014)

"Forecasting Bank Financials Methodology" (February 2014)

Forecasting bank financials: Forward-looking estimates are an important analytical tool underpinning Scope's bank ratings. These forecasts cover the current financial year (before final year-end figures are published by the bank) plus the forthcoming two years. Depending on the complexity of the bank being assessed, different forecasting tools will be used. For a majority of banks operating primarily commercial and retail banking franchises (loans and deposits) the analysis is underpinned by an **accounting** forecast of the balance sheet and profit and loss account. For more complex groups with multiple ranges of activities – notably those with material wholesale and investment banking operations – Scope uses an **analytical** forecast, relying on the bank's business-line reporting to come up with plausible estimates. For all banks Scope also include a **regulatory metrics** forecast, considering the growing importance of this aspect in bank analysis.

For complex banks, divisional data is used to forecast profit and loss accounts and basic divisional balance sheet metrics. For less complex banks, a line-by-line forecasting of major P&L elements is forecast.

For balance-sheet forecasts, Scope estimates of all major balance sheet lines, using the P&L estimates to complete the forecast of the capital/shareholders' equity line. This comprehensive methodology for estimating the balance sheet is used for all the banks in our universe, irrespective of size and complexity.

Lastly, our forecasts include assessments of the major regulatory metrics: Tier 1 and CET 1 (historically CT1), Leverage, Liquidity Coverage Ratio, and Net Stable Funding Ratio (the latter two when and if sufficient public information to compute them is available).

Scope will not aim to forecast financials when it considers the public disclosure of the bank as insufficient for a transparent and credible outcome.

All Scope's bank financial forecasts are based on public information. For its forecasts Scope will not use any non-public information or data, even if such information or data were provided by rated banks. Scope's forecasting process is transparent, with a detailed roadmap provided in its *"Forecasting bank financials"* methodology.

Intesa Sanpaolo SpA
Issuer Rating Report

SCOPE POSITIVE OUTLOOK **BBB+** Financial Institutions

Overview

Scope Ratings assigns an Issuer Credit Strength Rating (ICSR) of BBB+ to Intesa Sanpaolo SpA, with a positive outlook, reflecting the likely improvement in the bank´s asset quality metrics and profitability on the back of a more favourable macroeconomic landscape, which at present represents a negative factor affecting the rating. The short-term rating is S-2, with a stable outlook.

The ratings are driven by Intesa's strong capital position and resilient profitability despite the challenging operating environment in Italy. Since the merger of Intesa BCI and San Paolo IMI in 2007, the group has been the leading retail and commercial bank in Italy. While Intesa has some operations in Central and Eastern Europe (CEE), 80% of the loan portfolio is Italian-based. Group earnings and asset quality have suffered from the weak domestic economic environment, but pre-provision profitability has been resilient and the group has remained profitable if we exclude large writedowns of goodwill in 2011 and 2013.

Intesa's primarily domestic operations combined with its significant holdings in Italian sovereign debt mean that it is particularly vulnerable to market confidence in Italian banks and Italy in general, but the expected improvement in Italy's macro background and in the profitability and asset quality of the group underpin our positive outlook on Intesa´s long term ratings. The ratings are not applicable to unguaranteed subsidiaries of the rated parent.

Issuer Credit-Strength Rating (assigned on June 11, 2014)	**BBB+**
Outlook	Positive
Senior unsecured debt	BBB+
Short term debt rating	S-2
Short term debt rating outlook	Stable

Unsolicited ratings with issuer participation.

Lead Analyst

Marco Troiano
m.troiano@scoperatings.com

Team Leader

Sam Theodore
s.theodore@scoperatings.com

Rating drivers (Summary)

The rating drivers, in decreasing order of importance in the rating assignment, are:

- (+) Largest retail and commercial bank in Italy, which has remained profitable during the crisis.
- (−) Unfavourable operating environment affecting asset quality metrics and credit costs.
- (+) Strong capital position despite weak asset quality and reduced profitability.
- (−) Material sovereign risk exposure remains a concern.

Rating change drivers

Turnaround in asset quality trends. Recent quarterly earnings reports have shown early signs of stabilising asset quality, including a slowdown in the pace of accumulation of new NPLs. In fact, the gross inflow of NPL from performing loans was stable in 2013 compared with 2012. The new business plan includes initiatives for a more proactive management of impaired loans, including for example the creation of a dedicated team for the management of high value substandard and restructured loans with a dedicated P&L. Moreover, Italy is expected to return to GDP growth in 2014, after two years of economic recession. The anticipated recovery in asset quality buoyed by a stronger Italian economy supports our positive outlook for the rating of Intesa.

Improved profitability. The group's new business plan aims to achieve a significant improvement in profitability. According to the business plan presented in March 2014, Intesa's ROE will increase to 10% in 2017. This will not be easy to achieve in light of the continued pressure on earnings from low economic activity and depressed lending margins. In 2013, even excluding goodwill writedown, the reported ROE was 2.9%, but we see this improving in the coming years thanks to the falling cost of credit on the back of lower NPL inflows. The normalization in the group's earnings underpins our positive outlook for the rating.

Improvement in funding profile. The group reported a loan-to-deposit ratio of 92% in 2013. This figure is calculated by the company on the basis of total direct banking deposits, an aggregate which includes debt securities. Adjusting to only include retail deposits, the group gross loan-to-deposit ratio stood at 163% according to our calculation. This number is high compared with international peers and partly reflects the bank's reliance on other forms of retail funds, such as bonds issued to retail clients. Adjusting the deposit base to include retail bonds would result in a loan-to-deposit ratio of 123%, in line with peers.

Reduced access to capital markets. While the group relies on retail placements for funding, it also remains dependent on wholesale funds and is vulnerable to investor sentiment regarding Italian banks and the Italian sovereign in general, at least for the portion of bonds that is placed to wholesale investors. As of year-end 2013, Intesa had c. EUR 100bn of senior bonds outstanding, although 74% of these were placed with retail clients. Intesa also has EUR12bn in covered bonds and EUR 8bn in subordinated liabilities, on top of EUR 26bn in senior bonds, placed to wholesale investors. We would view negatively a reduction in market access or more expensive access to wholesale funding.

Event Risk. Due to its ownership structure (five fondazioni control c. 25% of Intesa's capital) and relatively sound financial position, there remains a risk that the group could be subjected to political pressure or asked to support weaker domestic banks or companies deemed to be of national interest. During the 2014-2017 business plan presentation, recently appointed CEO Carlo Messina manifested a preference for increased distribution of excess capital to shareholders rather than M&A, stating that Intesa had no interest in taking part in any consolidation within Italy and allaying some investor concerns that the group could become involved in the rescue of domestic competitors who fail the AQR.

Recent events

Q1 2014 results

Intesa reported Q1 2014 results on May 15. While total revenues were flat, quality was high with both Net interest income (NII) and fees showing a positive performance (yoy growth of 4% and 8% respectively), and trading profits at just EUR 150m (2013 quarterly average of EUR 290m). The cost income ratio was 51%, in line with Q1 2013 and relatively low compared with both domestic and European peers. Cost of risk was stable compared with Q1

2013, at 126bps, but materially lower than the 2013 average of 200bps, which included a significant cleanup effort in Q4. Net profit of EUR 504m was the highest since Q1 2012. Gross inflows from performing to non-performing loans were 17.5% lower than in Q1 2013. As of March 2014, Intesa's capital position was very strong, with a fully loaded CRD4 CET1 Ratio of 12.6%

2014-2017 business plan

Intesa presented a new business plan on March 28, 2014. According to the plan, Intesa will emphasize fee-intensive businesses in anticipation of a prolonged period of low interest rates. A significant reduction in the number of branches in Italy (from 4,100 in 2013 to 3,300 in 2017) is planned, which should help keep the cost line under check. Management anticipates a significant decline in the cost of risk (80bps of loans in 2017 vs 207bps in 2013) Key financial targets include an ROE of 10% (ROTE of 11.8%), assuming a CRD4 CET1 Ratio of 12.2%.

Revaluation of Bank of Italy stake

In January 2014 the Italian parliament passed a law (5/2014, converting Law Decree 133/2013) to modify the Statute of the Bank of Italy and the economic and governance rights of its shareholders. Among other provisions, the law authorises Bank of Italy to significantly revalue its share capital. Bank of Italy capital, which had not been updated since 1936, will go from EUR 156,000 to EUR 7.5bn. As a result of its 42% stake in Bank of Italy, the group has booked a fair value gain of EUR 2.6bn gross of taxes in the full-year 2013 accounts with an 86bps estimated impact on CRD 4 fully phased CET1 Ratio.

Rating drivers (Details)

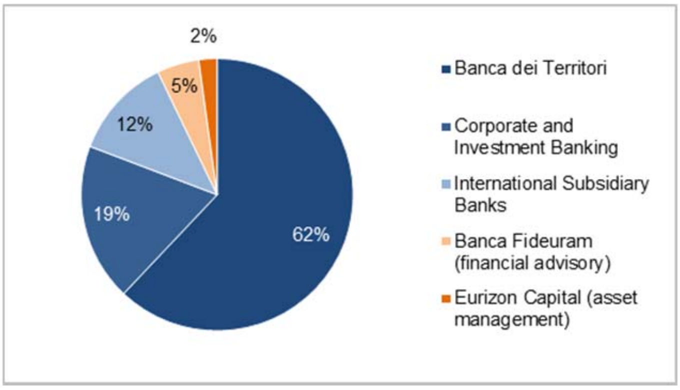
1. Largest retail and commercial bank in Italy, which has remained profitable during the crisis

The Italian banking system is characterized by numerous mid-tier and small players, with two large players dominating. Intesa is the leading retail and commercial bank in Italy with approximately 4,700 total branches in the country. Formed in 2007 through the merger of Gruppo IntesaBCI and Gruppo Sanpaolo IMI, Intesa is present throughout the country and has a particularly strong footprint in the wealthiest regions of Northern Italy. The group holds number one positions in loans (market share of 15%), deposits (16%), pension funds (24%) and asset management (22%).

Over 60% of group operating income is derived from Banca dei Territori (domestic commercial banking), which offers traditional lending and deposit collection operations in Italy, servicing households, small businesses, SMEs, and Italian mid-size corporations (turnover of up to EUR350mn), as well as the group´s product companies. . The other main contributor to operating income is Corporate and Investment Banking, which serves large corporate clients as well as public finance entities, and includes the factoring and leasing businesses. In terms of international operations, the group is present in 12 countries, primarily in Central and Eastern Europe as well as in Egypt, with 1,400 branches. The largest international operations are in Slovakia, Croatia and Hungary. As of year-end 2013, international subsidiary banks accounted for 13% of operating income and 8% of the total loan portfolio. Overall, Intesa's foreign presence, while material, does not contribute to significant revenue and asset diversification away from the Italian market. In this respect, Intesa's business model is different from Unicredit's.

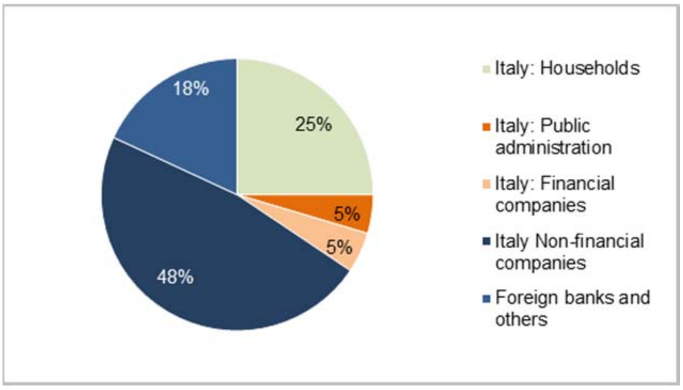
With over 80% of total loans in Italy, Intesa Sanpaolo is heavily dependent on the performance of the Italian economy. The loan book is well diversified with households (25%, most of which comprises residential mortgages with an average LTV ratio of 52% at year end 2013), mid corporates and public finance (12%), SMEs (13%) and industrial credit, leasing and factoring (13%) as the main segments. The group's loan exposure to non-financial companies is also well-diversified by sector, with no single sector accounting for more than 10% of the total. The largest sectors are construction (6.8% of total loan portfolio), distribution (6.2%) and services (6%).

Chart 1a: Revenues by division (2013)



Source: Company data, Scope Ratings
Note: excluding Corporate Center

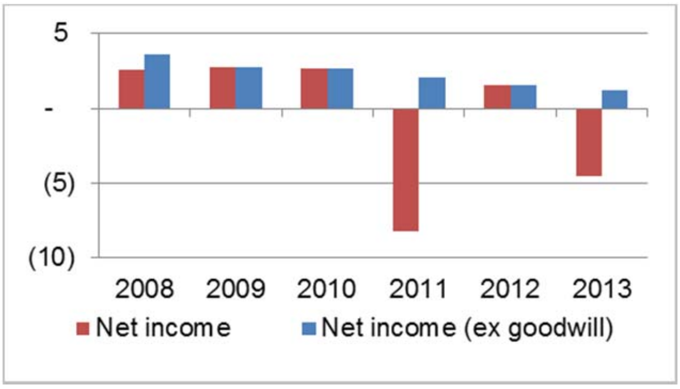
Chart 1b: Loan book composition (2013)



Source: Company data, Scope Ratings

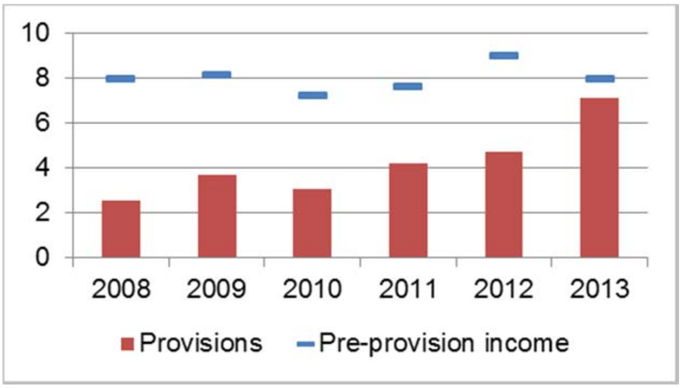
Despite the difficult operating environment in its domestic market, Intesa has largely remained profitable at the operating level. Indeed, while it has posted net statutory losses in 2011 and 2013 due to large writedowns of goodwill, the operating performance has remained satisfactory, with pre-provision income able to absorb significant provisions, especially in 2013 (see Chart 2.b).

Chart 2a: Intesa's losses were entirely driven by goodwill impairments (EUR bn)



Source: Company data, Scope Ratings

Chart 2b: Pre-provision profitability has been enough to absorb rising credit provisions (EUR bn)



Source: Company data, Scope Ratings

2. Unfavourable operating environment affecting asset quality metrics and credit costs.

While the group aims to generate returns above the cost of equity, its actual profitability remains weak. In 2013, even excluding the large goodwill writedown, the reported ROE was only 2.9%. Revenues remain under pressure due to weak credit demand and low interest rates affecting the net interest margin. Management has successfully reduced the cost base in recent years to offset the negative pressure on revenues and profits and the current cost-to-income ratio of 51% compares favourably with Italian and international peers. However, rising loan-loss charges have been keeping profits at bay.

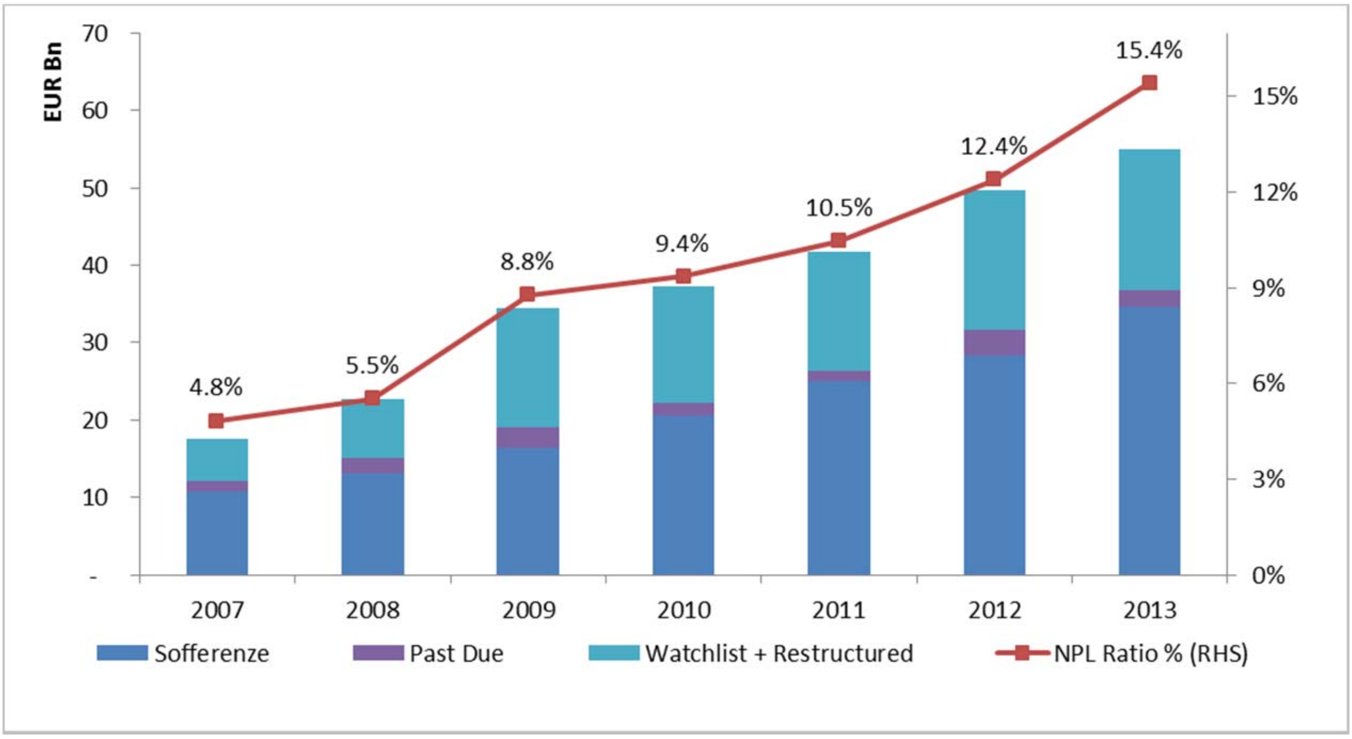
Indeed, loan-loss charges went from an average of 15% of pre-provision income in 2005-2007 to 40% in 2008-2010 and 66% in 2011-2013. Such provision needs were largely attributable to the sluggish domestic macro environment.

The Italian economy has been in recession for the past two years, with output falling 2.5% in 2012 and 1.9% in 2013.

The lengthy recession has tested private and public sector balance sheets, and while the financial condition of households has remained relatively sound[1], companies remain under stress. In particular, small and medium enterprises (SMEs), which rely on the banking channel for their access to credit, represent a key risk to the bank's asset quality.

Given the weak economic environment, particularly in Italy, the group's gross NPL ratio has increased to 15.4% in 2013 (from 12.4% in 2012). We are aware that recent studies[2] have found the Italian definition of impaired loans to be somewhat broader compared with other European countries, but still see this as a significant negative rating driver for the bank.

Chart 3: Gross NPLs and NPL ratio (2007-2013)



Source: Company data, Scope Ratings
Note: NPL = sofferenze + watchlist + restructured + past due

As of year end 2013, coverage of NPLs was 46%, or 128% including collateral and guarantees. With the upcoming ECB asset quality review, there continue to be concerns about the asset quality of Italian banks and the potential

[1] as described by the Bank of Italy's November 2013 Financial Stability report
[2] e.g. Barisitz, 2013 – "Nonperforming loans in Western Europe : a selective comparison of countries and national definitions".

need for additional provisions and capital, although we see coverage of NPLs as adequate following the material provisions taken in Q4 2013.

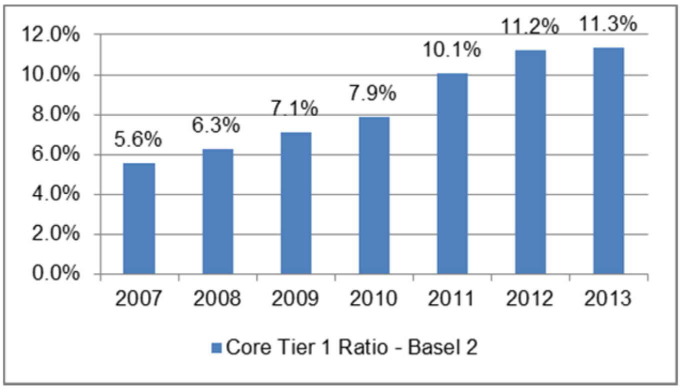
Towards the end of 2013, there were tentative signs of a nascent economic recovery in Italy, as leading indicators have begun signaling a business cycle expansion. Among them, Markit's manufacturing PMIs moved above 50 (the threshold that signals economic expansion) in August 2013. GDP turned positive (albeit by just 0.1%) in Q4 2013 after eight quarters of recession and Italy's GDP is expected to grow by 0.6% in 2014[3]. If confirmed, the economic recovery should have a positive impact on Intesa's asset quality and profitability. However, given the poor growth performance of the past decade during which the average real GDP growth in Italy was negative, questions remain about the strength and durability of such a recovery. We have taken a conservative approach and only forecast a mild decline in loan losses.

3. Strong capital position despite weak asset quality and reduced profitability

Despite the weak operating environment, Intesa has significantly improved its capital position in recent years.

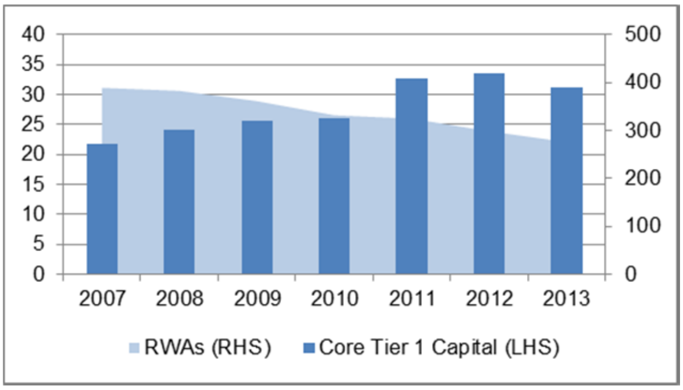
On a Basel 2 basis, the Core Tier 1 ratio has doubled since 2007 (from 5.6% of RWAs to 11.3% of RWAs), partly driven by the reduction in group RWAs, which declined from EUR 389bn in 2007 to EUR 276bn in 2013 despite the slight increase in total assets during the period.

Chart 4a: Basel 2 Core Tier 1 Ratio significantly improved in recent years



Source: Company data, Scope Ratings

Chart 4b: RWA reduction was a major driver for the improvement in the capital ratio (EUR bn)



Source: Company data, Scope Ratings

Part of the decline in asset risk intensity at Intesa is due to the adoption of Basel 2 IRB-Advanced models in the period and we note that the average risk weighting of Intesa balance sheet (44% at year end 2013) is in line with other Italian peers.

At year-end 2013, the group's CRD4 fully phased CET1 ratio was 12.3%.

In terms of leverage, Intesa compares well with European peers. The group reported a balance sheet leverage ratio of 6% at year-end 2013 (defined as tangible equity / tangible assets) improving from 5.3% at year-end 2012. On the basis of Tier 1 capital (Basel 2) / Total Assets, the leverage ratio for the group is 5.4%.

The strong capital position has allowed management to present a business plan that includes a generous dividend distribution policy with a commitment to raise distributions should the group not find profitable investment

[3] Source: European Commission 2014 Spring estimates, published May 6 2014

opportunities. It signals that management is comfortable with current capitalization levels and is not targeting further increases in the capital ratios.

4. Material sovereign risk exposure remains a concern

As the largest Italian bank with limited international diversification, Intesa has a large exposure to Italian government debt. According to data from the EBA transparency exercise in June 2013, Intesa had an exposure to Italian sovereign risk of EUR 79bn, including EUR 27bn in loans; this amount was more than twice its Core Tier 1 capital, at the time, measured according to the EBA definition. More recently, the company reported in March 2014 a total exposure of EUR77 bn, including EUR19bn of loans.

The Italian sovereign maintains a high debt position (133% of GDP in 2013) and suffers from often volatile politics. As a result, the group is vulnerable to investor sentiment about Italian sovereign risk.

In recent years, Italy has been successful in bringing its public deficit under control (3% of GDP in 2013 from 5.5% of GDP in 2009) despite the decline in GDP. This result was mainly obtained through the introduction of new taxes in the country, but also through measures aimed at containing spending growth, including a freeze on public sector wages and a reform of the pension system. With the return of economic growth in 2014 (0.6% according to European commission estimates), the deficit should improve further.

Peer comparison

At Scope Ratings, we compare banks within peer groups at domestic and cross border level.

Domestically we compare Intesa with UniCredit and other smaller domestic players. In comparison to UniCredit, Intesa does not benefit from the same earnings diversification. UniCredit's domestic operations account for only about a third of earnings while for Intesa's domestic operations account for more than three-fourths of earnings. However, Intesa's operations in Italy appear to be of better quality as reflected in its market positioning, lower cost of risk and higher profitability. With respect to the smaller domestic banks, Intesa ranks very high in almost every metric, particularly capital, asset quality, and profitability.

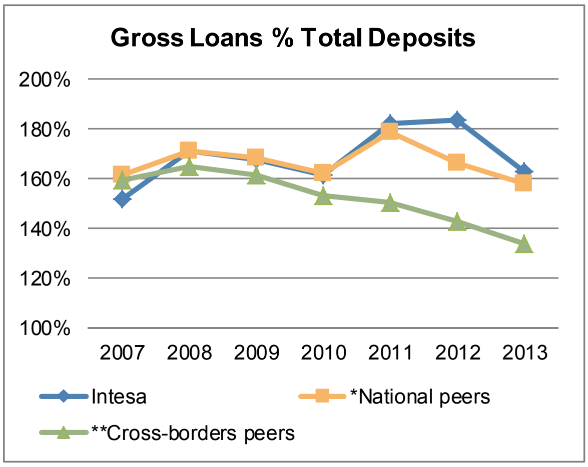
We believe that it would be appropriate to compare the group with other leading domestic banks such as Rabobank in the Netherlands, Credit Agricole in France, DNB in Norway, Lloyds in the UK and Caixabank in Spain. In comparison with international peers, the group's earnings are relatively weak – reflecting the difficult operating environment in Italy. Indeed, despite a competitive cost-income ratio, high credit costs have kept profitability at bay in recent years.

In terms of funding, Intesa is more dependent on bond funding than peers and has a loan-to-deposit ratio of 163%, using only retail deposits as a denominator. However, this is not adjusted for bonds placed with retail investors, which are an important source of stable funding for Italian banks.

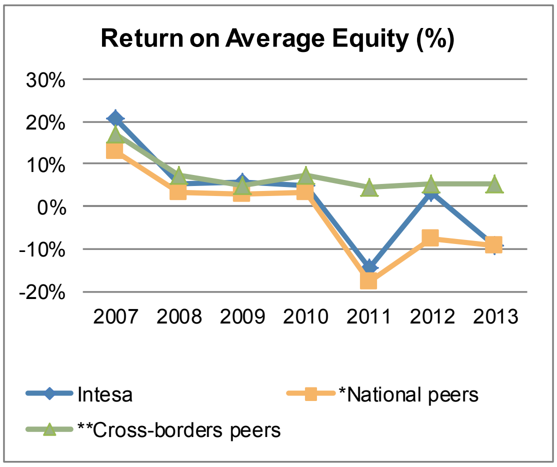
Adjusting the ratio for retail bonds, the loan-to-deposit ratio is 123%, which is in line with cross border peers.

In terms of capital, the group compares well with peers, having reported a fully-loaded Basel 3 ratio of 12.3% at December 2013. Intesa Tier 1 leverage of 5.4% is in line with peer group average.

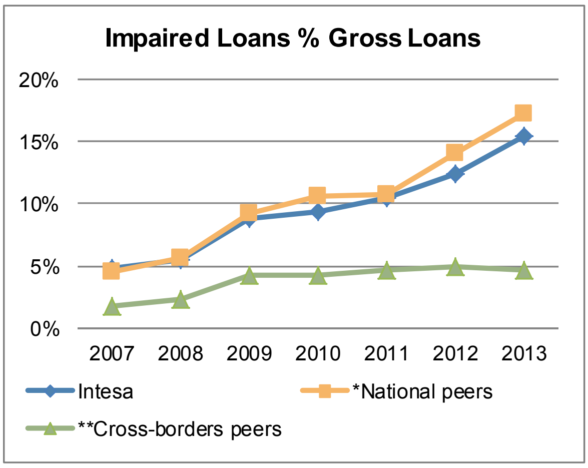
Peer Comparison



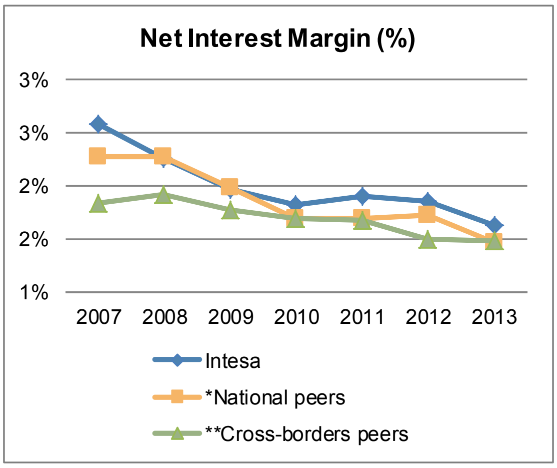
Source: SNL Financial, Scope Ratings



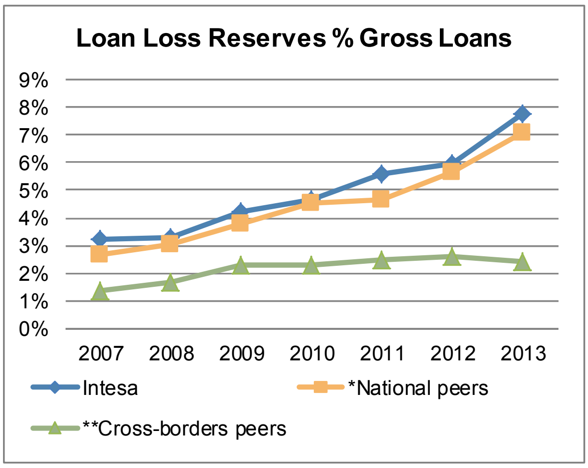
Source: SNL Financial, Scope Ratings



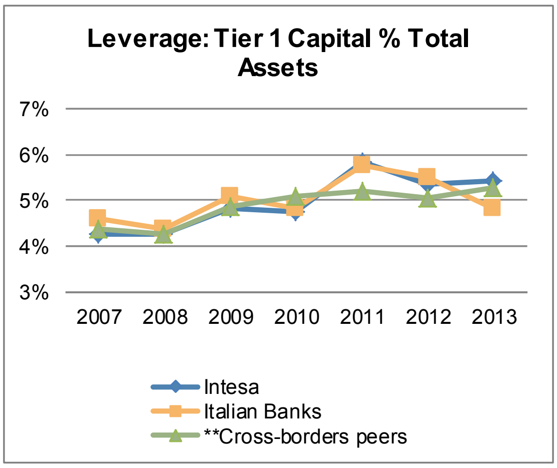
Source: SNL Financial, Scope Ratings



Source: SNL Financial, Scope Ratings



Source: SNL Financial, Scope Ratings



Source: SNL Financial, Scope Ratings

*National peers: Unicredit, UBI, BPM, Monte dei Paschi, Banco Popolare, Intesa.

**Cross-border peers: Group BPCE, Credit Mutuel Group, Credit Agricole, DNB, CaixaBank, Sw edbank, Lloyds, Wells Fargo, Rabobank, Intesa.

Selected Financial Information - Intesa Sanpaolo

	2007	2008	2009	2010	2011	2012	2013	2014E	2015E
Balance Sheet summary (EUR billion)									
Assets									
Cash and balances with central banks	3.5	7.8	8.4	4.8	4.1	5.3	6.5	6.7	6.8
Interbank assets	62.8	56.4	43.3	42.8	36.1	36.8	26.9	26.1	25.3
Total securities	95.0	72.9	94.3	133.9	123.5	154.6	173.8	168.6	163.6
of which debt instruments	72.4	59.6	77.6	113.2	105.5	134.9	143.1	138.8	134.6
of which equity instruments	22.6	13.3	16.7	20.7	18.0	19.6	30.8	29.8	28.9
Derivatives	23.0	47.8	44.9	46.4	52.2	56.7	37.5	37.2	37.3
Gross customer loans	347.6	409.0	390.6	397.8	399.1	400.5	373.0	374.4	381.3
of which impaired loans	16.6	22.6	34.4	37.1	41.8	49.7	57.6	57.6	54.7
Total funded assets	549.3	585.7	578.3	609.2	582.5	611.9	581.4	585.8	591.0
Total Assets	**572.9**	**636.1**	**624.8**	**658.8**	**639.2**	**673.6**	**626.3**	**630.2**	**635.7**
Liabilities									
Interbank liabilities	70.9	53.5	45.7	55.4	80.6	75.9	55.2	53.5	51.9
Senior debt	127.8	172.2	165.6	157.1	141.5	145.9	124.5	120.7	117.1
Derivatives	23.6	50.4	46.5	49.6	56.7	61.7	44.9	44.4	44.6
Customer deposits	229.7	238.7	233.6	246.2	219.5	218.6	229.0	235.9	242.9
Subordinated debt + hybrid securities	16.3	20.0	22.9	24.1	19.4	13.4	13.6	13.2	12.8
Total Liabilities	**520.7**	**586.1**	**571.1**	**604.2**	**591.5**	**623.7**	**581.2**	**584.1**	**588.1**
Ordinary equity	51.6	49.0	52.7	53.5	47.0	49.3	44.5	45.6	47.0
Minority interests	0.8	1.1	1.1	1.1	0.7	0.6	0.5	0.5	0.5
Total Liabilities and Equity	**573.0**	**636.1**	**624.8**	**658.8**	**639.2**	**673.6**	**626.3**	**630.2**	**635.7**
Core Tier 1 Capital [1]	*21.7*	*24.1*	*25.7*	*26.2*	*32.8*	*33.5*	*31.3*	*32.3*	*33.8*
Income Statement summary (EUR billion)									
Net interest income	10.4	11.5	10.5	9.7	9.8	9.4	8.1		
Net fee & commission income	6.7	5.7	5.4	5.6	5.4	5.5	6.1		
Net trading income	1.2	-0.1	1.1	0.5	0.9	2.2	1.2		
Operating Income	**19.2**	**17.8**	**17.7**	**16.4**	**16.7**	**17.9**	**16.2**	**17.5**	**18.2**
Operating expenses	10.5	10.2	9.8	9.6	9.3	9.2	8.6	8.8	8.9
Loan loss provision charges	1.6	3.5	3.9	3.2	5.3	5.0	7.5	5.5	4.8
Non-recurring items	3.3	-1.3	0.1	0.5	-11.2	-0.6	-3.8	-0.2	-0.2
Pre-Tax Profit	**10.5**	**2.8**	**4.0**	**4.2**	**-9.0**	**3.2**	**-3.7**	**3.1**	**4.3**
Income tax	2.9	0.1	1.0	1.4	-0.9	1.5	0.9	1.3	1.8
Net profit attributable to minority interests	0.3	0.1	0.2	0.1	0.1	0.0	0.0	0.1	0.1
Net Income Attributable to Parent	**7.3**	**2.6**	**2.8**	**2.7**	**-8.2**	**1.6**	**-4.6**	**1.7**	**2.4**

Source: SNL Financial and Scope Ratings for historical figures. Scope's forecasts are based on publicly available information. Please refer to "Methodologies Used for this Report" for further details.
[1] Basel 2 basis

Ratios - Intesa Sanpaolo

	2007	2008	2009	2010	2011	2012	2013	2014E	2015E
Funding/Liquidity									
Gross loans % Total deposits	151.3%	171.3%	167.2%	161.6%	181.8%	183.2%	162.9%	158.8%	157.0%
Total deposits % Total funds	51.6%	49.3%	49.9%	51.0%	47.6%	48.2%	54.2%	55.7%	57.2%
Wholesale funds % Total funds	48.4%	50.7%	50.1%	49.0%	52.4%	51.8%	45.8%	44.3%	42.8%
Asset Mix, Quality and Growth									
Total loans % Funded assets	63.3%	69.8%	67.5%	65.3%	68.5%	65.5%	64.2%	63.9%	64.5%
Impaired loans % Gross loans	4.8%	5.5%	8.8%	9.3%	10.5%	12.4%	15.4%	15.4%	14.3%
Loan loss reserves % Impaired loans	70.5%	60.1%	47.8%	50.0%	53.3%	47.9%	50.3%	52.8%	55.6%
Gross loan growth (%)	76.3%	17.7%	-4.5%	1.8%	0.3%	0.4%	-6.9%	0.4%	1.8%
Impaired loan growth (%)	76.1%	36.5%	52.2%	7.7%	12.8%	18.8%	15.9%	0.0%	-5.0%
Funded assets growth (%)	98.6%	6.6%	-1.3%	5.3%	-4.4%	5.0%	-5.0%	0.8%	0.9%
Earnings									
Net interest income % Revenues	53.9%	64.6%	59.6%	58.7%	58.3%	52.7%	49.9%	51.0%	50.5%
Fees & commissions % Revenues	34.6%	31.9%	30.4%	34.1%	32.5%	30.5%	37.7%	36.7%	37.1%
Trading income % Revenues	6.4%	-0.3%	6.4%	2.8%	5.5%	12.2%	7.1%	6.8%	6.9%
Other income % Revenues	5.1%	3.8%	3.7%	4.4%	3.7%	4.6%	5.2%	5.5%	5.5%
Net interest margin (%)	2.8%	2.3%	2.1%	1.8%	1.8%	1.8%	1.5%	1.7%	1.8%
Pre-provision Income % Risk-weighted assets (RWAs)	2.2%	2.0%	2.2%	2.1%	2.3%	2.9%	2.8%	3.2%	3.3%
Loan loss provision charges % Pre-provision income	18.1%	45.8%	50.3%	46.4%	70.7%	57.3%	98.6%	62.2%	51.9%
Loan loss provision charges % Gross loans (cost of risk)	0.6%	0.9%	1.0%	0.8%	1.3%	1.2%	1.9%	1.4%	1.3%
Cost income ratio (%)	54.8%	57.0%	55.6%	58.3%	55.5%	51.2%	53.0%	50.0%	49.1%
Net Interest Income / Loan loss charges (x)	6.6	3.3	2.7	3.0	1.9	1.9	1.1	1.6	1.9
Return on average equity (ROAE) (%)	20.8%	5.1%	5.5%	5.1%	-16.3%	3.3%	-9.7%	3.9%	5.2%
Return on average funded assets (%)	1.1%	0.3%	0.3%	0.3%	-0.9%	0.2%	-0.5%	0.2%	0.3%
Retained earnings % Prior year's book equity	13.1%	4.9%	3.6%	3.2%	-16.8%	1.6%	-10.9%	2.3%	3.2%
Pre-tax return on core tier 1 capital	13.2%	0.4%	3.9%	5.3%	-2.7%	4.6%	2.8%	4.1%	5.3%
Capital and Risk Protection [1]									
Common equity tier 1 ratio (common equity tier 1 capital % RWAs)	5.6%	6.3%	7.1%	7.9%	10.1%	11.2%	11.3%	11.6%	12.1%
Tier 1 leverage ratio (%)	0.0%	4.3%	4.8%	4.7%	5.8%	5.3%	5.4%		
Median of tier 1 leverage ratio and core tier 1 ratio (%)	2.8%	5.3%	6.0%	6.3%	8.0%	8.3%	8.4%		
Total loss coverage (core tier 1 capital + loan loss provisions) % RWAs	8.6%	9.8%	11.7%	13.4%	16.9%	19.2%	21.8%		
Non-senior bailinable debt cushion (as % of total liabilities)	3.1%	3.4%	4.0%	4.0%	3.3%	2.2%	2.3%		
Asset risk intensity (RWAs % total assets)	68.0%	60.2%	57.9%	50.4%	50.9%	44.3%	44.1%	44.1%	44.1%

Source: SNL Financial and Scope Ratings for historical figures. Scope's forecasts are based on publicly available information. Please refer to "Methodologies Used for this Report" for further details.
[1] Basel 2 basis

METHODOLOGIES USED FOR THIS REPORT

For the rating and analysis contents of this report, Scope has used the following methodologies which were published on www.scoperatings.com:

“Bank Rating Methodology” (February 2014)

“Forecasting Bank Financials Methodology” (February 2014)

Forecasting bank financials: Forward-looking estimates are an important analytical tool underpinning Scope’s bank ratings. These forecasts cover the current financial year (before final year-end figures are published by the bank) plus the forthcoming two years. Depending on the complexity of the bank being assessed, different forecasting tools will be used. For a majority of banks operating primarily commercial and retail banking franchises (loans and deposits) the analysis is underpinned by an **accounting** forecast of the balance sheet and profit and loss account. For more complex groups with multiple ranges of activities – notably those with material wholesale and investment banking operations – Scope uses an **analytical** forecast, relying on the bank’s business-line reporting to come up with plausible estimates. For all banks Scope also includes a **regulatory metrics** forecast, considering the growing importance of this aspect in bank analysis.

