AT1 Securities: 2Q 2018 Wrap-up

European banks have been diligently bolstering their capital positions in recent years to fulfil increasing requirements. We are now seeing a slowdown in this trend or even a reversal as the regulatory cycle is stabilising and banks have greater clarity about their requirements. As we have noted previously, the current headroom that banks have against MDA relevant requirements is likely to decline. Consequently, we remain focused on issuer fundamentals and particularly on how stable and predictable a bank's organic capital generation is when assessing the credit risks of investing in AT1 securities.

AT1 investors should not be unnecessarily concerned about the headroom to the MDA threshold as banks overall are solidly capitalised, although differences still exist between individual banks. Importantly, management teams are now more focused and risk conscious. There are unlikely to be rash acquisitions or aggressive expansion into new businesses or geographies. Further, banks are working through legacy issues, such as conduct investigations and non-performing loans which pose threats to capital levels.

Most large European banks have restructured or are completing restructuring programmes necessitated by the financial crisis. Aside from the longer-term threats of new competitors and technologies, the earnings generation of banks should now be in a steadier state, although generally lower than pre-crisis. With growth opportunities still somewhat subdued, earnings are being returned to shareholders via dividends and share buybacks.

We highlight the following recent developments of interest for AT1 investors:

- **Barclays**' capital position recovered from the impact of conduct-related settlements in 1Q 2018. A settlement with the US DoJ relating to RMBS and additional provisions for PPI cost 61bps of CET1 capital in the first quarter. Meanwhile, in the second quarter, earnings generated 44bps of CET1 capital and the regulatory deconsolidation of Barclays Africa added another 11bps. As of end-June 2018, the group's fully loaded CET1 ratio was 12.6%, up from 12.2% in 1Q 2018. The group targets an end-state CET1 ratio of around 13%.

- **DNB** launched a new share buy-back programme. After receiving approval from the Norwegian FSA for up to a 2% buy-back programme, the bank initiated a 1.5% buy-back, reducing CET1 capital by 37bps in the quarter. Discussions related to the full implementation of CRR/CRD IV into Norwegian legislation are ongoing. Of significance are the removal of the Basel 1 floor when calculating capital requirements and the inclusion of Pillar 2 requirements in the MDA threshold. DNB currently targets a CET1 ratio of around 16.1%, translating into a buffer of nearly 1% above SREP CET1 requirements of 15.2% (includes Pillar 2 requirement of 1.6%).

- **ING** set a CET1 target of around 13.5% after assessing the impact of Basel IV and the ECB's Targeted Review of Internal Models (TRIM); the group estimates that they will lead to a dilution in CET1 capital of about 2% over time. With an expected fully-loaded SREP CET1 requirement of 11.8%, this implies a headroom of 1.7% to the MDA threshold. During 2Q 2018, earnings equivalent to 0.2% of CET1 capital were offset by the impact of higher volume growth and a macro-prudential add-on related to Belgian mortgages.

