SCOPE Scope Ratings

2021 European Banking Outlook

First real-life stress test since post-GFC sector de-risking

Financial Institutions, Scope Ratings GmbH, 9 December 2020

info@scoperatings.com | www.scoperatings.com

| Bloomberg: RESP SCOP

Executive summary

European banks have proven resilient in the face of Covid-19. There has been no banking crisis and no bank has come close to resolution. Supportive fiscal, monetary and supervisory policies have offset credit, funding and solvency risks. Most banks entered the current crisis with healthy balance sheets. Balancing the stabilisation effect of the expected economic rebound against asset-quality deterioration, and factoring in business-model adjustments will underpin our rating approach to the European banking industry in the coming year.

- **No widespread banking crisis.** Supportive fiscal and monetary support will stay in place, as will the pragmatic approach by bank regulators. Strong sector fundamentals will be key to avoiding a worst-case scenario. Banks' resolvability remains questionable until a real test emerges; meanwhile banks are issuing sizeable amounts of subordinated debt with the aim of protecting senior creditors.

- **Concerns over asset-quality cliffs are misplaced.** Authorities will err on the side of caution when tightening their regulatory stance; most banks will be able to absorb high credit costs through their pre-impairment profits.

- **Banking is and will remain a value-destroying business for equity investors, which provides the push for an accelerated adjustment of business models.** The combination of low and flat yield curves and high capital requirements will continue to dog bank profitability. With very few exceptions, banks will not clear their implied cost of equity next year.

- **The release of trapped capital will go hand in hand with visibility on asset quality and earnings.** Supervisors will resist industry calls to reinstate dividends and buybacks for as long as uncertainty over credit losses remains. The current blanket approach will morph into a more differentiated one, but we expect supervisory authorities to remain sceptical about banks normalising their dividend policies.

  Branch reductions and M&A will characterise the sector in 2021 along with increased digital and ESG-related initiatives. Faced with revenue pressure and penetration of digital channels, banks will strive to accelerate the reduction of their physical distribution costs to protect pre-provision profitability. Domestic M&A can achieve that at the same time as allowing economies of scale in IT investments.

- **Recognition of banks' post GFC de-risking.** After an initial scare in March, bank credit performed well in 2020. This is in contrast to equity under-performance on the sector. We believe the Covid crisis will validate industry claims of de-risking post GFC, as well as their status as utilities.

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Scope Financial Institutions Ratings

Dierk Brandenburg
Managing Director, Head of Financial Institution Ratings
d.brandenburg@scoperatings.com

Marco Troiano, CFA
Executive Director
m.troiano@scoperatings.com

Pauline Lambert
Executive Director
p.lambert@scoperatings.com

Nicolas Hardy
Executive Director
n.hardy@scoperatings.com

Chiara Romano
Associate Director
c.romano@scoperatings.com

Alvaro Dominguez
Associate Analyst
a.dominguez@scoperatings.com

Alessandro Boratti
Associate Analyst
a.boratti@scoperatings.com

Andre Hansen
Associate Analyst
a.hansen@scoperattings.com

Key trends for 2021

We expect bank profitability to remain subdued in 2021, but the sector should avoid large losses and capital erosion as a whole, helped by supportive monetary and fiscal policy and pragmatic supervision.

Asset quality will deteriorate, as moratoriums gradually expire and leave some weaker borrowers exposed. As uncertainty starts to dissipate, banks will restart dividend payments, though perhaps at a lower level than before the crisis, at least initially.

With limited room for growth, ongoing challenges to margins from the interest-rate environment, and the need to scale up IT investments, banks will continue to seek cost savings from their distribution networks.

The recent flurry of M&A activity and speculation will continue, and we expect domestic deals to remain the option of choice, due to their stronger industrial logic.

Covid-19: the first real-life stress test for banks since post-GFC de-risking

Since the global financial crisis, the European banking industry has moved in a much safer direction, with new regulations triggering a profound re-think of business models and risk/return combinations.

The Capital Requirements Regulation and Directive, the Bank Recovery and Resolution Directive and their subsequent updates have led to significant reductions in leverage, while more proactive supervision has led to the de-risking of legacy bad assets.

For their part, a new breed of bank managers has steered business models away from risky and capital-intensive activities to lower profitability businesses and shed the aggressive cash-financed acquisition model.