For complex banks, divisional data is used to forecast profit and loss accounts and basic divisional balance sheet metrics. For less complex banks, a line-by-line forecasting of major P&L elements is forecast.

For balance sheet forecasts, Scope estimates of all major balance sheet lines, using the P&L estimates to complete the forecast of the capital/shareholders’ equity line. This comprehensive methodology for estimating the balance sheet is used for all the banks in our universe, irrespective of size and complexity.

Lastly, our forecasts include assessments of the major regulatory metrics: Tier 1 and CET 1 (historically CT1), Leverage, Liquidity Coverage Ratio, and Net Stable Funding Ratio (the latter two when and if sufficient public information to compute them is available).

Scope will not aim to forecast financials when it considers the public disclosure of the bank as insufficient for a transparent and credible outcome.

All Scope’s bank financial forecasts are based on public information. For its forecasts Scope will not use any non-public information or data, even if such information or data were provided by rated banks. Scope’s forecasting process is transparent, with a detailed roadmap provided in its *“Forecasting bank financials”* methodology.

KBC Group NV
Issuer Rating Report

SCOPE A- STABLE OUTLOOK Financial Institutions

Overview

The Issuer Credit-Strength Rating (ICSR) of A- with a stable outlook on KBC Group NV is driven by its focused and solid franchise as a leading bancassurer in Belgium and the Czech Republic as well as the meaningful progress made in recovering from the financial crisis. The Irish operations remain the exception and continue to drag on KBC's performance. Solvency has improved to satisfactory levels and liquidity is sound.

In assigning our rating, we have focused on KBC Group, rather than the standalone banking operations, as KBC remains committed to its integrated bank and insurance strategy. At year-end 2013, banking assets accounted for over 85% of group assets with insurance assets accounting for the remainder.

The rating of A- also applies to senior unsecured debt issued by KBC Bank NV but not to unguaranteed debt issued by its subsidiaries. Further, the rating is not applicable to debt issued by KBC Insurance NV.

Issuer Credit-Strength Rating (assigned on April 2, 2014)	**A-**
Outlook	Stable
Senior Unsecured Debt	A-
Short term rating (May 22, 2014)	S-1
Short term rating outlook	Stable

Unsolicited ratings with issuer participation.

Lead Analyst

Pauline Lambert
p.lambert@scoperatings.com

Team Leader

Sam Theodore
s.theodore@scoperatings.com

Rating drivers (Summary)

The ratings drivers, in decreasing order of importance in the rating assignment, are:

- (+) Solid franchise as a leading bancassurer in Belgium and the Czech Republic.
- (+) Improving solvency and solid liquidity position.
- (−) Relatively weak asset quality driven by operations in Ireland.
- (+) Focused strategy facilitated by the near completion of restructuring agreed with the European Commission.

Rating change drivers

Failure to repay aid received from the Flemish Regional Government. During the financial crisis, KBC received EUR 7bn in State aid (EUR 3.5bn from the Belgian Government and EUR 3.5bn from the Flemish Regional Government). To date, there remains EUR 2bn outstanding to the Flemish Regional Government – to be repaid in equal installments from 2014 to 2020. The expected source of repayment is earnings.

Change in business strategy which increases the risk profile of the Group. As KBC is nearly at the end of the restructuring prompted by the financial crisis, it has become more focused and lower risk. We would view negatively a change in strategy which increases risk – such as pursuing acquisitions in non-core markets, investing in higher risk assets or developing wholesale banking activities.

Maintaining a CRD4 fully loaded CET1 ratio of at least 10%. Management targets a CET1 ratio above 10% which exceeds the 9.25% requested by supervisory authorities. While KBC's capital ratio is currently above this target, future levels will be negatively impacted by expected impairments on the Irish loan portfolio as well as the repayment of State aid.

Improvement in Irish operations. The Irish operations continue to be loss making due to the high level of impairments. KBC has guided to a return to profitability in 2016 for this business. We would view positively an improvement in the Irish business as this is weakest part of the Group and continues to be a drag on performance.

Material deterioration in asset quality. The asset quality of the loan portfolio, driven by loans in Ireland, is relatively low compared with peers. After last year's review of the loan portfolio and the subsequent impairments in Ireland and Hungary, management has indicated that it does not expect any further material impairments. While significantly reduced, the Group still also has about EUR 4bn of net exposure to structured credit products.

Recent events

Q1 2014 results

For the three months ending March 31, 2014, KBC reported a net profit of EUR 397m, compared with EUR 524m in the prior year period. However, results in Q1 2013 included EUR 165m in gains on legacy CDOs. Excluding the impact of legacy items (CDOs, divestments) and the valuation of own credit risk, adjusted net profit was EUR 387m, up from EUR 359m. Banking activities accounted for about 75% of group adjusted net profit while insurance activities accounted for the remainder.

During the quarter, income from both banking and insurance operations was relatively stable. However, income was negatively impacted by mark-to-market changes in the value of derivatives used for asset/liability management purposes (primarily for mortgage loans). These adjustments amounted to a negative EUR 83m, compared to a quarterly average in 2013 of a positive EUR 70m. Management noted that future interest rate movements will continue to impact the fair value of derivatives. On the expense side, loan impairment charges were significantly lower in Ireland and remained subdued in other countries (1Q2014: 102m; 1Q2013: 293m). Despite the strong improvement in the quarter, KBC confirmed its earlier guidance in regards to credit costs for the year.

Of note, the National Bank of Belgium intends to remove the zero percent risk weighting on home country government bonds. This resulted in a EUR 4.4bn increase in RWAs to EUR 94.2bn. Consequently, under the Danish compromise, the CRD4 fully loaded CET1 ratio was 12.5% on a proforma basis (including impact of remaining divestments – Antwerp Diamond Bank and KBC Bank Deutschland).

Repayment of State aid

In January 2014, KBC repaid a second installment to the Flemish Regional Government of EUR 500m (EUR 330m principal plus a 50% premium), leaving a balance of EUR 2bn. This repayment is ahead of the schedule agreed with the European Commission. While repayments may be accelerated with the approval of the Belgian National Bank, management has indicated that this is unlikely to happen until there is further clarity regarding the ECB's upcoming asset quality review.

Management has stated that it does not intend to pay dividends in 2013 and 2015, thus avoiding the need to pay coupons on the outstanding securities subscribed to by the Flemish Regional Government in 2013 and 2015. However, as the terms of these securities do not allow coupon payments to be skipped for two consecutive years, KBC has announced that it intends to pay the coupon and a dividend in 2014. The dividend may be up to EUR 2 per share, depending on earnings. It is KBC's intention to resume regular dividend payments from 2016 onwards.

Rating drivers (Details)

1. Solid franchise as a leading bancassurer in Belgium and the Czech Republic

KBC is a leading financial institution in its home market of Belgium, as well as in the Czech Republic, serving mainly retail, SME and mid-cap customers. In both of these markets, the Group holds significant market share: 20% in loans and deposits and around 30% in investment funds. In addition, market shares in insurance are relatively solid.

Since the financial crisis, KBC has re-focused its business to concentrate on these two markets as well as on Slovakia, Hungary, Bulgaria and Ireland. In all markets except Ireland, where it provides only banking services, KBC offers both banking and insurance services. Unlike other financial groups, KBC remains committed to its integrated bancassurance model as it believes that it leads to higher cross-selling rates and "good operational results through the cycle."

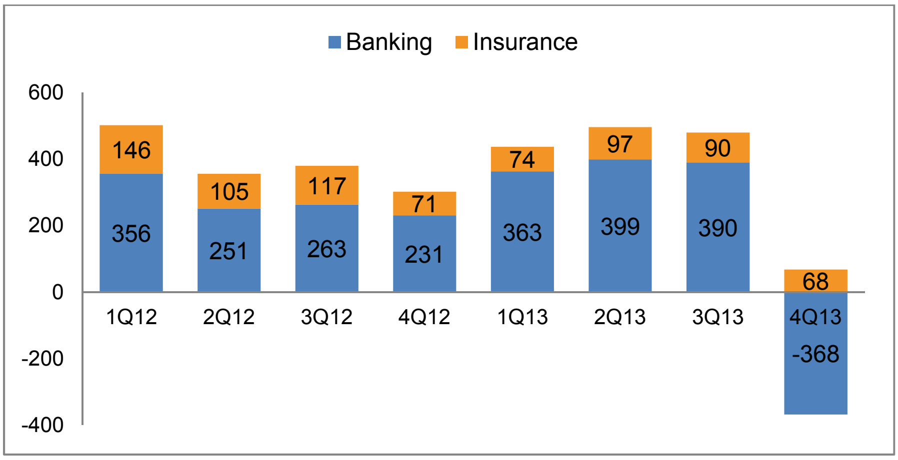
Table 1: Market shares, year-end 2013

	Belgium	Czech	Slovakia	Hungary	Bulgaria
Loans and deposits	20%	20%	10%	9%	2%
Investment funds	35%	29%	7%	17%	-
Life insurance	17%	6%	5%	3%	10%
Non-life insurance	9%	6%	3%	5%	10%

Source: Company data, Scope Ratings

After significant losses in 2008 and 2009, KBC has since consistently generated profits. Earnings, however, continue to be negatively impacted by impairments and divestments. 2011 was a particularly poor year as there were also EUR 0.4bn in impairments related to Greek government bonds. And in 2013, earnings suffered from a significant increase in loan impairments, primarily for the Irish and Hungarian businesses (2013: EUR 1.6bn, 2012: EUR 1.1bn).

Chart 1: Underlying net result from banking and insurance (EURm)



Note: Underlying result excludes changes in fair value of own debt and legacy businesses (CDOs, structured derivatives, divestments). Source: Company data, Scope Ratings

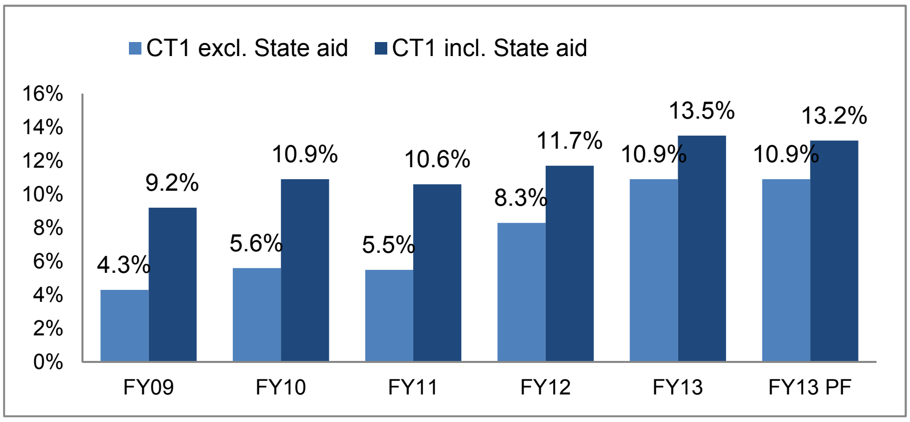
2. Improving solvency and sound liquidity position

KBC's capital position has strengthened considerably since 2009 (even excluding state aid) through a combination of retained earnings, a EUR 1.25bn rights issue in 2012, a reduction in risk-weighted assets and active capital management. The remaining EUR 2bn of aid from the Flemish Regional Government is grandfathered as common equity under CRD4 until January 2018.

At year-end 2013, on a pro-forma CRD4 fully-loaded basis, the Group's reported CET1 ratio was 12.5% and the Bank's leverage ratio was 4.4%. The 12.5% CET1 ratio is based on the Danish compromise, which assigns a 370% risk weighting to the holdings of own funds instruments of the insurance company. The figure is also pro-forma the EUR 500m payment made to the Flemish Regional Government in January 2014 and the impact of the signed divestments of KBC Bank Deutschland and Antwerp Diamond Bank.

Excluding the EUR 2bn in State aid, we estimate that KBC's fully loaded CET1 ratio would be about 10.3%. If the EUR 2bn in aid as well as the associated EUR 1bn premium were deducted, we estimate that the CET1 ratio would be about 9.2%. KBC's internal minimum target for the CET1 ratio is 10% on a fully loaded basis, while the National Bank of Belgium has requested that KBC maintain a minimum fully loaded CET1 of 9.25%, excluding latent gains.

Chart 2: Capital development under Basel 2.5



Note: 2013 proforma figures include the EUR 500m repayment of State made in January 2014 and the signed divestments of KBC Bank Deutschland and Antwerp Diamond Bank.
Source: Company data, Scope Ratings

KBC Bank maintains a sound liquidity and funding profile. Deposits account for 75% of the funding mix and within this, over 60% is comprised of retail and SME deposits and another 30% of mid-cap deposits. Over the years, the proportion of customer deposits and equity has increased while the proportion of unsecured interbank funding has declined. Deposits are now sufficient to fully fund loans.

At year-end 2013, KBC Bank had EUR 13.1bn in short-term unsecured funding outstanding, compared with EUR 57bn in liquid assets. The reported LCR of 131% and NSFR of 111% were above their 2015 targets of 100% and 105%, respectively. In Q1 2013, the Group repaid EUR 8.3bn in LTRO borrowings, with the remaining EUR 0.37bn outstanding being used in businesses to be disposed of.

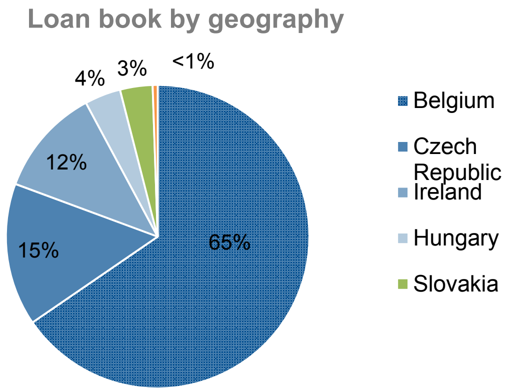
The Group has diversified access to capital markets funding. With the introduction in late 2012 of a new framework for Belgian covered bonds, KBC has issued over EUR 4bn in benchmark bonds based solely on a cover pool of Belgian residential mortgages. KBC intends to be a regular issuer of covered bonds as it further diversifies funding. The Group has also issued USD 1bn of capital contingent notes in January 2013 and EUR 1.4bn in CRD4 compliant Additional Tier 1 capital securities in March 2014.

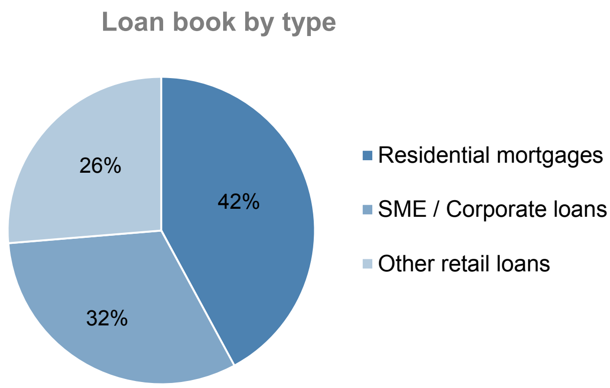
3. Relatively weak asset quality driven by operations in Ireland

KBC reported a non-performing loan ratio of 5.9% at year-end 2013. However, when adjusted to include restructured loans, over 10% of the loan portfolio is impaired which is relatively high compared to peers. Impairments are not evenly spread throughout the loan portfolio, but are concentrated in Ireland and Hungary.

The largest exposure within the loan portfolio is Belgian-based (over 65%), with the second largest exposure being to the Czech Republic at 15%, followed by Ireland at 12%. Hungary accounts for less than 5% of the loan portfolio.

Chart 3: 2013 loan book by geography and type





Note: Excluding Corporate Centre. Source: Company data, Scope Ratings

In Belgium, mortgages account for about a third of the loan portfolio, with another third being retail lending and the remaining third being SME/corporate lending. The average loan-to-value (LTV) on mortgages is a reasonable 61%. The Belgian economy has been relatively resilient and while home sales have declined, home prices have not. Since late 2007, the 3 month arrears rate for Belgian mortgage loans have been around 1% while for KBC this has been even lower (between 0.2% and 0.4%). Within the Belgian business unit, 2.5% of loans are non-performing. In the Czech Republic, mortgages with an average LTV of 66% account for 45% of the loan portfolio. Within the Czech loan book, 3.0% of loans are non-performing.

In Ireland, nearly 80% of the portfolio is comprised of mortgages. However, the average LTV is a high 117% and nearly half of mortgages have a LTV above 100%. The amount impaired (rather than just non-performing) on the entire Irish loan book is nearly 48%, with provisions providing a relatively modest coverage of 37%. As mentioned above, KBC has recently reassessed this portfolio in light of the EBA's guidelines on non-performing loans and the upcoming asset quality review. In addition to the EUR 773m in loan loss provisions incurred in Q4 2013 due to the reclassification of EUR 2bn of restructured mortgage loans and lower recovery expectations for the SME sector, management has guided to loan loss provisions of EUR 150-200m in 2014 and EUR 50-100m in 2015 and in 2016.

Within Hungary, mortgages with a LTV of 84% account for 35% of the portfolio. About 15% of the entire Hungarian loan book is impaired and provisions provide coverage of 52%. There has been some uncertainty in the Hungarian banking market due to the introduction of a financial transaction levy and the desire by the government to address foreign-currency denominated mortgage loans. KBC has EUR 1.4bn in foreign-currency denominated mortgages outstanding.

4. Focused strategy facilitated by the near completion of restructuring agreed with the European Commission

In 2008/2009, KBC was one of three banks in Belgium that required government support. The Group had a large financial markets business that originated as well as invested in structured credit products. As these products suffered credit rating downgrades leading to losses, investors became increasingly concerned about KBC's exposure. In addition to capital support, KBC secured a guarantee from the Belgian State covering 90% of the default risk on a notional amount of EUR 20bn in structured credit exposure (EUR 5.5bn for super senior CDO investments and EUR 14.5bn of counterparty risk on MBIA, the US monoline insurer). At year-end 2013, the net exposure to structured credit products had reduced to EUR 6.3bn, with EUR 5.3bn of CDO exposure protected by MBIA. In Q1 2014, KBC collapsed another CDO, which led to a further EUR 2bn decrease in exposure.

As agreed with the European Commission in 2009, KBC would lower its RWA by 25% through significant reductions in capital markets activities, non-domestic corporate lending, private banking and structured credit exposures. The agreement was renegotiated twice, in 2011 and 2012, but the required divestments are now nearly complete. During the last quarter of 2013, the Group completed the divestment of KBC Banka in Serbia and reached agreements to sell Antwerp Diamond Bank and KBC Bank Deutschland AG. The disposals are expected to have a negligible impact on earnings. Between 2008 and 2013, the Group has actually reduced RWA by over 40%, from EUR 155bn to EUR 90bn.

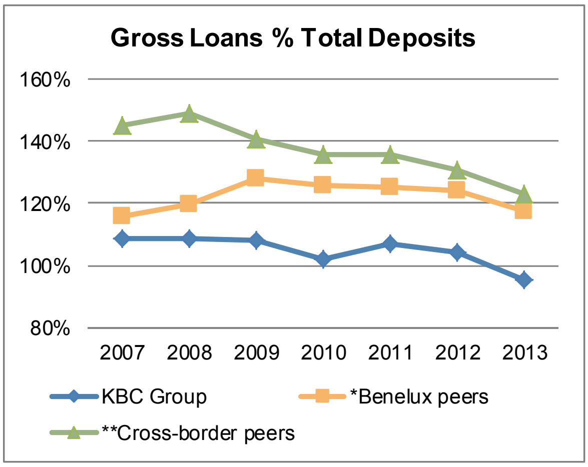
Consequently, KBC has a focused bancassurance strategy in its core markets of Belgium and the Czech Republic, complemented by Slovakia, Hungary and Bulgaria. And in Ireland, KBC intends to turnaround the banking business so that it is profitable in 2016. As a reflection of this focus, effective January 2013, the Group changed its reporting business lines to the following: Belgium, the Czech Republic, International Markets and Group Centre (includes legacy businesses such as CDOs, activities in run-off and divestments).

Peer comparison

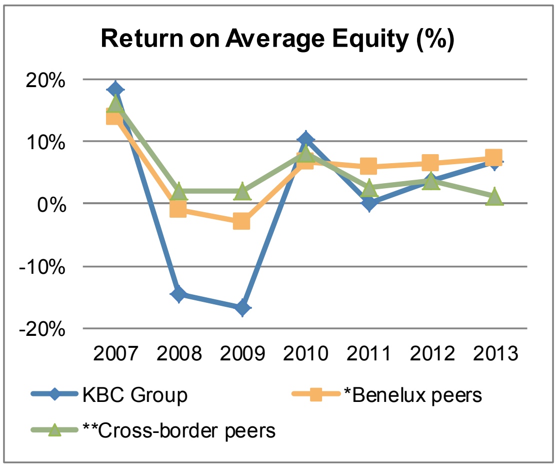
KBC Group is largely a domestic bancassurer with 65% of earnings coming from its home market. However, it also benefits from diversification in selected CEE countries. Within Belgium, KBC competes against ING Belgium and BNP Paribas Fortis, both part of larger financial services groups. It also competes against Belfius Bank and Insurance, which emerged from the dismantling of Dexia Group and is a domestic player that is fully owned by the Belgian State.

At Scope Ratings, we also compare banks within cross-border peer groups and have included KBC Group in the category of international retail banks. This peer group includes banks such as ING Bank, Santander, BBVA, Unicredit, Nordea, Danske and Commerzbank. Compared with peers, KBC has a solid liquidity profile with customer funding accounting for a significant portion of funding and a loan to deposit ratio below 100%. In terms of asset quality, the level of impaired loans is much higher than for peers due to its operations in Ireland. Impairments have so far been adequately covered by pre-provision income. And in regards to solvency, KBC's CET1 and leverage ratios appear somewhat better than peers but we note that KBC's figures include the benefit of State aid, which will need to be repaid over the following six years.

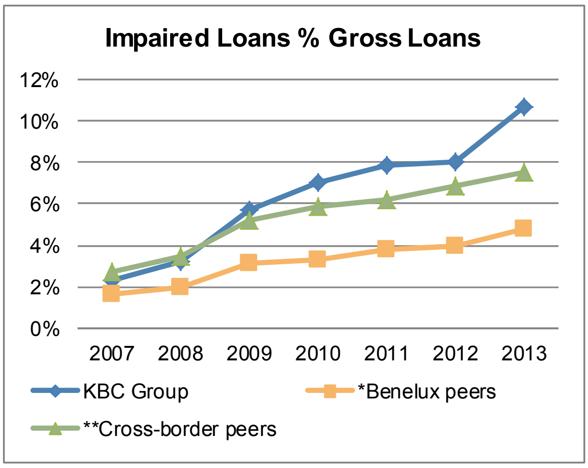
Peer Comparison - KBC Group NV



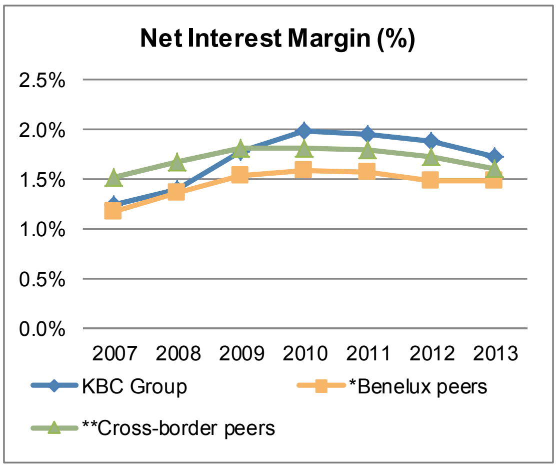
Source: SNL Financial, Scope Ratings



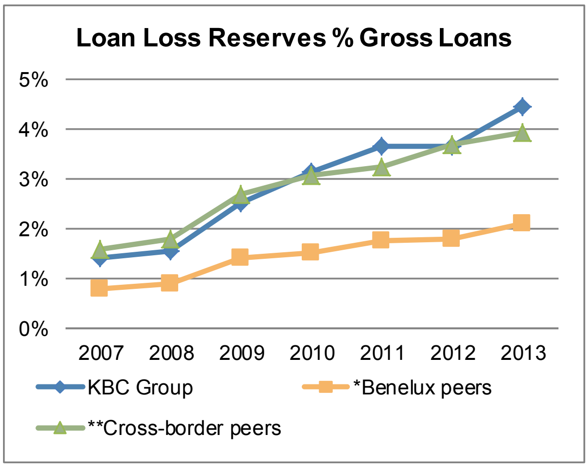
Source: SNL Financial, Scope Ratings



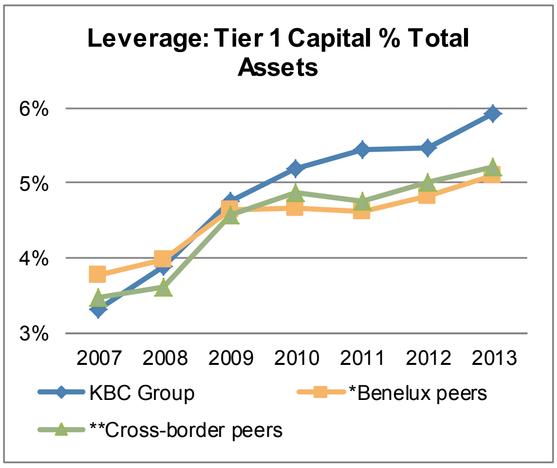
Source: SNL Financial, Scope Ratings



Source: SNL Financial, Scope Ratings



Source: SNL Financial, Scope Ratings



Source: SNL Financial, Scope Ratings

*Benelux Peers : KBC Group, ABN AMRO, ING Bank, Rabobank.

**Cross-border peers based on business model : Santander, BBVA, Unicredit, RBS, Erste Bank, RZB AG, Commerzbank, Nordea, KBC Group, Danske Bank, ING Bank.

Notes: Cross-border peer group averages exclude RZB in 2013

Selected Financial Information - KBC Group NV

	2007	2008	2009	2010	2011	2012	2013	2014E	2015E
Balance Sheet summary (EUR billion)									
Assets									
Cash and balances with central banks	4.6	4.5	7.2	15.3	6.2	4.4	4.4	4.4	4.5
Interbank assets	53.8	36.8	21.2	15.5	19.2	16.1	16.3	16.4	16.6
Total securities	108.1	97.3	100.5	91.7	66.8	79.1	77.9	75.4	73.1
of which debt instruments	83.1	86.0	93.1	85.9	62.9	64.9	63.3	60.1	57.1
of which equity instruments	22.2	9.1	5.4	3.8	2.5	2.4	1.9	1.9	2.0
Derivatives	22.2	39.0	21.5	16.3	17.7	13.4	8.7	8.5	8.4
Gross customer loans	149.3	160.4	157.4	155.7	143.5	133.4	128.5	126.1	124.9
of which impaired loans	3.4	5.1	9.0	11.0	11.2	10.8	13.7	13.0	12.8
Total funded assets	329.1	314.6	296.8	297.4	261.8	240.0	231.5	231.8	232.8
Total Assets	**355.6**	**355.3**	**324.2**	**320.8**	**285.4**	**256.9**	**241.3**	**241.4**	**242.3**
Liabilities									
Interbank liabilities	73.1	60.6	45.4	27.9	25.9	22.9	14.3	13.6	12.9
Senior debt	47.2	40.0	38.7	35.8	22.7	24.8	22.9	21.8	20.7
Derivatives	26.5	40.7	27.4	23.4	23.6	16.9	9.8	9.6	9.4
Customer deposits	137.3	147.0	145.3	152.9	134.5	128.3	134.8	137.5	138.8
Subordinated debt + hybrid securities	7.6	9.7	9.4	9.1	8.1	6.6	6.5	5.8	5.2
Total Liabilities	**337.2**	**339.9**	**307.1**	**302.1**	**268.6**	**241.1**	**226.5**	**226.6**	**226.9**
Ordinary equity	17.2	10.7	9.7	11.1	9.8	12.0	12.1	12.4	13.3
Minority interests	1.1	1.2	0.5	0.5	0.5	0.4	0.4	0.4	0.4
Total Liabilities and Equity	**355.7**	**355.3**	**324.2**	**320.8**	**285.4**	**256.9**	**241.3**	**241.4**	**242.3**
Core Tier 1 Capital [1]	*10.0*	*11.1*	*13.2*	*14.4*	*13.4*	*11.6*	*11.2*	*12.0*	*12.9*
Income Statement summary (EUR billion)									
Net interest income	4.1	5.0	5.8	6.2	5.5	4.7	4.1	4.0	3.9
Net fee & commission income	2.0	1.7	1.1	1.2	1.2	1.3	1.5	1.6	1.7
Net trading income	2.3	-3.4	-3.3	0.0	-0.1	0.5	1.3	1.0	0.8
Operating Income	**9.7**	**4.8**	**4.6**	**8.3**	**7.3**	**7.7**	**7.5**	**7.2**	**7.0**
Operating expenses	5.2	5.6	4.8	4.4	4.3	4.2	3.9	3.7	3.7
Loan loss provision charges	0.3	2.2	2.2	1.5	1.5	1.1	1.8	1.2	1.1
Non-recurring items	0.0	0.0	0.0	0.0	-0.3	-0.1	0.0	-0.5	-0.7
Pre-Tax Profit	**4.4**	**-3.0**	**-2.9**	**2.2**	**0.8**	**1.0**	**1.7**	**1.7**	**1.6**
Income tax	1.0	-0.6	-0.3	0.1	0.3	0.4	0.7	0.7	0.6
Net profit attributable to minority interests	0.1	0.1	-0.1	0.0	0.0	0.0	0.0	0.0	0.0
Net Income Attributable to Parent	**3.3**	**-2.5**	**-2.5**	**1.9**	**0.0**	**0.6**	**1.0**	**1.0**	**0.9**

Source: SNL Financial and Scope Ratings for historical figures. Scope's forecasts are based on publicly available information. Please refer to "Methodologies Used for this Report" for further details.
[1] CRD 4 basis from 2012 onwards

Ratios - KBC Group NV

	2007	2008	2009	2010	2011	2012	2013	2014E	2015E
Funding/Liquidity									
Gross loans % Total deposits	108.7%	109.1%	108.3%	101.8%	106.7%	104.0%	95.4%	91.7%	89.9%
Total deposits % Total funds	51.7%	56.3%	59.1%	65.7%	68.0%	68.9%	74.6%	76.1%	77.4%
Wholesale funds % Total funds	48.3%	43.7%	40.9%	34.3%	32.0%	31.1%	25.4%	23.9%	22.6%
Asset Mix, Quality and Growth									
Gross loans % Funded assets	45.4%	51.0%	53.0%	52.4%	54.8%	55.6%	55.5%	54.4%	53.6%
Impaired loans % Gross loans	2.3%	3.2%	5.7%	7.0%	7.8%	8.1%	10.7%	10.3%	10.2%
Loan loss reserves % Impaired loans	64.8%	59.7%	46.9%	46.1%	46.7%	45.2%	41.8%	44.0%	44.9%
Gross loan growth (%)	15.4%	7.4%	-1.8%	-1.1%	-7.8%	-7.1%	4.0%	7.7%	6.7%
Impaired loan growth (%)	3.7%	48.5%	75.5%	21.9%	2.6%	-4.2%	27.5%	21.1%	-6.9%
Funded assets growth (%)	9.4%	-4.4%	-5.7%	0.2%	-12.0%	-8.3%	-3.6%	-3.4%	0.6%
Earnings									
Net interest income % Revenues	42.0%	103.4%	126.4%	75.1%	75.6%	60.4%	55.0%	55.7%	55.9%
Fees & commissions % Revenues	20.5%	35.5%	24.6%	14.7%	16.1%	17.0%	19.7%	22.2%	24.2%
Trading income % Revenues	24.1%	-70.2%	-70.7%	0.2%	-0.8%	6.4%	17.2%	13.6%	11.0%
Other income % Revenues	13.4%	31.3%	19.7%	10.0%	9.1%	16.2%	8.1%	8.6%	8.9%
Net interest margin (%)	1.5%	1.7%	2.1%	2.3%	2.2%	2.1%	2.0%	2.0%	2.0%
Pre-provision Income % Risk-weighted assets (RWAs)	3.1%	-0.5%	-0.1%	2.9%	2.3%	3.2%	4.1%	4.1%	3.8%
Loan loss provision charges % Pre-provision income	5.7%	n.m.	n.m.	39.0%	52.0%	32.1%	48.1%	35.4%	33.7%
Loan loss provision charges % Gross loans (cost of risk)	0.2%	1.4%	1.4%	1.0%	1.0%	0.8%	1.4%	1.0%	1.0%
Cost income ratio (%)	53.6%	116.0%	103.8%	53.3%	59.9%	54.9%	51.5%	52.0%	52.0%
Net Interest Income / Loan loss charges (x)	15.8	2.3	2.6	4.1	3.6	4.2	2.4	3.3	3.4
Return on average equity (ROAE) (%)	19.2%	-17.8%	-24.2%	17.9%	0.1%	5.6%	8.4%	8.3%	7.2%
Return on average funded assets (%)	0.7%	-0.5%	-0.5%	0.4%	0.0%	0.2%	0.3%	0.3%	0.3%
Retained earnings % Prior year's book equity	11.7%	-14.5%	-23.0%	10.4%	-5.3%	-3.6%	n/a	2.1%	7.5%
Pre-tax return on common equity tier 1 capital	9.7%	-5.7%	-1.9%	0.6%	2.4%	3.1%	6.1%	5.7%	4.9%
Capital and Risk Protection [1]									
Common equity tier 1 ratio (common equity tier 1 capital % RWAs)	6.8%	7.2%	9.2%	10.9%	10.6%	10.5%	12.5%	13.3%	14.3%
Tier 1 leverage ratio (%)	3.3%	3.9%	4.8%	5.2%	5.4%	5.5%	5.9%		
Median of tier 1 leverage ratio and common equity tier 1 ratio (%)	5.1%	5.5%	7.0%	8.0%	8.0%	8.0%	9.2%		
Total loss coverage (CET 1 capital + loan loss provisions) % RWAs	8.3%	9.1%	12.2%	14.7%	14.8%	14.9%	18.9%	19.7%	20.7%
Non-senior bailinable debt cushion (as % of total liabilities)	2.3%	3.9%	5.2%	5.2%	5.3%	4.1%	3.8%	3.4%	3.0%
Asset risk intensity (RWAs % total assets)	41.5%	43.7%	44.2%	41.2%	44.3%	39.8%	37.1%	37.1%	37.1%

Source: SNL Financial and Scope Ratings for historical figures. Scope's forecasts are based on publicly available information. Please refer to "Methodologies Used for this Report" for further details.
[1] CRD 4 basis from 2012 onwards

METHODOLOGIES USED FOR THIS REPORT

For the rating and analysis contents of this report Scope has used the following methodologies which were published on www.scoperatings.com:

"Bank Rating Methodology" (February 2014)

"Forecasting Bank Financials Methodology" (February 2014)

Forecasting bank financials: Forward-looking estimates are an important analytical tool underpinning Scope's bank ratings. These forecasts cover the current financial year (before final year-end figures are published by the bank) plus the forthcoming two years. Depending on the complexity of the bank being assessed, different forecasting tools will be used. For a majority of banks operating primarily commercial and retail banking franchises (loans and deposits) the analysis is underpinned by an **accounting** forecast of the balance sheet and profit and loss account. For more complex groups with multiple ranges of activities – notably those with material wholesale and investment banking operations – Scope uses an **analytical** forecast, relying on the bank's business-line reporting to come up with plausible estimates. For all banks Scope also include a **regulatory metrics** forecast, considering the growing importance of this aspect in bank analysis.

