

Legal Risks and Bank Ratings:

The case of the two recent guilty pleas in the US

Recently two of the largest European banks, Credit Suisse and BNP Paribas (BNPP), had to plead guilty for violating various US laws. Such a guilty plea (which, in the case of banks, had not occurred since 1988), could have been enough to put some strain on the business and the financial fundamentals of the banks concerned.

However, for both Credit Suisse and BNPP, the announced settlements have not, to date, triggered any major business franchise or financial problems.

Scope has identified two components to both settlements:

- A financial component (the fine), which has a direct impact on both banks' level of capital but which, in our opinion, can easily be absorbed by retained earnings and existing legal reserves;
- A reputational impact that is much more difficult to quantify and potentially more threatening for the franchises of both banks in the medium-term.

In this report we detail and compare the two settlements, their procedures, as well as their financial and business impact which underpin our rating actions.

We conclude that both settlements draw a precedent in European banking in terms of the requirement that both banks had to plead guilty and of the materiality of the financial penalty.

Even if manageable, BNPP's settlement strikes us as more demanding than Credit Suisse's both because the financial penalty is higher and because it includes some limited business restrictions.

Scope will pay particular attention to the consequences of the settlements on the business franchise of both banks and on the behavior of their clients and counterparties. Tangible evidence of revenue sustainability over several quarters would be a prime driver for revisiting positively the Negative outlooks on the two ratings.

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Credit Suisse and BNP Paribas: comparative analysis of settlements

	Credit Suisse AG	BNP Paribas SA
CASE		
Official settlement announcement	Yes	Yes
Nature of the case	US Tax evasion	USD-denominated transactions with embargoed countries
Guilty Plea?	Yes	Yes
Nature of the plea?	One count of conspiracy for presenting false returns to IRS	One count of conspiracy to violate the IEEPA (International Emergency Economic Powers Act) and the TWTEA (Trading with the Enemy Act), and falsifying business records.
Any licence removed?	No	No
Any activity restriction?	No	Yes
If yes, which one(s)?	-	Temporary suspension of one year starting 01.01.2015 of the USD direct clearing focused mainly on the Oil & Gas Energy & Commodity Finance business line in certain locations
If yes, likely commercial and financial impact?	-	BNPP expects no impact on its operational or business capabilities to serve the vast majority of its clients
Existing precedents on similar case?	Yes	Yes
Guilty pleas demanded at the time?	No	No
FINE AND FINANCIALS		
Fine?	Yes	Yes
How much?	USD 2,815m/ CHF 2,510m	USD 8,974m/EUR 6,554m
Already provisioned?	Partly	Partly
By how much?	CHF 892m	EUR 798m
Net payment to be disbursed (after tax)?	CHF 1,598m	EUR 5,751m
As a % of 2014E profits	57%	111%
As a % of Q1 14 CET1?	6%	9%
Impact on proforma CET1 ratio (%)	-0.70%	-0.93%
Q1 2014 CET 1 ratio (pre-settlement)	10.0%	10.7%
Q1 2014 CET 1 ratio (post-settlement)	9.3%	9.7%

	Credit Suisse AG	BNP Paribas SA
Estimated impact on proforma Leverage ratio (BIS Tier 1) (%)	-0.2%	-0.31%
Q1 2014 T1 leverage ratio (pre-settlement)	3.2%	3.70%
Q1 2014 T1 leverage ratio (post-settlement)	3.0%	3.39%
Detailed plans to recover pre-settlement capital levels?	Yes	Yes
How?	RWAs down from CHF 280bn to CHF 266bn plus sale of surplus real-estate and other non-core assets	Retained earnings and "adaptation of dividend" to get to 10% CET1 ratio by Q2 2014
REACTIONS & AFTERMATH		
Time between first press reports and official announcement	21 days (30/04-20/05/2014)	62 days (30/04-30/06/2014)
Management stability	Yes, confirmed	Departure of Chief Operating Officer + 12 employees
Regulatory action	PR and report by FINMA the day of the announcement. FINMA confirms banking licence retention in US, UK and Switzerland	Press release of ACPR confirming BNP Paribas's solid solvency and liquidity position
Counterparty & Franchise impact	"no material impact over last few weeks", according to company PR. But Employee Retirement System of Texas suspended trading with CS (USD 700k commission paid to CS in 2013)	BNP Paribas expects "no impact on its operational and business capabilities to serve the vast majority of its clients".
Other	CS raised USD 5bn of senior debt two days after settlement announced	"no need and no rush for AT1 instruments" (CFO Lars Machenil on the conference call detailing the conclusions of the case, 01.07.2014)
RATING ACTION BY SCOPE	A+ rating confirmed; Outlook changed from "Stable" to "Negative"	1-notch downgrade to A+, negative outlook

Source: Scope estimates, company data, US Department of Justice

The details in the above table are based on public data (company press releases and presentations, legal documents from the US Department of Justice or State courts) and on our financial estimates (particularly for Q1 2014 proforma impact of settlements on CET1 ratios and for leverage ratio impacts).

Irrespective of the relative importance of the nature of each plea we drew the conclusion of our rating actions on the basis of

- financial impact;
- potential franchise impact,
- nature of the case versus precedents.

Financial impact of the two settlements

The financial impacts amounted to USD 2.8bn for Credit Suisse, with the unreserved portion representing 57% of the bank's 2014E profits, and USD 9bn for BNP Paribas, with the unreserved portion representing more than 100% of the bank's 2014E profits.

