Introducing Scope's European Bank Ratings

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April 2, 2014

Scope is publishing credit ratings on 18 large banks in seven countries across Europe, 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, in time 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 – arguably the most transformational regulatory change for European banks in many years – are all creating a new and 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. In the near future we will assign short-term ratings for the rated banks' financial commitments with a maturity of 13 months or less.

We do not plan to use additional rating scales or symbols for components of the main ratings, reflecting our view 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 banks' subordinated debt and capital instruments, based on its existing methodology. For example, for banks with ICSRs in the A range Tier 2 and Additional Tier 1 (AT1) securities will be rated one and respectively two notches below the ICSR; for banks with ICSRs in the BBB range the number of notches down will be two and three, respectively. Additional notching down from the ICSR may be warranted by security-specific

features such as a relatively high trigger point. Scope does not however aim to rate retroactively legacy hybrid securities issued mostly in the pre-crisis years. Neither does it 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)**	**Senior unsecured Rating**	**Rating Outlook**
Banco Santander SA	A	A	Stable
Barclays Bank plc	A	A	Stable
BBVA SA	A	A	Stable
BNP Paribas SA	AA-	AA-	Stable
BPCE SA	A+	A+	Stable
Commerzbank AG	BBB+	BBB+	Positive
Credit Agricole SA	A	A	Positive
BFCM SA (Credit Mutuel)	A	A	Stable
Credit Suisse AG	A+	A+	Stable
Deutsche Bank AG	A-	A-	Stable
HSBC Holdings plc	AA-	AA-	Stable
ING Bank NV	A	A	Stable
KBC Group NV	A-	A-	Stable
Lloyds Bank plc	A	A	Stable
Rabobank	A+	A+	Stable
Royal Bank of Scotland plc*	BBB+	BBB+	Stable
Societe Generale SA	A	A	Stable
UBS AG	A	A	Stable

**Note: 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 18 rated banks, there is no notching between the ICSR and the senior unsecured debt rating at this time. The latter reflects the remote likelihood of resolution for these banks, and the even more remote likelihood that if it does occur senior unsecured liabilities will actually be 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. This would be recognized by the ICSR, although the ratings for various categories of the bank's bailinable liabilities will 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 it is not 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 18 rated banks it is only RBS's ICSR and senior unsecured debt ratings which are boosted by a one-notch uplift due to the firm's majority ownership by the UK government.

No automatic links between banks and sovereigns: At this time Scope does not plan to assign public ratings on sovereigns although it does assess the credit risk of various sovereigns as a significant input in the ratings of banks or other issuers. However, 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 aim to privatize bank rescues. Among the 18 rated banks, this aspect is particularly relevant in the case of BBVA and Santander.

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.

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 18 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	Credit Mutuel Group
BNP Paribas	Commerzbank	Groupe BPCE
Credit Suisse	ING Bank	Lloyds
Deutsche Bank	KBC	Rabobank
HSBC	RBS	Crédit Agricole
Société Générale	Santander	
UBS		

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.

Public vs. non-public information

The ratings assigned to the 18 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 18 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.

Key trends

Based on the assessment above and relating to some key takeaways of the rating reports, Scope's bank analysts see the following trends developing for 2014:

- Benefitting from more regulatory clarity and feeling that they are now closer to the enhanced prudential metrics they were asked to reach – especially on capital and liquidity – many large banks, from both core and peripheral countries, are increasingly turning again to "value-creation" strategies. The crisis years, in which they were mostly concerned with being able to navigate the demanding regulatory changes and policy challenges, leave now place for new earnings targets and growth strategies. However profitability targets like ROE remain more subdued than pre-crisis levels and on average risk aversion should remain in place for the time being.

- Actual bank earnings should remain under some pressure, due to the mix of persistently low net interest margins, low volume growth and still elevated credit expenses. Preparing for the ECB's forthcoming Asset Quality Review (AQR), several banks have boosted provisions early on thus hoping to avoid being affected by the supervisory review later. This aspect has been visible in the latest bank reporting round. If carried out thoroughly, this process should ease the burden of the AQR later in the year on banks with more stressed loan portfolios.