For complex banks, divisional data is used to forecast profit and loss accounts and basic divisional balance sheet metrics. For less complex banks, a line-by-line forecasting of major P&L elements is forecast.

For balance-sheet forecasts, Scope estimates of all major balance sheet lines, using the P&L estimates to complete the forecast of the capital/shareholders' equity line. This comprehensive methodology for estimating the balance sheet is used for all the banks in our universe, irrespective of size and complexity.

Lastly, our forecasts include assessments of the major regulatory metrics: Tier 1 and CET 1 (historically CT1), Leverage, Liquidity Coverage Ratio, and Net Stable Funding Ratio (the latter two when and if sufficient public information to compute them is available).

Scope will not aim to forecast financials when it considers the public disclosure of the bank as insufficient for a transparent and credible outcome.

All Scope's bank financial forecasts are based on public information. For its forecasts Scope will not use any non-public information or data, even if such information or data were provided by rated banks. Scope's forecasting process is transparent, with a detailed roadmap provided in its *"Forecasting bank financials"* methodology.

Lloyds Bank plc
Issuer Rating Report

SCOPE — A STABLE OUTLOOK — Financial Institutions

Overview

Scope Ratings assigns an Issuer Credit-Strength Rating (ICSR) of A and a short-term debt rating of S-1 for Lloyds Bank plc, both with Stable outlooks. The ratings are based on the strength of the Lloyds Banking Group. Lloyds enjoys a strong domestic franchise in the UK as a leading provider of current accounts, savings, personal loans, credit cards, mortgages and insurance. Over the last five years, management has made clear progress in transforming the Group into a lower risk UK focused retail and commercial bank. Lloyds, however, still needs to generate more sustainable earnings and further clean up its balance sheet to strengthen its financial profile.

The ratings also apply to senior unsecured and short-term debt issued by the parent of Lloyds Bank plc, Lloyds Banking Group plc. However, the ratings are not applicable to unguaranteed debt issued by subsidiaries of Lloyds Bank plc.

Issuer Credit-Strength Rating (assigned April 2, 2014)	**A**
Outlook	Stable
Senior unsecured debt	A
Short term debt rating (May 22, 2014)	S-1
Short term debt rating outlook	Stable

Unsolicited ratings with issuer participation.

Lead Analyst

Pauline Lambert
p.lambert@scoperatings.com

Team Leader

Sam Theodore
s.theodore@scoperatings.com

Rating drivers (Summary)

The rating drivers, in decreasing order of importance in the rating assignment, are:

- (+) Strong domestic retail and commercial banking franchise in the UK which should generate sustainable earnings.
- (−) Performance continues to be hampered by non-core, restructuring and legacy costs.
- (+) Management has delivered on implementing a focused low risk strategy.
- (−) Significant exposure to the UK housing market.

Rating change drivers

Higher and more stable earnings. Lloyds's earnings remain depressed by impairment, restructuring and legacy costs. We would view positively a reduction in these costs and a continual improvement in margins and volumes for the core business.

Sell-down of government stake. After two successful sales of shares to institutional investors in September 2013 and March 2014, the UK government now holds a 24.9% stake, down from 43.4%. The UK government is expected to continue selling down its stake. Further, in February 2014, Lloyds confirmed that it was preparing documents required for a possible future sale of shares to the public.

Inability to meet the evolving demands of the national regulator, the Prudential Regulatory Authority (PRA). The PRA has set some precedence in being more demanding than other European regulators. For example, the PRA expects banks to meet at least 56% of their Pillar 2A capital requirements with common equity tier 1 capital (CET1). As well, Pillar 2A capital is expected to sit below the CRD IV combined buffer. Going forward, UK banks will also be subject to annual stress testing and the ring-fencing of certain retail activities.

Recent events

Q1 2014 results

For the three months ending March 31, 2014, Lloyds reported a statutory profit after tax of GBP 1.2bn, down from GBP 1.5bn in the prior year period. The results of Q1 2013 included a gain of GBP 776m from the sale of government bonds and GBP 462m of insurance volatility gain (Q1 2014: GBP 64m negative insurance volatility). Meanwhile, underlying profit increased 22% to GBP 1.8bn, driven by a ten percent rise in net interest income as well as a five percent decline in costs and a 57% decline in impairments. The reported banking net interest margin continued to improve and was 2.32% in the quarter (4Q 2013: 2.29%). Consequently, Lloyds revised its guidance for the 2014 full year net interest margin to around 2.4%, an increase of about 10bps on previous guidance. The asset quality ratio for full year 2014 is now also expected to reduce to around 45 bps, compared to previous guidance of 50 bps (1Q 2014: 35 bps).

During the quarter, the Group’s capital position strengthened to 10.7% on a proforma fully loaded CET1 basis (2013: 10.3%). The increase was driven by underlying earnings, a further dividend of GBP 400m from the insurance business and the continued reduction in risk-weighted assets. On a proforma fully loaded CRD4 basis, the leverage ratio was 4.1% (2013: 3.4%). Management reaffirmed its expectations to generate 2.5% of fully loaded CET1 capital over the next two years and then 1.5% to 2% per year, before dividends. Our forecasts incorporate management’s expectations to apply to the PRA in the second half of 2014 to restart paying a modest dividend. Over the medium term, the target is a dividend payout ratio of at least 50% of sustainable earnings.

Enhanced Capital Notes (ECN) exchange offers

During the first four months of 2014, under various exchange offers, Lloyds repurchased GBP 5bn (nominal) of ECNs and issued GBP 5.35bn in new AT1 securities, improving the quality of its capital. These transactions increased the proforma leverage ratio by approximately 50 bps and are expected to benefit the net interest margin in 2014 by approximately 7bps.

In the second quarter, the exchanges are expected to result in an accounting charge of GBP 1.3bn. At the same time, this charge negatively impacted the first quarter proforma fully loaded CET1 capital ratio by about 50bps.

Project Verde

As a condition for receiving state aid, Lloyds was required by the European competition authorities to divest a portion of its retail business by November 2013 (Project Verde). Verde comprises around 630 branches, serving 4.6 million customers and will be the eighth largest bank in the UK. In September 2013, these branches were launched as a new challenger bank under the name of TSB. With the proposed sale to Co-operative Bank falling through, Lloyds plans to divest Verde through an IPO in mid-2014, subject to regulatory and EC approval. The disposal is not expected to materially change the Group’s strong domestic retail franchise.

Rating drivers (Details)

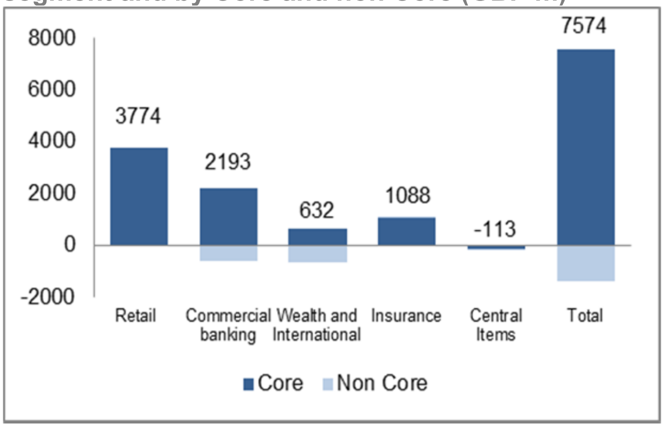
1. Strong domestic retail and commercial franchise in the UK which should generate sustainable earnings

In 2008, as the financial crisis began to take hold, the former Lloyds was in a relatively sound position. It was considered the “most trusted bank” in the UK and had generated GBP 0.8bn in net profit despite market dislocation and a deteriorating UK economy. Meanwhile, investors and customers were increasingly concerned about the creditworthiness of HBOS. For 2008, HBOS recorded a loss of GBP 10.8bn due to losses in its loan portfolio and impairments on its investments. In January 2009 when the two banks merged, assets more than doubled to GBP 1 trillion. The new entity combined the largest and third largest mortgage providers at the time and became the clear market leader in terms of personal current accounts. While integrating HBOS, Lloyds has committed to reducing GBP 200bn of non-core assets by year-end 2014.

Lloyds today remains a leading financial services provider, serving over 30 million customers with the largest branch network in the UK. Unlike other players, Lloyds pursues a multi-brand and multi-channel strategy and remains committed to its bancassurance model. Its well-known brands include Lloyds, Halifax, Bank of Scotland and Scottish Widows. The Group is the UK’s leading provider of current accounts, savings, personal loans, credit cards and mortgages. In insurance, the focus is on pensions, protection, annuities and home insurance. Over 15% of FTSE 350 companies use Scottish Widows for their corporate pension arrangements.

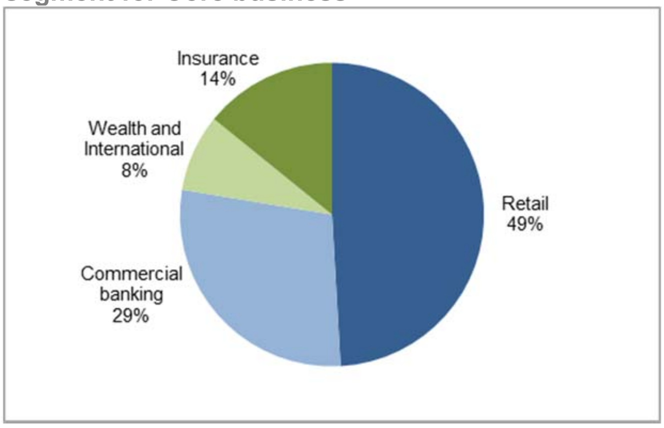
Lloyds enjoys strong market positions and is active in lower risk retail and commercial banking activities. In mortgages, Lloyds plans to grow in line with the market, with an emphasis on first time buyers as there are greater cross-selling opportunities. Efforts are focused on areas such as lending to SMEs and mid-sized corporates (low 20% market share) and unsecured personal lending (about 15% market share) where the Group has less than 25% market share. Reflecting this strategy, a new Consumer Finance division was created in January 2014, which comprises the asset finance (primarily auto lease and motor finance) and credit card businesses.

Chart 1: 2013 underlying profit by business segment and by Core and non Core (GBP m)



Source: Company data, Scope Ratings

Chart 2: 2013 underlying profit by business segment for Core business



Source: Company data, Scope Ratings

2. Performance continues to be hampered by non-core, restructuring and legacy costs

Weak earnings. While Lloyds has made good progress in its business transformation, its earnings remain relatively weak. Furthermore, there is a degree of volatility in reported earnings due to the accounting treatment of its insurance operations. Over GBP 100bn of financial assets backing insurance and investment contracts are accounted for as “other financial assets at fair value through profit or loss” on the balance sheet. Changes in the fair value of these financial assets are consequently reflected in the “trading income” line in the income statement.

2013 results included GBP 668m of positive insurance and policyholder interests volatility, reflecting the rise in equity markets during the year (2012: GBP 312m).

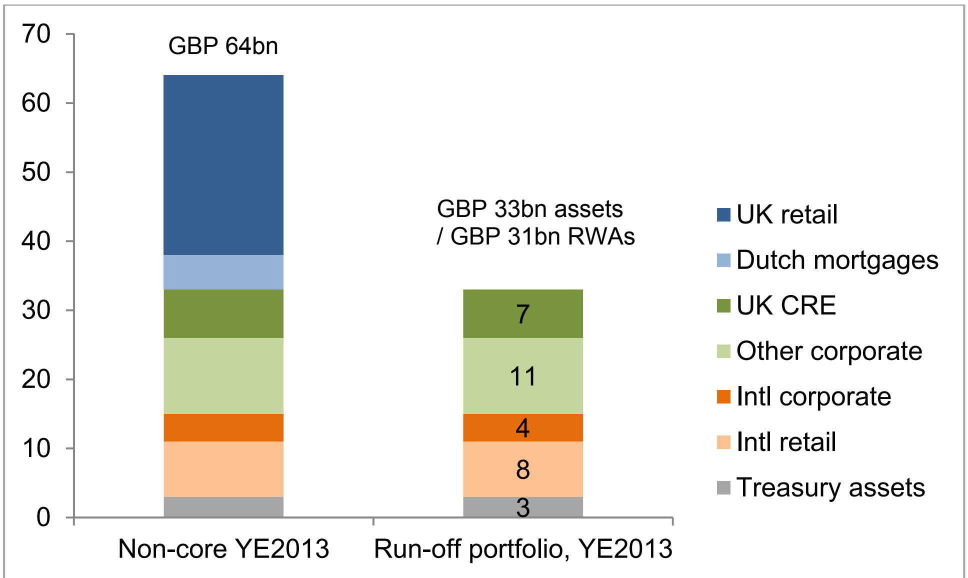
Lloyds is aiming to generate sustainable, predictable returns on equity above the cost of equity. On an underlying basis, the trends are positive but there is much room for improvement. Over the last year, Lloyds has reported an improving banking net interest margin (NIM) each quarter (Q1 2014: 2.32%, Q4 2013: 2.29%, Q3 2013: 2.17%, Q2 2013: 2.06%). In 2013, the Group made a statutory profit before tax of GBP 415m but has been loss-making on a statutory post-tax basis since 2010.

Non-core. Lloyds' non-core assets continue to negatively impact performance. In 2013, the core generated an underlying profit of GBP 7.6bn while the non-core generated an underlying loss of GBP 1.4bn. Although just accounting for 15% of total risk weighted assets, the non-core accounted for half of total impairments. Non-core businesses have below-hurdle returns, are outside of the Group's risk appetite or are distressed, are sub-scale or have a poor fit with the Group's customer strategy. More specifically, they include activities in Ireland, retail self-certified mortgages, shipping, aerospace and international.

As of 2014, Lloyds no longer reports its non-core assets separately. The GBP 64bn of non-core assets have been separated into a GBP 33bn run-off portfolio, with the remainder re-incorporated into the ongoing Group. The run-off portfolio is comprised of non-core non-retail assets and certain non-core retail assets, including Ireland and Hong Kong. The aim is to reduce the run-off portfolio to approximately GBP 23bn, from GBP 33bn in 2014. The businesses re-incorporated into the ongoing Group include Black Horse Asset Finance, UK retail specialist mortgages (closed book) and Dutch mortgages. As non-core assets are being run-off, they are still likely to have a negative although declining impact on Lloyds' earnings.

During Q1 2014, the run-off portfolio declined by 11% to GBP 30bn. The underlying loss on the portfolio was GBP 183m.

Chart 3: Non-core / run-off portfolio (GBP bn)



Source: Company data, Scope Ratings

Legacy costs. In addition, Lloyds continues to be impacted by legacy costs related to PPI and interest rate hedging products. The Group has been one of the banks most impacted by PPI charges with provisions from 2011 to 2013 totalling GBP 9.8bn, GBP 2.8bn remaining unutilized. In Q4 2013, a provision of GBP 1.8bn was made to reflect a slower decline in future complaint volumes than previously expected, upward revisions to uphold and response rates and increased estimates for remediation costs. Uncertainties remain in regards to complaint volumes, uphold rates, average redress costs and the outcome of the Financial Conduct Authority Enforcement Team investigation. In the quarter, Lloyds also made a provision of GBP 130m for interest rate hedging products sold to SMEs.

Restructuring costs. As part of its 2011 strategic review, Lloyds announced a Simplification program with an expected cost of GBP 2.3bn. To year-end 2013, GBP 1.7bn in costs have been incurred, realizing run-rate cost savings of approximately GBP 1.5bn (target of GBP 2.0bn by year-end 2014). Lloyds will also incur costs related to the EC mandated business disposal of Verde (GBP 1.5bn incurred to year-end 2013). Expected additional costs include GBP 200m for building out the business and GBP 150m of dual running and transaction costs. Assuming a successful IPO, these costs should no longer hamper earnings after 2014.

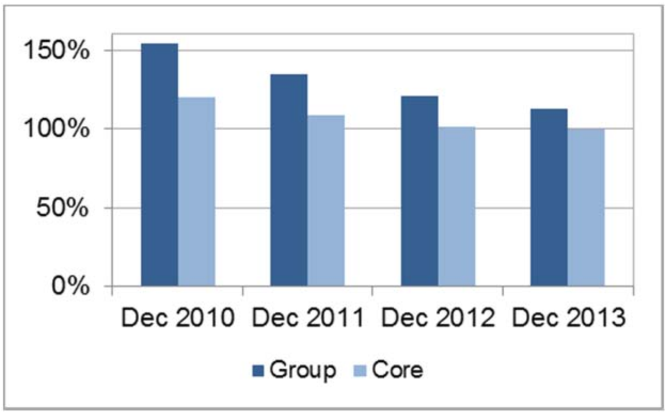
At year-end 2013, Lloyds' reported cost income ratio on an underlying basis was 53% excluding St. James's Place which compares favourably to UK peers. However, if restructuring and legacy costs are included, the cost income ratio remains high and was nearly 80%.

3. Management has delivered on implementing a focused low risk strategy

In June 2011, Lloyds announced a three-to-five year plan to transform itself into a simpler, lower-risk, customer focused UK retail and commercial bank. To date, management has made good progress in delivering on its strategy and is ahead on many targets. In particular,

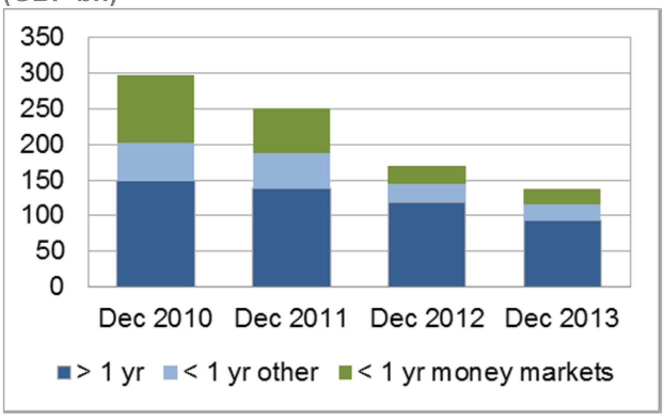
- Reduce non-core assets by at least half (i.e. less than GBP 90bn by YE2014): GBP 64bn at YE2013.
- Fully loaded CRD 4 CET 1 ratio greater than 10% in 2013: 10.0% at YE2013; 10.3% on a proforma basis.
- Group loan-to-deposit ratio less than 130% by YE2014 and 100% for the core business: 113% and 100% respectively, at YE2013.
- Cost income ratio of 42 to 44% by YE2014: 53% at YE2013 excluding St. James's Place.
- Group asset quality ratio (as % of average gross loans) of 50 to 60 bps by YE2014: 57bps in 2013.

Chart 4: Reported loan to deposit ratio for Group and Core business



Source: Company data, Scope Ratings

Chart 5: Decreasing use of wholesale funding (GBP bn)



Source: Company data, Scope Ratings

4. Significant exposure to UK housing market

With the reduction in non-core assets, Lloyds is largely a UK domestic bank with approximately 60% of the loan book being comprised of mortgages. Hence, Lloyds' performance is dependent on the health of the UK economy. While the UK economy has been recovering, there remain concerns about the drivers of economic growth – e.g. consumer spending, manufacturing vs. service output. In particular, increases in housing prices are being scrutinized as prices are historically high compared to wages. In its recent paper regarding the 2014 stress test for the UK banking system, the Bank of England noted that house prices in the UK are at a relatively elevated level in a historical context. For example, house prices in relation to earnings and rents remain above historical averages. As well, the current low interest rate environment enables even financially weaker homeowners to remain current with their mortgage payments. This may change when interest rates rise and could lead to a material increase in arrears.

At year-end 2013, Lloyds' mortgage book was GBP 323bn, with 2.7% being greater than three months in arrears in value terms. Over 75% of the mortgages are considered mainstream while the average loan-to-value (LTV) ratio for the entire portfolio was a reasonable 52.8%. New business mortgages have a somewhat higher LTV of 63.6%. Lloyds has said that approximately 80% of the mortgages it approved during 2013 under the Help-to-Buy program were outside of London and the Southeast, with the average mortgage value being GBP 150,000. Just over 5% of the loan book had LTVs above 100%, down from nearly 12% in the prior year.

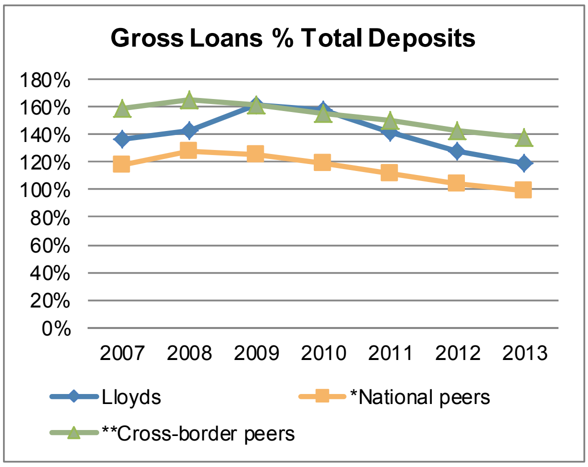
Peer comparison

Within the UK, it is not easy to compare the four major players in the market. Lloyds is largely a domestic retail focused bank. Meanwhile, RBS is implementing a strategic plan to become primarily a domestic retail and commercial bank with limited wholesale banking operations. The two other large players, Barclays and HSBC, each have different business models – being more diversified geographically as well as by business line – although the UK market remains an important home market for both. Barclays and HSBC benefit from having strong income streams in different businesses and geographies.

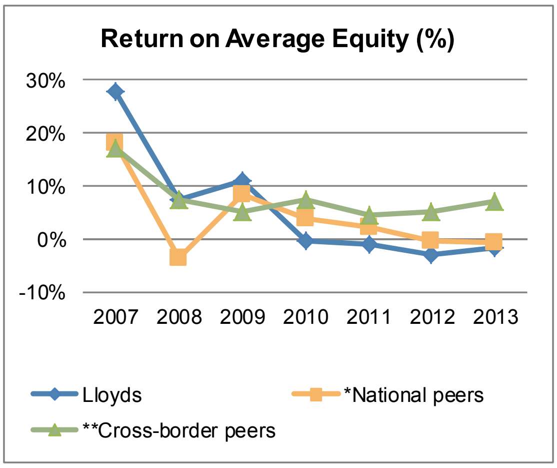
At Scope Ratings, we also compare banks within cross-border peer groups based on business model. We have included Lloyds in the category of primarily domestic retail and commercial banks. This peer group includes Credit Agricole, Credit Mutuel, Intesa, CaixaBank, Rabobank and Swedbank. Over the last few years, Lloyds' financial metrics have improved to levels which are generally consistent with peers. This is the case in regards to liquidity, funding and solvency. At year-end 2013, Lloyds reported a proforma fully loaded CRD 4 CET1 ratio of 10.3%, with a leverage ratio of 3.4% excluding Tier 1 instruments. The proforma figures include the benefits of the announced sales of Heidelberger Leben, Scottish Widows Investment Partnership and Sainsbury's Bank.

The key area of weakness remains profitability as Lloyds continue to incur non-core, restructuring and legacy costs. Non-core assets also lead to a higher impaired loan ratio in comparison to peers but this has been declining steadily. In addition, there is some volatility in earnings due to Lloyds' insurance operations.

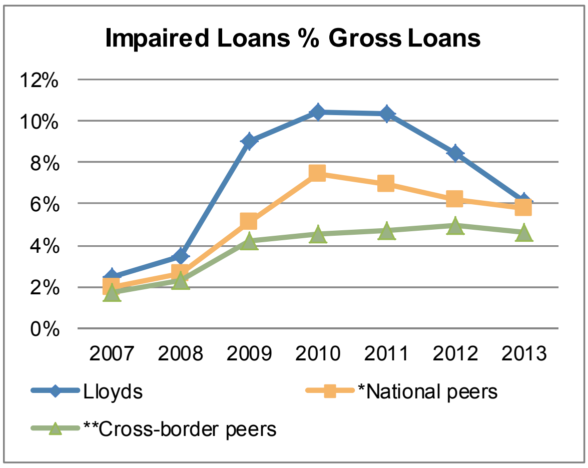
Peer Comparison - Lloyds Banking Group plc



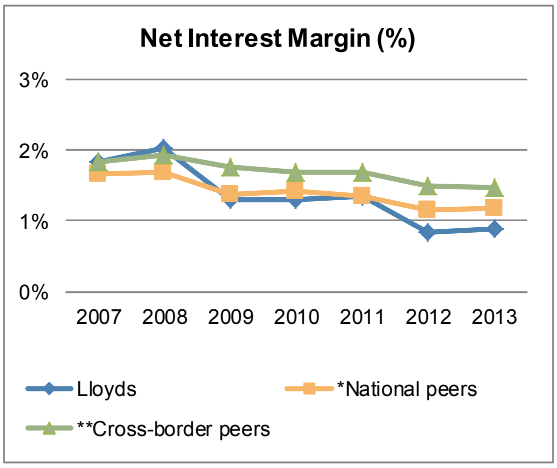
Source: SNL Financial, Scope Ratings



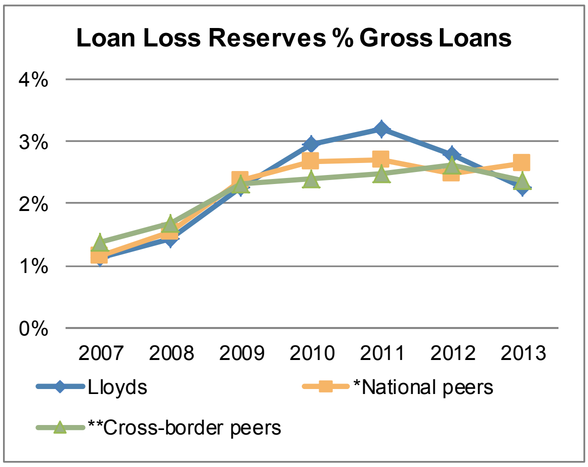
Source: SNL Financial, Scope Ratings



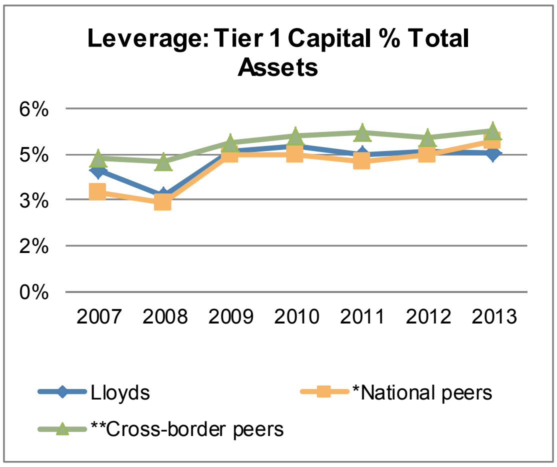
Source: SNL Financial, Scope Ratings



Source: SNL Financial, Scope Ratings



Source: SNL Financial, Scope Ratings



Source: SNL Financial, Scope Ratings

*National peers: Barclays, HSBC, Lloyds, RBS

**Cross-border peers: Groupe BPCE, Credit Mutuel Group, Intesa, DNB ASA, Credit Agricole Group, CaixaBank, Sw edbank, Lloyds Banking group, Wells Fargo & Co., Rabobank Group

Notes: Cross-border peer group excludes Credit Mutuel Group in 2013 as w ell as Intesa for Net Interest Margin and the Return on Average Equity. We use H1 2013 numbers as a 2013 proxy for Intesa on all other ratios.

Selected Financial Information - Lloyds Banking Group plc

	2007	2008	2009	2010	2011	2012	2013	2014E	2015E
Balance Sheet summary (GBP billion)									
Assets									
Cash and balances with central banks	4.3	5.0	39.0	38.1	60.7	80.3	49.9	49.9	49.9
Interbank assets	36.1	39.7	42.3	34.4	35.4	34.9	34.7	34.7	34.7
Total securities	76.9	104.6	210.2	220.2	186.4	182.7	158.6	154.3	153.4
of which debt instruments	45.1	81.3	124.0	127.8	108.7	92.7	91.6	90.7	89.8
of which equity instruments	31.8	23.3	86.2	92.5	77.7	90.0	67.0	63.6	63.6
Derivatives	8.7	28.9	49.9	50.8	66.0	56.6	33.1	32.7	33.1
Gross customer loans	211.0	241.0	653.5	618.0	592.4	546.1	528.4	523.2	533.4
of which impaired loans	5.3	8.5	58.8	64.6	60.3	46.3	32.3	29.0	27.6
Total funded assets	345.8	409.1	986.8	949.4	912.3	885.5	816.6	811.1	823.3
Total Assets	**353.3**	**436.0**	**1,027.3**	**991.6**	**970.5**	**934.2**	**847.0**	**841.2**	**853.7**
Liabilities									
Interbank liabilities	39.8	67.0	83.5	51.2	40.7	39.4	14.8	14.0	13.3
Senior debt	54.7	82.5	262.0	250.1	202.8	147.5	121.3	109.2	103.7
Derivatives	7.6	26.9	40.5	42.2	58.2	48.7	30.5	30.0	30.5
Customer deposits	156.6	170.9	406.7	393.6	413.9	426.9	441.3	450.1	463.6
Subordinated debt + hybrid securities	12.0	17.3	34.7	36.2	35.1	34.1	32.3	29.1	26.2
Total Liabilities	**340.9**	**426.3**	**983.1**	**944.7**	**924.0**	**891.6**	**807.7**	**800.0**	**810.4**
Ordinary equity	12.1	9.4	43.3	46.1	45.9	41.9	39.0	40.8	43.0
Minority interests	0.3	0.3	0.8	0.8	0.7	0.7	0.3	0.3	0.3
Total Liabilities and Equity	**353.3**	**436.0**	**1,027.3**	**991.6**	**970.5**	**934.2**	**847.0**	**841.2**	**853.7**
Core Tier 1 Capital [1]	*12.1*	*9.5*	*39.8*	*41.4*	*38.0*	*26.0*	*27.9*	*29.8*	*31.9*
Income Statement summary (GBP billion)									
Net interest income	6.1	7.7	9.0	12.5	12.7	7.7	7.3	7.2	7.4
Net fee & commission income	2.6	2.5	2.7	3.3	3.5	3.2	2.7	2.9	3.0
Net trading income	3.0	-9.2	19.2	16.1	0.0	18.6	17.1	17.1	17.1
Operating Income	**10.7**	**9.9**	**22.5**	**24.9**	**20.8**	**20.5**	**18.5**	**18.9**	**20.4**
Operating expenses	5.6	6.0	15.7	13.0	16.1	16.0	15.3	13.2	13.3
Loan loss provision charges	1.8	3.0	16.7	11.0	8.1	5.1	2.7	2.6	2.5
Non-recurring items	0.7	0.0	11.2	-0.4	0.0	0.0	0.0	0.0	0.0
Pre-Tax Profit	**4.0**	**0.8**	**1.0**	**0.3**	**-3.5**	**-0.6**	**0.4**	**3.1**	**4.7**
Income tax	0.7	0.0	-1.9	0.5	-0.8	0.8	1.2	0.8	1.2
Net profit attributable to minority interests	0.0	0.0	0.1	0.1	0.1	0.1	0.0	0.3	0.4
Net Income Attributable to Parent	**3.3**	**0.8**	**2.8**	**-0.3**	**-2.8**	**-1.5**	**-0.8**	**2.1**	**3.1**

Source: SNL Financial and Scope Ratings for historical figures. Scope's forecasts are based on publicly available information. Please refer to "Methodologies Used for this Report" for further details.
[1] CRD 4 basis from 2012 onwards

Ratios - Lloyds Banking Group plc

	2007	2008	2009	2010	2011	2012	2013	2014E	2015E
Funding/Liquidity									
Gross loans % Total deposits	134.8%	141.0%	160.7%	157.0%	143.1%	127.9%	119.7%	116.2%	115.0%
Total deposits % Total funds	59.5%	50.6%	51.7%	53.8%	59.8%	65.9%	72.4%	74.7%	76.4%
Wholesale funds % Total funds	40.5%	49.4%	48.3%	46.2%	40.2%	34.1%	27.6%	25.3%	23.6%
Asset Mix, Quality and Growth									
Gross loans % Funded assets	61.0%	58.9%	64.9%	63.5%	63.1%	59.9%	63.2%	63.0%	63.3%
Impaired loans % Gross loans	2.5%	3.5%	9.0%	10.5%	10.2%	8.5%	6.1%	5.5%	5.2%
Loan loss reserves % Impaired loans	0.0%	0.0%	21.7%	24.1%	28.2%	32.9%	37.1%	41.2%	43.4%
Gross loan growth (%)	11.6%	14.2%	171.2%	-5.4%	-4.1%	-7.8%	-3.3%	3.7%	6.8%
Impaired loan growth (%)	8.1%	60.8%	588.7%	9.8%	-6.7%	-23.2%	-30.3%	-10.0%	-5.0%
Funded assets growth (%)	2.3%	18.3%	141.2%	-3.8%	-3.9%	-2.9%	-7.8%	-0.7%	1.5%
Earnings									
Net interest income % Revenues	57.0%	78.2%	40.1%	50.5%	61.0%	37.6%	39.7%	38.3%	36.1%
Fees & commissions % Revenues	24.5%	25.7%	12.2%	13.3%	17.0%	15.6%	14.8%	15.2%	14.9%
Trading income % Revenues	28.3%	-92.9%	85.2%	64.8%	-0.1%	90.4%	92.5%	90.6%	83.8%
Other income % Revenues	-9.8%	89.0%	-37.4%	-28.6%	22.0%	-43.7%	-47.0%	-44.1%	-34.8%
Net interest margin (%)	2.1%	2.3%	1.5%	1.5%	1.6%	1.0%	1.0%	1.0%	1.1%
Pre-provision Income % Risk-weighted assets (RWAs)	3.0%	2.3%	1.4%	2.9%	1.3%	1.5%	1.2%	2.1%	2.6%
Loan loss provision charges % Pre-provision income	34.9%	77.8%	243.2%	92.2%	172.4%	113.3%	86.9%	45.4%	34.7%
Loan loss provision charges % Gross loans (cost of risk)	0.9%	1.3%	3.8%	1.8%	1.4%	0.9%	0.5%	0.5%	0.5%
Cost income ratio (%)	52.0%	60.8%	69.6%	52.2%	77.4%	77.9%	82.9%	70.0%	65.0%
Net Interest Income / Loan loss charges (x)	3.4	2.6	0.5	1.1	1.6	1.5	2.7	2.8	3.0
Return on average equity (ROAE) (%)	28.2%	7.2%	10.7%	-0.7%	-6.1%	-3.4%	-2.1%	5.1%	7.4%
Return on average funded assets (%)	0.6%	0.1%	0.2%	0.0%	-0.2%	-0.1%	-0.1%	0.2%	0.3%
Retained earnings % Prior year's book equity	11.2%	6.4%	30.1%	-0.7%	-6.1%	-3.2%	-2.0%	4.7%	5.3%
Pre-tax return on common equity tier 1 capital	33.1%	8.0%	2.6%	0.7%	-9.3%	-2.3%	1.5%	10.4%	14.6%
Capital and Risk Protection [1]									
Common equity tier 1 ratio (common equity tier 1 capital % RWAs)	7.0%	5.6%	8.1%	10.2%	10.8%	8.1%	10.3%	11.1%	11.7%
Tier 1 leverage ratio (%)	3.9%	3.1%	4.6%	4.8%	4.5%	4.6%	4.9%		
Median of tier 1 leverage ratio and common equity tier 1 ratio (%)	5.5%	4.4%	6.3%	7.5%	7.7%	6.3%	7.6%		
Total loss coverage (CET 1 capital + loan loss provisions) % RWAs	7.0%	5.6%	10.7%	14.0%	15.6%	12.8%	14.7%	15.5%	16.1%
Non-senior bailinable debt cushion (as % of total liabilities)	3.5%	4.0%	3.5%	3.8%	3.8%	3.8%	4.0%	3.6%	3.2%
Asset risk intensity (RWAs % total assets)	48.7%	39.1%	48.0%	41.0%	36.3%	33.2%	31.2%	32.0%	32.0%

Source: SNL Financial and Scope Ratings for historical figures. Scope's forecasts are based on publicly available information. Please refer to "Methodologies Used for this Report" for further details.
[1] CRD 4 basis from 2012 onwards. Common equity tier 1 figure for 2013 is proforma including announced disposals.

METHODOLOGIES USED FOR THIS REPORT

For the rating and analysis contents of this report Scope has used the following methodologies which were published on www.scoperatings.com:

"Bank Rating Methodology" (February 2014)

"Forecasting Bank Financials Methodology" (February 2014)

Forecasting bank financials: Forward-looking estimates are an important analytical tool underpinning Scope's bank ratings. These forecasts cover the current financial year (before final year-end figures are published by the bank) plus the forthcoming two years. Depending on the complexity of the bank being assessed, different forecasting tools will be used. For a majority of banks operating primarily commercial and retail banking franchises (loans and deposits) the analysis is underpinned by an **accounting** forecast of the balance sheet and profit and loss account. For more complex groups with multiple ranges of activities – notably those with material wholesale and investment banking operations – Scope uses an **analytical** forecast, relying on the bank's business-line reporting to come up with plausible estimates. For all banks Scope also include a **regulatory metrics** forecast, considering the growing importance of this aspect in bank analysis.

For complex banks, divisional data is used to forecast profit and loss accounts and basic divisional balance sheet metrics. For less complex banks, a line-by-line forecasting of major P&L elements is forecast.

For balance-sheet forecasts, Scope estimates of all major balance sheet lines, using the P&L estimates to complete the forecast of the capital/shareholders' equity line. This comprehensive methodology for estimating the balance sheet is used for all the banks in our universe, irrespective of size and complexity.

Lastly, our forecasts include assessments of the major regulatory metrics: Tier 1 and CET 1 (historically CT1), Leverage, Liquidity Coverage Ratio, and Net Stable Funding Ratio (the latter two when and if sufficient public information to compute them is available).

Scope will not aim to forecast financials when it considers the public disclosure of the bank as insufficient for a transparent and credible outcome.

All Scope's bank financial forecasts are based on public information. For its forecasts Scope will not use any non-public information or data, even if such information or data were provided by rated banks. Scope's forecasting process is transparent, with a detailed roadmap provided in its *"Forecasting bank financials"* methodology.