Even if the amounts are extremely important, they are nonetheless manageable for both banks. Credit Suisse communicated very clearly that the negative impact of the financial settlement on its proforma Q1 2014 CET1 ratio would stand at 70bps, while we estimate that the impact of the settlement on BNP Paribas's Q1 2014 CET1 would stand at around 93bps. The proforma CET 1 ratio of Credit Suisse as of Q1 2014 would stand at 9.3%, versus 9.7% for BNP Paribas. Credit Suisse plans to get back to the 10% CET1 level by YE 2014 through RWA reduction and asset sales, while BNP Paribas should get there as early as Q2 2014 through retained earnings and an "adaptation" of its dividend payment policy.

As far as the leverage ratio is concerned, Credit Suisse has communicated on a 20bps impact (with a proforma Q1 2014 BIS Tier 1 leverage ratio falling to 3.0%), while we estimate that BNPP's decreased by 31bps to 3.4%. Both ratios are at or above the current minimum.

Potential Franchise impacts

The main reason as to why Scope Ratings took two rating actions on Credit Suisse and BNP Paribas can be explained by the fact that there are a lot of uncertainties around the impact of a guilty plea:

Can clients and counterparties still work with a bank that had to acknowledge guilt? Obviously we expect that both banks will have extensively tested their major counterparties and clients to verify that their major business and financial relationships would be safe, but still, considering that the "guilty plea" is a rare event in banking, we do not believe that the potential impact can only be traced in the very short-term. It is our willingness to "test" the resilience of the two franchises that explains why Scope Ratings has changed the outlook of the LT ratings of both banks from "Stable" to "Negative".

For Credit Suisse the franchise impact stemming from deterioration in reputation is only driven by the guilty plea.

The situation is less straightforward for BNPP, for several reasons. First, the media exposure of BNPP's case was more significant as the publicized aspect of the case went on for 62 days (as opposed to 21 days for Credit Suisse).

Second, on top of financial restrictions BNPP had to agree to a temporary suspension of its ability to clear US Dollar activities focused mainly on the Oil & Gas, Energy & Commodity Finance business line in certain locations. Again, this is a manageable situation as the suspension only takes place as of 01.01.2015 and it is restricted to a narrow perimeter of the bank. Also, as communicated by the bank, "during 2015 the activities of the perimeter concerned will clear US Dollars through a third party bank instead of clearing through BNP Paribas New York and all necessary measures are being taken to ensure smooth transition and no material impact for the clients concerned. BNP Paribas notes that part of the group's USD clearing is already done today through third-party banks".

The nature of the case versus precedents

Even if no guilty plea had been requested from European banks in the past for similar cases, the two legal issues faced by Credit Suisse and BNPP (US tax evasion and US-denominated transactions with embargoed countries respectively) were certainly not recent and had been the object of much publicized precedents. We note however that the settlement terms that the two banks were asked to reach were noticeably harder, in both financial terms and the demanded guilt plea.

Financial metrics

Even considering the extent of the fines, the next table shows that the CET1 metrics at both banks for Q1 2014 (and proforma of the impact of the fine) remain acceptable. We note that Deutsche Bank's numbers include the recently-announced EUR 8.5bn capital increase, while both Credit Suisse and BNPP have announced that their CET 1 ratio would shortly be back to the 10% mark (Q2 2014 for BNPP and FY 2014 for Credit Suisse).

Financial metrics of BNPP's and Credit Suisse's peer group

			CET 1 ratio (proforma)		Tier 1 Leverage ratio	ROAE	Cost-Income ratio	Impaired Loans % Gross Loans	Loan Loss Reserves % Impaired Loans	Loans % Deposits	Deposits % Total Funds	Pre-Provision Income % RWAs
	Rating	Outlook	2013 FY	Q1 2014	2013 FY	2013 FY	2013 FY	2013 FY	2013 FY	2013 FY	2013 FY	2013 FY
BNP Paribas	A+	Negative	10.34%	9.70%	3.70%	6.07%	66.74%	7.05%	58.68%	115.49%	51.33%	2.32%
Credit Agricole	A	Positive	11.20%	11.70%	4.37%	6.98%	63.08%	3.79%	82.45%	112.85%	59.44%	2.42%
BPCE	A+	Stable	10.38%	10.80%	3.78%	5.63%	69.47%	3.87%	59.44%	131.39%	53.62%	1.73%
Societe Generale	A	Stable	10.01%	10.10%	3.26%	5.03%	71.17%	7.29%	60.63%	109.66%	46.51%	2.10%
BNP Paribas	A+	Negative	10.34%	9.70%	3.70%	6.07%	66.74%	7.05%	58.68%	115.49%	51.33%	2.32%
Societe Generale	A	Stable	10.01%	10.10%	3.26%	5.03%	71.17%	7.29%	60.63%	109.66%	46.51%	2.10%
UBS	A	Stable	12.84%	13.20%	2.86%	6.75%	87.95%	0.37%	61.11%	73.59%	66.03%	1.48%
Credit Suisse	A+	Negative	10.00%	9.30%	3.91%	5.99%	82.17%	0.61%	58.36%	73.16%	55.47%	1.62%
Deutsche Bank	A-	Positive	9.70%	12.00%	2.11%	1.23%	85.88%	2.56%	78.02%	95.89%	47.85%	1.27%
HSBC	AA-	Stable	10.90%	10.80%	5.92%	9.46%	58.32%	3.16%	63.73%	74.75%	77.31%	2.27%
Barclays	A	Stable	9.30%	9.60%	4.25%	1.04%	73.57%	5.50%	28.85%	104.94%	49.04%	2.08%

Source : SNL, Scope Ratings



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