Analyst

Pauline Lambert
p.lambert@scoperatings.com

Associate

Alessandro Boratti
a.boratti@scoperatings.com

Investor Outreach

Debbie Hartley
d.hartley@scoperatings.com

Related Research

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Scope Ratings GmbH

Suite 301
2 Angel Square
London EC1V 1NY

Phone +44 20 3457 0444

Headquarters

Lennéstraße 5
10785 Berlin

Phone +49 30 27891 0
Fax +49 30 27891 100

info@scoperatings.com
www.scoperatings.com

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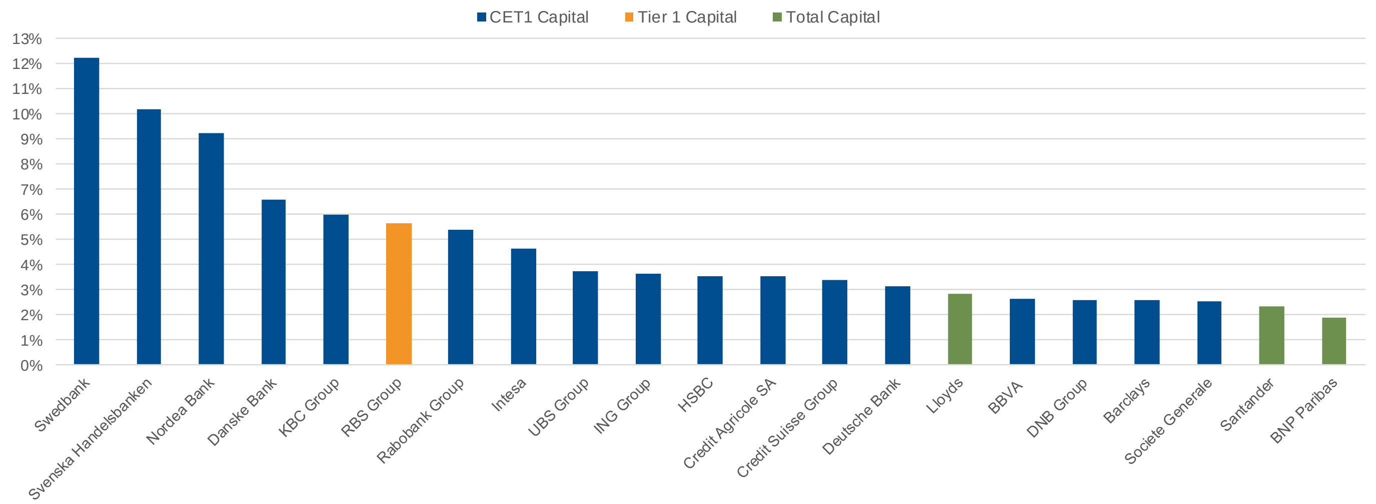
- **Lloyds** provided further details on capital requirements and upgraded its capital guidance. In July 2018, the group's Pillar 2A capital requirement reduced to 4.6% from 5.4% of RWAs. From 1 January 2019, when the UK's ring-fencing regime enters into force, the group's Pillar 2A requirement will be 4.7%, of which 2.7% must be met with CET1 capital. Meanwhile, the group's view on the level of required CET1 capital remains unchanged at about 13%, plus a management buffer of around 1%. The revised guidance for capital build in 2018 is about 200bps pre-dividend, up from 170bps to 200bps previously.
- **RBS** resolved key legacy issues and announced the intention to restart dividends. During 1H 2018, the settlement with the US DoJ relating to RMBS and addressing the deficit in the group's main pension fund cost 1.3% of CET1 capital while earnings generated 1% in CET1 capital. Management aims to build up to an ordinary dividend payout ratio of around 40% of attributable profits. Additional distributions will also be considered although these are unlikely until 2019.
- **Santander's** capital position was negatively impacted by exceptional items. During 2Q 2018, 18bps of organic capital generation was offset by the elimination of excess capital from minority interests in the US consumer finance business, SC USA (18bps), the valuation of held to collect and sell portfolios (12bps) and restructuring costs (5bps). Meanwhile, the expected disposal of the stake in WiZink will add about 9bps in CET1 capital.
- **Societe Generale** settled conduct issues. In June 2018, the bank reached agreements with US and French authorities regarding LIBOR and Libya-related investigations. The bank agreed to pay penalties totalling approximately USD 1.3bn and entered into a three-year deferred prosecution agreement. There was no impact on SocGen's results as the penalties were fully covered by provisions. On 4 September 2018, the bank communicated that it was in active discussion with US authorities regarding certain USD transactions involving countries subject to US economic sanctions. Approximately EUR 1.1bn in provisions have been allocated for this issue and management currently believes that penalties will be "almost entirely covered" by existing provisions.

Figure 1: Narrowest headroom to MDA relevant requirements



Notes: Based on capital figures as of 2Q 2018. All capital requirements and not only the CET1 requirement are relevant when assessing whether the MDA threshold is in breach. Source: Company data, Scope Ratings

Appendix:

Headroom to MDA relevant CET1 requirements

	2016	2017	2018	1Q 2018	2Q 2018			
	YE CET1	YE CET1	Req CET1	1Q18 CET1	2Q18 CET1	Gap %	Currency	Gap bn
Barclays	12.4%	13.3%	10.4%	12.7%	13.0%	2.6%	GBP	7.0
BBVA	12.2%	11.7%	8.4%	11.1%	11.1%	2.6%	EUR	9.4
BNP Paribas	11.6%	11.9%	9.2%	11.6%	11.5%	2.3%	EUR	15.2
Credit Agricole Group	14.4%	14.8%	8.6%	14.6%	14.8%	6.1%	EUR	32.8
Credit Agricole SA	12.1%	11.7%	7.9%	11.4%	11.4%	3.5%	EUR	10.8
Credit Suisse Group	13.4%	13.4%	9.7%	12.9%	13.0%	3.4%	CHF	8.7
Danske Bank	16.3%	17.6%	9.4%	16.4%	15.9%	6.6%	DKK	49.5
Deutsche Bank	13.4%	14.8%	10.6%	13.4%	13.7%	3.1%	EUR	10.8
DNB Group	16.0%	16.4%	13.6%	16.6%	16.2%	2.6%	NOK	27.4
HSBC	13.6%	14.5%	10.6%	14.5%	14.2%	3.5%	USD	34.5
ING Group	14.1%	14.7%	10.4%	14.3%	14.1%	3.6%	EUR	11.6
Intesa	12.7%	13.3%	8.1%	13.3%	12.8%	4.6%	EUR	13.0
KBC Group	16.2%	16.5%	9.9%	15.9%	15.8%	6.0%	EUR	5.5
Lloyds	13.6%	14.1%	10.4%	14.1%	14.1%	3.8%	GBP	7.9
Nordea Bank	18.4%	19.5%	10.7%	19.8%	19.9%	9.2%	EUR	11.3
Rabobank Group	14.0%	15.8%	10.4%	15.8%	15.8%	5.4%	EUR	10.7
RBS Group	13.4%	15.9%	10.2%	16.4%	16.1%	5.8%	GBP	11.6
Santander	12.5%	12.3%	8.7%	11.2%	11.0%	2.3%	EUR	13.8
Societe Generale	11.8%	11.6%	8.7%	11.3%	11.2%	2.5%	EUR	9.1
Svenska Handelsbanken	25.1%	22.7%	11.2%	21.6%	21.4%	10.2%	SEK	56.4
Swedbank	25.0%	24.6%	11.3%	24.8%	23.6%	12.3%	SEK	53.3
UBS Group	16.8%	14.9%	9.7%	13.1%	13.4%	3.7%	CHF	8.6