Rabobank Group
Issuer Rating Report

SCOPE

A+ STABLE OUTLOOK
Financial Institutions

Overview

The A+ Issuer Credit-Strength Rating (ICSR) on the Rabobank Group is driven by its leading position in the Netherlands as a low risk cooperative bank. The Group enjoys a reputation for being prudently managed and this is reflected in its robust capital position and resilient performance throughout the financial crisis. More recently, earnings have been negatively impacted by the weak economic environment in the Netherlands. The Group is somewhat dependent on wholesale funding but continues to benefit from regular market access. As credit costs and regulatory capital requirements have increased, Rabobank is aiming to improve profitability to maintain capital levels at a high standard.

We note that the A+ rating does not apply to unguaranteed debt issued by subsidiaries of the Rabobank Group.

Ratings (assigned on April 2, 2014)

Issuer Credit-Strength Rating	**A+**
Outlook	Stable
Senior unsecured debt	A+

Unsolicited ratings with issuer participation.

Lead Analyst

Pauline Lambert
p.lambert@scoperatings.com

Team Leader

Sam Theodore
s.theodore@scoperatings.com

Rating drivers (Summary)

The ratings drivers, in decreasing order of importance in the rating assignment, are:

- (+) The dominant retail and commercial bank in the Netherlands.
- (+) Management's moderate risk approach underpinned by a cooperative ownership structure.
- (+) Robust capital position supported by resilient earnings.
- (−) Regular use of capital markets funding with deposits meeting about half of funding needs.
- (−) Less proactive than some peers in adapting its business to a changing operating environment.

Rating change drivers

The successful implementation of the Vision 2016 restructuring program would lead to a structural improvement in the earnings of the domestic retail banking business. As customers increasingly prefer to handle their banking needs via computers and phones, the Group is focused on the "virtualisation" of its services. This involves a reduction in costs of EUR 1bn as 8,000 jobs are eliminated and the number of local Rabobanks is cut to approximately 100 from the current 129.

A change in management's moderate risk approach. The Group pursues a risk strategy aimed at protecting earnings, maintaining sound balance sheet ratios and protecting its identity and reputation. Rabobank enjoys a reputation for being a safe and conservative bank, despite the unexpected involvement in the recent

LIBOR/EURIBOR investigations. We would view negatively an increase in management's risk appetite or further significant lapses in risk management.

Reduced capital markets access. As Rabobank regularly utilizes capital markets funding, it is vulnerable to financial market shocks and refinancing risks. We would view negatively a significant decline in access or prohibitively expensive access.

Recent events

2013 results

Rabobank reported a net profit of EUR 2.0bn for the year. While the net profit figure was basically unchanged from the prior year, the results in 2013 included two large exceptional items – EUR 774m in fines related to the LIBOR/EURIBOR settlement and EUR 1.7bn in gains related to disposals (primarily the sale of Robeco). Excluding the impact of these two items, pre-tax profit was EUR 1.2bn, down from EUR 2.0bn in 2012. Group credit costs increased to EUR 2.6bn, from EUR 2.4bn in the prior year, primarily due to deterioration in the real estate division. While it appears that the Dutch economy has started to recover, management has said that it expects higher provisions in 2014 and 2015 for their real estate portfolios. Solvency and liquidity remained sound as reflected in a Basel 2.5 Core Tier 1 ratio of 13.5% and a liquidity buffer of EUR 121bn compared with EUR 54bn in short-term debt outstanding.

LIBOR/EURIBOR settlement

In October 2013, Rabobank entered into agreements with authorities in the Netherlands, the UK, the US and Japan regarding its submission processes for LIBOR and EURIBOR between 2005 and 2010. Thirty employees were involved in inappropriate conduct and the Group was found to be insufficiently aware of the risks involved. In addition to paying EUR 744m in charges, Rabobank is investing in strengthening its compliance, risk management and internal audit functions. Consequently, the Chairman of the Executive Board, who was scheduled to retire in 2014, resigned and was succeeded by Rinus Minderhoud (member of the Supervisory Board since 2002) on an interim basis. There remains a risk of reputational damage as this type of behaviour is not in line with the Group's standing.

Rating drivers (Details)

1. The dominant retail and commercial bank in the Netherlands

The Group is the leading domestic bank in the Netherlands providing a broad range of services. The 129 autonomous local Rabobanks have the largest branch network with over 700 branches serving approximately 6.7 million retail customers and approximately 800,000 corporate clients. The Group maintains very strong and leading domestic market positions in mortgages (26% market share), savings (38%), SME lending (44%) and food and agriculture (F&A, 85%).

Rabobank is also active in wholesale banking, international rural and retail banking, leasing and real estate. Wholesale banking activities are focused on serving Dutch corporates with revenues in excess of EUR 250m and customers involved in the international trading of raw materials as well as exports and imports. Stemming from its roots as a collection of small agricultural cooperative banks, Rabobank holds a leading position in the food and agri-sector internationally (accounts for 58% of the wholesale and international retail loan portfolio). As part of its international retail banking activities, the Group also operates direct banks in Germany, Ireland, Belgium, Australia and New Zealand. The RaboDirect business is a meaningful source of funding, accounting for nearly 20% of Group savings deposits.

Table 1: 2013 total income by business (EUR m)

Domestic retail	7,540
Wholesale and international retail	4,047
Leasing	1,570
Real estate	(209)
Other	1,115
Total	**14,063**

Note: Excludes consolidation effects and hedge accounting.
Source: Company data, Scope Ratings

2. Management's moderate risk approach underpinned by a cooperative ownership structure

As a cooperative, the Group's guiding principle is to provide services that are in the interests of its customers. In line with this approach, management aims to be a robust and strong bank by managing risks to ensure "creditworthiness at the highest level."

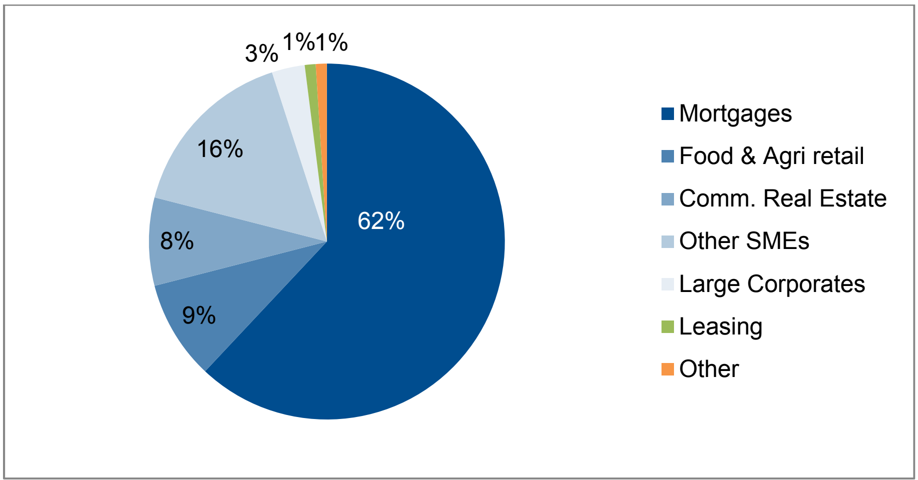
More than 75% of the loan portfolio is domestic, with the exposure being broad and diversified across mortgages, SMEs, food and agribusiness as well as commercial real estate. While non-performing loans have increased due to the weak economic environment, the loan portfolio remains of high quality overall, with 2.8% of loans being impaired at year-end 2013. Commercial real estate lending, accounting for less than 10% of the loan portfolio, is the weakest sector with 15.1% being impaired. The Dutch National Bank recently reviewed the Group's commercial real estate portfolio and determined that sufficient capital was being maintained for this portfolio.

Rabobank reports a 10-year average cost of risk of 28 bps (credit costs % average loans), which is very low. As of year-end 2013, the cost of risk remained elevated at 59 bps, up from 49 bps in the prior year. The coverage of impaired loans by provisions is 34%, relatively modest compared with peers. However, for several years, Rabobank has been writing-off amounts in portfolios which have a very low probability of recovery. Excluding these write-offs of EUR 4.4bn, the coverage ratio would be 51%.

Nearly half of the loan portfolio is comprised of domestic mortgages. At year-end, the average loan-to-value (LTV) of the mortgage book was 81%, which is relatively high compared to European norms. However, Rabobank notes that LTV figures do not take into account the available savings and other assets of the borrower, or the fact that the majority of clients have life insurance pledged to the bank to cover premature death risk. Furthermore, 20% of the mortgage portfolio benefits from a national mortgage guarantee. The proportion of mortgage loans more than 90 days past due remains low at 0.55%. This is also well below the level of the two other large Dutch banks, which have impaired mortgage loan ratios above 1%.

The Dutch housing market is characterized by demand exceeding supply structurally due to an increasing number of households, limited land available for housing and a shortage of housing stock. However, since 2008, the average house price has declined more than 20%. The recovery of the Dutch economy has lagged behind other countries since the financial crisis and after two years of declines, GDP growth is expected to resume in 2014. The European Commission is forecasting GDP growth of 1% in 2014 compared to negative growth of 0.8% in 2013.

Chart 1: Domestic lending portfolio, EUR 338bn at year-end 2013, 77% of total

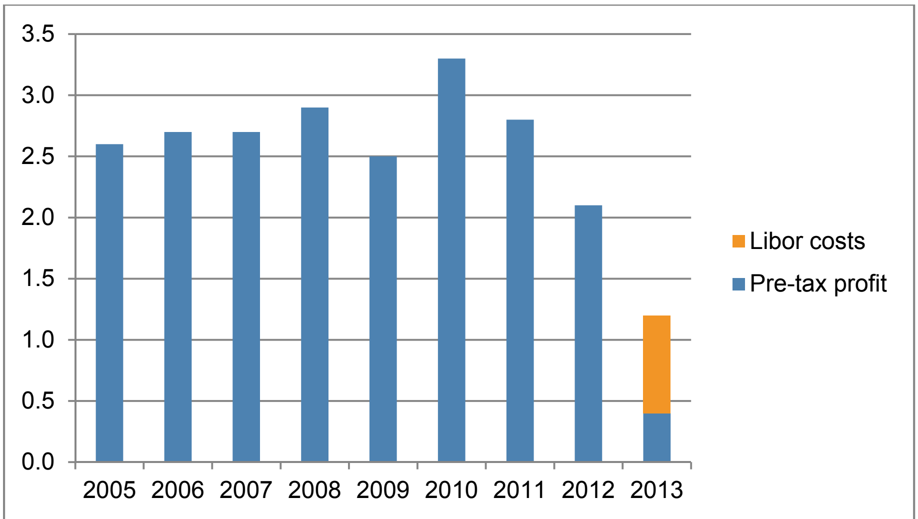


Note: International lending portfolio, EUR 101bn (o/w Large corporates, 49%; Rural and retail, 31%; Leasing, 21%). Source: Company data, Scope Ratings

3. Robust capital position supported by resilient earnings

As evidence of a sustainable core franchise, the Group has generated resilient earnings over a period of many years. Even during the financial crisis, earnings were solid. Unlike many peers, Rabobank did not materially suffer from impairments and revaluations on its assets. In addition, Rabobank was the only large financial institution in the Netherlands that did not require State aid during the financial crisis.

Chart 2: Pre-tax profit (EUR bn)



Source: Company data, Scope Ratings

Rabobank has consistently maintained a robust capital position, with a Core Tier 1 ratio well above peers. At year-end 2013, the Basel 2.5 Core Tier 1 ratio was 13.5%, up from 13.2% in the prior year. The Group aims to further increase its capital position with a target Core Tier 1 ratio of at least 14%, and a Total Capital ratio of at least 20% in 2016. This is expected to be achieved by improved earnings and control over the volume of risk-weighted assets. The capital structure will also be enhanced by increasing the proportion of retained earnings and Tier 2 capital while decreasing the proportion of Rabobank Certificates and hybrid capital. On a fully-loaded CRD 4 basis, the reported CET1 and leverage ratios were 11.1% and 4.8%, respectively at year-end 2013.

Rabobank Certificates are an important source of capital as, due to its cooperative structure, Rabobank is unable to issue shares via equity markets. Between 2000 and 2005, the Group had issued certificates to its members and employees, which could only be traded or transferred once a month via an internal market. As part of its capital strategy, the certificates as of January 2014 became available for investment by institutional investors as well and are traded on the Euronext exchange. There are nearly 238 million Rabobank Certificates outstanding, representing EUR 5.9bn of common equity Tier 1 capital.

Proceeds from Rabobank Certificates are available to the Group on a perpetual basis and are subordinated to all liabilities. As the payment of any distributions is fully discretionary, the proceeds from Rabobank Certificates are recognized as equity under IFRS and are considered Tier 1 capital. The intended pay-out distribution is the higher of 6.5% (raised from 5.2% in December 2013), or the effective return on a 10-year Dutch state loan plus 150bps. Rabobank has consistently paid distributions on its certificates. We note that between 2006 and 2013, distributions have been equivalent to about 15-20% of net profit. In 2013, distributions on certificates and other capital securities amounted to EUR 1.0bn.

4. Regular use of capital markets funding with deposits meeting about half of funding needs

Like other Dutch banks, Rabobank is reliant to some extent on capital markets funding. Dutch banks on the whole are unable to match their loan books to local savings as they are held predominantly in pension funds. According to 2012 data from De Nederlandsche Bank, Dutch households held 72% of their assets in pensions compared with 22% in deposits. At year-end 2013, the Group's reported loan to deposit ratio was a relatively high 135% (2012: 139%). The goal is to reduce this to 130% in 2016.

Rabobank's funding and liquidity policies focus on funding the long-term loan portfolio with stable sources of funding (i.e. amounts Due to Customers and long-term funding from the capital markets). The retail banking division is expected to largely meet its own funding requirements by raising customer funds. As shown below, the amount Due to Customers plus Long-term Debt exceeds Loans. As well, Short-term Assets are more than double the amount of Short-term Liabilities.

Table 2: Balance sheet structure at year-end 2013 (EUR bn)

Assets		Liabilities and Equity	
Loans	460	Capital	40
		Due to Customers	329
		Long-term debt	165
Short-term Assets	141	Short-term Liabilities	70
Derivatives	40	Derivatives	34
Other	33	Other	36

Source: Company data, Scope Ratings

Benefiting from its reputation as a safe and conservative bank, the Group has been able to consistently tap capital markets for funding, even during the financial crisis. Between 2009 and 2011, Rabobank borrowed more than EUR 40bn annually. Rabobank has also issued hybrid capital securities and senior contingent notes. As part of its strategic plan, Rabobank intends to reduce and diversify its capital markets funding. The use of short-term funding has declined (2013: EUR 54bn outstanding, 2012: EUR 61bn, 2011: EUR 70bn) and the average maturity of the funding portfolio is over 4.5 years.

At year-end 2013, Rabobank maintained a high liquidity buffer of EUR 121bn comprised of cash (32%), government debt (32%) and other central bank assets (36%). This amount is well above the EUR 54bn of short-term debt outstanding. Furthermore, Rabobank reported LCR and NSFR ratios of 126% and 114%, respectively.

5. Less proactive than some peers in adapting its business to a changing operating environment

Having fared relatively well during the financial crisis, Rabobank has faced less pressure than peers to adapt its business to a changing operating environment. However, as business conditions remain challenging, management has acknowledged the need to focus on costs in order to maintain the Group's profitability and capital position at a high standard. This is reflected in the Group's 2013-2016 strategy, which includes strengthening earnings capacity as a key focus as well as the Vision 2016 restructuring program. Actions taken over the last year include reducing the number of local Rabobanks from 136 to 129, reducing the number of branches from over 800 to over 700, modifying wage agreements, selling BGZ Bank in Poland and reducing commercial real estate development activities.

While maximizing profitability is not management's key priority, earnings remain important for bolstering capital and providing protection against credit costs. Management is targeting a return on Tier 1 capital of 8% for year-end 2016 (5.2% in 2013). We note that in recent years credit costs have accounted for an increasing proportion of pre-provision income, up from about one-third in 2010/2011 to over 85% in 2013. With the Dutch economy starting to recover, we would expect credit costs to stabilize.

Other information

Cooperative structure and cross guarantee

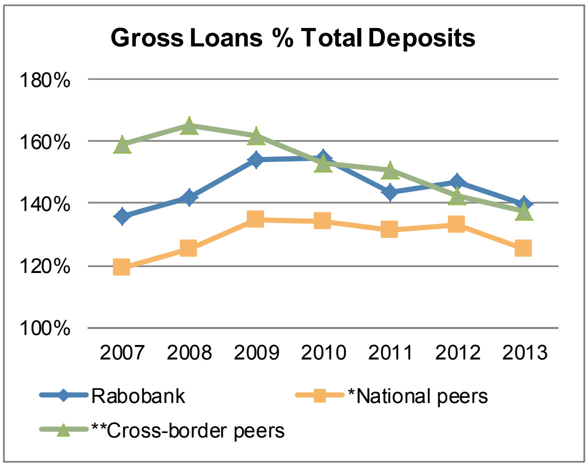
The Rabobank Group consists of the local Rabobanks, their central organization Rabobank Nederland and its subsidiaries and other affiliated entities. Pursuant to the Dutch Financial Supervision Act, Rabobank Nederland is responsible for monitoring the operations, solvency and liquidity of the local Rabobanks. Further, under Article 3:111, there is a formalized internal cross-guarantee system which stipulates that if a participating institution has insufficient funds to meet its obligations towards creditors, the other participants must supplement that institution's funds in order to enable it to fulfil those obligations. For regulatory and financial reporting purposes, the various entities of the Rabobank Group are treated as one consolidated entity.

Peer comparison

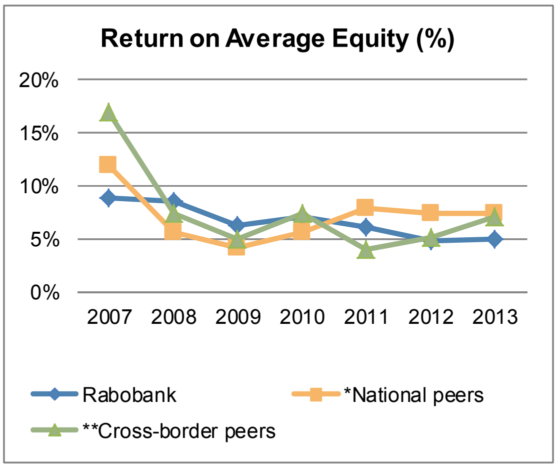
As Rabobank is largely a domestic retail and commercial bank, it is appropriate to compare it with other Dutch banks. Since the financial crisis, the other large Dutch banks, ING Group and ABN Amro, have become more focused, retail and commercial banks. Both of these peers received a significant amount of State aid and continue to deal with the aftereffects. As agreed with the European Commission, ING Group is in the process of disposing its insurance activities and in two years time will be active primarily in banking. Meanwhile, ABN Amro remains completely State-owned.

At Scope Ratings, we also compare banks within peer groups based on business models and have included Rabobank within the category of primarily domestic retail and commercial banks. This peer group includes Lloyds Banking Group, Credit Agricole, Credit Mutuel, BPCE, DNB, CaixaBank and Wells Fargo. Overall, Rabobank's metrics are largely in line with peers. However, we note that asset quality is much better compared to cross-border peers, consistent with the Group's moderate risk approach. At year-end 2013, the impaired loan ratio was 2.8% vs. an average of nearly 5% for cross-border peers. Rabobank's capital position has also historically been stronger than peers, but the gap has narrowed as peers have been bolstering their capital levels in light of the financial crisis and evolving regulatory requirements. As the Group implements its restructuring program, we would expect earnings to improve.

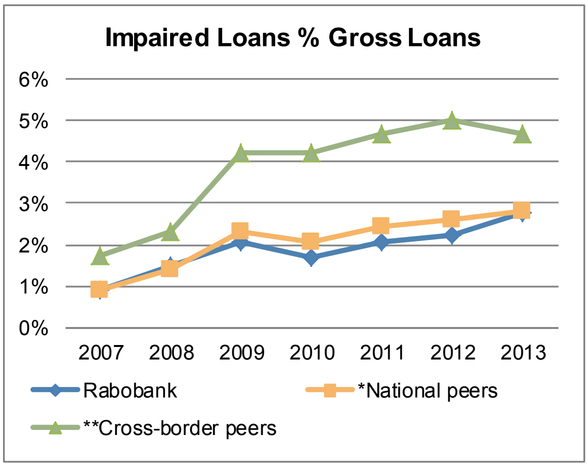
Peer Comparison - Rabobank Group



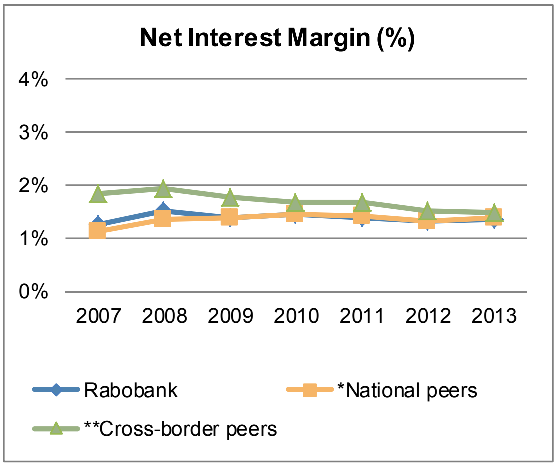
Source: SNL Financial, Scope Ratings



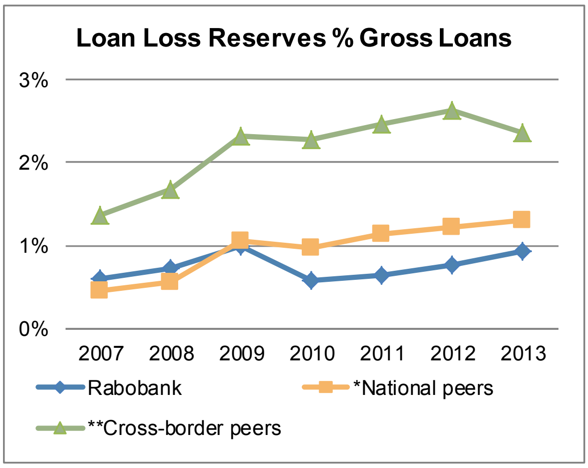
Source: SNL Financial, Scope Ratings



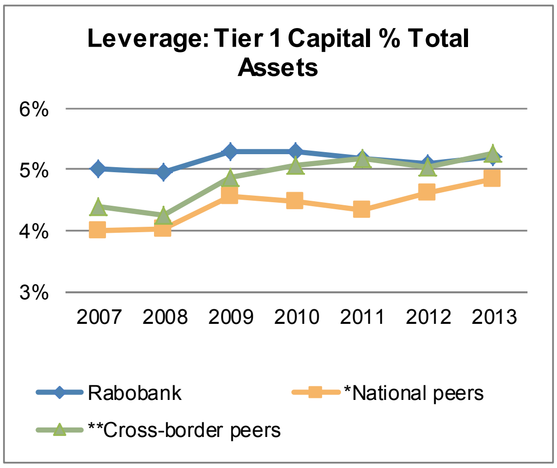
Source: SNL Financial, Scope Ratings



Source: SNL Financial, Scope Ratings



Source: SNL Financial, Scope Ratings



Source: SNL Financial, Scope Ratings

*National Peers : Rabobank, ABN AMRO, ING Bank

**Cross-Border Peers based on business model : Lloyds, Rabobank, CaixaBank, Sw edbank, DNB, Intesa, Wells Fargo, Credit Mutuel Group, BPCE, Credit Agricole

Notes: Cross-border peer group excludes Credit Mutuel Group in 2013 as w ell as Intesa for Net Interest Margin and Return on Average Equity. We use H1 2013 numbers as a 2013 proxy for Intesa on all other ratios.

Selected Financial Information - Rabobank Group

	2007	2008	2009	2010	2011	2012	2013	2014E	2015E
Balance Sheet summary (EUR billion)									
Assets									
Cash and balances with central banks	2.1	7.1	16.6	13.5	70.4	68.1	43.0	43.0	45.2
Interbank assets	43.2	33.8	35.6	33.5	25.2	35.4	40.8	42.9	47.2
Total securities	96.2	49.0	52.1	75.4	64.6	60.5	56.7	54.0	53.9
of which debt instruments	78.0	44.9	46.2	70.4	60.7	57.0	53.0	50.3	50.3
of which equity instruments	15.1	4.1	5.8	4.9	3.5	3.0	2.8	2.8	2.7
Derivatives	26.1	66.8	39.1	43.9	59.0	65.4	39.7	39.5	39.1
Gross customer loans	377.0	431.6	441.0	461.1	473.7	491.9	464.5	464.7	460.1
of which impaired loans	3.4	6.5	9.1	7.9	9.7	11.2	12.8	13.7	14.1
Total funded assets	544.4	537.2	561.2	604.6	668.4	677.5	639.9	647.0	654.6
Total Assets	**570.5**	**612.1**	**607.5**	**652.5**	**731.7**	**750.7**	**674.1**	**681.1**	**688.4**
Liabilities									
Interbank liabilities	46.3	23.9	22.4	23.5	26.3	27.1	15.5	15.5	16.3
Senior debt	168.1	159.7	198.4	226.5	239.2	247.4	211.5	211.5	211.5
Derivatives	26.1	75.0	46.3	48.0	63.2	73.2	34.3	34.1	33.8
Customer deposits	277.6	305.1	287.0	298.9	330.0	334.3	332.3	338.9	345.7
Subordinated debt + hybrid securities	2.3	2.2	2.4	2.5	2.4	5.4	7.8	8.2	8.6
Total Liabilities	**539.1**	**578.7**	**569.6**	**611.8**	**686.7**	**708.6**	**634.1**	**641.0**	**648.6**
Ordinary equity	19.7	20.1	22.0	24.7	26.5	25.3	24.6	24.7	25.1
Minority interests	2.7	3.6	3.4	3.1	2.7	1.4	1.0	1.0	1.0
Total Liabilities and Equity	**570.5**	**612.1**	**607.5**	**652.5**	**731.7**	**750.7**	**674.1**	**681.1**	**688.4**
Core Tier 1 Capital	*24.5*	*25.6*	*25.6*	*27.7*	*28.3*	*29.3*	*28.6*	*28.6*	*29.0*
Income Statement summary (EUR billion)									
Net interest income	6.8	8.5	8.1	8.6	9.2	9.2	9.1	9.1	9.3
Net fee & commission income	2.9	2.9	2.6	2.8	2.4	2.2	2.0	2.0	2.1
Net trading income	0.0	-0.6	-0.3	0.4	0.5	1.0	0.3	0.3	0.3
Operating Income	**11.1**	**12.3**	**12.5**	**12.7**	**12.7**	**13.6**	**13.0**	**13.0**	**13.3**
Operating expenses	7.7	7.6	8.0	8.2	8.3	9.2	10.0	9.1	9.1
Loan loss provision charges	0.7	1.8	2.0	1.3	1.6	2.4	2.6	2.6	2.5
Non-recurring items	0.4	0.0	0.0	0.0	0.1	0.1	1.7	0.0	0.0
Pre-Tax Profit	**3.1**	**2.9**	**2.4**	**3.3**	**3.0**	**2.2**	**2.1**	**1.3**	**1.7**
Income tax	0.4	0.1	0.2	0.5	0.4	0.2	0.1	0.1	0.1
Net profit attributable to minority interests	0.7	0.7	0.1	0.1	0.1	0.1	0.1	0.0	0.0
Net Income Attributable to Parent	**2.0**	**2.1**	**2.1**	**2.7**	**2.5**	**2.0**	**2.0**	**1.2**	**1.6**

Source: SNL Financial and Scope Ratings for historical figures. Scope's forecasts are based on publicly available information. Please refer to "Methodologies Used for this Report" for further details.

Ratios - Rabobank Group

	2007	2008	2009	2010	2011	2012	2013	2014E	2015E
Funding/Liquidity									
Gross loans % Total deposits	135.8%	141.5%	153.7%	154.3%	143.5%	147.1%	139.8%	137.1%	133.1%
Total deposits % Total funds	55.2%	60.9%	54.9%	53.0%	53.8%	53.1%	57.1%	57.6%	58.0%
Wholesale funds % Total funds	44.8%	39.1%	45.1%	47.0%	46.2%	46.9%	42.9%	42.4%	42.0%
Asset Mix, Quality and Growth									
Gross loans % Funded assets	80.3%	78.6%	76.3%	70.9%	72.6%	72.6%	72.6%	71.8%	70.3%
Impaired loans % Gross loans	0.9%	1.5%	2.1%	1.7%	2.1%	2.3%	2.8%	2.9%	3.1%
Loan loss reserves % Impaired loans	48.2%	40.8%	44.1%	27.9%	27.1%	34.3%	33.6%	33.0%	32.0%
Gross loan growth (%)	5.1%	14.5%	2.2%	4.6%	2.7%	3.9%	-5.6%	0.0%	-1.0%
Impaired loan growth (%)	-21.1%	87.9%	40.8%	-13.6%	24.1%	14.9%	14.3%	7.0%	3.0%
Funded assets growth (%)	1.9%	-1.3%	4.5%	7.7%	10.6%	1.4%	-5.6%	1.1%	1.2%
Earnings									
Net interest income % Revenues	60.9%	69.3%	64.8%	67.6%	72.2%	67.4%	69.8%	69.8%	69.8%
Fees & commissions % Revenues	25.7%	23.5%	20.7%	22.2%	18.6%	16.4%	15.4%	15.4%	15.8%
Trading income % Revenues	0.2%	-4.6%	-2.0%	2.8%	3.8%	7.4%	2.2%	2.2%	2.2%
Other income % Revenues	13.2%	11.8%	16.6%	7.3%	5.4%	8.9%	12.6%	12.6%	12.3%
Net interest margin (%)	1.4%	1.7%	1.5%	1.5%	1.5%	1.4%	1.5%	1.5%	1.6%
Pre-provision Income % Risk-weighted assets (RWAs)	1.3%	2.0%	1.9%	2.1%	2.0%	2.0%	1.5%	n/a	n/a
Loan loss provision charges % Pre-provision income	21.5%	39.0%	44.8%	27.6%	36.1%	53.2%	86.4%	67.2%	59.1%
Loan loss provision charges % Gross loans (cost of risk)	0.2%	0.4%	0.5%	0.3%	0.3%	0.5%	0.6%	0.6%	0.6%
Cost income ratio (%)	68.9%	61.9%	64.5%	64.3%	64.9%	67.6%	76.5%	70.0%	68.0%
Net Interest Income / Loan loss charges (x)	9.1	4.7	4.1	6.9	5.7	3.9	3.4	3.5	3.7
Return on average equity (ROAE) (%)	10.6%	10.5%	10.0%	11.5%	9.9%	7.6%	7.8%	4.8%	6.5%
Return on average funded assets (%)	0.2%	0.3%	0.3%	0.3%	0.3%	0.2%	0.2%	0.1%	0.2%
Retained earnings % Prior year's book equity	9.6%	9.0%	8.9%	10.8%	6.6%	3.6%	3.7%	0.2%	1.6%
Pre-tax return on common equity tier 1 capital	12.6%	11.1%	9.5%	11.8%	10.5%	7.6%	7.3%	4.5%	6.0%
Capital and Risk Protection									
Common equity tier 1 ratio (common equity tier 1 capital % RWAs)	9.2%	10.8%	11.0%	12.6%	12.7%	13.2%	13.5%	n/a	n/a
Tier 1 leverage ratio (%)	5.0%	5.0%	5.3%	5.3%	5.2%	5.1%	5.2%		
Median of tier 1 leverage ratio and common equity tier 1 ratio (%)	6.7%	7.5%	7.6%	8.4%	8.3%	8.5%	8.9%		
Total loss coverage (CET 1 capital + loan loss provisions) % RWAs	9.8%	12.1%	12.4%	13.6%	13.8%	14.9%	15.6%	n/a	n/a
Non-senior bailinable debt cushion (as % of total liabilities)	2.1%	2.0%	2.6%	2.5%	2.6%	2.9%	3.4%	3.4%	3.4%
Asset risk intensity (RWAs % total assets)	46.7%	38.1%	39.2%	33.6%	30.6%	29.7%	31.3%	n/a	n/a

Source: SNL Financial and Scope Ratings for historical figures. Scope's forecasts are based on publicly available information. Please refer to "Methodologies Used for this Report" for further details.

METHODOLOGIES USED FOR THIS REPORT

For the rating and analysis contents of this report Scope has used the following methodologies which were published on www.scoperatings.com:

"Bank Rating Methodology" (February 2014)

"Forecasting Bank Financials Methodology" (February 2014)

Forecasting bank financials: Forward-looking estimates are an important analytical tool underpinning Scope's bank ratings. These forecasts cover the current financial year (before final year-end figures are published by the bank) plus the forthcoming two years. Depending on the complexity of the bank being assessed, different forecasting tools will be used. For a majority of banks operating primarily commercial and retail banking franchises (loans and deposits) the analysis is underpinned by an **accounting** forecast of the balance sheet and profit and loss account. For more complex groups with multiple ranges of activities – notably those with material wholesale and investment banking operations – Scope uses an **analytical** forecast, relying on the bank's business-line reporting to come up with plausible estimates. For all banks Scope also include a **regulatory metrics** forecast, considering the growing importance of this aspect in bank analysis.

For complex banks, divisional data is used to forecast profit and loss accounts and basic divisional balance sheet metrics. For less complex banks, a line-by-line forecasting of major P&L elements is forecast.

For balance-sheet forecasts, Scope estimates of all major balance sheet lines, using the P&L estimates to complete the forecast of the capital/shareholders' equity line. This comprehensive methodology for estimating the balance sheet is used for all the banks in our universe, irrespective of size and complexity.

Lastly, our forecasts include assessments of the major regulatory metrics: Tier 1 and CET 1 (historically CT1), Leverage, Liquidity Coverage Ratio, and Net Stable Funding Ratio (the latter two when and if sufficient public information to compute them is available).

Scope will not aim to forecast financials when it considers the public disclosure of the bank as insufficient for a transparent and credible outcome.

All Scope's bank financial forecasts are based on public information. For its forecasts Scope will not use any non-public information or data, even if such information or data were provided by rated banks. Scope's forecasting process is transparent, with a detailed roadmap provided in its *"Forecasting bank financials"* methodology.

Royal Bank of Scotland plc
Issuer Rating Report

BBB+ STABLE OUTLOOK
Financial Institutions

Overview

Scope Ratings assigns an Issuer Credit-Strength Rating (ICSR) of BBB+ and short-term debt rating of S-2 to Royal Bank of Scotland plc, both with Stable outlooks. The ratings are based on the strength of the Royal Bank of Scotland Group plc. RBS's ratings are driven by its significant positions in the UK corporate and retail market, which should remain a key strength even after capital markets and foreign activities are wound down considerably. The evolving business model has yet to translate into reliable and sustainable earnings – legacy issues and restructuring continue to be a drag on performance which remains poor.

Majority ownership by the UK government is a supporting element for the BBB+ rating, which incorporates one notch of uplift. We would likely remove the notch of support as RBS's credit profile improves to a point where the UK government could consider reducing its majority ownership stake.

The ratings also apply to senior unsecured and short-term debt issued by RBS's parent, Royal Bank of Scotland Group plc. However, the rating is not applicable to unguaranteed debt issued by subsidiaries of Royal Bank of Scotland plc.

Issuer Credit-Strength Rating (assigned April 2, 2014)	**BBB+**
Outlook	Stable
Senior unsecured debt	BBB+
Short term debt rating (May 22, 2014)	S-2
Short term debt rating outlook	Stable

Unsolicited ratings with issuer participation.

Lead Analyst

Pauline Lambert
p.lambert@scoperatings.com

Team Leader

Sam Theodore
s.theodore@scoperatings.com

Rating drivers (Summary)

The rating drivers, in decreasing order of importance in the rating assignment, are:

- (+) Leading UK corporate and retail bank.
- (–) Restructuring is far from complete. Newly formed management team has lots to implement and execute.
- (–) Legacy issues to hamper performance for at least the next two to three years.
- (+) Majority ownership by the UK government on balance is credit positive at this time. Nevertheless, RBS faces additional accountability and needs to manage a politically sensitive relationship.

Rating change drivers

Successful execution of strategy announced in conjunction with the "good bank/bad bank" review. Key milestones include the IPO of Citizens in the US, reducing risk-weighted assets (RWAs), addressing SME lending practices and lowering costs. Success would be credit positive as it would align the business with the goals of the majority shareholder as well as improve RBS's financial profile. With the strategic plan spanning a four-to-six year period, meaningful results will likely materialize over the medium-term.

Inability to generate sustainable net profits. RBS is targeting a return on tangible equity of about 9% to 11% in 2016/2017 to be achieved primarily via the run-down of non-core assets, cost reductions and lower impairments. There will be execution risks as well as significant restructuring costs. In addition, the resizing of certain businesses may also negatively impact earnings.

Improvement in capital position to stated targets. Achieving a fully loaded CRD 4 CET1 ratio of around 11% by end-2015 and 12% by end-2016 would be positive, as it would provide a greater buffer for dealing with further potential conduct-related claims and evolving regulatory requirements. Management intends to reach these targets primarily via the IPO of Citizens and the run-down of legacy assets.

Reduction in government ownership and return to private ownership. Removal of the Dividend Access Share and simplification of the government's holding would be positive initial first steps. Full re-privatisation will likely take a few years to achieve. We are confident that the UK government will not reduce its stake in RBS as long as it is not fully competitive and able to generate value for shareholders.

Failure to deal effectively with a changing operating environment. In particular, RBS will be subject to evolving regulations regarding the ring-fencing of certain activities in the UK. As well, the ongoing debate about Scottish independence may have consequences for RBS's business and strategy.

Recent events

Q1 2014 results

For the three months ending March 31, 2014, RBS reported an attributable profit of GBP 1.2bn, compared to GBP 0.4bn in the prior year period. The result included GBP 0.2bn in Treasury AFS gains and a GBP 0.2bn profit from the sale of the remaining stake in Direct Line Insurance Group. Operating profit improved year-over-year to GBP 1.6bn, primarily due to lower operating expenses (down 5%) and impairments (down 65%). There were significant improvements in impairments for the UK Corporate business and Ulster Bank, resulting in Ulster Bank reporting its first quarterly operating profit since 2009. Further, RBS stated that operations in the UK were showing "early signs of growth", particularly in regards to SME and retail mortgage loan growth. The reported net interest margin continued to improve and was 2.12% (Q4 2013: 2.08%).

Driven by retained earnings and continuing RWA reduction, the Group's CRD 4 fully-loaded CET1 ratio strengthened to 9.4%, from 8.6% at year-end 2013. Helped by favourable market conditions, RBS Capital Resolution (RCR) reduced funded assets to GBP 24bn from GBP 29bn, with lower than expected operating losses of GBP 114m. Guidance of a CET1 ratio of around 11% by year-end 2015 and 12% or higher by year-end 2016 was maintained.