Since the creation of the European Banking Union, credible regulatory stress tests have validated the narrative of a safer, more stable European banking industry. Stress-test failures have been few and far between in recent years and limited to marginal players whose balance sheets were irreparably damaged by the previous credit cycle.

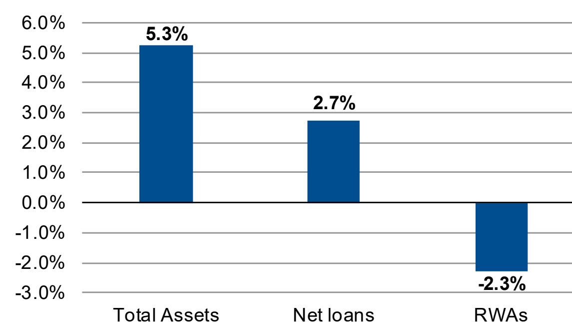
But the proof of the pudding is in the eating, and the Covid crisis is the banking sector's first real-life stress test since the GFC. Despite deep damage to the economy, we see no signs yet of a banking crisis. This is partly the result of the significant fiscal policy response that has included direct public-sector support to households and companies in the form of grants, generous furloughs, and tax breaks. It is also due to the material relaxation of accounting and solvency requirements which has provided banks and their clients with breathing room.

In addition, the strong financial fundamentals of banks entering the crisis, played a paramount role in avoiding a credit crunch that would otherwise have exacerbated the initial output shock of the lockdowns.

At the end of September 2020, European banks' balance sheets were 4.4% larger than a year before, bloated by TLTRO liquidity and central bank asset purchases. Loan growth was there too, though RWAs were down at most lenders. This was in large part due to the lower risk-weight of lending under public guarantee schemes. We note, however, that they are not all fully guaranteed and will not fully benefit from public backstops if asset quality deteriorates.

According to the EBA's stocktake on moratoriums and public guarantees published in November 2020, EU banks had EUR 162bn in exposures under public guarantees as of June 2020, with the corresponding RWA figure being only EUR 29bn. The implied average risk-weight of 18% is one third of the average risk-weight for non-financial corporations not under public guarantee schemes (54%).

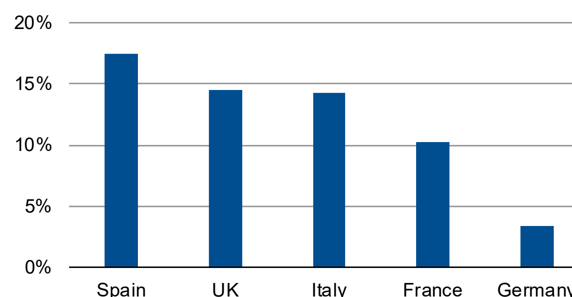
Figure 1: Banks have kept the taps open in 2020 (% growth 9M 2020 vs 9M 2019)



Source: SNL, Scope ratings

Note: Sample of top 50 European banks by total assets

Figure 2: State-guaranteed loans % Total loans to nonfinancial companies, by country



Source: Bruegel, Bank of England, Bundesbank, Bank of Spain, Bank of Italy, Bank of England, Banque of France.

Note: Italy and Spain's total loans to NFC figures as of June 2020

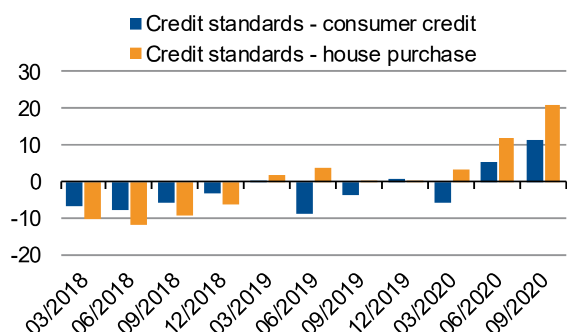
But we are not out of the tunnel yet. Achieving herd immunity through vaccinations is still several months away, and there remain several question marks over the strength of the economic rebound and the depth of the credit cycle. Public support measures are expected to taper in 2021, leading to a belated increase in non-performing loans. The path of fiscal consolidation and monetary normalisation is highly uncertain. The only certainty is the increased size of the public-debt stock and central-bank balance sheets along with a re-engagement of the sovereign-bank nexus in highly-indebted euro area economies. Authorities will have to walk a tightrope, with limited room for mistakes.