- It is plausible that the AQR – and the subsequent stress test – will not reveal large holes in banks' balance sheets. The purpose of the regulatory exercise is to clear the air through better consistency and transparency on EA banks' asset quality, not to create new material uncertainties and scare off again market participants. Specific problems with some banks are likely to be addressed by the new ECB supervisors but perhaps not primarily through public channels. It remains to be seen how effective the process will end up being and whether national politics will be avoided when deciding on remedial steps.

- Market funding conditions should continue to display relative stability, the geopolitical situation permitting. Despite the prospect of debt bailins for banks in resolution, the issuance of senior unsecured debt should continue. Banks are especially aiming to boost their bailinable cushion by issuing more capital instruments (AT1 and Tier 2). Another funding source likely to grow further is corporate and other wholesale deposits. In the case of weaker banks in peripheral markets which would still experience funding challenges, it is possible that the ECB extend LTRO past end-2014 (or replace these facilities with similar funds but possibly at higher rates).

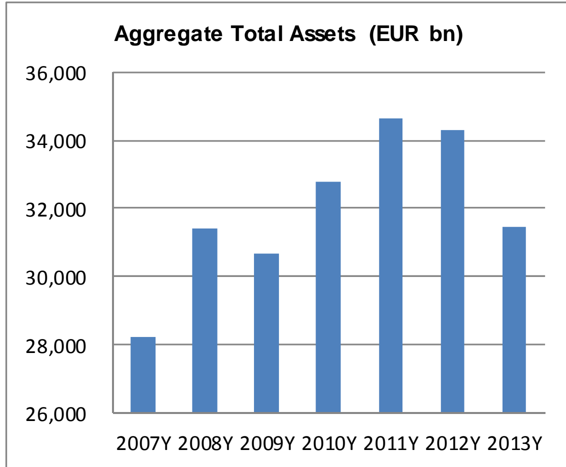
- Following several difficult years it is plausible that the national consolidation will resume some time later this year. Unlike the crisis years, the process would no longer be driven solely by regulatory and state aid-related steering – such as the consolidation of failing banks into financially stronger national peers – but also by banks' focus on strengthening their franchises, balance sheets and earnings potential. Some cross-border M&As are also a possibility, as stronger capitalized banks in core countries seek to acquire weakened institutions elsewhere which offer the right upside potential. This process may at times also be partially driven by some of the large and more complex groups wishing to adjust their structures to the new resolution regime, for example by building strengths and flexibilities in their business models and balance sheets which would make them more resolvable.

To conclude

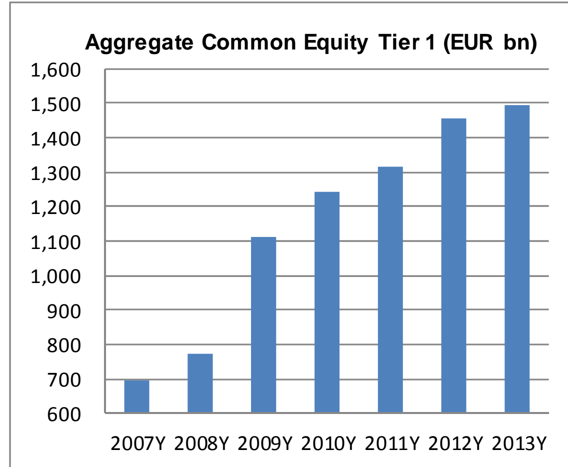
Scope believes that going forward credit ratings for European banks need to take account of a few essential new factors:

- 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



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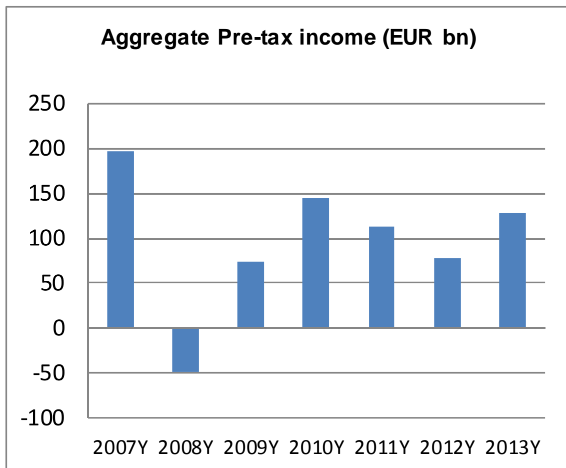