Management emphasized that RBS had a "good start to the year" but that the Group was in the midst of restructuring and "headwinds remain." Despite the positive trends regarding costs, impairments and asset reductions, management largely reaffirmed its earlier guidance. RBS also reiterated that there continues to be uncertainty about future conduct and litigation costs.

Dividend Access Share retirement agreement

In April 2014, RBS reached an agreement with the UK government to retire the Dividend Access Share (DAS). The DAS was created in 2009 as a means to provide preferential dividend rights to the UK government on the capital support provided to the Group. If independent shareholders approve the agreement, RBS will pay the UK government an initial dividend of GBP 320m in 2014, followed by a further GBP 1.18bn at management's discretion (subject to interest if not paid before January 2016). Afterwards, the DAS will no longer have enhanced dividend rights and convert into a single B share. Currently, no dividends can be paid on RBS's ordinary shares unless equivalent dividends are paid on B shares (held by the UK government) and a dividend is also paid on the DAS.

Retirement of the DAS should enable management to communicate a clearer dividend policy and is considered an important milestone for returning RBS to full private ownership. Including the contemplated dividend, the CRD 4 fully loaded CET1 ratio would decline by 8 bps, thus remaining at 9.4%.

Good bank/bad bank review

In June 2013, the UK government undertook a review of the case for an external "bad bank" to deal with RBS's legacy and poorly performing assets. Subsequently, RBS created an internal "bad bank", RCR, comprised of GBP 29bn in assets which are expected to provide poor returns and/or perform badly in a stress scenario. The goal is to remove most of these assets from the balance sheet in three years (target of GBP 6bn or less at year-end 2016). Furthermore, RBS will take measures to restore its financial strength and sharpen its focus on core UK businesses and international corporate capabilities.

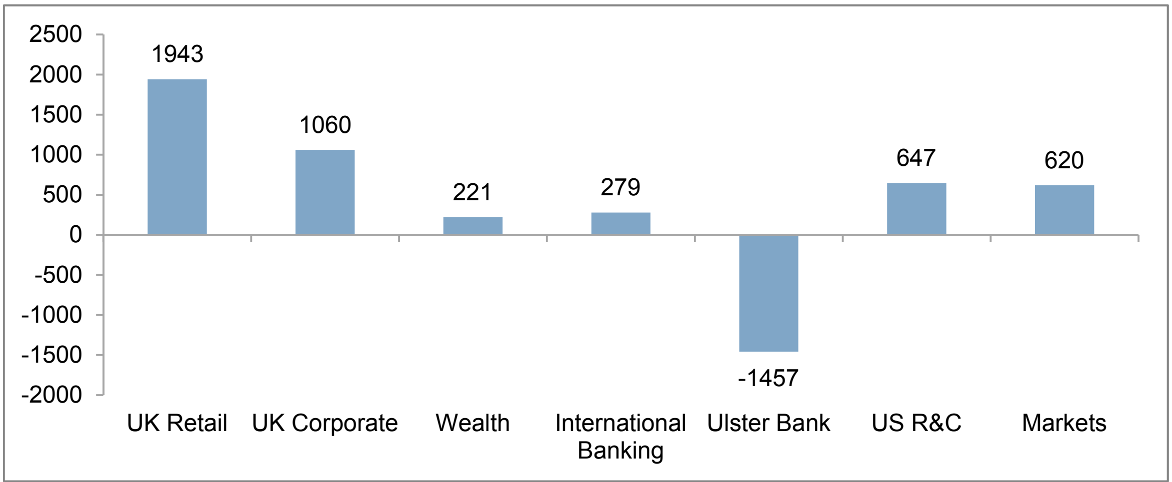
Rating Drivers (Details)

1. Leading UK corporate and retail bank

RBS is the largest corporate bank in the UK, serving SMEs to UK-based multi-national companies. Having lent aggressively in the run-up to the financial crisis, RBS's lending volumes have fallen from an unsustainably high level in 2008 to a level which is more in line with its customer base. However, RBS now faces increasing competition as well as scrutiny from the government who is keen on seeing the Bank support the UK economy. RBS intends to implement the recommendations from the Independent Lending Review which should help it maintain its leading position in corporate banking.

In retail, the Bank has the second largest branch network in the UK and operates primarily through two subsidiaries, NatWest and RBS. The Bank holds market shares of about 18% in retail current accounts and 8% in mortgages[1]. In Ireland, RBS operates via Ulster Bank, which is the number one retail and commercial bank in Northern Ireland and the number three bank in Ireland overall. With the legacy asset reduction in RCR, the size of the Irish franchise will decrease and the aim is to reposition Ulster as a challenger bank to the systemic banks.

Chart 1: 2013 operating profit/loss of Core divisions (GBP m)



Source: Company data, Scope Ratings.

[1] Source: GfK (6 months ending December 2013)

Management has stated that RBS's "future is a UK-focused retail and commercial bank with markets and international capabilities" to meet client needs in their UK and Western European operations. Areas of strength include European FX, GBP debt capital markets, international cash management and trade finance. In the next three to five years, RBS intends to have the majority of its business and assets in the UK (2018-2020 target: 80% UK, 20% non-UK; 2013: 60%/40%). As well, the Bank will continue shifting its emphasis from wholesale towards retail and commercial (2018-2020 target: 85% retail and commercial, 15% wholesale; 2013: 80%/20%).

Consequently, RBS is reorganizing from seven divisions to three businesses: Personal and Business Banking, Commercial and Private Banking and Corporate & Institutional Banking. Reporting from Q2 2014 will reflect this new structure, with RCR stated separately. We believe that the streamlined organization and disclosure adds clarity of purpose and provides better visibility of where the Bank is heading.

Table 1: Management's target profile between 2018 and 2020

	RWA	Op profit	ROE
Personal & Business Banking	35%	50%	15%+
Commercial & Private Banking	30%	30%	15%+
Corporate & Institutional Banking	35%	20%	About 10%

Source: Company data, Scope Ratings

2. Restructuring is far from complete. Newly formed management team has lots to implement and execute

During the last five years, RBS has made significant progress in improving its financial soundness. The Bank has achieved its stated medium-term targets in regards to liquidity and capital. In particular, loans as a percentage of deposits at 100% (2013: 94%), short-term wholesale funding less than 10% of third party assets (2013: 4.3%), liquidity portfolio greater than 1.5x short-term wholesale funding (2013: 4.5x) and a Tier 1 leverage ratio less than 18x (2013: 14.4x). Furthermore, RBS has reduced non-core assets to GBP 28bn from GBP 258bn five years ago.

However, the work is far from finished. RBS is embarking on an ambitious restructuring plan to address operational effectiveness so that it can generate sustainable returns. Since 2008, RBS has incurred over GBP 45bn in cumulative net losses. For 2016/2017, the return on tangible equity target is about 9-11% (2013: negative) – to be achieved through the run-down of RCR, cost reductions and lower impairments. Further, management expects 200-300 bps of capital uplift from the IPO of Citizens. Preparations for a partial IPO in 2014 are on track and RBS expects to fully divest the business by year-end 2016. Meanwhile, the cost-income ratio target is about 55% (2013 reported: 73%). Restructuring costs through 2017 are expected to amount to GBP 5.2bn.

The new CEO, Ross McEwan, took over in October 2013, having spent one year as head of the UK retail division and previously as head of retail banking at Commonwealth Bank of Australia. Clearly, the newly formed management team has a lot to implement and execute – aiming to achieve needed improvements in operational effectiveness, costs, asset quality and capital. Progress will take time. Encouragingly, there appears to be support for the strategic plan from the Bank of England and the UK government.

3. Legacy issues to hamper performance for at least the next two to three years

RCR became operational from January 1, 2014 with GBP 29bn in assets, of which approximately 50% comes from the non-core portfolio (excluding Ulster Bank), 17% from Ulster Bank (core and non-core) and the remainder from UK corporate, International Banking and Markets. Commercial real estate and the Irish operations continue to be the key problem areas. Impairments and disposal losses are being brought forward as high-risk loans are being run-down more quickly. Additional loan impairments related to the creation of RCR were GBP 4.5bn in 2013. RBS estimates that lifetime credit costs could be GBP 5bn to 6bn and cash costs of disposals could be GBP 1.5bn to 2bn.

However, over the medium-term, RBS expects to benefit from a meaningful improvement in its capital position as well as a lower risk and simpler organization – steady state RWAs of approximately GBP 300bn in 2018-2020 (2013: GBP 429bn), 40-50% reduction in stress impairments and a non-performing loan ratio of 2.5-3.5% at year-end 2016 from the reported 9.4% in 2013. There will be execution risks as the assets within RCR are expected to be run-off or sold.

Furthermore, RBS remains exposed to further potential costs related to conduct and litigation. In particular, lawsuits and investigations regarding mortgage-backed securities, LIBOR and other trading benchmarks, interest rate hedging products, PPI and technology incidents. Significant provisions were made in 2013 for regulatory and legal actions (GBP 2.4bn), PPI (GBP 900m) and interest rate hedging products (GBP 550m).

The above costs will continue to be a drag on performance and hinder the build-up of retained earnings.

4. Majority ownership by the UK government on balance is credit positive at this time. Nevertheless, RBS faces additional accountability and needs to manage a politically sensitive relationship

During the financial crisis, RBS was one of four UK banks that received direct government support. In 2008, RBS reported a pro-forma attributable loss of more than GBP 24bn due to loan losses, writedowns on credit assets and goodwill impairments related to the acquisition of ABN Amro and Charter One in the US. Consequently, between 2008 and 2009, the UK government acquired ordinary and B shares in RBS, bringing its current economic ownership to 80%.

In November 2013, after completing a review into the case for a bad bank, the government concluded that RBS should focus on its core job of supporting the British economy and lending to British businesses. The government emphasized that measures should be taken to address a “lack of strategic coherence” as well as poorly-performing legacy assets and weak returns in core businesses. Management’s latest strategic plan directly addresses these concerns. If successfully implemented, RBS will become an increasingly UK focused, lower risk corporate and retail bank. However, if not executed in a timely manner, RBS may be subject to further political intervention.

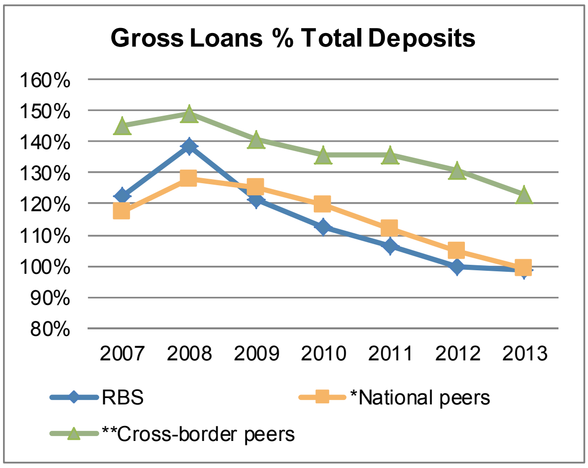
Peer comparison

In addition to national peer analysis, Scope Ratings compares banks within peer groups based on their business models and have included RBS in the category of international retail and commercial banks with limited investment banking activities. This peer group includes banks such as ING Bank, KBC Group, Commerzbank and Nordea. As RBS executes its announced strategy and further reduces its geographic footprint and business scope, we may consider changing its peer group to reflect its more domestic and retail and commercial focus.

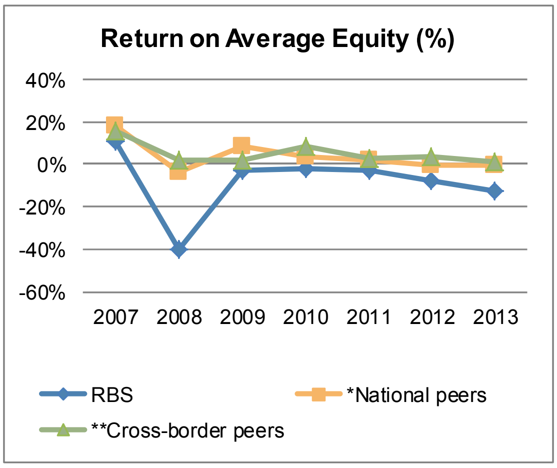
With the strategic focus being on its core UK businesses and international corporate capabilities, RBS is becoming increasingly a UK-focused retail and commercial bank. This means that its business profile will become more comparable to that of Lloyds, having moved away from comparability with Barclays (which was to some extent the case during the pre-crisis years). However, while RBS is particularly strong in the corporate market, Lloyds is more dominant in the retail market. This is evidenced in their loan books – e.g. mortgages comprise over a third of RBS' loan book while they account for nearly two-thirds of Lloyds' loan book. RBS also has a more developed capital markets business to support its corporate clients but this will be reduced going forward. Otherwise, there will be a good deal of similarity in their business models. The other large player in the UK market, HSBC, has a different business model, being much more diverse geographically and by business line.

Reflecting the progress made, RBS' liquidity profile now compares well to peers, with a loan to deposit ratio below 100% and a relatively moderate use of wholesale funding (less than 30% of total funds). Capital and leverage have also improved but remain somewhat below peers. At year-end 2013, RBS's reported CRD 4 fully loaded CET1 and leverage ratios were 8.6% and 3.5%, respectively. Where RBS continues to compare poorly to peers is in regards to asset quality and profitability. RBS has been loss making since 2008, with earnings being negatively impacted by loan loss charges, impairments on financial assets and conduct and litigation costs.

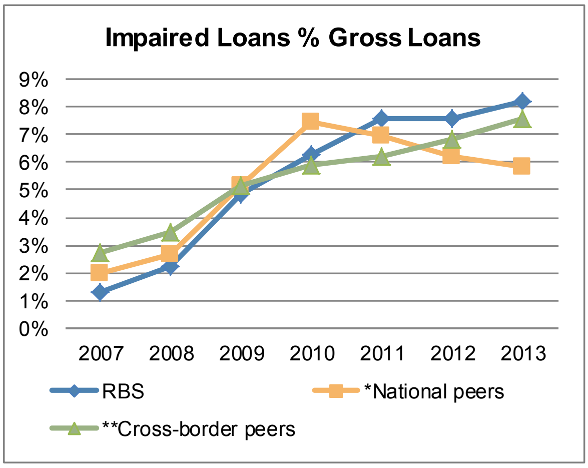
Peer Comparison - RBS Group plc



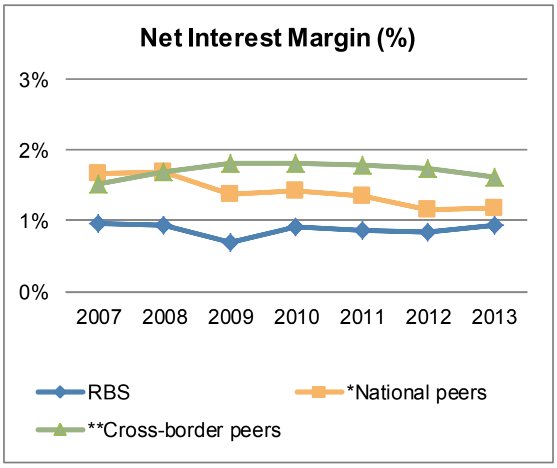
Source: SNL Financial, Scope Ratings



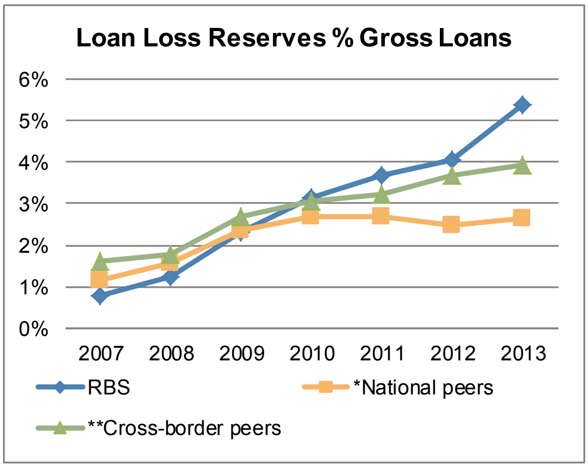
Source: SNL Financial, Scope Ratings



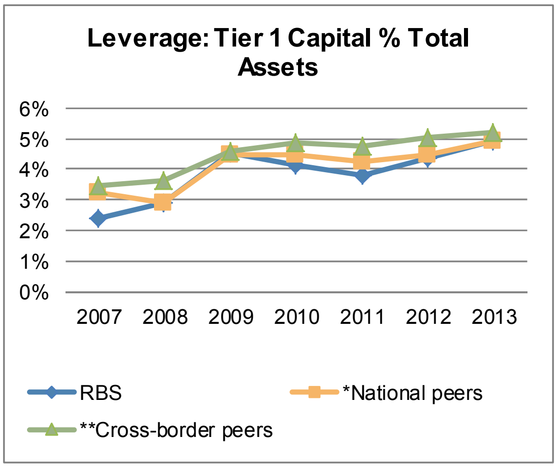
Source: SNL Financial, Scope Ratings



Source: SNL Financial, Scope Ratings



Source: SNL Financial, Scope Ratings



Source: SNL Financial, Scope Ratings

*National peers: Barclays, HSBC, Lloyds, RBS

**Cross-border peers based on business model : Santander, BBVA, Unicredit, RBS, Erste Bank, RZB AG, Commerzbank, Nordea, KBC, Danske Bank, ING Bank.

Notes: Cross-border peer group averages exclude RZB in 2013

Selected Financial Information - RBS Group plc

	2007	2008	2009	2010	2011	2012	2013	2014E	2015E
Balance Sheet summary (GBP billion)									
Assets									
Cash and balances with central banks	17.9	12.4	52.3	57.0	79.3	79.3	82.7	94.2	115.2
Interbank assets	219.5	138.2	91.8	100.5	83.3	64.0	54.1	48.7	43.8
Total securities	364.3	311.7	300.2	251.3	232.0	178.4	128.0	115.8	110.3
of which debt instruments	294.7	267.5	267.3	217.5	209.1	157.4	113.6	102.2	97.1
of which equity instruments	53.0	26.3	19.5	22.2	15.2	15.2	8.8	7.9	7.5
Derivatives	277.4	992.6	441.5	427.1	529.6	441.9	288.0	270.8	257.4
Gross customer loans	833.4	880.8	736.7	578.6	536.3	521.4	465.9	443.9	423.0
of which impaired loans	11.0	19.6	36.0	36.2	42.4	41.1	39.4	37.4	35.6
Total funded assets	1,568.8	1,430.3	1,272.3	1,029.6	982.9	878.0	742.4	714.0	703.6
Total Assets	**1,840.8**	**2,401.7**	**1,696.5**	**1,453.6**	**1,506.9**	**1,312.3**	**1,027.9**	**982.5**	**958.8**
Liabilities									
Interbank liabilities	312.3	258.0	142.1	98.8	108.8	101.4	64.0	57.6	51.8
Senior debt	274.2	300.3	267.6	218.4	162.6	94.6	67.8	67.8	67.8
Derivatives	272.1	971.4	424.1	424.0	524.0	434.3	285.5	268.5	255.2
Customer deposits	682.4	639.5	614.2	510.7	503.0	521.3	470.9	447.3	442.9
Subordinated debt + hybrid securities	38.0	49.2	37.7	27.1	26.3	26.8	24.0	25.9	25.9
Total Liabilities	**1,749.4**	**2,321.2**	**1,601.9**	**1,376.7**	**1,430.8**	**1,241.8**	**968.7**	**923.6**	**900.1**
Ordinary equity	44.7	45.5	69.9	70.4	70.1	63.4	53.5	53.1	53.0
Minority interests	38.4	21.6	16.9	1.7	0.7	1.8	0.5	0.5	0.5
Total Liabilities and Equity	**1,840.8**	**2,401.7**	**1,696.5**	**1,453.6**	**1,506.9**	**1,312.3**	**1,027.9**	**982.5**	**958.8**
Core Tier 1 Capital [1]	*27.3*	*46.2*	*59.5*	*49.6*	*46.3*	*50.9*	*36.8*	*36.5*	*36.3*
Income Statement summary (GBP billion)									
Net interest income	12.1	18.7	13.4	13.8	12.3	11.4	11.0		
Net fee & commission income	6.1	7.4	5.9	6.3	5.4	4.9	4.5		
Net trading income	3.0	-8.9	7.8	5.0	5.3	0.1	3.3		
Operating Income	**24.9**	**20.3**	**28.8**	**26.0**	**24.4**	**17.4**	**19.4**	**17.6**	**16.6**
Operating expenses	13.9	21.6	17.1	17.5	17.3	17.8	18.2	14.7	13.7
Loan loss provision charges [2]	2.0	8.1	13.9	9.2	7.4	5.3	8.4	3.3	3.0
Non-recurring items	0.7	5.1	-0.2	-0.3	-0.7	0.4	0.5	0.0	0.0
Pre-Tax Profit	**9.8**	**-36.9**	**-2.8**	**-1.0**	**-1.0**	**-5.4**	**-8.1**	**-0.4**	**-0.2**
Income tax	2.0	-2.3	-0.4	0.7	1.1	0.4	0.4	-0.1	0.0
Net profit attributable to minority interests	0.4	-10.2	1.3	-0.5	0.0	-0.1	0.1	0.0	0.0
Net Income Attributable to Parent	**7.3**	**-24.3**	**-3.6**	**-1.1**	**-2.2**	**-5.8**	**-8.6**	**-0.3**	**-0.2**

Source: SNL Financial and Scope Ratings for historical figures. Scope's forecasts are based on publicly available information. Please refer to "Methodologies Used for this Report" for further details.
[1] CRD 4 basis from 2013 onwards.
[2] For 2008 and 2009, the figures include GBP 0.9bn and GBP 0.8bn, repsectively of impairments on financial assets.

Ratios - RBS Group plc

	2007	2008	2009	2010	2011	2012	2013	2014E	2015E
Funding/Liquidity									
Gross loans % Total deposits	122.1%	137.7%	119.9%	113.3%	106.6%	100.0%	99.0%	99.2%	95.5%
Total deposits % Total funds	51.9%	50.7%	57.4%	59.4%	62.4%	69.6%	74.5%	74.1%	74.6%
Wholesale funds % Total funds	48.1%	49.3%	42.6%	40.6%	37.6%	30.4%	25.5%	25.9%	25.4%
Asset Mix, Quality and Growth									
Gross loans % Funded assets	52.8%	61.2%	57.2%	53.9%	52.5%	57.0%	59.4%	58.6%	56.5%
Impaired loans % Gross loans	1.3%	2.2%	4.9%	6.3%	7.9%	7.9%	8.5%	8.4%	8.4%
Loan loss reserves % Impaired loans	44.4%	30.9%	23.1%	64.5%	48.8%	51.7%	64.0%	67.4%	71.0%
Gross loan growth (%)	77.3%	5.7%	-16.4%	-21.5%	-7.3%	-2.8%	-10.6%	-4.7%	-4.7%
Impaired loan growth (%)	75.2%	77.8%	84.1%	0.4%	17.1%	-3.0%	-4.2%	-5.0%	-5.0%
Funded assets growth (%)	108.2%	-8.8%	-11.0%	-19.1%	-4.5%	-10.7%	-15.4%	-3.8%	-1.5%
Earnings									
Net interest income % Revenues	48.4%	91.9%	46.5%	52.9%	50.4%	65.7%	56.7%		
Fees & commissions % Revenues	24.4%	36.6%	20.7%	24.2%	22.2%	28.1%	23.3%		
Trading income % Revenues	11.9%	-43.7%	27.1%	19.3%	21.7%	0.8%	17.2%		
Other income % Revenues	15.3%	15.2%	5.7%	3.6%	5.7%	5.5%	2.8%		
Net interest margin (%)	1.2%	1.4%	1.1%	1.3%	1.4%	1.4%	1.5%		
Pre-provision Income % Risk-weighted assets (RWAs)	1.8%	-0.2%	2.2%	1.8%	1.6%	-0.1%	0.3%	0.7%	0.7%
Loan loss provision charges % Pre-provision income	17.9%	n.m.	118.6%	107.6%	104.1%	n.m.	699.8%	113.2%	106.5%
Loan loss provision charges % Gross loans (cost of risk)	0.3%	0.9%	1.7%	1.4%	1.4%	1.0%	1.8%	0.8%	0.7%
Cost income ratio (%)	55.9%	106.4%	59.3%	67.0%	70.7%	102.6%	93.8%	83.4%	82.8%
Net Interest Income / Loan loss charges (x)	6.1	2.3	1.0	1.5	1.7	2.2	1.3		
Return on average equity (ROAE) (%)	17.2%	-53.9%	-6.3%	-1.6%	-3.1%	-8.6%	-14.7%	-0.6%	-0.3%
Return on average funded assets (%)	0.4%	-1.1%	-0.2%	-0.1%	-0.1%	-0.4%	-0.7%	0.0%	0.0%
Retained earnings % Prior year's book equity	12.4%	-54.4%	-7.9%	-1.6%	-3.1%	-8.2%	-13.6%	-0.6%	-0.3%
Pre-tax return on common equity tier 1 capital	35.7%	-79.8%	-4.6%	-1.9%	-2.3%	-10.7%	-22.0%	-1.1%	-0.5%
Capital and Risk Protection [1]									
Common equity tier 1 ratio (common equity tier 1 capital % RWAs)	4.5%	6.6%	11.0%	10.7%	10.6%	10.3%	8.6%	8.9%	9.1%
Tier 1 leverage ratio (%)	2.4%	2.9%	4.5%	4.1%	3.8%	4.4%	4.9%		
Median of tier 1 leverage ratio and common equity tier 1 ratio (%)	3.5%	4.8%	7.8%	7.4%	7.2%	7.3%	6.8%		
Total loss coverage (CET 1 capital + loan loss provisions) % RWAs	5.3%	7.5%	12.5%	15.7%	15.3%	15.7%	14.5%	15.0%	15.4%
Non-senior bailinable debt cushion (as % of total liabilities)	2.6%	2.7%	2.8%	2.3%	2.2%	2.6%	3.0%	3.4%	3.4%
Asset risk intensity (RWAs % total assets)	33.1%	29.0%	31.9%	32.0%	29.1%	35.0%	37.5%	41.7%	41.7%

Source: SNL Financial and Scope Ratings for historical figures. Scope's forecasts are based on publicly available information. Please refer to "Methodologies Used for this Report" for further details.
[1] CRD 4 basis from 2013 onwards

METHODOLOGIES USED FOR THIS REPORT

For the rating and analysis contents of this report Scope has used the following methodologies which were published on www.scoperatings.com:

"Bank Rating Methodology" (February 2014)

"Forecasting Bank Financials Methodology" (February 2014)

Forecasting bank financials: Forward-looking estimates are an important analytical tool underpinning Scope's bank ratings. These forecasts cover the current financial year (before final year-end figures are published by the bank) plus the forthcoming two years. Depending on the complexity of the bank being assessed, different forecasting tools will be used. For a majority of banks operating primarily commercial and retail banking franchises (loans and deposits) the analysis is underpinned by an **accounting** forecast of the balance sheet and profit and loss account. For more complex groups with multiple ranges of activities – notably those with material wholesale and investment banking operations – Scope uses an **analytical** forecast, relying on the bank's business-line reporting to come up with plausible estimates. For all banks Scope also include a **regulatory metrics** forecast, considering the growing importance of this aspect in bank analysis.

For complex banks, divisional data is used to forecast profit and loss accounts and basic divisional balance sheet metrics. For less complex banks, a line-by-line forecasting of major P&L elements is forecast.

For balance-sheet forecasts, Scope estimates of all major balance sheet lines, using the P&L estimates to complete the forecast of the capital/shareholders' equity line. This comprehensive methodology for estimating the balance sheet is used for all the banks in our universe, irrespective of size and complexity.

Lastly, our forecasts include assessments of the major regulatory metrics: Tier 1 and CET 1 (historically CT1), Leverage, Liquidity Coverage Ratio, and Net Stable Funding Ratio (the latter two when and if sufficient public information to compute them is available).

Scope will not aim to forecast financials when it considers the public disclosure of the bank as insufficient for a transparent and credible outcome.

All Scope's bank financial forecasts are based on public information. For its forecasts Scope will not use any non-public information or data, even if such information or data were provided by rated banks. Scope's forecasting process is transparent, with a detailed roadmap provided in its *"Forecasting bank financials"* methodology.

Société Générale SA
Issuer Rating Report

SCOPE | A STABLE OUTLOOK | Financial Institutions

Overview

Scope Ratings assigns an Issuer Credit-Strength Rating (ICSR) of A and a short-term debt rating of S-1 to Société Générale SA (SocGen), both with a stable outlook. These ratings reflect the considerable efforts undertaken by the bank to comply with the Basel 3 capital regulations, considering that SocGen's pre-crisis capitalization levels had been lower than its peers. They also reflect the strong retail franchises of Société Générale, both in France and in Central & Eastern Europe (CEE), and its solid position in the global equity derivatives business. However, the ratings also incorporate what we perceive as a dent in the bank's revenue base resulting from the recent deleveraging.

The A and S-1 ratings apply to senior unsecured debt issued by Société Générale SA. However, the ratings do not apply to unguaranteed debt issued by subsidiaries of Société Générale SA.

Issuer Credit-Strength Rating (assigned on April 2, 2014)	**A**
Outlook	Stable
Senior unsecured debt	A
Short term debt rating (May 22, 2014)	S-1
Short term debt rating outlook	Stable

Unsolicited ratings with issuer participation.

Lead Analyst

Jacques-Henri Gaulard
j-h.gaulard@scoperatings.com

Team Leader

Sam Theodore
s.theodore@scoperatings.com

Rating drivers (Summary)

The rating drivers, in decreasing order of importance in the rating assignment, are:

- (+) A reliable management team, which proved its mettle during the crisis but had already shown its efficiency in developing high-growth businesses. This dual ability to perform well in favorable as well as unfavorable markets is a competitive advantage in the European banking sector.
- (+) A very substantial de-risking and capital build-up effort.
- (−) The ongoing crisis has challenged SocGen's traditional business model based on leadership positions in high-growth markets such as Central and Eastern Europe, supported by a very stable domestic retail business in France. The performance of some of the bank's franchises has disappointed and, in our view, it will be some time before SocGen can rebuild its revenue base to its full potential.
- (+) The bank has successfully overhauled its balance sheet structure in the last five years, making it much more liquid and less reliant on short-term wholesale funding.
- (−) The risk-asset intensity of SocGen (i.e. its ratio of risk-weighted assets to assets) remains low by international standards, raising questions about the modeling of the bank's IRB risk-weighting.

Rating change drivers

The capacity of SocGen to recover lost revenues in some of the bank's key differentiating franchises (financing & advisory, international retail banking and, to a lesser extent, equity derivatives) will be closely monitored by Scope and could lead to positive rating changes.

SocGen has successfully built-up its Basel 3 CET1 ratio to roughly 10%, and management intends to run the bank at this level of capital. However, both Crédit Agricole and BPCE in France have clearly expressed 12-13% targets. Assuming management feels compelled to raise the bank's capital to this level, the impact would be positive on the credit ratings – unless this increase required further deleveraging that would be detrimental to the bank's franchise.

Recent events

Q1 2014 results

The Q1 2014 results of SocGen did not yet contribute to put an end to the revenue drought that we identified as the bank's major negative rating driver last April. Underlying group revenues (excluding CVAs, DVAs and impact of own credit) were down 5.4% Year-on-Year to EUR 5,778m. The main contributors to the decline were the international retail bank – which was penalized by the collapse of the Ruble in crisis-stricken Russia, while the corporate and investment bank posted a weak quarter in a difficult environment.

Costs were under control (as they were down 2% YoY) but if SocGen managed to stabilize pretax profits it was essentially due to a 28% fall in the bad debt charge, driven by the French network and the corporate centre. Overall, Société Générale's pre-tax profits stood at EUR 1,289m, a 2.5% increase on Q1 2013.

We will spend more time on the balance sheet metrics when we look at the 4th rating driver below. Suffice it to say at this point that the CET1 ratio stood at 10.1% and the leverage ratio at 3.6% at the end of Q1 2014.

Investor Day – Strategic Plan

On May 13 Société Générale presented to the market its 2014-2016 strategic plan.

This plan strikes us as realistic but also financially demanding.

Realistic, because the bank is very aware of the "new world" of banking. In his keynote at the beginning of the Investor Day, the group CEO made very clear that banks would have to keep maintaining very high buffers of liquidity, even in times of apparent calm, because of the uncertainties as to how Central Banks would exit accommodating monetary policies. The CEO also acknowledged that SocGen's financials would not be enough to make the bank different from other financial institutions, simply because banks need more or less to have the same balance sheets because of regulation.

As a result, a key differentiator will be the business model – and here, SocGen articulates its medium-term strategy along three key priorities:

- Put client satisfaction at the center of the model through expertise and innovation;
- Capture growth through business development and increase synergies across divisions – the "integrated model" being at the heart of the bank's strategy;
- Deliver sustainable profitability.

But SocGen's business plan is also **financially demanding**. Prima facie, the 2016 financial targets are not that aggressive: 3% revenue CAGR only (for a bank with a major presence in emerging markets); ROE ≥ 10%; and CET1 ratio ≥ 10%. The moderate revenue targets are not exactly surprising in light of the fact that reverting the negative effects of deleveraging will, in our view, take time. But the 3% 2013-2016 revenue CAGR sounds aggressive in light of the Q1 2014 numbers (down YoY as we mentioned above). Assuming we annualize Q1 2014 revenue numbers, SocGen would have to grow revenues by more than 7% in 2015 and 2016 to get to the number corresponding to the 3% 2013-2016 CAGR.

Overall though, and despite the bank's financial targets, we find SocGen's strategy fundamentally supportive of the credit rating because it is well-balanced. Contrary to what has been done by other institutions, SocGen has no intention of aggressively reducing its investment banking presence or cutting its ties with Russia. We therefore feel that SocGen's model is balanced enough to enable the bank to benefit from a return to form of activities such as fixed income, while the bank's diversification (both geographically and by product) should be a competitive advantage in case markets would start deteriorating.

In an integrated model, it is not necessarily a bad idea to offer either lowly profitable (cash equity) or capital intensive (FICC) activities if their existence can be justified by increased cross-selling in other areas of the organization.

Rating drivers (Details)

1. A reliable management team

Over the last six years, SocGen's management team successfully handled:

- The Kerviel fraud (EUR 4.9bn loss) in January 2008 during which the bank liquidated all the positions and underwrote a EUR 5.5bn capital increase before making the fraud public;
- Losses and mark-downs from assets repatriated to SocGen's balance sheet by clients of the Asset Management division in 2007-2008 (EUR 4.7bn estimated). This was one reason why the bank reduced its position in Asset Management. The other was a lack of critical mass, an issue solved by the creation of Amundi, which includes the assets of Société Générale Asset Management (SGAM) and enables the bank to maintain a minority stake in this business without bearing the cost of a full infrastructure. To this day, SocGen only owns a 25%, equity-accounted stake in Amundi, which is likely to be brought down to 20% once the Newedge transaction is completed (see above);
- Losses and mark-downs from legacy assets (estimated cumulative losses of EUR 10.6bn at September 30, 2013). From 2011 onwards, SocGen stepped up the reduction of the legacy assets portfolio through a very aggressive strategy of assets disposals, restructuring and natural run-off. As of year-end 2013, the net losses on the legacy asset portfolio were a modest EUR 210m. As of 2014, the portfolio is not reported separately anymore.
- Aggressive deleveraging and asset disposals between 2011 and 2013 to enable the bank to meet Basel 3 regulatory standards (the object of the second rating driver).

Overall we believe that without a strong management team SocGen might have fared worse in the face of so many hurdles. Over the last six years, the bank has shown an adequate mix of composure and a sense of urgency where needed. This may serve the bank well as it gathers its forces to rebuild its franchise and re-launch its growth strategy.

2. An uncompromising deleveraging and capital build-up effort

SocGen had to resolutely change its strategy in the autumn of 2011 following (1) the implementation of tighter Basel 3 capital rules; (2) strains on liquidity following the withdrawal of US money-market funds from the French banking sector, and (3) the impact of the euro area crisis on market sentiment regarding European banks. These factors led SocGen to drop the growth strategy announced in 2010 and launch a complete overhaul of its balance sheet management. This included building up an imposing liquidity buffer of EUR 160bn, which covers 136% of the short-term funding needs of the bank as of Q1 2014, and securing Liquidity Coverage Ratio (LCR) levels that are above 100%. The legacy assets portfolio was disposed of more aggressively from 2011 onwards: after standing at an overall book value of around EUR 37bn in 2009, the portfolio was worth EUR 5.1bn at YE 2013 (after provisions and impairments), of which only EUR 0.7bn were non-investment grade. Furthermore, SocGen sold off significant parts of its corporate and investment banking loan portfolio from June 2011 to December 2012: a total of EUR 16bn of assets, for recorded losses on disposals of EUR 652m. It also began disposing of some subsidiaries. The sale of asset manager TCW to Carlyle Group was announced on August 2012, contributing 13bps of supplementary CET 1. This was followed by the sale of the Greek subsidiary Geniki to Piraeus Group for EUR 1m. The sale of these two assets was positive as they were non-strategic.