Note: Barclays' capital figures are on a transitional basis from 2018, rather than fully loaded.
Source: Company data, Scope Ratings

Headroom to write-down/conversion trigger

			2016	2017	1Q 2018		2Q 2018	
	Basis	Trigger	FYE CET1	FYE CET1	1Q18 CET1	Gap %	2Q18 CET1	2Q18Gap %
Barclays	Fully loaded	7.00%	12.4%	13.3%	12.2%	5.2%	12.6%	5.6%
BBVA	Transitional	5.125%	12.2%	11.7%	11.1%	6.0%	11.1%	6.0%
BNP Paribas	Transitional	5.125%	11.6%	11.9%	11.6%	6.5%	11.5%	6.4%
Credit Agricole Group	Transitional	7.00%	14.4%	14.8%	14.6%	7.6%	14.8%	7.8%
Credit Agricole SA	Transitional	5.125%	12.1%	11.7%	11.4%	6.3%	11.4%	6.3%
Credit Suisse Group	Transitional	7.00%	13.4%	13.4%	12.9%	5.9%	13.0%	6.0%
Danske Bank	Transitional	7.00%	16.3%	17.6%	16.4%	9.4%	15.9%	8.9%
Deutsche Bank	Transitional	5.125%	13.4%	14.8%	13.4%	8.2%	13.7%	8.6%
DNB Group	Transitional	5.125%	16.0%	16.4%	16.6%	11.5%	16.2%	11.1%
HSBC	Fully loaded	7.00%	13.6%	14.5%	14.5%	7.5%	14.2%	7.2%
ING Group	Transitional	7.00%	14.1%	14.7%	14.3%	7.3%	14.1%	7.1%
Intesa	Transitional	5.125%	12.7%	13.3%	13.3%	8.2%	12.8%	7.6%
KBC Group	Transitional	5.125%	16.2%	16.5%	15.9%	10.8%	15.8%	10.7%
Lloyds	Fully loaded	7.00%	13.6%	14.1%	14.1%	7.1%	14.1%	7.1%
Nordea Bank	Transitional	8.00%	18.4%	19.5%	19.8%	11.8%	19.9%	11.9%
Rabobank Group	Transitional	7.00%	14.0%	15.8%	15.8%	8.8%	15.8%	8.8%
RBS Group	Fully loaded	7.00%	13.4%	15.9%	16.4%	9.4%	16.1%	9.1%
Santander	Transitional	5.125%	12.5%	12.3%	11.2%	6.1%	11.0%	5.9%
Societe Generale	Transitional	5.125%	11.8%	11.6%	11.3%	6.2%	11.2%	6.1%
Svenska Handelsbanken	Fully loaded	8.00%	25.1%	22.7%	21.6%	13.6%	21.4%	13.4%
Swedbank	Fully loaded	8.00%	25.0%	24.6%	24.8%	16.8%	23.6%	15.6%
UBS Group	Transitional	7.00%	16.8%	14.9%	13.1%	6.1%	13.4%	6.4%

Source: Company data, Scope Ratings

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
33 rue La Fayette
F-75009 Paris

Phone +33 1 82885557

London
Suite 301
2 Angel Square
London EC1V 1NY

Phone +44 203-457 0 4444

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

Phone +34 914 186 973

Milan
Via Paleocapa 7
IT-20121 Milan

Phone +39 02 30315 814

Oslo
Haakon VII's gate 6
N-0161 Oslo

Phone +47 21 62 31 42

info@scoperatings.com
www.scoperatings.com