

Bank Ratings: Credit Fundamentals vs. Market Metrics

Issue 2



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In this report, we look at credit-market valuation metrics concerning the banks Scope covers publicly (currently 25 of them) and assess their relative positioning compared to our ratings and credit opinions.

We have decided to pursue this initiative based on the belief that investors, issuers and other rating users have an interest in ratings and the research behind them which is more than academic. More to the point, we consider that relating credit ratings – which inherently address longer-term fundamentals – with market-valuation indicators can offer rating users a practical and relevant perspective.

In addition to senior unsecured debt and CDS spreads, this month we have included bank capital securities (Additional Tier 1 and Tier 2) in our analysis. In the future we aim to further broaden our coverage to include other classes of liabilities. Our plan is to publish this report monthly, with more frequent updates if the parameters we focus on change more materially.

Importantly, we point out that the commentary is made by credit analysts from a rating agency, thus by professionals uninvolved with trades and trade recommendations. Our commentary stems solely from the comparison of market metrics with issuer credit fundamentals, as reflected in our ratings. The primary source of market-valuation indicators is Bloomberg.

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Explanatory notes

The following charts form the basis of our views:

- *Chart 1:* Scope ratings compared to the spreads of representative senior unsecured bonds (constituents of iBoxx EUR Senior Financials index generally with five-to-seven year maturities)
- *Chart 2:* 12-month spread performance of the representative senior unsecured bonds found in Chart 1
- *Chart 3:* Scope ratings compared to 5-year senior CDS spreads
- *Chart 4:* Scope ratings compared to yields on AT1 and T2 securities (constituents of iBoxx EUR Contingent Convertible index)
- *Chart 4:* Scope ratings compared to Bloomberg composite ratings (an aggregate of ratings from North American agencies)

We present the 25 banks by business model as per our bank rating methodology, and as follows:

- *Global wholesale and retail banks:* Barclays, BNP Paribas, Credit Suisse, Deutsche Bank, HSBC, Société Générale and UBS.
- *International mostly retail banks:* BBVA, ING Bank, KBC, Nordea, Santander and Unicredit.
- *Large mostly domestic retail banks:* BPCE, Commerzbank, Credit Agricole, Credit Mutuel, Danske Bank, DNB, Intesa, Lloyds, Rabobank, RBS, Svenska Handelsbanken and Swedbank.

We caution that spreads and yields on specific securities may not be the most reliable proxy of a bank's credit risk. We nevertheless compare them with our ratings as they are widely used and followed by market participants.

Commentary

The overriding event over the last month has been the situation in Greece. While we do not see a material change in the risk profile of the banks we cover because of Greece – as European banks shed their Greek exposures to a large extent several years ago – there has been unsurprisingly a strong market reaction. Since the end of May, the average spread of the iBoxx EUR Senior Financials index has widened to 82bps from 55bps. This is the wide over a one-year horizon. Looking at individual banks, the story is similar – most are trading at their wides (Chart 2).

As could be expected, the widening in senior spreads has not been uniform – with banks outside of the EUR currency area among the best performers during the period observed. Meanwhile, Italian and Spanish bank spreads widened more than average (+35bps at Intesa and +43bps at BBVA), also reflecting the wider risk premia on peripheral sovereign bonds (+15bps on Italian 7y BTP and +25bps on 7y Bonos).

Perhaps more surprising was the marked widening of spreads for German banks (+35bps at Deutsche and +41bps at Commerzbank), despite a 7bps narrowing of the 7y Bund. In the case of Commerzbank, we would venture that the spread widening was due to historic market perceptions of the bank rather than fundamentals. The bank's exposure to Greece totals just EUR 300mn (excluding the shipping portfolio which sits in the non-core asset division) and its credit profile has improved materially since 2008. For Deutsche, spread widening was likely driven by investors questioning the Strategy 2020 plan.

RBS also experienced noticeable spread widening – again more likely driven by bank-specific issues rather than the situation in Greece. Prominent in the news have been conjecture about the UK government's plans to sell down its stake in the bank and potential fines related to the mis-selling of mortgage-backed securities in the US.

In addition, there has been a fair amount of rating activity over the last few weeks as the large North American agencies have started to remove state support from their ratings. Some of the more striking changes have been for banks with holding company structures.

From the start of its analysis of European banks in mid-2013, Scope's rating approach has incorporated post-crisis realities – investors face increased risks as taxpayers are no longer willing and/or able to support failing banks. Therefore, we only notch ratings up if there are valid reasons to assume support in a timely manner.