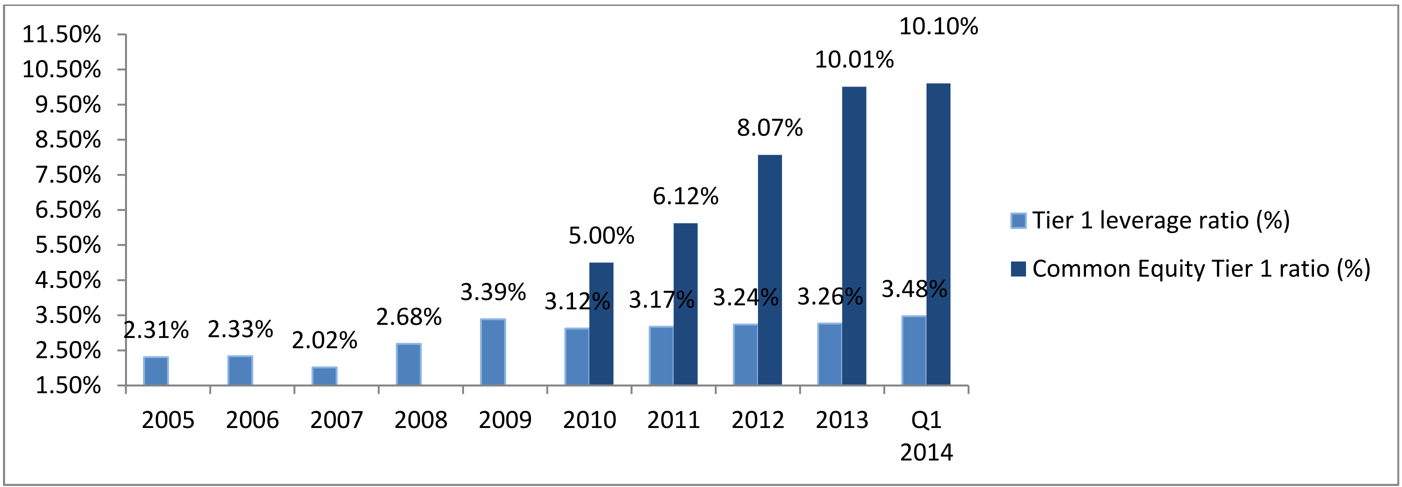
Less straightforward, in our view, was the disposal of National Société Générale Bank (NSGB), the bank's flagship in Egypt and one of the main contributors to the International retail division (after Komercni Banka), with reported net profits of close to EUR 187m at year-end 2012. At least the disposal was made at a good price, as SocGen sold NSGB for 2x book value and close to USD 2bn, a capital gain of EUR 350m and a positive impact on the Basel 3 CET1 ratio of 30bps.

The overall results of these transactions can be seen in Chart 1.

The bank did manage to accelerate its Basel 3 CET1 accumulation by a sizeable 500bps (on our estimates) in three years, of which close to 200bps in 2012 and in 2013. The Basel 3 CET1 of SocGen stood at 10.01% at year-end 2013, in line with its target.

The other section of the chart is dedicated to the leverage ratio of the bank, i.e. Tier 1 capital as a percentage of total IFRS assets (with standard switching from Basel 2.5 to Basel 3 in 2013).

Chart 1: Capital position of Société Générale 2005-2013 (in %)



Source: Scope Ratings estimates, SNL, Company data

3. The rapid transformation of the bank had some negative impact on its revenues

One of the key drivers of SocGen's rating is our belief that the uninterrupted crisis environment experienced by SocGen between 2008 and 2012 (with the notable exception of 2010) may have taken its toll on some of the key franchises of the bank. On Table 1 we have attempted to assess more thoroughly the damage by looking at the yearly revenue growth (expressed in EUR million) of the main divisions of the bank. We have restated the revenues to exclude non-recurring items such as gains/losses on own credit and the losses on sales of the corporate loan book between 2011 and 2012. We have also restated CVA/DVA adjustments. However we have not restated legacy mark-downs, or the lost revenues from deleveraging, which are both parts of the day-to-day business of the bank, in our view.

As a result, some revenue metrics are materially different from what the bank is disclosing.

Table 1: Divisional annual revenue growth at Société Générale between 2006 and 2013 (EUR m)

	2006	2007	2008	2009	2010	2011	2012	2013
Domestic Retail Banking	538	189	389	55	325	374	-4	74
Int'l Retail & Spec FinServ.	792	984	1,891	-141	420	-97	-112	-486
Asset Mgt, PB, SS	611	381	-731	-311	-207	-158	-9	-115
CIB - Financing & Advisory	71	300	-48	699	234	-266	-407	-298
CIB - Fixed Income	494	-3,219	2,758	2,116	-1,452	-693	1,028	-526
CIB - Equities	598	465	-2,402	2,319	-965	-87	-294	397
CIB - Legacy Portfolio	0	0	-3,333	513	2,891	-547	208	418
Insurance	32	108	-39	-5	61	88	84	66
Other	41	-407	2,502	-5,381	3,047	-76	-567	317
Underlying revenues	3,177	-1,199	987	-136	4,354	-1,462	-73	-153
Excl. Legacy portfolio	3,177	-1,199	4,320	-649	1,463	-915	-281	-571

Source: Company data, Scope Ratings estimates

We can draw several conclusions from the table. First, SocGen significantly restated its international retail business by including the consumer finance product engine (essentially servicing foreign markets). This has the consequence of including mature markets in the international retail banking division and therefore making long-term comparisons difficult. As a result, we opted to "merge" the international retail banking division with the specialized financial services division, so as to find a comparable ground for both divisions.

The second major conclusion is that some businesses that formerly enjoyed rapid growth were hurt by the crisis and the ensuing deleveraging. This is the case for the "Financing & Advisory" division due to the sale of the corporate loan book mentioned above, but also for the equities business; despite a significant recovery in 2013, the division is still far from its peak revenues of EUR 3-3.5bn annually. The international business, for its part, has been penalized by the sale of NSGB. We note that after years of stable growth, the French retail business has plateaued, while at group level the revenue picture is somewhat flattered by the shrinking marks on the legacy portfolio.

The third conclusion is that the vast majority of revenue growth for 2008, 2009 and 2012 can largely be attributed to the FICC business. Low interest rates and the ECB's help are probably responsible for this fact as SocGen has never been, in our opinion, a major fixed income franchise, but we are surprised by the extreme volatility of this business – as can be seen in the table. Lastly, after having been a major drag on the company's revenue growth, the legacy portfolio has more recently contributed positively to SocGen's income, even if this is bound to disappear as this portfolio has now diminished to quasi-insignificant levels.

The fourth and last conclusion is that SocGen is putting more emphasis on the profitability of its different businesses, and revenues are only one part of the equation. SocGen has moved its strategy towards optimizing client satisfaction, and the bank has announced a new cost savings program of EUR 900m, following on the EUR 550m achieved in 2012. There are therefore more variables to be considered than just revenues.

4. Overhaul of the balance sheet structure

One of SocGen's major successes in the last five years has been its ability to materially de-risk its balance sheet and increase liquidity. Table 2 compares the funded balance sheets (i.e. the balance sheet excluding insurance and netting of derivatives, repos and accruals) of the bank in 2007 and 2013.

In absolute terms, total assets have not materially changed (going from EUR 660bn to EUR 641bn – a CAGR of less than -1%) but the overall composition is significantly different.

In 2007, SocGen was a very aggressively funded bank: about EUR 55bn of the loan book was funded by short-term wholesale funds and the remaining EUR 53bn of short-term funding supported a sizeable trading assets portfolio of EUR 210bn.

The interbank position of SocGen was as net debtor (by more than EUR 70bn), and the bank had just EUR 8bn in cash and very little equity.

The 2013 balance sheet in Table 2 shows how successful SocGen has been in terming out its funding. Short-term wholesale funding decreased by more than EUR 60bn versus 2007, while long-term debt increased by EUR 46bn. The interbank positions have been drastically reduced and, even if SocGen is still a net interbank debtor, the net position in 2013 (EUR -20bn) bears no resemblance to the 2007 position (EUR -71bn). At the same time, the shareholders' equity of the bank almost doubled while its cash balances have increased nearly eight-fold.

All in all, the loan-to-deposit ratio of the bank improved 10 percentage points from 120% to 110% between 2007 and 2013. The bank is now much more liquid, and its funding is far more balanced towards long-term debt and deposits.

Because of the application of IFRS 10 and 11, it is now more difficult to update the numbers on Table 1 (below). Looking at the restated balance sheet though, it seems that between 2013 and Q1 2014 the size of the funded balance sheet has remained flat with the main liquidity and funding metrics broadly unchanged. We will switch to the new reporting of the funded balance sheet with the YE 2014 numbers.

Table 2: Funded balance sheet Société Générale 2007 & 2013 (EUR bn)

	2007	2013
Cash & central banks	8	63
Due to banks	51	45
Trading assets	210	85
Securities	44	59
Customer loans	332	354
Long-Term & fixed assets	15	35
TOTAL ASSETS	**660**	**641**
ST wholesale funding	118	56
Due from banks	122	65
Other liabilities	20	9
LT wholesale funding (> 1 year)	91	137
Customer deposits	277	322
Shareholders' equity	32	52
TOTAL LIABILITIES + SHAREHOLDERS EQUITY	**660**	**641**

Source: Company data

5. Low risk-weighted asset intensity

Amongst its global peers, French banks post among the lowest risk-weighted intensity in the sector. In other words, the proportion of risk-weighted assets to assets remains low versus international peers. Within the French banking sector though, SocGen strikes us as the one where the RWA % assets ratio has declined steadily: from around 30% (under Basel 2 between 2005 and 2011) to 25% since the introduction of Basel 2.5. Investors have shown some concern about the degree to which model changes have underpinned the fall in the French bank's risk intensity.

When restated for the accounting differences between IFRS and US GAAP (as enabled by IFRS 7), SocGen's RWA intensity increases to 35%, still a comparatively low level versus peers.

The difference in weightings between banks can be mainly explained by different portfolio compositions.

Looking first at credit risk, 75% of SocGen's loan portfolio is located in economically mature countries and 47% is located in France – where default probabilities are historically low for French home loans (with NPL ratios lower than other large French peers in the French home loan market).

As far as SocGen's market risk is concerned, the trend reflects a persistently lower Value at Risk and very low levels in absolute terms in Q4 2013 – particularly on a five-year view. Market risk stress tests are also markedly lower.

As for operational risk, the bank reported a 70% fall in operational losses between 2008 and 2013 and a 78% fall in execution errors in the same time period. ins low, at about 5%.

Overall, we will carefully monitor the evolution of the risk-weighted assets-to-assets ratio in future. Considering its current level, we do not expect it to materially fall further.

Peer Comparison

At Scope Ratings, we compare banks within peer groups at domestic and cross-border level.

In its domestic market, Société Générale is comparable to BNP Paribas, Crédit Agricole Group, BPCE and Crédit Mutuel Group.

Looking at the performance of SocGen versus domestic peers, it is interesting to note that on many metrics the five rated banks show very similar rankings. This is particularly the case of liquidity metrics, since the loan-to-deposits ratio of all French banks is comprised between 110% and 130%. Société Générale has strongly improved this metric over the years and appears among the best positioned, even if the weight of wholesale funds to total funds remains higher than domestic peers.

In asset quality terms, French banks are clearly divided between domestically-biased and internationally-biased banks. The internationally-biased banks (SocGen and BNPP) post higher impaired loans-to-total loans ratios, but the coverage ratios are homogenous.

It is only in profitability terms that French banks can properly be differentiated, and this is where SocGen has the biggest room for improvement. Loan loss charges have remained high over the years due to the credit costs of the international retail portfolio. The cost-income ratio has also been at the upper end of the peer group, resulting in disappointing return metrics and therefore lower internal capital generation than peers in times of intense deleveraging.

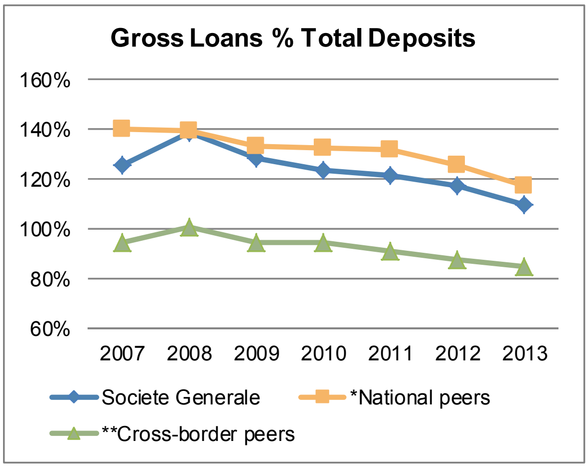
The story is a bit different at cross-border level. Outside France, we have positioned SocGen in the bucket of large universal banks operating in a variety of markets and geographies. This peer group includes HSBC, Barclays, Deutsche, UBS, Credit Suisse, Citigroup, Bank of America, JP Morgan as well as BNP Paribas.

Within its peer group, SocGen has an acceptable position. SocGen's only relative weakness is the loan-to-deposit ratio, where the two large French banks post the worst metrics. We nonetheless note that SocGen's reported loans-to-deposits ratio has improved by almost 30 percentage points between 2008 and 2013, declining from 138% to 110% - quite an achievement in our opinion.

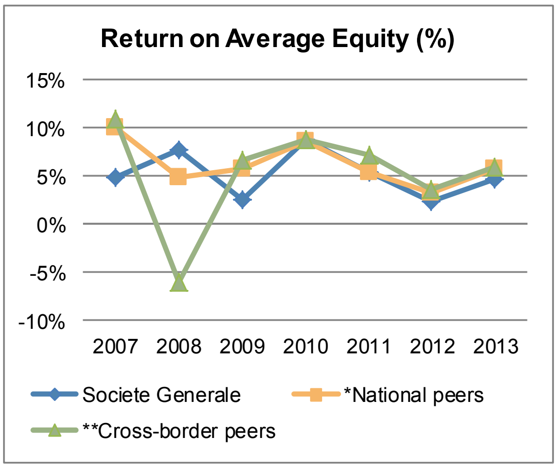
Following six very difficult crisis years and a comprehensive restructuring effort, SocGen is starting 2014 on the front foot, in our view.

The bank's major challenge will be to recover some of the lost revenue ground in selected areas of its business model.

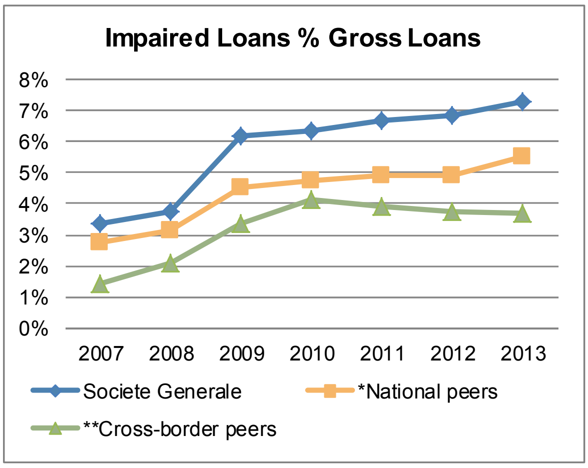
Peer Comparison - Societe Generale group



Source: SNL Financial, Scope Ratings



Source: SNL Financial, Scope Ratings



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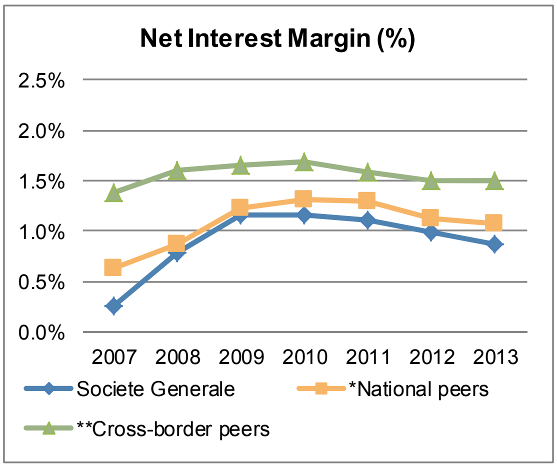
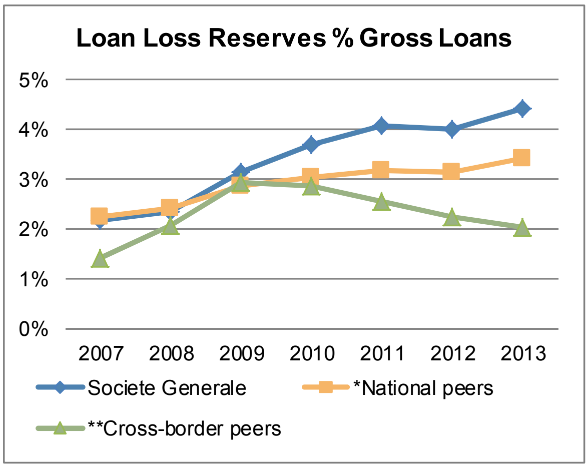
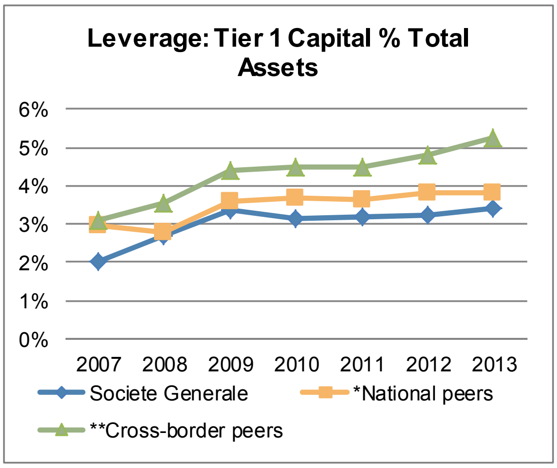


Source: SNL Financial, Scope Ratings



Source: SNL Financial, Scope Ratings



Source: SNL Financial, Scope Ratings

*National peers: BNP Paribas, Credit Agricole Group, Credit Mutuel Group, Groupe BCPE, Societe Generale
**Cross-border peers: Bank of America Corp, Barclays, BNP Paribas, Citigroup Inc, Credit Suisse, Deutsche Bank, HSBC, JP Morgan Chase, Societe Generale, UBS

Selected Financial Information - Societe Generale group

	2007	2008	2009	2010	2011	2012	2013	2014E	2015E
Balance Sheet summary (EUR billion)									
Assets									
Cash and balances with central banks	11.3	13.7	14.4	14.1	44.0	67.6	66.6	82.5	113.0
Interbank assets	73.1	71.2	67.7	70.3	86.4	77.2	84.8	84.8	84.8
Total securities	429.8	260.5	315.5	370.1	307.0	394.8	457.3	457.0	467.8
of which debt instruments	240.2	157.0	162.4	174.5	170.8	185.9	208.1	197.7	197.7
of which equity instruments	127.3	67.9	101.7	109.2	60.9	99.5	144.5	154.7	165.5
Derivatives	153.1	320.3	185.3	201.3	257.7	238.5	177.2	177.4	180.6
Gross customer loans	339.4	392.1	385.6	416.3	413.6	394.8	378.0	378.0	381.6
of which impaired loans	11.4	14.7	23.7	26.4	27.7	26.9	27.6	27.0	26.5
Total funded assets	910.2	819.3	839.0	926.7	925.0	1,014.3	1,055.7	1,069.8	1,113.5
Total Assets	**1,071.8**	**1,130.0**	**1,023.7**	**1,132.1**	**1,181.4**	**1,250.9**	**1,235.3**	**1,249.6**	**1,296.6**
Liabilities									
Interbank liabilities	134.9	121.8	92.6	80.1	112.2	124.4	94.7	94.7	94.7
Senior debt	253.2	185.8	214.9	235.7	189.0	243.0	287.3	287.3	316.0
Derivatives	161.5	310.7	184.7	205.3	256.4	236.6	179.6	179.8	183.1
Customer deposits	270.7	282.5	300.1	337.4	340.2	337.2	344.7	351.6	358.6
Subordinated debt + hybrid securities	11.5	13.9	12.6	12.0	10.5	7.1	7.4	6.7	6.0
Total Liabilities	**1,040.5**	**1,089.1**	**976.9**	**1,081.1**	**1,130.3**	**1,197.3**	**1,181.2**	**1,194.0**	**1,239.4**
Ordinary equity	19.9	25.7	34.8	39.1	40.8	42.5	43.9	45.4	47.1
Minority interests		4.8	4.6	4.6	4.0	4.3	3.1	3.1	3.1
Total Liabilities and Equity	**1,071.8**	**1,130.0**	**1,023.7**	**1,132.1**	**1,181.4**	**1,250.9**	**1,235.3**	**1,249.6**	**1,296.6**
Core Tier 1 Capital [1]	*20.2*	*22.8*	*26.9*	*27.8*	*29.2*	*29.9*	*34.3*	*35.8*	*37.4*
Income Statement summary (EUR billion)									
Net interest income	2.5	7.9	11.6	12.0	12.2	11.3	10.1		
Net fee & commission income	7.5	7.4	7.8	7.5	7.2	7.0	6.5		
Net trading income	10.4	5.5	2.7	5.6	4.7	3.4	4.1		
Operating Income	**22.1**	**22.6**	**23.5**	**26.8**	**26.0**	**23.5**	**23.0**	**23.7**	**24.3**
Operating expenses	14.3	15.5	15.7	16.5	17.0	16.4	16.4	16.3	16.7
Loan loss provision charges	1.0	3.4	7.7	4.4	3.7	4.1	2.4	3.3	3.0
Non-recurring items	-4.9	0.6	0.7	0.0	-0.9	-0.5	-1.1	0.1	0.1
Pre-Tax Profit	**1.9**	**4.0**	**0.8**	**5.8**	**4.1**	**1.6**	**3.1**	**4.1**	**4.6**
Income tax	0.3	1.2	-0.3	1.5	1.3	0.3	0.5	1.1	1.4
Net profit attributable to minority interests	0.7	0.8	0.4	0.4	0.4	0.4	0.4	0.5	0.5
Net Income Attributable to Parent	**0.9**	**2.0**	**0.7**	**3.9**	**2.4**	**0.8**	**2.2**	**2.5**	**2.7**

Source: SNL Financial and Scope Ratings for historical figures. Scope's forecasts are based on publicly available information. Please refer to "Methodologies Used for this Report" for further details.
[1] CRD 4 basis from 2011 onwards

Ratios - Societe Generale group

	2007	2008	2009	2010	2011	2012	2013	2014E	2015E
Funding/Liquidity									
Gross loans % Total deposits	125.4%	138.8%	128.5%	123.4%	121.6%	117.1%	109.7%	107.5%	106.4%
Total deposits % Total funds	40.0%	46.0%	47.8%	50.2%	51.7%	46.9%	46.5%	47.0%	45.8%
Wholesale funds % Total funds	60.0%	54.0%	52.2%	49.8%	48.3%	53.1%	53.5%	53.0%	54.2%
Asset Mix, Quality and Growth									
Gross loans % Funded assets	37.3%	47.9%	46.0%	44.9%	44.7%	38.9%	35.8%	35.3%	34.3%
Impaired loans % Gross loans	3.3%	3.7%	6.2%	6.3%	6.7%	6.8%	7.3%	7.1%	6.9%
Loan loss reserves % Impaired loans	63.1%	60.8%	51.2%	57.9%	60.5%	58.8%	60.6%	61.9%	63.1%
Gross loan growth (%)	14.7%	15.5%	-1.7%	8.0%	-0.7%	-4.5%	-4.3%	0.0%	1.0%
Impaired loan growth (%)	16.2%	29.1%	61.8%	11.3%	4.9%	-2.8%	2.4%	-2.0%	-2.0%
Funded assets growth (%)	9.5%	-10.0%	2.4%	10.5%	-0.2%	9.7%	4.1%	1.3%	4.1%
Earnings									
Net interest income % Revenues	11.3%	35.2%	49.4%	44.7%	46.9%	48.2%			
Fees & commissions % Revenues	34.1%	32.8%	33.2%	28.0%	27.6%	29.7%			
Trading income % Revenues	47.0%	24.4%	11.7%	20.9%	18.2%	14.5%			
Other income % Revenues	7.6%	7.6%	5.7%	6.4%	7.3%	7.6%			
Net interest margin (%)	0.4%	1.2%	1.9%	1.9%	1.8%	1.6%			
Pre-provision Income % Risk-weighted assets (RWAs)	2.4%	2.1%	2.4%	3.1%	2.6%	2.2%	2.1%	2.1%	2.1%
Loan loss provision charges % Pre-provision income	13.2%	47.9%	97.1%	42.9%	41.7%	58.4%	36.0%	44.5%	39.6%
Loan loss provision charges % Gross loans (cost of risk)	0.3%	0.9%	2.0%	1.1%	0.9%	1.1%	0.6%	0.9%	0.8%
Cost income ratio (%)	64.7%	68.6%	66.6%	61.8%	65.5%	70.0%	71.2%	68.7%	68.6%
Net Interest Income / Loan loss charges (x)	2.4	2.3	1.5	2.7	3.3	2.8			
Return on average equity (ROAE) (%)	4.3%	8.8%	2.2%	10.6%	6.0%	1.9%	5.0%	5.6%	5.8%
Return on average funded assets (%)	0.1%	0.2%	0.1%	0.3%	0.2%	0.1%	0.1%	0.2%	0.2%
Retained earnings % Prior year's book equity	2.2%	6.6%	1.9%	10.1%	6.1%	1.6%	3.3%	3.4%	3.6%
Pre-tax return on common equity tier 1 capital	9.3%	17.6%	3.0%	21.0%	14.1%	5.2%	8.9%	11.5%	12.3%
Capital and Risk Protection [1]									
Common equity tier 1 ratio (common equity tier 1 capital % RWAs)	6.2%	6.6%	8.3%	8.3%	6.1%	8.1%	10.0%	10.3%	10.4%
Tier 1 leverage ratio (%)	2.0%	2.7%	3.4%	3.1%	3.2%	3.2%	3.3%		
Median of tier 1 leverage ratio and common equity tier 1 ratio (%)	4.1%	4.6%	5.8%	5.7%	4.6%	5.7%	6.6%		
Total loss coverage (CET 1 capital + loan loss provisions) % RWAs	8.4%	9.2%	12.0%	12.9%	13.2%	14.1%	16.2%	16.2%	15.2%
Non-senior bailinable debt cushion (as % of total liabilities)	1.8%	2.2%	2.0%	1.8%	1.5%	1.1%	1.2%	1.1%	1.0%
Asset risk intensity (RWAs % total assets)	30.5%	30.6%	31.7%	29.6%	29.5%	25.9%	25.5%	27.7%	27.7%

Source: SNL Financial and Scope Ratings for historical figures. Scope's forecasts are based on publicly available information. Please refer to "Methodologies Used for this Report" for further details.
[1] CRD 4 basis from 2011 onwards

METHODOLOGIES USED FOR THIS REPORT

For the rating and analysis contents of this report Scope has used the following methodologies which were published on www.scoperatings.com:

"Bank Rating Methodology" (February 2014)

"Forecasting Bank Financials Methodology" (February 2014)

Forecasting bank financials: Forward-looking estimates are an important analytical tool underpinning Scope's bank ratings. These forecasts cover the current financial year (before final year-end figures are published by the bank) plus the forthcoming two years. Depending on the complexity of the bank being assessed, different forecasting tools will be used. For a majority of banks operating primarily commercial and retail banking franchises (loans and deposits) the analysis is underpinned by an **accounting** forecast of the balance sheet and profit and loss account. For more complex groups with multiple ranges of activities – notably those with material wholesale and investment banking operations – Scope uses an **analytical** forecast, relying on the bank's business-line reporting to come up with plausible estimates. For all banks Scope also include a **regulatory metrics** forecast, considering the growing importance of this aspect in bank analysis.

For complex banks, divisional data is used to forecast profit and loss accounts and basic divisional balance sheet metrics. For less complex banks, a line-by-line forecasting of major P&L elements is forecast.

For balance-sheet forecasts, Scope estimates of all major balance sheet lines, using the P&L estimates to complete the forecast of the capital/shareholders' equity line. This comprehensive methodology for estimating the balance sheet is used for all the banks in our universe, irrespective of size and complexity.

Lastly, our forecasts include assessments of the major regulatory metrics: Tier 1 and CET 1 (historically CT1), Leverage, Liquidity Coverage Ratio, and Net Stable Funding Ratio (the latter two when and if sufficient public information to compute them is available).

Scope will not aim to forecast financials when it considers the public disclosure of the bank as insufficient for a transparent and credible outcome.

All Scope's bank financial forecasts are based on public information. For its forecasts Scope will not use any non-public information or data, even if such information or data were provided by rated banks. Scope's forecasting process is transparent, with a detailed roadmap provided in its *"Forecasting bank financials"* methodology.

UBS AG
Issuer Rating Report

A STABLE OUTLOOK
Financial Institutions

Overview

Scope Ratings assigns an Issuer Credit-Strength Rating (ICSR) of A and a short-term debt rating of S-1 to UBS AG, both with a stable outlook. These ratings reflect the significant downsizing of the bank during the crisis and good relative levels of underlying profitability from core franchises over the past five years. At the same time, the ratings reflect the uncertain outcome of several high-profile litigation cases as well as the complexity attached to the de-risking of the investment bank (IB) and the resulting size of the corporate center.

The ratings apply to senior unsecured debt issued by UBS AG. However, the ratings are not applicable to unguaranteed debt issued by subsidiaries of UBS AG.

Issuer Credit-Strength Rating (assigned on April 2, 2014)	**A**
Outlook	Stable
Senior unsecured debt	A
Short term debt rating (May 22, 2014)	S-1
Short term debt rating outlook	Stable

Unsolicited ratings with issuer participation.

Lead Analyst

Jacques-Henri Gaulard
j-h.gaulard@scoperatings.com

Team Leader

Sam Theodore
s.theodore@scoperatings.com

Rating drivers (Summary)

The rating drivers, in decreasing order of importance in the rating assignment, are:

- (+) The bank has reduced its overall size by more than half since the crisis while increasing its tangible equity by more than 90%.
- (−) High-profile litigation cases and operational incidents have occurred since 2011 and raise uncertainties concerning UBS's ability to close the book on the crisis years.
- (+) UBS's Private Banking franchise has contributed to the resilience of the bank's earnings.
- (+) Despite a very momentous history since 2007, the relative profitability of UBS's assets (both on and off balance sheet) has remained consistent with pre-crisis levels.
- (−) In our opinion, the de-risking of the investment bank lacked clarity so far and has led to the formation of a very large, complex corporate center.
- (+) The influence of two very thorough, proactive public authorities (SNB and FINMA) in the field of financial stability and bank supervision in Switzerland.

Rating change drivers

The gross margin of UBS in wealth management is likely to have bottomed out. It has been declining steadily over the years, from 100bps in 1999-2006 to a current level of 85-90bps, thus demonstrating that Swiss banks can no longer charge for banking secrecy and that the business is geographically shifting to more transaction-driven (and therefore lower margins) Asian and onshore US markets. However, less risk-adverse asset allocation from clients and supportive market conditions could strengthen the profitability of the wealth management business, secure its cash generation and make its earnings stream more stable, further reducing the bank's dependency on the more volatile investment banking business.

Since the beginning of the crisis, UBS has had four Chairmen of the Board, four CEOs, five heads (or co-heads) of the Investment Bank and three CFOs in quick succession. This high turnover has led to various shifts in strategy that have lacked clarity at times. More managerial stability should be positive for the rating and would help the bank assert its strategy and secure its financial recovery.

Recent events

UBS reported its Q1 2014 results on May 6. The results show good P&L resilience versus peers and continuously improved balance sheet metrics. In particular, UBS has shown very solid net new inflows in Wealth Management (CHF 10.9bn in Q1 versus a quarterly average of CHF 9bn in 2013), continuous reduction in the non-core and legacy assets portfolios (with total RWAs declining from CHF 63.5bn to CHF 60.1bn quarter-on-quarter), and a 40bps increase in the CET1 and the leverage ratio QoQ, to 13.2% and 3.8% respectively.

On the same day, UBS also announced that it was modifying its legal structure to enhance resolvability. In this respect, the group stated that a holding company will be created later in 2014 and a Swiss legal entity will be spun out of UBS AG – in a structure not dissimilar to what Credit Suisse announced at the end of 2013.

Strategic update

Still on May 6, UBS held an "Investor Update" during which the bank essentially confirmed its strategy, its 15% ROE target, a 50%+ payout ratio and a reduction in its leverage denominator. We highlight the following key take-aways:

- **UBS now discloses its profitability by region** and the new disclosure shows that the bank is effectively profitable in every continent, Switzerland is unsurprisingly the main contributor with pre-tax profits of CHF 2.7bn in 2013, followed by Americas (CHF 1.7bn), Asia-Pacific (CHF 1.5bn) and EMEA (CHF 1.5bn). The corporate center contribution was a negative CHF (4.2)bn.
- **The new cost reduction target of CHF 2.1bn** (of which CHF 0.7bn "after 2015") is located at corporate center level and is driving the improvement in the divisional cost-income ratio targets of Wealth Management, Wealth Management Americas and the Investment Bank. UBS first expects CHF 0.4bn of cost reduction in the non-core and legacy portfolio by YE 2015, and CHF 0.7bn later on. In the core function, the cost reduction stands at CHF 1bn. Overall, UBS aims at working on group IT costs, streamline operations, outsource some important group functions (such as legal and finance) and launch some cross-divisional cost savings measures. As a result, divisions should benefit from lower cost allocations from the corporate center and therefore be able to reduce their cost-income ratio.
- **Wealth Management has detailed its strategy to achieve a 10-15% pre-tax profit growth**. Four of these drivers are already well-known: (1) highlight the investment performance of a UBS "house view" which is then applied to the whole client base; (2) grow the Ultra High Net Worth (UHNWI) business (particularly through lending); (3) expand the bank's global footprint and (4) leverage UBS's platform. The two remaining drivers are quite interesting: (5) rejuvenate the HNW franchise – which forms the bulk of the profits and the cash-flow of the division; and (6) transform the advisory business by turning the traditional advisory business into a mandate-driven business. The idea would be for mandates (both advisory and discretionary) to represent 40% of the Wealth Management's book of invested assets (as opposed to 22% currently). This would lead to higher margins and more stable revenues for the division.

Rating drivers (Details)

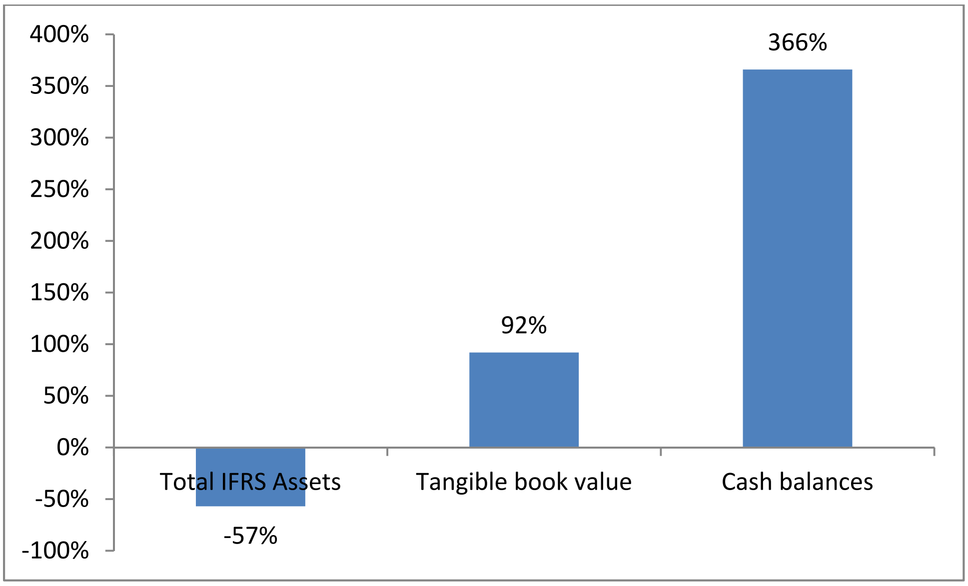
1. UBS has successfully reduced its size and increased its capital base since the crisis

Since 2007 and the outburst of the financial crisis, UBS has steadily reduced its level of assets. The pace of the reduction has been irregular (taking place essentially in 2009 and then 2012-Q1 2014), but very effective. Chart 1 below shows the trends regarding the main metrics.

In more than six years, UBS has managed to reduce its total asset base by 57%, from CHF 2.3trn to less than CHF 1trn. This spectacular fall was fairly homogenous at every balance sheet line, except for cash balances (increasing by 366% during the same time period) and the tangible equity (up 92%, reflecting a 33% increase in shareholders' equity and a 57% decrease in goodwill and intangibles).

In terms of balance sheet structure, the metrics have not changed fundamentally since 2007. UBS was always a very liquid bank with a very low loan-to-deposits ratio and ample liquid assets. The improving liquidity trends have accelerated in 2013 and Q1 2014, with the weight of deposits to total funding now very close to 60% and the weight of liquid assets shifting towards more cash. We expect these trends to continue in 2014 and beyond.

Chart 1: Percentage change in key balance sheet aggregates at UBS - 2007-Q1 2014



Source: Company data, Scope Ratings estimates

2. Many unexpected incidents have occurred since 2011

Even if the bank has succeeded in considerably de-risking its balance sheet over the years, the ability to fully level the score with its checkered past remains a challenge. In our view, the scope and frequency of the litigation cases and various operational problems disclosed by UBS over the last two years explain why FINMA felt compelled to impose a capital surcharge on the bank. In September 2011, a trading incident involving unauthorized transactions was unveiled, revealing a USD 2.3bn fraud at the investment bank. The LIBOR fixing case (already mentioned in the 2010 annual report) led UBS to seek conditional immunity in different jurisdictions, enabling the bank to limit the damage of this case to total fines of CHF 1.4bn. However, after this case was made public, UBS revealed the extent of its exposure to the RMBS securities market and the warranties and representations made by the bank on loans transferred to securitization trusts. The scope of the problem came as a surprise since, amongst all global banks, UBS had kept most of these instruments on-balance sheet and was not perceived as having distributed many of them out. In July 2013, UBS announced a charge of CHF 865m ahead of its Q2 results publication, stating that the bank had settled claims related to US RMBS offerings between 2004 and 2007 with the FHFA (Federal Housing Finance Agency). In its Q3 2013 financial report, UBS confirmed that it had launched an internal investigation on “possible manipulation of the global foreign exchange market”. In its press release on the Q3 results, UBS consequently announced that it “expected elevated charges for litigation and regulatory matters to continue through 2014”. Until then, UBS had not indicated that litigation charges would continue beyond the end of 2013.

The hard work done by the bank on its balance sheet, its solid cash generation and the provisions and capital buffer already accumulated mean that the impact of these litigation events on UBS’s CET 1 ratio would be limited. However, collateral reputational risk is much more difficult to assess. Litigation risk is, in our view, the most important challenge that UBS will face in the near futur.

3. UBS’s Private Banking franchise has contributed to the resilience of the bank’s earnings

It is difficult to analyze UBS’s Private Banking business over a long period of time as the business has been subjected to numerous restatements over the years.

Table 1 summarizes some of the main metrics since before the crisis.