Scope's baseline scenario reflects the second round of lockdowns in Europe followed by a bumpy recovery in 2021. On this basis, Scope expects the euro area economy to recover by 5.6% in 2021, after a severe 8.9% contraction in 2020.

How banks navigate the Covid recession and its aftermath will shed light on whether the new regulations were successful in ensuring that the sector has turned from a source of financial instability into a stabilising factor at a time of high macroeconomic volatility.

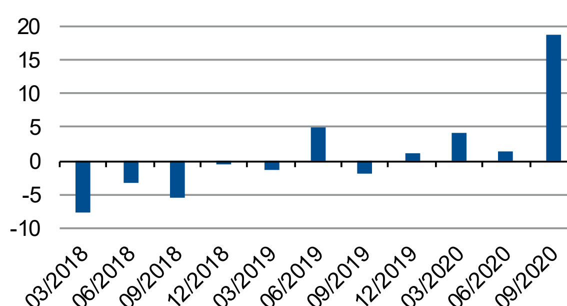
One key area to monitor is the extent to which banks will continue to support the economy throughout the late phases of the pandemic and through the rebound. Worryingly, the latest ECB lending survey data points to tightening credit standards in the euro area.

Figure 3: Expected change in credit standards, next 3 months – Households



Source: ECB, Scope ratings

Figure 4: Expected change in credit standards, next 3 months – Corporates



Source: ECB, Scope Ratings

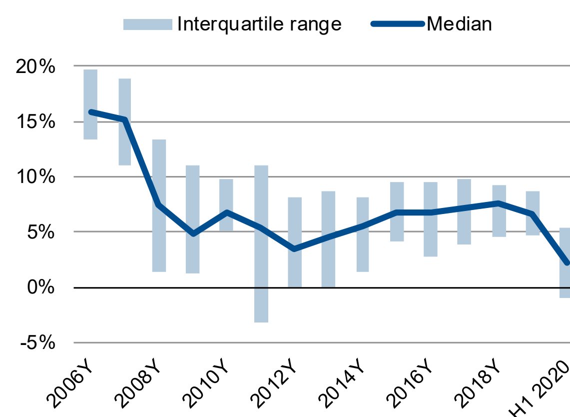
Profitability to remain lower for longer

It is too early to draw conclusions on the longer-term impact of the pandemic on bank asset quality. The full extent of the economic damage to the economy and to bank balance sheets still carries a degree of uncertainty.

But one takeaway we can have confidence in is that public-debt sustainability is even more dependent than before on negative real interest rates. The low-rate/flat yield-curve environment that has dogged bank profitability throughout most of Europe in recent years is here to stay.

Markets that managed to stay at higher levels before the pandemic such as Norway, the UK, and the US have now moved into this environment. This year, banks' top lines have been resilient mostly because of a strong performance in trading, and support from attractively priced TLTROs that reversed the cost of negative policy rates. Core banking revenues nevertheless suffered from the lower levels of activity, which means that diversification of revenues appears as a major differentiating factor among banks.

Figure 5: Return on average equity, historical



Source: SNL, Scope Ratings

Note: Sample of top 50 European banks by total assets

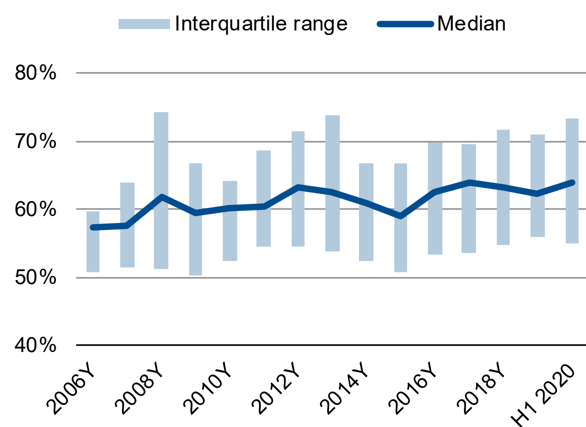
Faced with persistent revenue challenges, bank management will reduce the cost base to protect pre-provision profitability. We expect more cuts to physical distribution networks because 2020 lockdowns have catalysed the move to digital banking channels.

Several banks have announced cuts to their branch networks, either as part of merger plans (Bankia/Caixabank, Intesa/UBI) or as part of stand-alone rationalisations (Sabadell, Santander, Commerzbank, Deutsche Bank).