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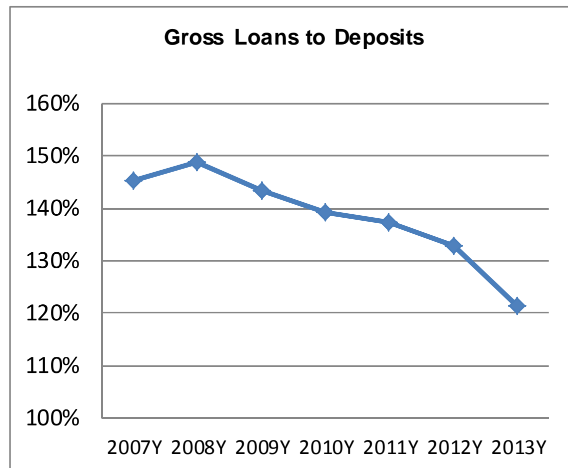
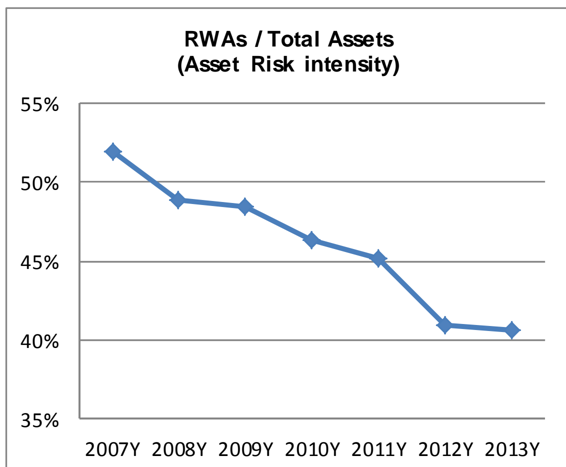


Source: SNL Financial, Scope Ratings



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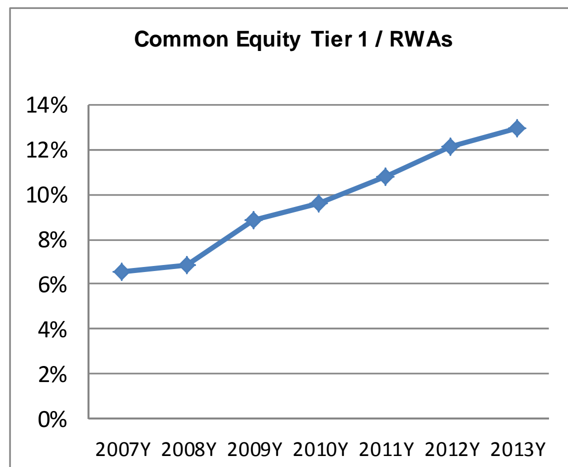

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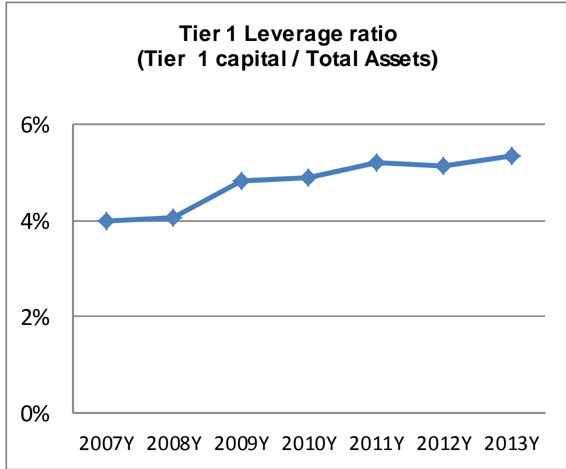