Table 1: UBS Wealth Management businesses – key metrics (CHF m except when indicated)

	2006	2007	2008	2009	2010	2011	2012	2013
Wealth Management revenues	10,555	12,473	10,500	7,427	6,703	7,228	7,040	7,573
Wealth Management Americas revenues	6,223	7,153	6,450	5,512	5,558	5,207	5,891	6,565
Total Wealth Management revenues	**16,778**	**19,626**	**16,950**	**12,939**	**12,261**	**12,435**	**12,931**	**14,138**
Total cumulative assets under management (AuMs) (CHF trn)	n/a	n/a	1,478	1,515	1,457	1,459	1,593	1,751

Total group revenues	46,895	28,516	1,820	26,140	30,770	27,155	27,155	27,829
Total Wealth Management revenues % total group revenues	36%	69%	931%	49%	40%	46%	48%	51%
Gross margin on AuM (%)	n/a	n/a	1.15%	0.86%	0.83%	0.85%	0.85%	0.85%

Source: Company data

As seen above, following a large decrease in revenues from the 2007-2008 levels, the Wealth Management business of UBS (defined as the addition of the Wealth Management and Wealth Management Americas divisions) stabilized its revenue contribution until 2012, while more favorable market conditions led to an encouraging upturn in 2013. The recovery of the US wealth management revenues in the course of 2013 has been very convincing.

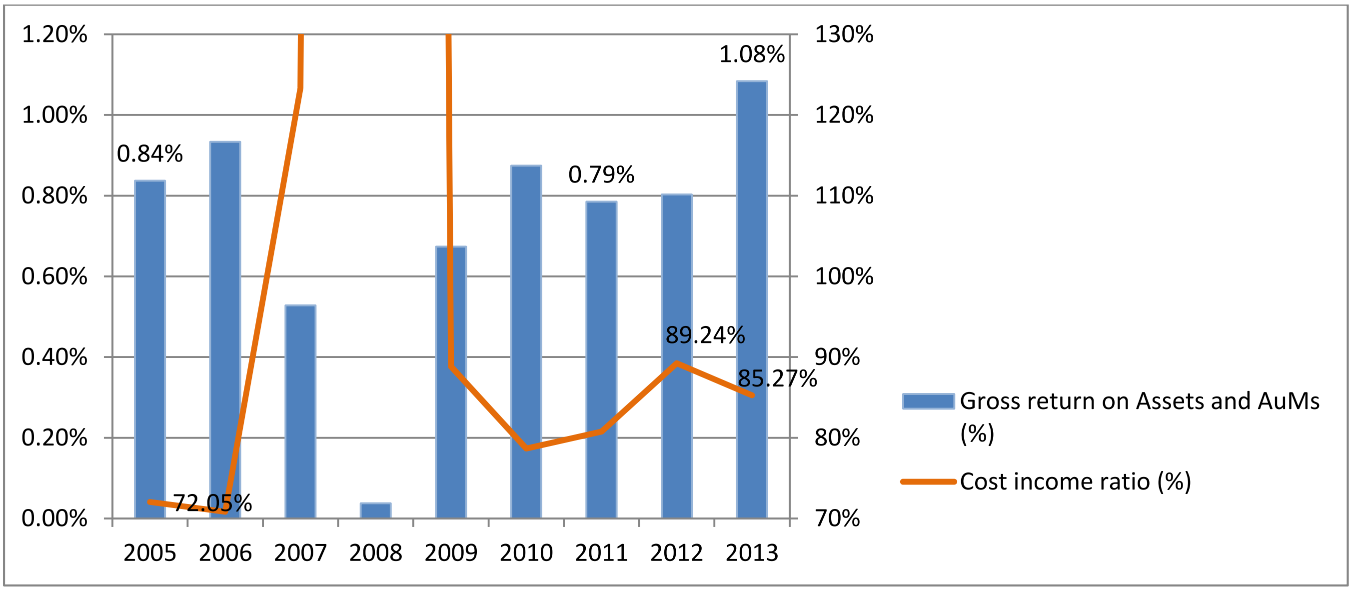
Since 2009, Wealth Management has accounted for about half of UBS's total revenue and the gross margin on Assets under Management (AuM) has been stable. UBS's weight in the wealth management business and its sheer size have proven to be very positive earnings stabilizers in the course of the financial crisis and we would expect this role to continue in the future.

4. Despite various restructurings, UBS's profitability has improved since the crisis

In light of the difficulty in tracing the performance of UBS at the divisional level (see above), we have decided to simplify our analysis and consider the profitability of the whole group. We have made very light restatements (in particular excluding own credit items, restructuring charges, property capital gains, goodwill impairments and strategic capital gains or losses) to the P&L and compared these restated revenues of UBS Group to the combination of on-balance sheet total IFRS assets plus the total assets under management of the bank.

By doing so, we compared the revenues of the bank to its real revenue-yielding assets. Indeed, working on the basis of traditional revenue-to-asset ratios would not give a fair view of the bank's real income generation, as all the off-balance sheet assets under management would be excluded from the metrics. Measuring revenues with both assets and assets under management enables us to include the key metric of AuM, which is the real determinant of the profitability of the wealth and asset management divisions. The conclusions are shown in Chart 2.

Chart 2: Gross margin on assets & AuM (%, LHS) and cost-income ratio (%, RHS) of UBS 2005-2013



Source: Scope ratings estimates, Company data

We find it very encouraging to see that, despite the extensive restructuring, the relative gross profitability of UBS on assets and AuM (defined as Group Revenues % Total assets & AuMs) has recovered since the financial crisis. At 108bps, this metric is pretty much at record levels. In our view, this means that UBS can extract the same level of profits from its franchise, even if the bank has thoroughly reduced its size since 2005.

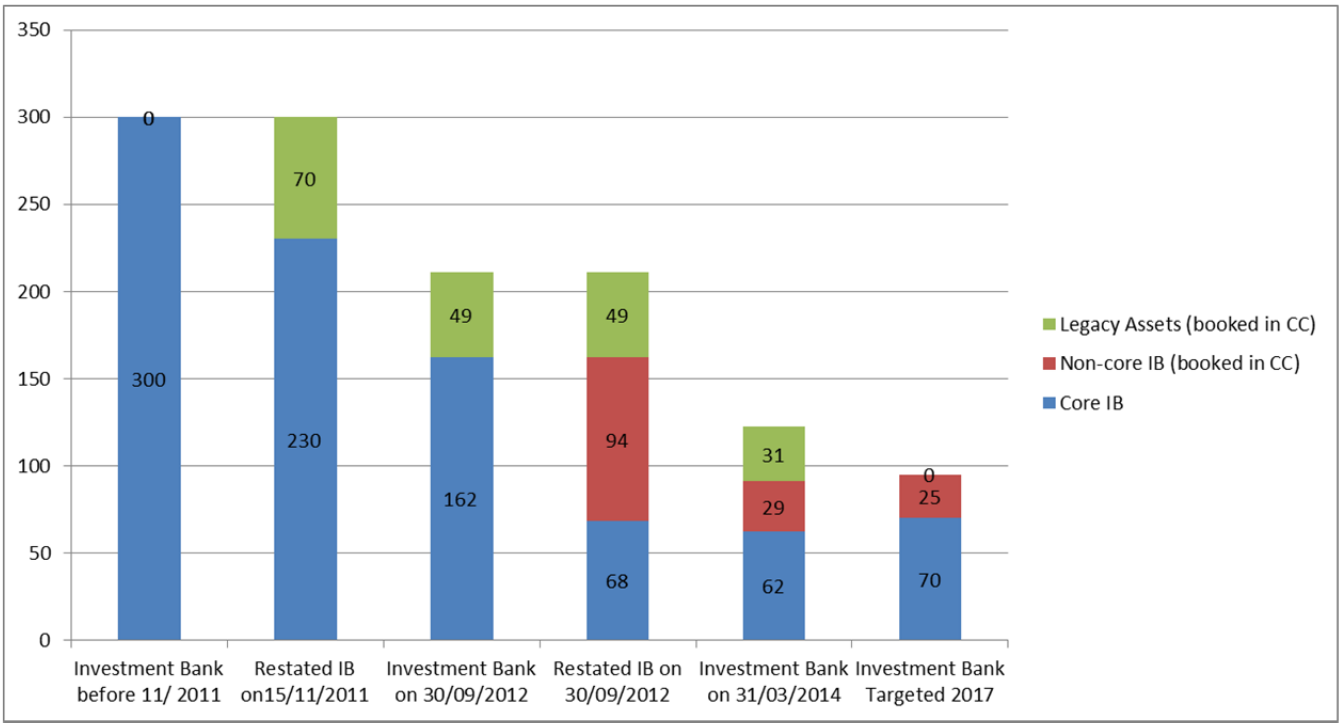
But the graph also illustrates the key problem preventing UBS from materializing in full the cash generation ingrained in the franchise that is its cost base, which is still very high considering the cost savings programs that have taken place at the bank since 2007-2008. Since 2009, the cost-income ratio of the bank has never dropped below 79% and it compares unfavorably with the 2005-2006 benchmarks of around 70%. Reassuringly though, once all the litigation issues are absorbed, the cost problem should be relatively easy to solve. In any case, UBS's recurring profitability issue is not linked to revenue – which would have been much more problematic.

5. The de-risking of the investment bank has lacked clarity so far and has led to the formation of a very large, complex corporate center

Since the management change that followed the September 2011 trading incident, UBS has launched two major overhauls of its strategy; the second one being admittedly an extension of the first. In October 2011, UBS had planned a CHF 145bn (or 50%) reduction in the RWAs of the IB by 2016. Roughly half of the RWA reduction was assumed to be completed through the extinction of a legacy portfolio and another half through business realignment and optimization of the current platform.

Following the appointment of a new Head of IB, UBS announced a follow-up to this strategy in November 2012. This time, the bank was more explicit in its view and more aggressive in its targets. On top of the above legacy asset portfolio to be exited, UBS announced the exit from businesses representing another CHF 90bn of IB RWAs. To be able to manage its core IB as efficiently as possible, UBS transferred this non-core portfolio to the corporate center (CC). This means that the investment bank as it was known in 2011 is now split into three components: a core business - the only one to be reported independently and the only true and recognized investment bank of UBS; a non-core business representing the soon-to-be exited businesses (November 2012); and the legacy businesses, which are also up for disposal since November 2011. Both legacy and non-core businesses are part of the corporate center. Chart 3 clarifies these restatements.

Chart 3: Basel 3 RWA trends at the IB of UBS, 2011-2017E (CHF bn)



Source: Company data, Scope Ratings estimates

In light of the last four quarterly results, the restructuring of the IB is significant since the bank has posted a pretax ROE of close to 30% in 2013 (and 21.5% in Q1 2014) – an achievement easier to make than it may appear, considering the low RWAs of UBS's new core IB – but also a level which seems extremely high in comparison with peers. However, we are concerned by past asset transfers between the non-core and core IBs. We find evidence of this on page 62 of the Q2 2013 report. The largest decline in non-core IFRS assets quarter-on-quarter was attributed to the transfer of non-core Brazilian government bonds back to the emerging markets core business of the investment bank. Such transfers, if they were to recur, could be problematic for the risk profile of the company and the volatility of its earnings. Conversely, we also note that in Q4 2013 some CMBX positions were transferred from the investment bank to the legacy portfolio. However, we also acknowledge the commitment of UBS to reduce and ultimately unwind these portfolios, as made clear by the bank's Chief Risk Officer at the UBS Investor Update on May 6. UBS expects structured credit RWAs to reduce materially by YE 2014 (from current CHF 7.1bn to CHF 1bn) but OTC rates RWAs are more difficult to predict since the exiting and clearing of trades can only happen with the counterparty's authorization and consent. In any case, Scope will monitor the unwinding trends carefully.

Some collateral damage of the co-existence of two IB portfolios in the corporate center lies in the fact that the latter is becoming very large and more difficult to analyze. There are now 23,984 employees at the corporate center (out of a total of 60,326 FTEs at UBS Group) before cost allocations to the respective divisions. The bank has also changed treasury and cost allocations quite often since the crisis, which means that divisional performance has become increasingly difficult to assess over a long period of time. The opacity of the corporate center stemming from the realignment of the IB could lead to large, unattributed losses that would, in our opinion, be very difficult to trace.

6. The influence of two very thorough and proactive institutions in the field of financial stability and bank supervision

Following the financial crisis that brought another large bank to the brink of collapse, the Swiss financial authorities took steps to enhance the supervision of banks; in particular, the two large institutions that are critical in Switzerland as their banking assets represent five times the country's GDP. The respective prerogatives (and joint work) of the Swiss National Bank (SNB) and FINMA (Financial Regulator) are defined in the February 23, 2010 Memorandum of Understanding in the field of financial stability.

Measures implemented successfully since the crisis:

1. SNB and FINMA have managed to speedily insert Too Big To Fail (TBTF) and systematically-relevant-specific legislation within the 1934 Banking Act and the 1972 Ordinance on banks. The most important conclusions of Basel 3 rules and their Swiss interpretation (on minimum capital levels and liquidity) as well as the recommendations of the Financial Stability Board (FSB) on TBTF have all been incorporated into domestic regulations. For capital and liquidity, the Swiss Federal Council has written two specific ordinances (on June 1 and November 30, 2012) following — and sometimes going beyond — Basel 3 recommendations. All key measures have been enforced since January 2013.
2. On top of this extensive legislative effort, both SNB and FINMA have maintained a very close monitoring of the two large, systemically-relevant banks and have taken action when they deemed that some aspects of the financial fundamentals needed strengthening.

Most recently, FINMA has asked UBS to alter its computation of operational risk with a "supplemental analysis" (replacing a temporary CHF 28bn add-on announced in the course of the Q3 results). In doing so, FINMA has acted on one of the main risks at UBS since the "trading incident" in 2011: operational risk. The operational risk add-on represents CHF 22.5bn of supplementary RWAs. If we use the core equity Tier 1 ratio target of 13% for UBS, one could argue that the supplementary RWAs cover about CHF 2.9bn of supplementary capital that can be used to absorb the extra litigation charges and/or losses.

UBS reported CHF 1.6bn of litigation provisions in its FY 2013 report. If we assume that “elevated” (to quote the company) legal charges are in line with the 2012-2013 average of CHF 2.1bn, then it is probably fair to assume that UBS could probably reserve that same amount in 2014. Altogether, these P&L charges, existing provisions and capital add-ons would represent a total of around CHF 6.6bn (USD 7.3bn), to be compared, for example, with the JP Morgan mortgage settlement of USD 13bn with the FHFA (which is 1.8x higher than our UBS settlement estimates, bearing in mind that JP Morgan is about 2.5x bigger than UBS by total assets).

The Swiss supervisor has therefore preempted a potentially important credit problem and has forced UBS to allocate more capital to it, which we view as a very important intervention from a credit perspective.

Peer comparison

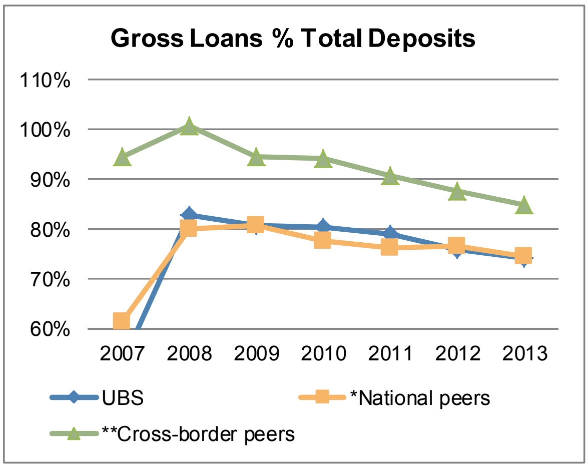
At Scope ratings, we compare banks within peer groups at the domestic and cross-border level.

Of the banks rated by Scope, UBS can only be compared to Credit Suisse at the domestic level. Since both banks are part of the same global peer group of large universal banks operating in varied markets, we do not focus specifically on the domestic comparison.

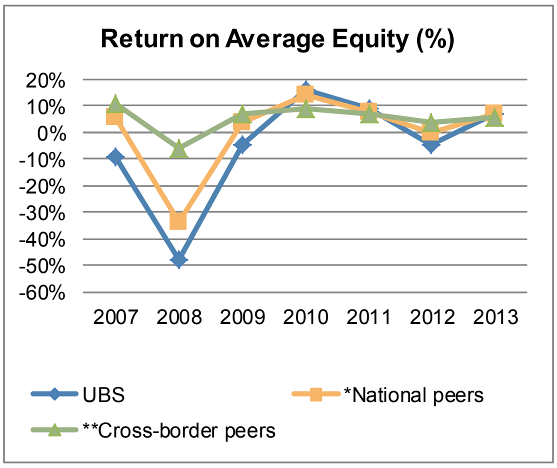
Scope’s global peer group includes BNP Paribas, Société Générale, HSBC, Barclays, Deutsche Bank and Credit Suisse, in addition to Citigroup, Bank of America and JP Morgan in the United States.

Overall, we find that UBS’s positioning is solid; particularly in light of the changes the bank underwent in the past years. Its total assets stand with those of the smaller-sized banks in the peer group, and it is undoubtedly clear that the low balance sheet usage of the bank helps, considering its mix of wealth management and less-capital-intense investment banking. The funding metrics are strong and UBS’s leverage ratio is inching back towards European peer averages, even if it is still lower than that of its US peers. However, the optical superiority of the US group (as well as Credit Suisse) is explained by reasons linked to accounting differences.

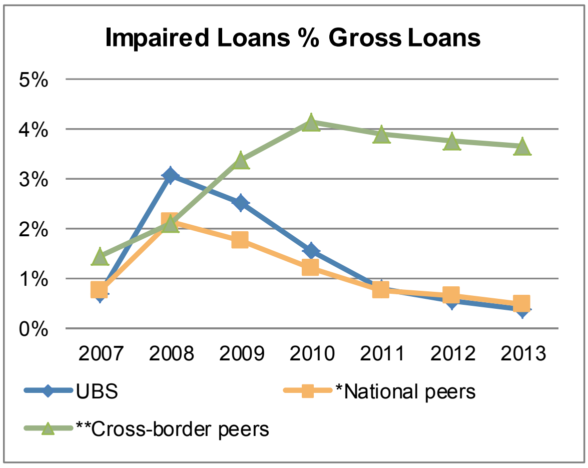
Peer Comparison - UBS group



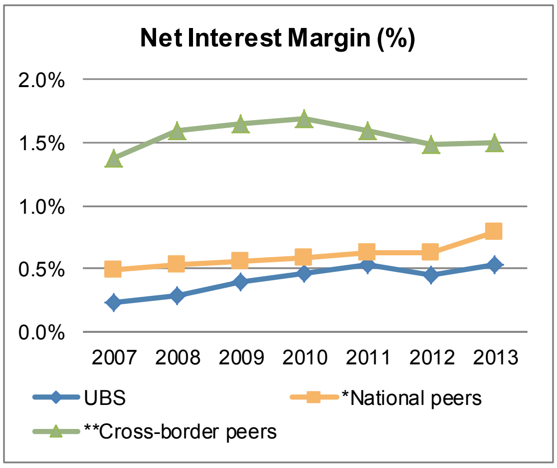
Source: SNL Financial, Scope Ratings



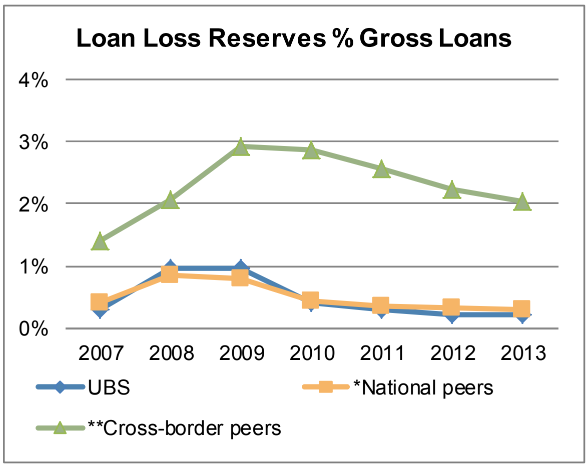
Source: SNL Financial, Scope Ratings



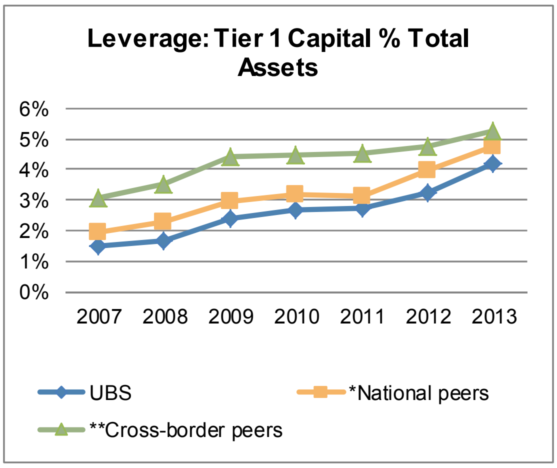
Source: SNL Financial, Scope Ratings



Source: SNL Financial, Scope Ratings



Source: SNL Financial, Scope Ratings



Source: SNL Financial, Scope Ratings

*National peers: Credit Suisse, UBS

**Cross-border peers: Bank of America Corp, Barclays, BNP Paribas, Citigroup Inc, Credit Suisse, Deutsche Bank, HSBC, JP Morgan Chase, Societe Generale, UBS

Selected Financial Information - UBS group

	2007	2008	2009	2010	2011	2012	2013	2014E	2015E
Balance Sheet summary (CHF billion)									
Assets									
Cash and balances with central banks	18.8	32.7	20.9	26.9	40.6	66.4	80.9	95.1	104.8
Interbank assets	60.9	17.7	16.8	17.1	23.2	21.2	17.2	13.7	11.0
Total securities	1,371.0	758.3	554.2	552.4	555.3	431.8	336.8	274.9	225.4
of which debt instruments	1,128.8	582.6	402.2	431.2	442.2	319.9	256.8	205.4	164.3
of which equity instruments	210.6	78.9	58.9	46.1	36.7	49.2	52.5	42.0	33.6
Derivatives	428.2	854.1	421.7	401.1	486.6	419.0	245.8	224.2	208.2
Gross customer loans	341.0	299.5	273.1	267.0	270.7	283.4	287.6	287.6	290.5
of which impaired loans	2.4	9.1	6.8	4.2	2.1	1.6	1.1	1.0	1.0
Total funded assets	1,831.4	1,161.0	928.3	921.0	943.6	864.5	769.9	716.5	675.1
Total Assets	**2,274.9**	**2,012.9**	**1,338.2**	**1,314.8**	**1,417.0**	**1,259.8**	**1,009.9**	**935.3**	**878.4**
Liabilities									
Interbank liabilities	145.8	76.8	31.9	41.5	30.2	23.0	12.9	10.3	8.2
Senior debt	857.7	452.0	340.2	342.1	358.7	265.1	186.3	149.0	119.2
Derivatives	443.5	851.9	409.9	393.8	473.4	395.3	240.0	218.8	203.2
Customer deposits	641.9	362.6	339.3	332.3	342.4	373.5	390.8	398.6	406.6
Subordinated debt + hybrid securities	14.1	12.8	11.2	8.5	7.0	0.0	0.0	0.0	0.0
Total Liabilities	**2,231.1**	**1,976.6**	**1,292.9**	**1,266.0**	**1,364.0**	**1,210.7**	**959.9**	**884.0**	**826.3**
Ordinary equity	36.9	28.2	37.7	43.7	48.5	45.9	48.0	49.4	50.1
Minority interests	7.0	8.0	7.6	5.0	4.4	0.0	0.0	0.0	0.0
Total Liabilities and Equity	**2,274.9**	**2,012.9**	**1,338.2**	**1,314.8**	**1,417.0**	**1,259.8**	**1,009.9**	**935.3**	**878.4**
Core Tier 1 Capital [1]	*27.7*	*25.8*	*24.6*	*30.4*	*25.5*	*25.4*	*28.9*	*30.3*	*31.0*
Income Statement summary (CHF billion)									
Net interest income	5.3	6.0	6.4	6.2	6.8	6.0	5.8		
Net fee & commission income	30.6	22.9	17.7	17.2	15.2	15.4	16.3		
Net trading income	-5.0	-25.2	-0.2	7.7	5.3	3.5	5.3		
Operating Income	**32.1**	**4.0**	**24.7**	**31.9**	**27.9**	**25.5**	**27.7**	**30.0**	**32.4**
Operating expenses	35.4	27.8	23.9	24.6	22.4	24.2	24.4	25.7	27.6
Loan loss provision charges	0.3	3.2	2.2	0.1	0.1	0.1	0.2	0.1	0.3
Non-recurring items	0.0	0.0	0.1	0.2	0.0	0.0	0.1	0.0	0.0
Pre-Tax Profit	**-3.3**	**-27.3**	**-2.5**	**7.3**	**5.3**	**-1.8**	**3.3**	**4.2**	**4.5**
Income tax	1.4	-6.8	-0.4	-0.4	0.9	0.5	-0.1	0.4	0.7
Net profit attributable to minority interests	0.5	0.6	0.6	0.3	0.3	0.2	0.2	0.3	0.3
Net Income Attributable to Parent	**-5.2**	**-21.1**	**-2.7**	**7.4**	**4.1**	**-2.5**	**3.2**	**3.5**	**3.5**

Source: SNL Financial and Scope Ratings for historical figures. Scope's forecasts are based on publicly available information. Please refer to "Methodologies Used for this Report" for further details.
[1] CRD 4 basis from 2011 onwards

Ratios - UBS group

	2007	2008	2009	2010	2011	2012	2013	2014E	2015E
Funding/Liquidity									
Gross loans % Total deposits	53.1%	82.6%	80.5%	80.3%	79.1%	75.9%	73.6%	72.1%	71.4%
Total deposits % Total funds	38.7%	40.1%	47.0%	45.9%	46.4%	56.2%	66.0%	71.2%	75.9%
Wholesale funds % Total funds	61.3%	59.9%	53.0%	54.1%	53.6%	43.8%	34.0%	28.8%	24.1%
Asset Mix, Quality and Growth									
Gross loans % Funded assets	18.6%	25.8%	29.4%	29.0%	28.7%	32.8%	37.4%	40.1%	43.0%
Impaired loans % Gross loans	0.7%	3.1%	2.5%	1.6%	0.8%	0.5%	0.4%	0.4%	0.4%
Loan loss reserves % Impaired loans	43.1%	32.0%	38.8%	26.0%	38.6%	45.5%	61.1%	62.4%	63.6%
Gross loan growth (%)	-2.3%	-12.2%	-8.8%	-2.3%	1.4%	4.7%	1.5%	0.0%	1.0%
Impaired loan growth (%)	-9.0%	282.3%	-25.3%	-38.9%	-48.8%	-27.4%	-31.2%	-2.0%	-2.0%
Funded assets growth (%)	-10.6%	-36.6%	-20.0%	-0.8%	2.4%	-8.4%	-10.9%	-6.9%	-5.8%
Earnings									
Net interest income % Revenues	16.6%	150.5%	26.1%	19.5%	24.5%	23.4%	20.9%		
Fees & commissions % Revenues	95.5%	576.0%	71.7%	53.8%	54.6%	60.3%	58.8%		
Trading income % Revenues	-15.6%	-633.1%	-0.9%	24.1%	18.9%	13.8%	19.3%		
Other income % Revenues	3.5%	6.7%	3.0%	2.6%	2.1%	2.5%	1.1%		
Net interest margin (%)	0.3%	0.5%	0.8%	0.9%	0.9%	0.8%	0.9%		
Pre-provision Income % Risk-weighted assets (RWAs)	-0.9%	-7.9%	0.4%	3.7%	1.4%	0.5%	1.5%	2.1%	2.4%
Loan loss provision charges % Pre-provision income	-9.3%	-13.4%	274.0%	1.9%	2.2%	8.7%	5.3%	2.9%	5.6%
Loan loss provision charges % Gross loans (cost of risk)	0.1%	1.0%	0.8%	0.1%	0.0%	0.0%	0.1%	0.0%	0.1%
Cost income ratio (%)	110.4%	698.3%	96.8%	77.2%	80.4%	94.7%	88.0%	85.6%	85.3%
Net Interest Income / Loan loss charges (x)	17.3	1.9	3.0	45.0	55.5	50.7	32.5		
Return on average equity (ROAE) (%)	-12.1%	-64.8%	-8.2%	18.3%	9.0%	-5.2%	6.8%	7.2%	7.1%
Return on average funded assets (%)	-0.2%	-1.0%	-0.2%	0.5%	0.3%	-0.2%	0.3%	0.3%	0.3%
Retained earnings % Prior year's book equity	-10.6%	-57.2%	-9.6%	19.8%	8.6%	-6.3%	4.9%	2.9%	1.4%
Pre-tax return on common equity tier 1 capital	-12.0%	-106.0%	-10.3%	24.1%	20.8%	-7.1%	11.3%	13.8%	14.5%
Capital and Risk Protection [1]									
Common equity tier 1 ratio (common equity tier 1 capital % RWAs)	7.4%	8.5%	11.8%	15.3%	6.7%	9.8%	12.8%	14.5%	15.8%
Tier 1 leverage ratio (%)	1.5%	1.6%	2.4%	2.7%	2.7%	2.0%	2.9%		
Median of tier 1 leverage ratio and common equity tier 1 ratio (%)	4.5%	5.1%	7.1%	9.0%	4.7%	5.9%	7.9%		
Total loss coverage (CET 1 capital + loan loss provisions) % RWAs	7.7%	9.5%	13.0%	15.8%	10.9%	13.5%	13.1%	14.8%	16.2%
Non-senior bailinable debt cushion (as % of total liabilities)	0.6%	0.6%	0.9%	0.7%	0.5%	0.3%	0.2%	0.2%	0.2%
Asset risk intensity (RWAs % total assets)	16.5%	15.0%	15.6%	15.1%	26.8%	20.6%	22.3%	22.3%	22.3%

Source: SNL Financial and Scope Ratings for historical figures. Scope's forecasts are based on publicly available information. Please refer to "Methodologies Used for this Report" for further details.
[1] CRD 4 basis from 2011 onwards

METHODOLOGIES USED FOR THIS REPORT

For the rating and analysis contents of this report, Scope has used the following methodologies which were published on www.scoperatings.com:

"Bank Rating Methodology" (February 2014)

"Forecasting Bank Financials Methodology" (February 2014)

Forecasting bank financials: Forward-looking estimates are an important analytical tool underpinning Scope's bank ratings. These forecasts cover the current financial year (before final year-end figures are published by the bank) plus the forthcoming two years. Depending on the complexity of the bank being assessed, different forecasting tools will be used. For a majority of banks operating primarily commercial and retail banking franchises (loans and deposits) the analysis is underpinned by an **accounting** forecast of the balance sheet and profit and loss account. For more complex groups with multiple ranges of activities – notably those with material wholesale and investment banking operations – Scope uses an **analytical** forecast, relying on the bank's business-line reporting to come up with plausible estimates. For all banks Scope also includes a **regulatory metrics** forecast, considering the growing importance of this aspect in bank analysis.

For complex banks, divisional data is used to forecast profit and loss accounts and basic divisional balance sheet metrics. For less complex banks, a line-by-line forecasting of major P&L elements is forecast.

For balance-sheet forecasts, Scope estimates of all major balance sheet lines, using the P&L estimates to complete the forecast of the capital/shareholders' equity line. This comprehensive methodology for estimating the balance sheet is used for all the banks in our universe, irrespective of size and complexity.

Lastly, our forecasts include assessments of the major regulatory metrics: Tier 1 and CET 1 (historically CT1), Leverage, Liquidity Coverage Ratio, and Net Stable Funding Ratio (the latter two when and if sufficient public information to compute them is available).

Scope will not aim to forecast financials when it considers the public disclosure of the bank as insufficient for a transparent and credible outcome.

All Scope's bank financial forecasts are based on public information. For its forecasts Scope will not use any non-public information or data, even if such information or data were provided by rated banks. Scope's forecasting process is transparent, with a detailed roadmap provided in its *"Forecasting bank financials"* methodology.

UniCredit SpA
Issuer Rating Report

SCOPE
POSITIVE OUTLOOK
BBB
Financial Institutions

Overview

Scope Ratings assigns an Issuer Credit Strength Rating (ICSR) of BBB to Unicredit SpA, with a positive outlook, reflecting the likely improvement in the bank´s asset quality metrics and profitability on the back of a more favourable macroeconomic landscape, which currently represents a negative factor affecting the rating. The short-term rating is S-2, with a stable outlook.

With sizeable franchises in Italy, Germany, Austria, several East European countries, as well as Russia and Turkey, Unicredit can rightly claim to be a true pan-European bank, rather than just an Italian bank with some foreign operations. The profitable foreign franchise only partly offsets the group's challenges elsewhere, primarily in Italy due to a high level of impaired loans. With the economic environment improving, however, we expect NPLs to stabilise and profitability to increase, supporting the positive outlook for long-term ratings.

We highlight the improvement in capital and liquidity at group level in recent years, noting nonetheless that most of the improvement in capital ratios was the result of asset sales and rights issues rather than internally generated profits. The ratings are not applicable to unguaranteed subsidiaries of the rated parent.

Issuer Credit-Strength Rating (assigned on June 11, 2014)	**BBB**
Outlook	Positive
Senior unsecured debt	BBB
Short term debt rating	S-2
Short term debt rating outlook	Stable

Unsolicited ratings without issuer participation.

Lead Analyst

Marco Troiano
m.troiano@scoperatings.com

Team Leader

Sam Theodore
s.theodore@scoperatings.com

Rating drivers (Summary)

The rating drivers, in decreasing order of importance in the rating assignment, are:

- (−) A weak macro environment in Italy affecting earnings and asset quality.
- (+) Solid retail and commercial banking franchises in several different geographies.
- (+) Improving capital and liquidity profile.
- (−) Track record on strategic delivery so far, especially in Italy.
- (−) Potential intervention by some national regulators could limit intragroup capital and liquidity flows across geographies at times of stress, as happened during the recent crisis.

Rating change drivers

Turnaround in asset quality trends. Early signs of a turnaround in group asset quality are starting to emerge, in our view a consequence of the improving macro environment in Italy, with lower accumulation of impaired loans in 2013 and a decline in the stock of impaired loans in Q1 2014, partly aided by sales and write-offs. This confirms the group's focus on improving asset quality. The material provisioning effort in Q4 2013 took coverage of impaired loans to over 52%, and management aims to maintain coverage at above 50% on an ongoing basis. As part of its 2013-2018 strategic plan, Unicredit created a non-core unit, which included EUR 58bn in gross impaired loans (70% of group total) in 2013, as well as EUR 27.6bn in performing loans. Unicredit aims to run down this unit to EUR 33bn in 2018, partly through sales of NPLs. If and when executed, a material reduction in impaired loans would be positive for Unicredit, which supports our positive outlook for the rating.

Stronger earnings. The Group aims to generate sustainable profits and a return on equity above the cost of capital. As part of its 2013-2018 strategic plan, the Group is concentrating on simplification and cost management in its commercial banking units, as well as on re-allocating capital to CEE and Asset management. If successfully implemented, these steps, combined with an improvement in asset quality, should lead to better earnings. The profitability target for 2018 is a return on tangible equity (ROTE) of 13%, which compares with 2013 ROTE of 2% excluding one-offs. Our forecasts include a mild improvement in profitability, underpinning the positive outlook.

Reduced access to capital markets. As the Group regularly uses capital markets funding and remains vulnerable to investor sentiment regarding Italian banks and the Italian sovereign in general, we would view negatively a reduction in access or a material increase in the cost of wholesale funding. Partly mitigating the reliance on bond funding, we note that Unicredit has a strong capacity to place its own securities with retail clients through its extensive branch network, with EUR 62bn of retail bonds outstanding at the end of 2013. The group is gradually repaying its LTRO loans, which were down to EUR16bn as of Q1 2014.

Material decline in earnings contribution from foreign businesses. Despite having a diversified presence in the region, the bulk of Unicredit CEE revenues and profits originate from Poland, Turkey and Russia. Together, these three countries account for 60% of 2013 CEE revenues and 94% of CEE pretax profit (we include Turkey and Russia in the CEE to reflect Unicredit's reporting). While we see Poland as a stable economy within the European Union, earnings coming from Russia and Turkey could be more volatile in the medium term.

The positive effect of the forthcoming Banking Union. We note the increased regulatory convergence across EU banking systems, especially for firms within the euro area, as a factor materially attenuating the potential impact of the home sovereign situation on Unicredit's credit fundamentals. We consider that the emergence later this year of a Banking Union (BU) for the euro area, underpinned by the Single Supervisory Mechanism (SSM) and a Single Resolution Mechanism (SRM), could be a positive rating driver to the extent that it will further de-link the credit standing of Unicredit from that of its home sovereign. At this time such an outcome is not yet a certainty but the current steps towards the creation of the BU are positive. The implementation of the BU is also likely to lower the risk of intervention by national regulators within the euro area.

Recent events

Q1 2014 results

Unicredit reported Q1 2014 results on May 14, including consolidated net profit of EUR 712m - the highest since Q1 2012, driven by declining loan loss provisions, possibly signalling that the bank has finally drawn a line on its asset quality problems with the large provisions taken in Q4 2013. Supporting this view is the 1.3% decline in the stock of impaired loans in the quarter (to EUR 82.5bn from EUR 83.6bn, driven by lower formation but also by sales and write-offs). The CRD4 CET1 ratio stood at 9.9% on a transitional basis and at 9.47% on a fully loaded Basel 3 basis. The leverage ratio stood at 5.2%

2013 results and new business plan

For 2013, Unicredit booked a net attributable loss of EUR 14bn as a result of a significant provisioning effort in the last quarter of the year. Q4 results included EUR 9.3bn in goodwill writedowns and EUR 7.2bn exceptional loan loss provisions, raising coverage of impaired loans to 52% (from 45% in Q3).

The group also presented a new business plan, which envisages an improvement of the profitability of the commercial banking units, the creation of a non-core division, which will include EUR 87bn in assets, and increasing capital allocation to the profitable CEE franchise to which the bank remains fully committed. According to the plan, Unicredit targets a return on tangible equity of 13% in 2018, while maintaining a CRD4 CET1 ratio of over 10% and NPL coverage of over 50%.

Revaluation of Bank of Italy stake

In January 2014 the Italian parliament passed a law (5/2014, converting Law Decree 133/2013) to modify the Statute of the Bank of Italy and the economic and governance rights of its shareholders. Among other provisions, the law authorises Bank of Italy to significantly revalue its share capital. The value of the central bank's capital, which had not been updated since 1936, will go from EUR 156.000 to EUR 7.5bn. As a result of its 22% stake in Bank of Italy, Unicredit has booked a pretax gain of EUR 1.4bn in the 2013 accounts.