Svenska Handelsbanken, historically focused on customer proximity in its strategic approach, announced a material reduction in its domestic bank franchise, from 380 branches to 180. Société Générale plans to consolidate its French network into 1,500 branches from 2,100 currently.

In-market consolidation may be a key avenue to achieving cost savings; we see material room for further consolidation in Italy and Germany, where branch numbers are expected to fall by 10% this year, and, to a lesser extent, in the UK and Spain.

Figure 6: Cost-to-income ratio, historical

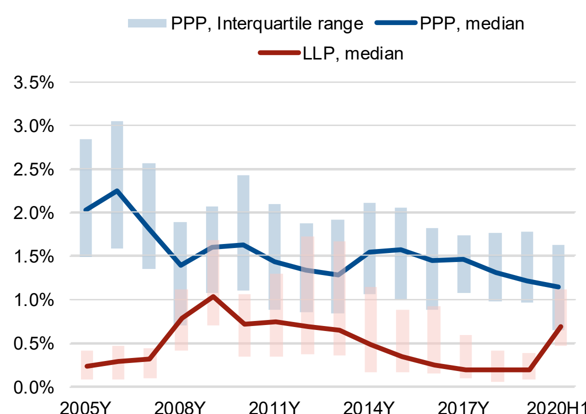


Source: SNL, Scope Ratings
Note: Sample of top 50 European banks by total assets

The sector's cost of risk will remain elevated in 2021 – though we expect most banks to maintain a positive bottom line this year.

Banks have already booked significant provisions under IFRS 9 in anticipation of future deterioration in the loan book. We think more will be coming in 2021; this time not related to macro-scenario adjustments but to actual asset-quality deterioration.

Figure 7: Pre provision profit (PPP) compared to loan loss provisions (LLPs), scaled by net average customer loans - Historical



Source: SNL, Scope Ratings
Notes: Sample of top 50 European banks by total assets.
Vertical bars reflect range between the first and third quartile of the peer group

Asset quality will deteriorate in 2021, but NPLs are backward-looking indicators

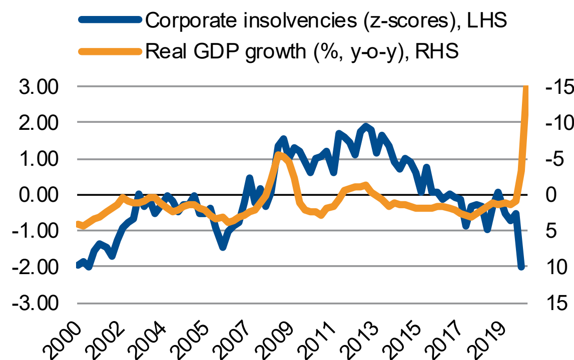
The multi-year trend of declining NPLs has come to an end, and 2020 will mark the bottom in sector NPL ratios. Bad loans will start increasing again in 2021, as moratoriums expire, public support is lifted, and some borrowers declare themselves insolvent when left on their own.

So far, banks have shown resilience, including on their headline asset-quality metrics. Few customers have defaulted, and this has been reflected by stable, or even declining, NPL ratios.

But the low number of insolvencies hides a more concerning picture. Outside of manufacturing, many small businesses, especially in the retail and hospitality sectors, have seen a collapse in their activity levels, and have often increased their recourse to debt, just as revenues and profits collapsed. They have avoided filing for bankruptcy thanks to public support, and the willingness of banks to refinance at affordable rates.

The ECB corporate vulnerability indicator, based on a broad set of indicators related to leverage, debt service capacity, level of activity, profitability and liquidity, shows a very sharp deterioration in corporate credit quality in 2020 – something that may only show up on banks' balance sheets at a later stage.

Figure 8: Corporate insolvencies have declined despite a sharp worsening of their fundamentals.

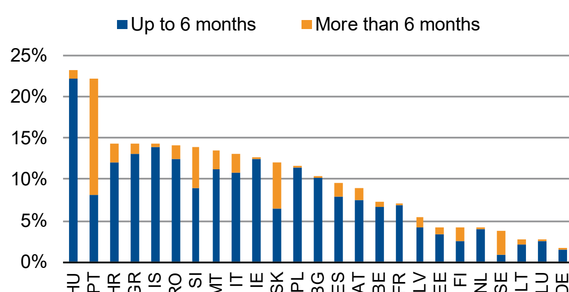


Source: EBA, Scope Ratings
Note: the banks in this EBA's sample represent 95% of total loans to HHs and NFCs in the EBA reporting sample. The EBA's supervised entities cover about 80% of the total assets of the EU banking sectors

Payment holidays have played an important role in supporting borrowers' viability in the short run. According to EBA data, loan moratoriums accounted for over 20% of loans in Cyprus, Hungary, and Portugal and over 10% of loans in Italy, Greece, and Ireland. Initially, programmes were only expected to last only a few months in most countries, but several countries (including Italy and Portugal) have extended them.