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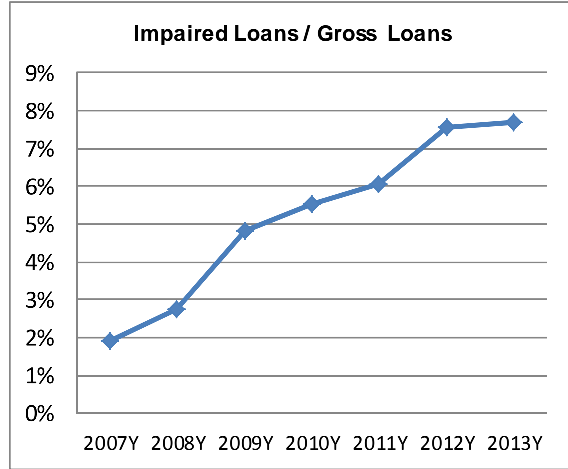

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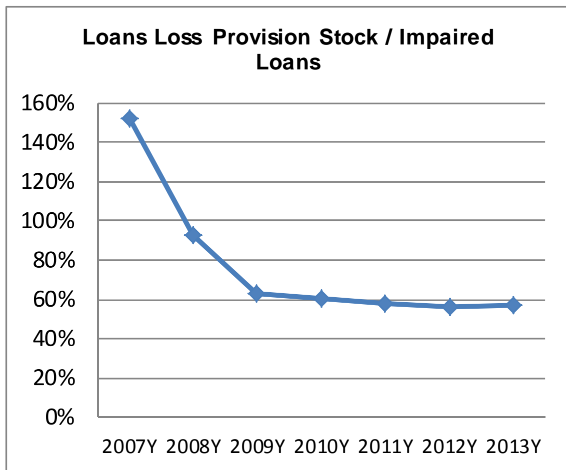

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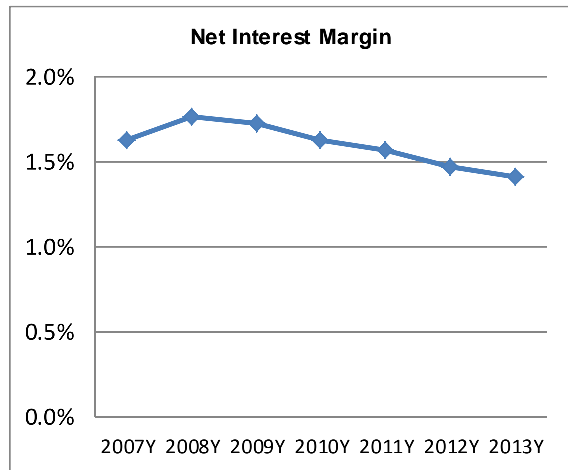

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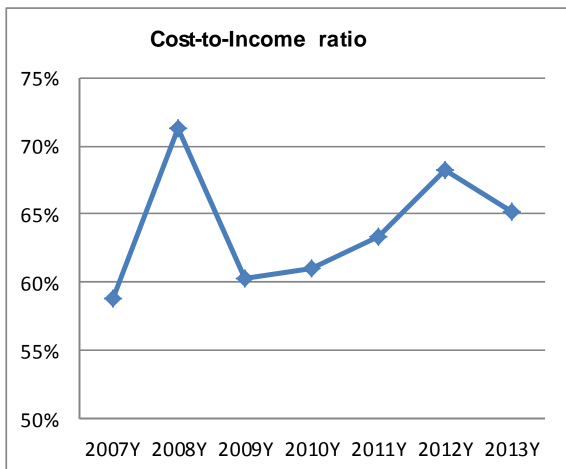

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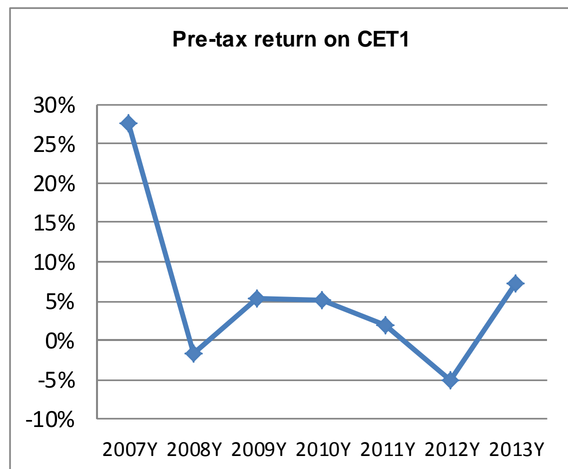

Source: SNL Financial, Scope Ratings

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
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