Rating drivers (Details)

1. A weak macro environment in Italy affecting profitability and asset quality

The prolonged weak operating environment in Italy continues to negatively impact group profitability and asset quality metrics.

Between 2009 and 2012, credit costs accounted for more than 70% of pre-provision income, while in 2013 loan loss charges exceeded pre-provision income, driving a pre-tax loss of c. EUR 5bn. Since 2009, return on average equity (ROAE) has been below 3%, including material losses in 2010 and 2013. At the country level, Italy accounted for most of the credit costs, reflecting the high level of impaired loans in the country. Since 2014, Unicredit has segregated most of the Italian non-performing exposures into a dedicated non-core division, which was reported separately starting from Q1 2014 and which mostly includes loans previously reported in the Italian commercial banking division. The table below shows the divisional split of Unicredit loan loss provisions, including the restating of 2013 to reflect the new divisional reporting of the group.

Table 1: Divisional loan loss charges

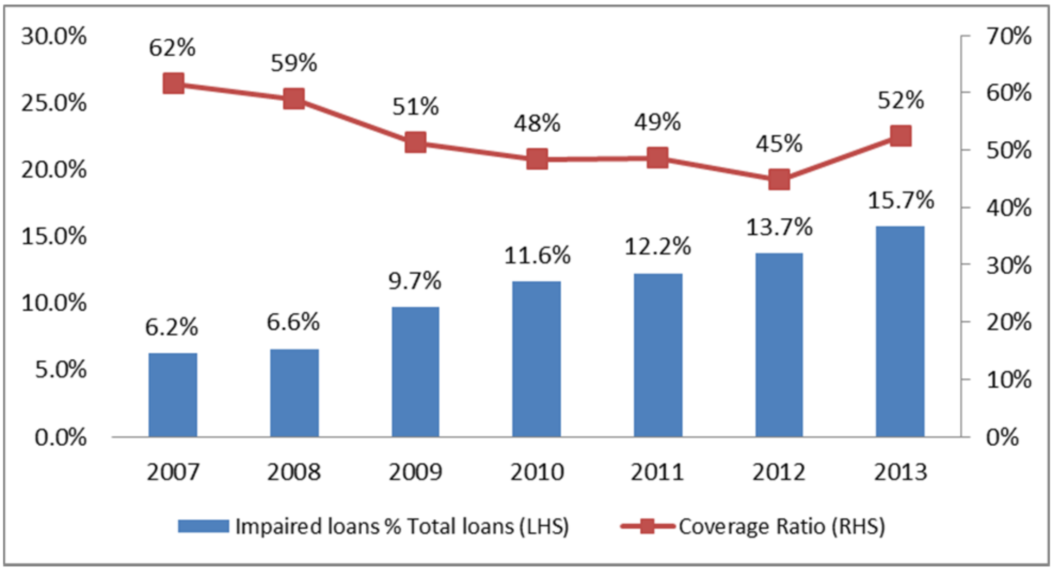
Divisional Loan Loss Charges (EUR mn)	1Q 12	2Q 12	3Q 12	4Q 12	1Q 13	2Q 13	3Q 13	4Q 13	1Q 14
Commercial Bank - Italy	(936)	(1,223)	(1,097)	(3,303)	(141)	(227)	(202)	(746)	(280)
Commercial Bank - Germany	(3)	141	(6)	216	(24)	122	(26)	(23)	(15)
Commercial Bank - Austria	(69)	(40)	(82)	(18)	(49)	(49)	(49)	(46)	(48)
CIB	(68)	(393)	(193)	(920)	(84)	(179)	(71)	(608)	0
Asset Gathering and management	(1)	(0)	(1)	(1)	(1)	(1)	(0)	(2)	(1)
Poland	(30)	(38)	(41)	(43)	(39)	(38)	(40)	(42)	(35)
CEE	(189)	(237)	(219)	(300)	(195)	(216)	(208)	(505)	(148)
Operating Areas	**(1,296)**	**(1,790)**	**(1,638)**	**(4,369)**	**(532)**	**(587)**	**(597)**	**(1,972)**	**(527)**
Corporate Center	(15)	(37)	(98)	(206)	1	(25)	12	(18)	4
Core Bank	**(1,311)**	**(1,827)**	**(1,736)**	**(4,574)**	**(531)**	**(611)**	**(585)**	**(1,990)**	**(523)**
Non Core	-	-	-	-	(642)	(920)	(896)	(7,305)	(315)
Group	**(1,311)**	**(1,827)**	**(1,736)**	**(4,574)**	**(1,173)**	**(1,532)**	**(1,482)**	**(9,295)**	**(838)**

Source: Company data, Scope Ratings
Note: 2012 quarters do not reflect the separation of non core assets, which mostly affects Commercial bank - Italy.

In Q4 2013, the group booked EUR 9.3bn in loan loss provisions, which included EUR 7.2bn to raise coverage on NPLs. This large provisioning effort came on top of a similar large provision of EUR 4.6bn in Q4 2012, also aimed at strengthening coverage of non-performing loans.

As of year end 2013, Unicredit had a large impaired loan book of EUR 83.6bn, equivalent to an impaired loan ratio of 15.7% with a cash coverage ratio of 52%. At country level, the Italian impaired loan ratio was 22.4%, well above impaired loan ratios of 6-7% in Germany, Austria and Poland and 10% in the rest of the CEE. We are aware that recent studies[1] have found the Italian definition of impaired loans to be somewhat broader compared with other European countries, but still see this as a significant negative rating driver for the bank.

Chart 1: Impaired loans as % of total loans and loan loss coverage



Source: Company data, Scope Ratings

1 e.g. Barisitz, 2013 – "Nonperforming loans in Western Europe : a selective comparison of countries and national definitions".

Towards the end of 2013, there were tentative signs of a nascent economic recovery in Italy but, given the poor growth performance of the past decade, questions remain about the strength and durability of the recovery. Leading indicators have started to signal a business cycle expansion. Among them, Markit's manufacturing PMIs moved above 50 (the threshold that signals economic expansion) in August 2013. GDP turned positive (albeit by just 0.1%) in Q4 2013 after eight quarters of recession and Italy's GDP is expected to grow by 0.6%[2]. If confirmed, the economic recovery should have a positive impact on Unicredit's Italian asset quality and profitability.

Another key area of vulnerability for the Italian economy remains the high level of public debt. At 133% of GDP, Italian public debt is amongst the highest in Europe. However, the debt trajectory now seems under control, with a public deficit of 3% of GDP and a primary surplus. While we believe that the Italian fiscal situation is manageable, we still regard large sovereign exposures as a material risk factor for Italian banks. Despite Unicredit Group's relatively diversified sovereign exposure compared with purely domestic peers, Italian sovereign risk remains fairly significant for the group, with a total exposure of EUR58bn as of March 2014 (comprising EUR52bn of debt securities and EUR6bn of loans), equivalent to 141% of CRD4 Core Equity Tier 1 capital, based on transitional rules.

2. Solid retail and commercial banking franchises in several different geographies

With over 4,000 branches in Italy, Unicredit holds approximately 13% of the domestic loan and deposit market. It is the second largest bank in a system composed of two large banks and several mid-tier and small banks.

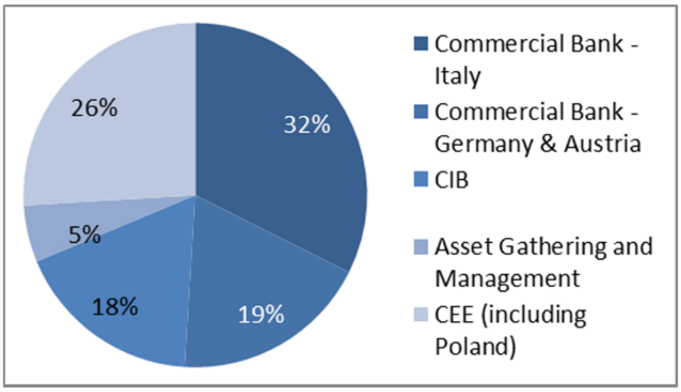
After merging with the HVB Group in 2005, Unicredit is now the third largest private bank in Germany with a particularly strong presence in Bavaria. Through its subsidiary, Bank Austria, Unicredit is the leading corporate bank and one of the largest retail banks in Austria.

It is also the leading bank in the CEE in terms of total assets and profits. With around 3,800 branches (more than any other banking group in the CEE region), the Group has a strong and diversified presence in the region, including top three market positions in Poland, Serbia, Bosnia, Croatia and Bulgaria. In terms of size, however Poland, Turkey and Russia are the main contributors in terms of revenues (60% of 2013 revenues) and profits (94% of 2013 pre-tax profits).

The businesses in Germany and CEE have been an important source of earnings diversification, especially in light of the still difficult operating environment in Italy. Central and Eastern Europe (including Russia and Turkey) remains a key investment area for Unicredit, although the Group is now pursuing opportunities on a more selective basis than in the past. As a result of a strategic review in 2011, the Group has identified Russia, Turkey, Poland and the Czech Republic as countries with profitable growth opportunities.

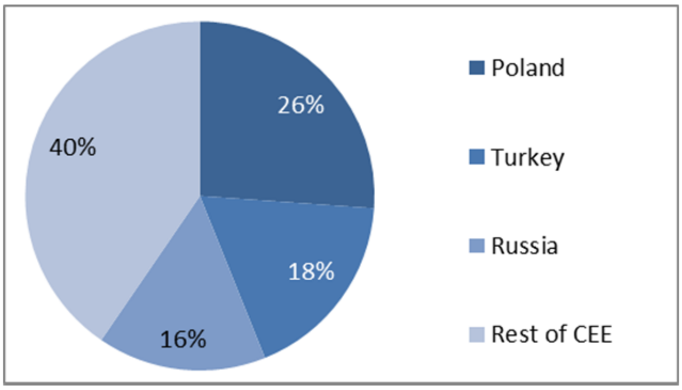
[2] European Commission 2014 Spring Estimate, published May 6 2014

Chart 2.a Revenue breakdown by business, 2013.



Source: Company data, Scope Ratings
Note: Excluding Corporate Center and Non Core unit. CEE includes Turkey and Russia, reflecting Unicredit managerial reporting.

Chart 2b: - CEE Revenue breakdown



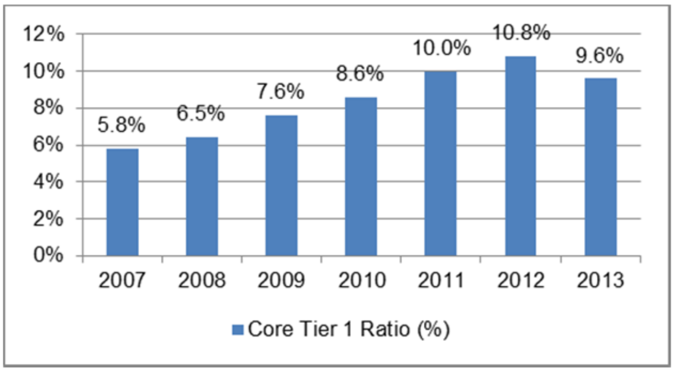
Source: Company data, Scope Ratings

3. Improving capital and funding profile

Despite weak profitability and the significant provisioning efforts in recent years, the Group has strengthened its capital position to satisfactory levels as shown in Chart 3a. The increase in capital ratios was aided by a EUR 7.5bn rights issue in January 2012, and several divestments, including a reduction of the stake in Pekao in Poland, the sale of the insurance business in Turkey (Yapi Sigorta) and the divestment of a stake in the Moscow Stock Exchange. Further divestments are currently planned, including the IPO of Fineco, the leading online broker in Italy.

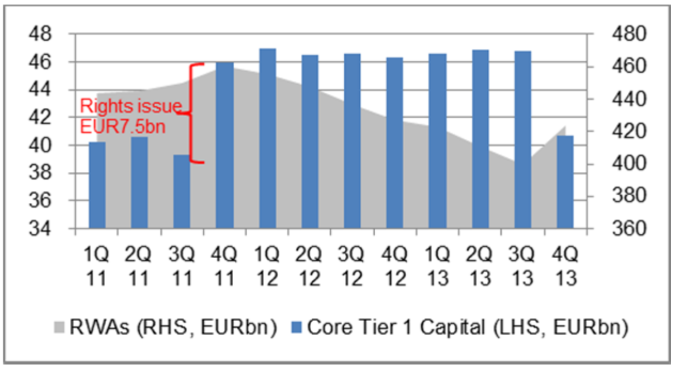
Chart 3b shows the quarterly evolution of Core Tier 1 capital and RWAs at Unicredit in the past three years. As shown, there was very little organic generation of capital, with the rights issue accounting for most of the increase in 2011, and a decline in RWAs also contributing to the improvement in the capital ratio. The decline in RWA reflects the group's deleveraging and mirrors the reduction in group total assets. The group's balance sheet RWA intensity has not declined materially in recent years and remains relatively high at close to 50%, which we see as a positive factor. The large loss in Q4 2013 eroded group capital, although the decline was lower than the reported loss, as it was offset by lower deductions (e.g. Goodwill, Expected loss shortfall).

Chart 3a: - Material improvement in core capital ratio since 2007



Source: Company data, SNL financial , Scope Ratings
Note: Basel 2.5 from 2011

Chart 3b: - Significant de-risking and capital raisings drive the improvement



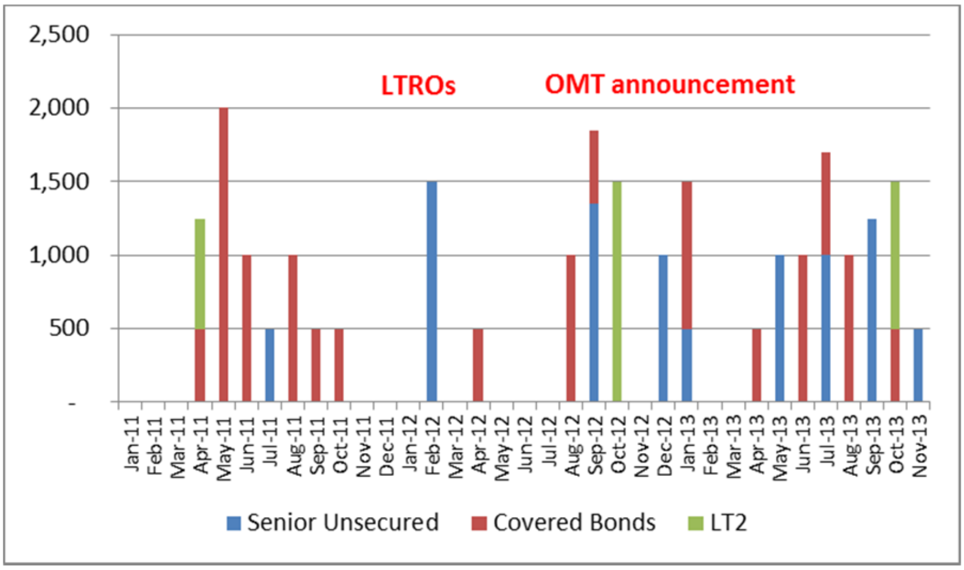
Source: Company data, Scope Ratings
Note: Q4 2013 RWAs include EUR 38bn due to the application of RWA floor

Including the capital erosion in Q4 2013, the pro-forma fully loaded Basel 3 CET1 ratio was 9.4% at year-end 2013, with a goal of being above 10% in the medium term. On the basis of Tier 1/Total Assets, the leverage ratio for the Group is 5.2%.

The Group's gross loan to deposit ratio was a more reassuring 129% at year-end 2013. Having gradually improved over the last few years from levels of above 150%, it is now in line with peers. Moreover, a significant part of the group's outstanding securities are placed with customers through the branch distribution network (EUR 63bn at year-end 2013). Although they are not within the perimeter of deposit guarantee schemes, these bonds are a relatively stable source of funding. If we adjust the deposit base to include this important source of retail funding, the loan to deposits ratio declines to 111%.

The Group makes regular use of capital markets funding, often through its various businesses outside of Italy. Like most South European peers, Unicredit struggled to issue debt (and especially unsecured debt) at the height of the Eurozone crisis (H2 2011, before the announcement of the LTRO and again in the spring of 2012). Since the OMT announcement in the summer of 2012, the group has had continued and diversified access to capital markets.

Chart 4: Unicredit Issuance in Euros 2011-2013



Source: Company data, Scope Ratings

Since 2007, the Group has pursued a group-wide liquidity management policy. Funding is accessed via four liquidity centers (Italy, Germany, Poland and Austria), which are self-sufficient in terms of liquidity, and the Group uses geographical specialization to leverage off local expertise (e.g. Pfandbriefe in Germany). In terms of short-term funding, the Group aims to keep a diversified funding base via wholesale deposits, CDs, and commercial paper. In terms of medium-term funding, the Group also uses covered and retail bonds. The Group believes that it has substantial additional capacity to issue retail bonds as they currently still represent a small portion of clients' total financial assets.

As of 2013, the group had a financial investment portfolio of EUR 125bn, including available for sale, held to maturity and fair value assets.

4. Track record on strategic delivery so far, especially in Italy

Before 2007, Unicredit could have rightly claimed to have benefited from the wave of bank mergers in Italy, emerging as the second largest banking group in the country, on top of having acquired high growth, profitable business franchises in CEE. Since then, however, we believe that Unicredit's post-merger delivery has been less convincing. In our opinion, the acquisition in 2007 of Capitalia (a banking group with negative structural and asset-quality legacies built in earlier years) as well as the delay in launching a rights issue in 2011 weighed more heavily on Unicredit's development.

On March 11, 2014, Unicredit updated its strategic plan targets. Amongst the key objectives is the turnaround of the still loss-making Italian business. According to the plan, Unicredit revenues will grow by 5% on average in 2013-2018, while profits will grow at a CAGR of 21% during the period. If the plan is successfully executed, Unicredit will deliver a return on tangible equity of 13% by 2018.The plan focus is threefold:

- Improve the profitability of the commercial banking businesses in Italy, Germany and Austria
- Increase capital allocation to the profitable businesses (CEE and Asset management)
- Leverage the profitable CIB business by increasing cross selling.

At the same time, the separation of non-performing Italian assets into a dedicated, non-core unit should improve visibility on the core divisions' asset quality trends. The above actions are sensible in our view and we would see especially favourably an improvement in asset quality and profitability accompanying the run down of the non-core assets. However, we take a conservative approach to forecasts and anticipate only a limited improvement in profitability, largely driven by falling impairments. Unicredit's execution track record is mixed so far: the strategic plan presented at the end of 2011 - when Unicredit made a EUR 7.5bn rights issue - aimed at EUR 3.8 bn profits in 2013 (vs. an actual net loss of EUR 14bn). We acknowledge that the bank has been operating in a very difficult environment in the past few years. We will, however, review our forecasts once we see more evidence of the announced plan being successfully executed.

5. Intervention by host or home regulators could limit intragroup capital and liquidity flows across geographies at times of stress, as happened during the recent crisis

The recent financial crisis has shown that intragroup capital and liquidity mobility across geographies can significantly diminish during periods of stress, limiting a cross-border banking group's financial flexibility just when it needs it the most. Faced with such restrictions, steps ranging from the listing of a minority stake to the disposal of the entire business may be used by some banking groups as alternatives to unlock capital from a subsidiary, for example. The extent to which cross-border banking groups have such alternatives at their disposal mitigates this risk.

An analysis of the accounts of Unicredit S.p.a (Italian parent company) shows that while the parent company is very well capitalised (Tier 1 Ratio of 27.4% in 2013), it would be loss making on an ongoing basis if we were to exclude the dividends from subsidiaries, and in particular from Unicredit Bank AG, which contributed over EUR 1bn in dividends in 2012 and almost EUR 2.5bn in 2013. We also note that no dividend was paid in recent years from Unicredit Bank Austria to Unicredit's parent. Bank Austria controls most of the Group's CEE franchise, meaning that the upstreaming of dividends from the profitable CEE business is conditional on Bank Austria having comfortable capital resources and on Austrian supervisors allowing such a transfer.

In the case of Unicredit, most of the group's business is carried out within the euro area, and we note the increased regulatory convergence across EU banking systems, especially for firms within the euro area, as a factor materially attenuating the potential impact of cross-border limitations on intragroup capital and liquidity transfers. We consider that the emergence later this year of a Banking Union (BU) for the euro area, underpinned by the Single Supervisory Mechanism (SSM) and a Single Resolution Mechanism (SRM), could be a positive rating driver to the extent that it will reduce the limitations on intragroup fungibility of capital and liquidity.

Peer comparison

At Scope Ratings, we compare banks within peer groups at domestic and cross-border level.

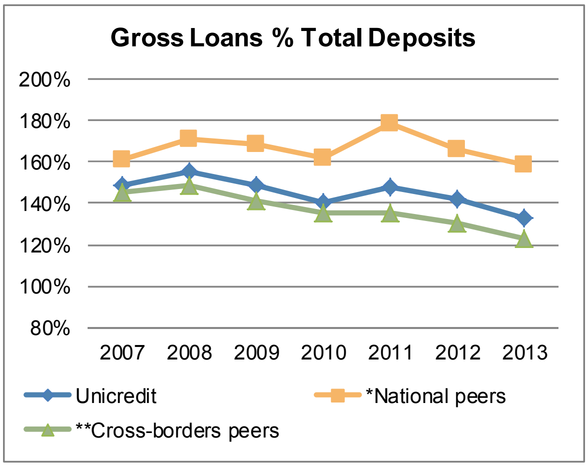
Domestically we compare Unicredit with Intesa as well as with mid-size Italian banks, like UBI, Banco Popolare, Popolare di Milano and Monte dei Paschi. Within this peer group, Unicredit compares well in terms of asset quality, capital and profitability (if we exclude the large loss in 2013). This is in large part due to its international diversification, which enables Unicredit to partly offset weaknesses in its Italian business with profits from Germany and the CEE.

At the cross-border level, we compare Unicredit with internationally diversified retail banks, such as Santander, BBVA, KBC, ING, Erste Bank, Nordea, Danske Bank, Commerzbank and RZB. The peer group is heterogeneous but common features are the predominant weight of retail in the banks' business model and their exposure to several developed and emerging markets. Several of the above names fall under the definition of systemically important financial institutions and, as such, are required to carry additional capital buffers (1% in the case of Unicredit).

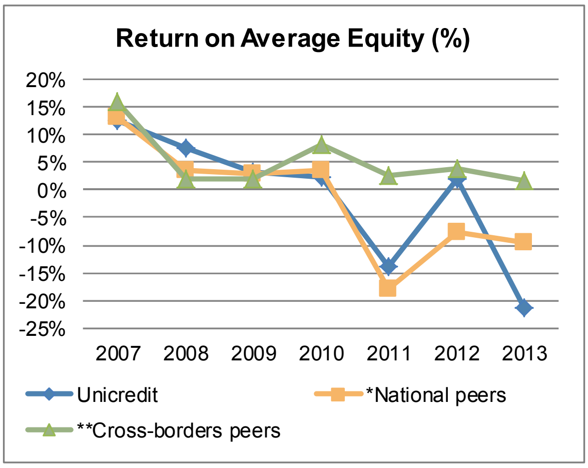
Compared with international peers, Unicredit appears weak in terms of profitability. With a net loss of EUR 14bn in 2013 and a return on average equity (ROAE) of just 2% in 2012, Unicredit's profitability is well below peer averages. The low group profitability is driven by the losses in the non-core business, which also drives the high level of impaired loans (Unicredit has the highest NPL ratio in the peer group).

In terms of capital, Unicredit ratios are in line with peers with a CRD4 CET1 Ratio of 9.4% at year-end 2013 and leverage of 5.2%. The gross loan to deposit ratio of c.130% stands at the high end of the international peer group, although this does not include the group's bonds placed with retail clients. Including retail bonds in the deposit base, the ratio would be slightly below peers at 111%.

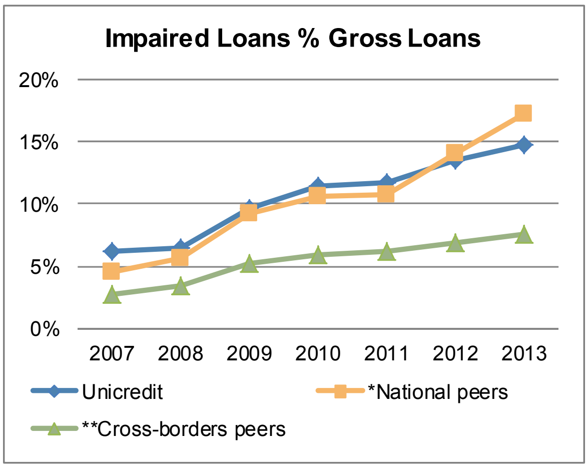
Peer Comparison



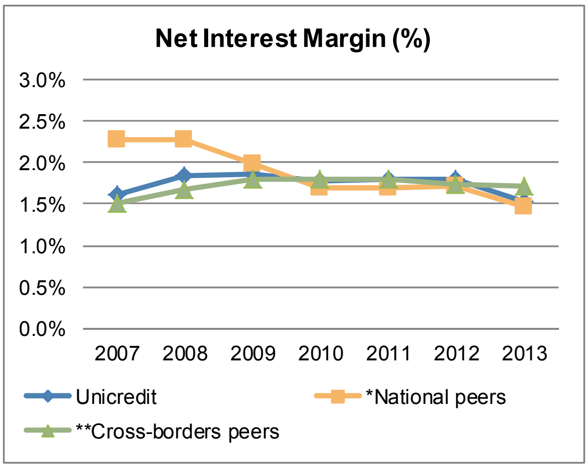
Source: SNL Financial, Scope Ratings



Source: SNL Financial, Scope Ratings



Source: SNL Financial, Scope Ratings



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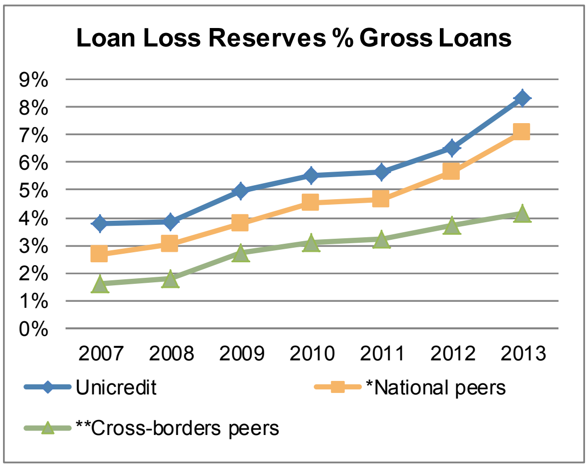
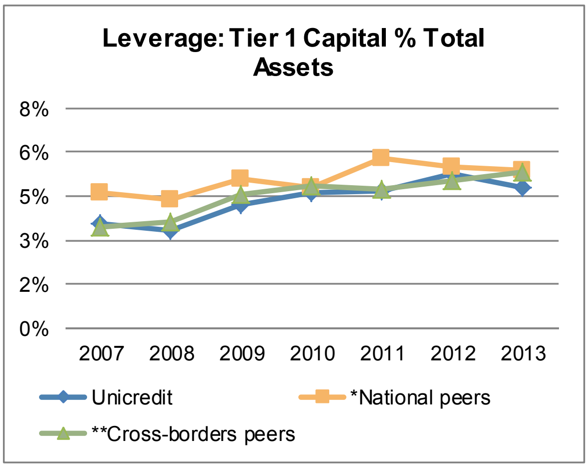


Source: SNL Financial, Scope Ratings



Source: SNL Financial, Scope Ratings

*National Peers : Intesa, UBI, Banco Popolare, Banca Popolare di Milano, Banca Monte dei Paschi Siena, Unicredit.

**Cross-Border Peers based on business model : BBVA, Santander, Commerzbank, ING Bank, RBS, Danske Bank, Erste Bank, KBC, Nordea, RZB, Unicredit.

Selected Financial Information - Unicredit Group

	2007	2008	2009	2010	2011	2012	2013	2014E	2015E
Balance sheet summary (EUR billion)									
Assets									
Cash and balances with central banks	11.1	7.7	12.0	6.4	9.5	7.6	10.8	18.0	20.8
Interbank assets	122.3	95.3	86.4	72.5	57.3	77.3	63.1	59.9	56.9
Total securities	167.0	128.8	107.2	129.4	116.5	122.9	144.1	146.0	148.0
of which debt instruments	128.3	114.3	92.5	115.9	106.9	113.2	130.3	132.9	135.5
equity instruments	38.6	14.4	14.7	13.4	9.5	9.7	13.8	13.1	12.5
Derivatives	66.1	129.2	88.9	88.4	105.9	102.7	61.9	61.1	60.8
Gross customer loans	605.5	639.5	598.6	597.1	597.9	590.1	556.4	548.5	543.5
of which impaired loans	37.2	41.8	57.6	68.2	69.8	79.8	82.4	86.5	86.5
Total funded assets	951.1	915.8	839.1	838.3	804.8	822.5	785.1	780.9	777.6
Total Assets	**1,021.8**	**1,045.6**	**928.8**	**929.5**	**913.6**	**926.8**	**845.8**	**840.8**	**837.3**
Liabilities									
Interbank liabilities	174.3	183.4	107.5	113.5	132.6	118.1	110.6	105.1	99.9
Senior debt	228.2	188.5	203.4	169.1	148.3	159.2	146.8	139.5	132.5
Derivatives	70.7	129.8	89.6	91.2	108.8	104.3	60.7	60.0	59.7
Customer deposits	407.0	412.2	403.4	424.5	404.3	416.4	419.3	427.7	436.2
Subordinated debt + hybrid securities	31.2	31.4	27.6	24.6	24.1	20.7	20.4	19.4	18.4
Total Liabilities	**959.4**	**987.4**	**865.9**	**861.8**	**858.8**	**861.6**	**795.7**	**789.5**	**784.6**
Ordinary equity	57.7	55.0	59.7	64.2	51.5	61.6	46.8	48.0	49.3
Minority interests	4.7	3.2	3.2	3.5	3.3	3.7	3.3	3.3	3.3
Total Liabilities and Equity	**1,021.8**	**1,045.6**	**928.8**	**929.5**	**913.6**	**926.8**	**845.8**	**840.8**	**837.3**
Core Tier 1 Capital [1]	*32.6*	*30.8*	*34.1*	*38.7*	*38.4*	*46.3*	*38.1*	*39.3*	*40.6*
Income Statement summary (EUR billion)									
Net interest income	16.2	18.4	17.3	15.0	13.0	14.2	12.3	12.1	12.2
Net fee & commission income	10.7	9.1	7.8	7.8	7.6	7.7	7.4	7.6	7.8
Net trading income	1.3	-2.0	1.8	1.8	2.5	2.8	2.5	2.1	2.1
Operating Income	**29.7**	**26.9**	**27.6**	**25.2**	**23.9**	**25.4**	**23.3**	**22.4**	**22.7**
Operating expenses	16.3	16.7	15.3	15.2	14.5	15.0	14.3	14.0	14.1
Loan loss provision charges	2.5	3.7	8.3	6.5	9.0	9.4	13.5	4.6	4.3
Non-recurring items	-0.4	-1.3	-0.9	-11.2	-1.2	-1.3	-10.9	-0.4	-0.5
Pre-Tax Profit	**10.4**	**5.2**	**3.0**	**-7.7**	**-0.8**	**-0.3**	**-15.3**	**3.5**	**3.8**
Income tax	3.2	0.6	1.0	1.4	-1.9	-1.5	-1.7	1.3	1.4
Net profit attributable to minority interests	0.7	0.5	0.3	0.3	0.4	0.4	0.4	0.5	0.5
Net Income Attributable to Parent	**6.6**	**4.0**	**1.7**	**-9.4**	**0.8**	**0.9**	**-14.0**	**1.7**	**1.9**

Source: SNL Financial and Scope Ratings for historical figures. Scope's forecasts are based on publicly available information. Please refer to "Methodologies Used for this Report" for further details.
[1] CRD 4 basis from 2013 onwards

Ratios - Unicredit Group

	2007	2008	2009	2010	2011	2012	2013	2014E	2015E
Funding/Liquidity									
Gross loans % Total deposits	148.8%	155.1%	148.4%	140.7%	147.9%	141.7%	132.7%	128.3%	124.6%
Total deposits % Total funds	48.4%	50.5%	54.4%	58.0%	57.0%	58.3%	60.1%	61.8%	63.5%
Wholesale funds % Total funds	51.6%	49.5%	45.6%	42.0%	43.0%	41.7%	39.9%	38.2%	36.5%
ASSET MIX, QUALITY AND GROWTH									
Total loans % Funded assets	61.2%	67.1%	67.8%	71.2%	74.3%	71.7%	70.9%	70.2%	69.9%
Impaired loans % Gross loans	6.1%	6.5%	9.6%	11.4%	11.7%	13.5%	14.8%	15.8%	15.9%
Loan loss reserves % Impaired loans	61.9%	59.0%	51.6%	48.5%	48.6%	48.3%	56.0%	56.0%	56.0%
Gross loan growth (%)	30.6%	5.6%	-6.4%	-0.2%	0.1%	-1.3%	-5.7%	-1.4%	-0.9%
Impaired loan growth (%)	33.1%	12.3%	37.9%	18.4%	2.4%	14.3%	3.2%	0.0%	-5.0%
Funded assets growth (%)	24.9%	-3.7%	-8.4%	-0.1%	-4.0%	2.2%	-4.5%	-0.5%	-0.4%
EARNINGS									
Net interest income % Revenues	54.6%	68.4%	62.8%	59.5%	54.3%	55.9%	52.8%	54.2%	54.0%
Trading income % Revenues	36.1%	33.8%	28.2%	31.1%	31.6%	30.5%	31.6%	33.9%	34.2%
Fees & commissions % Revenues	4.3%	-7.3%	6.5%	7.3%	10.6%	11.1%	10.7%	9.2%	9.1%
Other income % Revenues	5.0%	5.1%	2.5%	2.1%	3.5%	2.6%	4.9%	2.7%	2.7%
Net Interest Margin (%)	2.1%	2.2%	2.2%	2.0%	1.7%	1.9%	1.7%	1.7%	1.7%
Pre-provision Income % Risk-weighted assets (RWAs)	2.4%	2.0%	2.7%	2.2%	2.0%	2.4%	2.2%	2.1%	2.1%
Loan loss provision charges % Pre-provision income	18.5%	36.3%	67.9%	65.3%	95.5%	90.8%	148.7%	54.2%	50.7%
Loan loss provision charges % Gross loans (cost of risk)	0.9%	1.0%	2.0%	1.6%	2.2%	2.3%	3.3%	1.2%	1.2%
Cost income ratio (%)	55.0%	62.1%	55.6%	60.6%	60.5%	59.0%	61.1%	62.3%	62.2%
Net Interest Income / Loan Loss Charges (x)	6.6	5.0	2.1	2.3	1.4	1.5	0.9	2.6	2.8
Return on average equity (ROAE) (%)	13.7%	7.1%	3.0%	-15.2%	1.3%	1.5%	-25.8%	3.6%	3.8%
Return on average funded assets (%)	0.5%	0.3%	0.1%	-0.7%	0.1%	0.1%	-1.2%	0.1%	0.2%
Retained earnings % Prior year's book equity	8.0%	7.0%	2.2%	-8.8%	1.2%	0.7%	-22.7%	2.5%	2.7%
Pre-tax return on core tier 1 capital	32.1%	16.8%	8.9%	-20.0%	-2.0%	-0.7%	-40.2%	8.8%	9.3%
CAPITAL AND RISK PROTECTION [1]									
Common equity tier 1 ratio (common equity tier 1 capital % RWAs)	5.8%	6.0%	7.5%	8.5%	8.3%	10.8%	9.4%	9.7%	10.1%
Tier 1 leverage ratio (%)	3.6%	3.3%	4.2%	4.6%	4.7%	5.3%	5.2%		
Median of tier 1 leverage ratio and core tier 1 ratio (%)	4.7%	4.7%	5.9%	6.6%	6.5%	8.1%	7.3%		
Total loss coverage (core tier 1 + loan loss provisions) % RWAs	10.0%	10.8%	14.1%	15.8%	15.7%	19.9%	20.7%	21.7%	22.1%
Non-senior bailinable debt cushion (as % of Total liabilities)	3.3%	3.2%	3.2%	2.9%	2.8%	2.4%	2.6%		
Asset risk intensity (RWAs % Total assets)	54.7%	49.0%	48.7%	48.9%	50.4%	46.1%	48.1%	48.1%	48.1%

Source: SNL Financial and Scope Ratings for historical figures. Scope's forecasts are based on publicly available information. Please refer to "Methodologies Used for this Report" for further details.
[1] CRD 4 basis from 2013 onwards

METHODOLOGIES USED FOR THIS REPORT

For the rating and analysis contents of this report, Scope has used the following methodologies which were published on www.scoperatings.com:

"Bank Rating Methodology" (February 2014)

"Forecasting Bank Financials Methodology" (February 2014)

Forecasting bank financials: Forward-looking estimates are an important analytical tool underpinning Scope's bank ratings. These forecasts cover the current financial year (before final year-end figures are published by the bank) plus the forthcoming two years. Depending on the complexity of the bank being assessed, different forecasting tools will be used. For a majority of banks operating primarily commercial and retail banking franchises (loans and deposits) the analysis is underpinned by an **accounting** forecast of the balance sheet and profit and loss account. For more complex groups with multiple ranges of activities – notably those with material wholesale and investment banking operations – Scope uses an **analytical** forecast, relying on the bank's business-line reporting to come up with plausible estimates. For all banks Scope also includes a **regulatory metrics** forecast, considering the growing importance of this aspect in bank analysis.

For complex banks, divisional data is used to forecast profit and loss accounts and basic divisional balance sheet metrics. For less complex banks, a line-by-line forecasting of major P&L elements is forecast.

For balance sheet forecasts, Scope estimates of all major balance sheet lines, using the P&L estimates to complete the forecast of the capital/shareholders' equity line. This comprehensive methodology for estimating the balance sheet is used for all the banks in our universe, irrespective of size and complexity.

Lastly, our forecasts include assessments of the major regulatory metrics: Tier 1 and CET 1 (historically CT1), Leverage, Liquidity Coverage Ratio, and Net Stable Funding Ratio (the latter two when and if sufficient public information to compute them is available).

Scope will not aim to forecast financials when it considers the public disclosure of the bank as insufficient for a transparent and credible outcome.

All Scope's bank financial forecasts are based on public information. For its forecasts Scope will not use any non-public information or data, even if such information or data were provided by rated banks. Scope's forecasting process is transparent, with a detailed roadmap provided in its *"Forecasting bank financials"* methodology.