The performance of loans under moratorium is a key question mark for how asset-quality trends develop in 2021. Evidence for already-expired moratoriums is encouraging, with many borrowers returning to full performance. But this cannot be extrapolated to the stock of loans still under moratorium – a degree of positive-selection bias in the sample needs to be discounted.

Figure 9: Loans to HHs and NFCs granted moratoriums as a percentage of total loans to HHs and NFCs by country – June 2020



Source: EBA, Scope Ratings

Notes: The banks in this EBA's sample represent 95% of total loans to HHs and NFCs in the EBA reporting sample. The EBA's supervised entities cover about 80% of the total assets of the EU banking sectors.

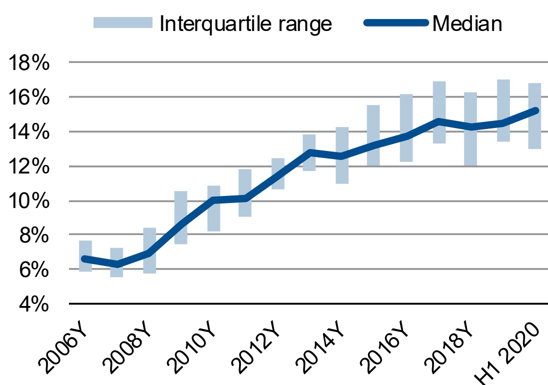
Cyprus (48.1% of total loans, 100% within 6 months) not included.

As visibility improves, trapped capital will be released

As the pandemic hit, supervisors in Europe were quick to demand that banks abstain from distributing capital. The blanket ban on dividends is a rational supervisory move to keep capital in the sector in the face of very low visibility over the scale of credit losses.

By not paying dividends, banks generated additional capital in 2020, bucking a trend of relative stability over the most recent past.

Figure 10: Transitional CET1 ratio – Historical



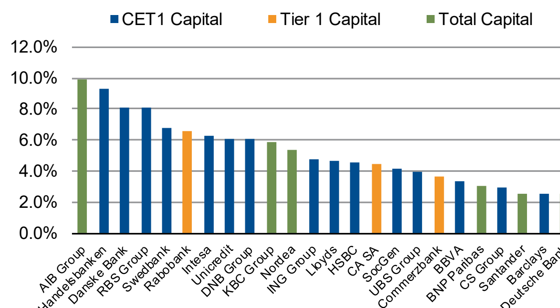
Source: SNL, Scope Ratings

Notes: Sample of top 50 European banks by total assets.

Vertical bars reflect range between the first and third quartile of the peer group

Together with the relaxation of capital requirements in March, most European banks now sit on material capital excesses over their SREP requirements, and have comfortable buffers to MDA triggers – the level at which, according to European capital regulations, legal restrictions on dividends, AT1 coupons and bonuses are triggered.

Figure 11: Headroom to MDA-relevant requirements, Q3 2020



Source: SNL, Company data, Scope Ratings

Some banks with larger MDA buffers lament that the blanket approach to distributions is unwarranted, and that the dividend ban should be lifted. So far at least, most supervisors have been unwilling to soften their stance, as the economic outlook remains highly uncertain.

In October 2020, Andrea Enria, the head of the ECB's supervisory arm, confirmed in a press interview that he would want more clarity over the economic outlook to greenlight dividend resumptions. The ultimate decision lies with the European Systemic Risk Board, which meets on 15 December 2020. Some supervisors such as in Sweden and Denmark have indicated a move away from broad to more bank-specific restrictions but will be looking to the ESRB for guidance before making changes.

We believe supervisors may initially resist the pressure but will eventually have to give in as visibility over 2021 earnings improves and allow a gradual reinstatement of dividend payments.

The relaxation could be differentiated depending on the degree of concern supervisors have with respect to individual lenders. The setting of higher Pillar 2 Guidance could be the avenue of choice for supervisors to lift the blanket ban while still pushing individual banks to retain additional equity above the MDA trigger to cover potential capital erosion in a worst-case scenario.

Rushing to distribute excess capital may be short-sighted, however. Keeping some degree of financial flexibility at a time of high uncertainty is not just a prudent choice to protect banks in case of further cyclical downside (a scenario not to be excluded, yet) but also provides the firepower to buy out fledgling competitors at bargain-basement prices.

In addition, we flag the reputational risk related to large dividend payment announcements at a time when society and the economy at large are suffering, and banks' performance has benefited from material public

support. Banks have so far managed to avoid negative headlines and painted themselves as part of the solution to the crisis. They should not throw this reputational gain away.

Swift central bank action will continue to backstop funding and liquidity risks.

We do not believe there is an imminent risk to bank liquidity. For many years, central bank liquidity programmes have neutralised liquidity risk for banks with sufficient collateral. As a result, liquidity positions improved in 2020. We believe liquidity conditions will remain supportive in 2021 because central banks will err on the side of caution before they start tapering.

Euro area banks have drawn roughly EUR1.5trn of funds from the TLTRO auctions of June and September alone, boosting their liquidity reserves. We believe liquidity conditions will remain supportive in 2021, as TLTRO 3 lines have a three-year maturity, and the programme could be extended by further auctions beyond 2021.

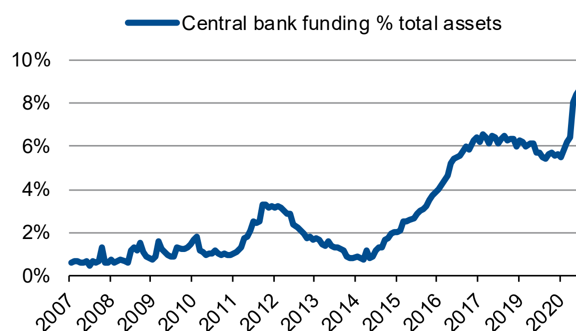
An increase in maximum borrowing allowances (50% of eligible loans, up from 30%), optionality around early repayments, and very attractive pricing (50bp below the deposit rate until June 2021 so long as banks do not deleverage) contributed to the success of the TLTRO 3 programme. Collateral availability is supported by a loosening of eligibility rules since April, which could be extended if need be.

While more central banks, notably the Bank of England, are pondering the move towards negative rates, the ECB is likely to take more steps to mitigate the impact of asset purchases and excess liquidity on its banking sector.

Central bank deposits will be excluded from the leverage ratio, in line with other major economies, and the ECB has the option to increase the deposit-rate tiering multiplier on the reserve requirement to offset the cost of liquidity, especially in case of further rate cuts.

A note of caution is warranted regarding the longer-term prospects for bank liquidity and the possibility that banks remain dependent on central bank funding well beyond the current crisis. But this is more of a medium-term issue rather than an immediate concern.

Figure 12: Reliance on central bank funding of euro area banks



Source: ECB, Scope Ratings

Note: Sample of top 50 European banks by total assets.

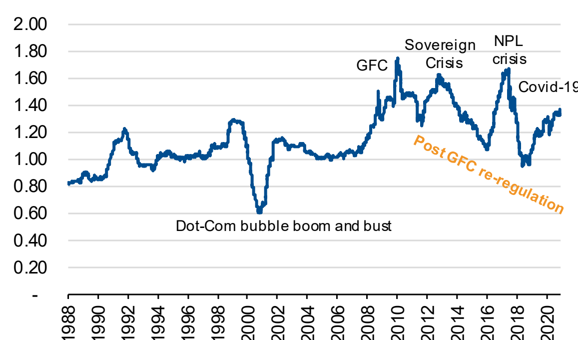
Vertical bars reflect range between the first and third quartile of the peer group

Are banks turning into utilities? Fundamentals vs market perception.

Over the past decade, a combination of tighter regulations, higher capital stacks, reduced risk and low-yielding business models have significantly reduced the returns available to bank equity investors. Rather than reducing their required cost of capital, equity markets have reacted with steep discounts on banks' book values, raising questions about the long-term viability of the sector.

Judging by bank equity under-performance this year, the market is not convinced that the sector has successfully reduced risks. Despite their substantial de-risking over the past decade, European banks have remained high Beta stocks, under-performing the broader market on down days.

Figure 13: Banks' equity beta still does not reflect the sector's deleveraging and derisking



Source: Macrobond, Scope Ratings

Note: beta calculated on 12 month rolling daily returns; STOXX Europe 600 Banks vs STOXX Europe 600

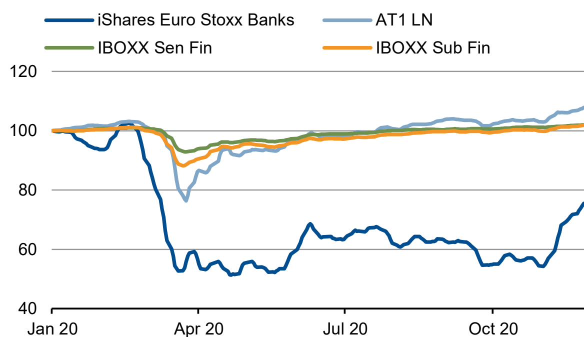
We believe such an ominous performance is due to the combination of several factors. Extending credit with a flat yield curve, slim risk margins and low leverage is a value-destroying business. Few banks can successfully cross-sell their banking clientele insurance and wealth management products.

With profitability permanently depressed by low interest rates and lack of profitable growth opportunities, many European bank CEOs embraced capital return as the strategy of choice to maximise shareholder value, raising expectations of generous dividend pay-outs and share buybacks. The supervisory blanket ban on bank dividends threw a spanner in the works, leaving the sector without an attractive equity story (no prospect of either growth or stable dividend yield).

The recent flurry of M&A activity shows just how cheap valuations had become for the sector. Trapped excess capital makes banks natural investors in other banks. Cost synergies add to the industrial logic, and we expect more deals to follow the deals already announced in Italy and Spain.

Looking at the sector from the perspective of a credit analyst leads to a much more positive assessment, as reflected in the pricing of AT1 securities in 2020 which once again materially outperformed bank equity. In addition, the consolidation of second and third-tier players into stronger competitors has further supported secondary market performance of smaller names.

Figure 14: Total Return (Jan 2020=100)



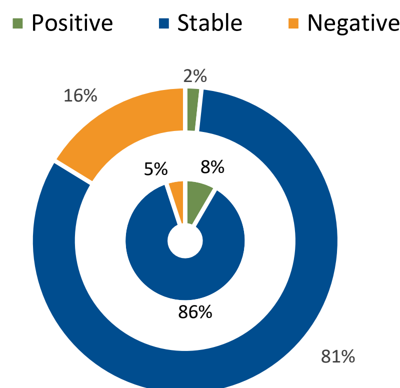
Source: Markit, Blackrock, Invesco, Scope Ratings

Capital, liquidity and asset-quality metrics of many banks look better today than at the start of the year. Perhaps more importantly, the pandemic showed that in times of crisis, politicians, supervisors, and central banks are willing to extend significant help to the banking sector. No major European bank has come close to resolution this year; nor will any in the near future in our view.

Credit markets took note. After an initial scare in March, senior spreads tightened close to pre-crisis levels. Our view is that banking is indeed becoming more and more utility-like and that the sector is turning to be what it should be: boring.

Across our coverage of about 75 banking groups in Europe, we have only had a handful of rating downgrades, and around 15 negative outlook changes, mostly related to banks with pre-existing financial health issues e.g. an unsustainably low level of pre-provision profitability, still-high levels of NPLs or high risk concentrations – including to domestic sovereign debt.

Figure 15: Scope's FI team outlook distribution



Source: Scope Ratings

Note: the inner ring shows the outlook distribution as of 2 January 2020, the outer ring the distribution as of 13 November 2020

M&A outlook: in-market consolidation remains the name of the game

In 2020, there was a noticeable pick up in M&A activity in Europe. Some very high profile deals in Italy (Intesa/UBI) and Spain (Caixabank/Bankia) drew investor attention, but a lot more has been going on under the radar – for example, among small mutual banks in Germany, savings banks in Norway and the Italian operations of Credit Agricole and regional lender Credito Valtellinese.

Several other negotiations were confirmed, including between Unicaja and Liberbank, and between BBVA and Sabadell (although the latter were called off after a week). Persistent rumours around mergers between small and mid-tier banks in Italy and Germany abound.

The clarifications from the SSM in the summer of 2020 about the supervisory approach to mergers has catalysed the process. Supervisors will not get in the way of sound merger projects through higher capital requirements; something we believe had previously put off bank management from seriously engaging in consolidation projects such as between Commerzbank and Deutsche Bank in 2019.

Despite clear supervisory encouragement of cross-border deals and risk sharing, consolidation is happening within national borders. The Credit Agricole bid for Creval is essentially a domestic deal, as Credit Agricole already controls a sizeable bank in Italy.

BBVA's move to exit the US market and the attempt to strengthen its domestic franchise with Sabadell is indicative of the better economics for domestic deals.

Aside from the supervisory green light last summer, we have identified three forces behind the recent revival of M&A activity:

- a rethink of distribution is more pressing now than at any time since the global financial crisis. Banks have more branches than they need. Covid-19 lockdowns have accelerated the move to digital channels,

including for older customers, raising the cost of carrying obsolete distribution networks. This is especially true in systems characterised by a high number of bank branches, such as Germany, France, Spain, or Italy. M&A can accelerate the reduction of such branch networks.

- The economic drivers are very strong. The recession caused by Covid-19 has not yet produced catastrophic impacts on asset quality or cost of risk, but it has enshrined the negative rates/flat yield curve outlook. This environment is highly damaging to bank revenues, and cost cutting is the main managerial lever to protect the bottom line. The value of cost synergies is higher than before.

- Trapped excess capital and low share prices make acquisitions more attractive. Bank equity valuations have tanked due to a combination of the adverse rate environment leading to low profitability, investor scepticism around book values, and the blanket dividend bans preventing excess capital from leaving the system. Unable to pay dividends, buy back shares or find enough lending opportunities to deploy capital organically, bank management is turning to inorganic growth to deploy excess capital.

We see in-market consolidation as positive, especially in countries like Italy, Spain, and Germany where banking is characterised by high degrees of fragmentation or very dense branch networks.

By contrast, we are more sceptical about the industrial logic for cross-border bank mergers, though we acknowledge that the financial rationale has become stronger in view of the higher pressure on profitability. The benefits of cross-mergers are less obvious as cost synergies tend to be limited and the potential for regulatory ring-fencing limits funding cost synergies. Within the euro area, the absence of a complete banking union further complicates cross-border mergers.

Nevertheless, with bank shares now trading near historical lows and capital buffers nearing all-time highs, cross-border deals are becoming more of a possibility, especially for banks with more limited options to deploy capital in their domestic markets. Banks would be better off, however, investing excess cash in best-in-class scalable technology, given the secular trends towards digitisation, and trying to conquer customers through better products and competitive prices, rather than acquiring out-dated distribution networks that may end up burdening the business in the longer term.

We expect the trend towards greater consolidation to continue in 2021, with domestic deals taking the lion’s share of activity.

Annex II: Related research

2020 European Bank Outlook: Over the hills but far from a profitable future" published Dec 2019 available here

AT1 Quarterly: legacy instruments, infection risk and usability of capital buffers, published Nov 2020 available here

Domestic bank consolidation wave gathers pace; cross-border outlook improves, published Nov 2020 available here

Italian banks: moratorium extension delays loss recognition, raising uncertainties, published Sep 2020 available here

French banks: Q3 results were comforting but it's not over, published Dec 2020 available here

The Wide Angle: more opportunities than risks for European banks in 2021, Nov 2020 available here

Earnings outlook for Norwegian banks more nuanced than zero interest rates suggest Oct, 2020 available here

When cash is no longer king: from mobile payments to central bank digital currencies, forthcoming.

The regulatory outlook for European banks in 2021 and beyond, forthcoming.

Scope Ratings GmbH

Headquarters Berlin
Lennéstraße 5
D-10785 Berlin

Phone +49 30 27891 0

Frankfurt am Main
Neue Mainzer Straße 66-68
D-60311 Frankfurt am Main

Phone +49 69 66 77 389 0

Paris
23 Boulevard des Capucines
F-75002 Paris

Phone + 33 1 82 88 55 57

London
111 Buckingham Palace Road
London SW1W 0SR

Madrid
Edificio Torre Europa
Paseo de la Castellana 95
E-28046 Madrid

Phone +34 914 186 973

Milan
Regus Porta Venezia
Via Nino Bixio, 31
20129 Milano MI

Phone +39 02 30315 814

Oslo
Karenslyst allé 53
N-0279 Oslo

Phone +47 21 62 31 42

info@scoperatings.com
www.scoperatings.com

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