In regards to European banks with holding company structures, Scope's rating methodology normally does not differentiate between operating and holding company debt when there are no grounds to believe that in a stress scenario creditors of the holding company would be treated differently from creditors of the operating bank. There could be differences however based on the terms and seniority of specific securities.

Regarding the comparison of Scope's ratings with Bloomberg Composite Ratings (BCR) (Chart 5), we observe that a majority of our ratings are either below the BCR or in line with it. A number of Scope ratings that are positioned above the BCR are there because, per our bank rating methodology, we do not use sovereign ratings or risk assessments to mechanistically cap bank ratings. This remains the case even as some BCRs have increased.

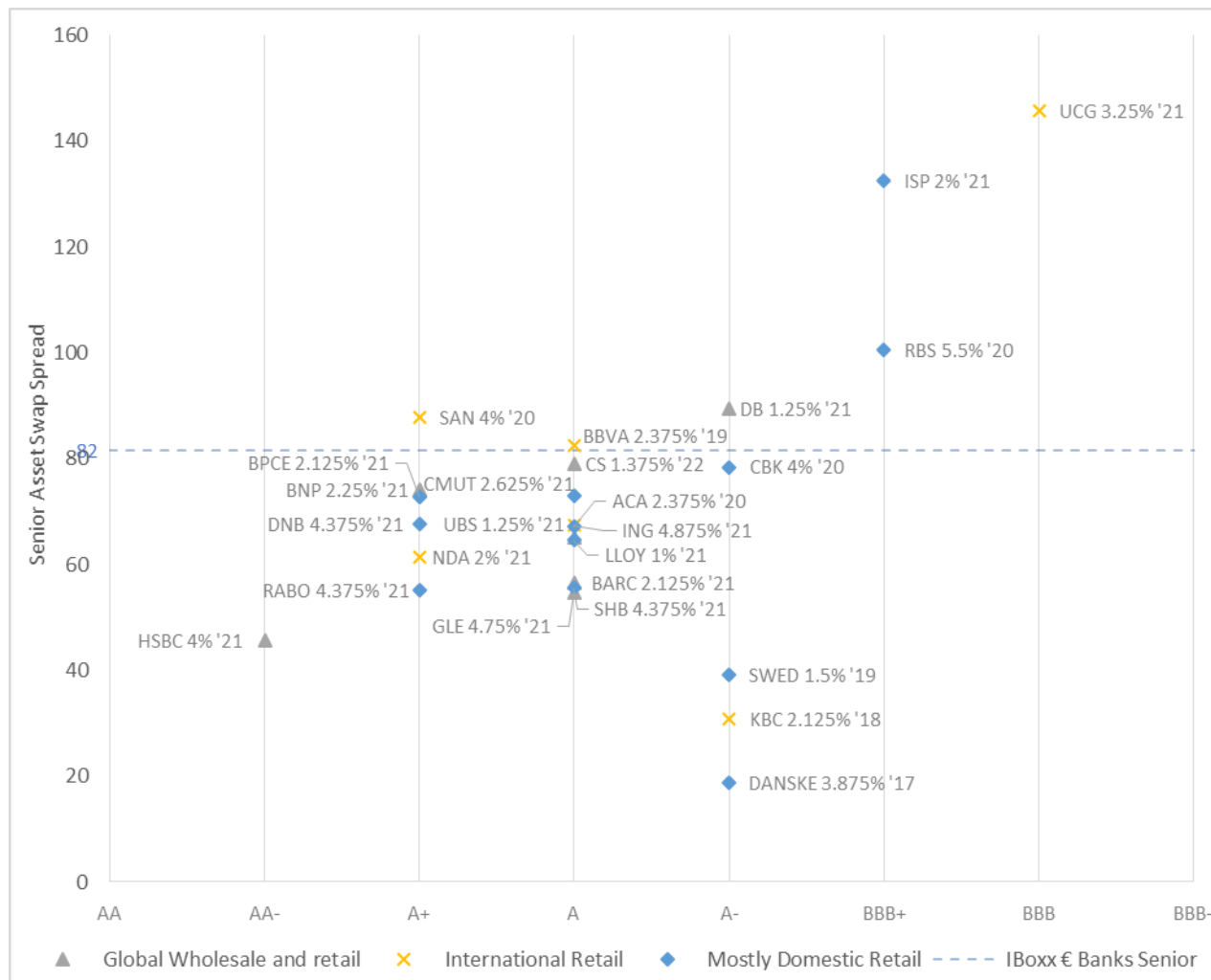
Senior unsecured bond spreads (Chart 1):

- Commerzbank no longer looks like an outlier now with our recent upgrade of the rating to A- from BBB+. The upgrade recognises the successful restructuring and redevelopment of Commerzbank's German retail business which has led the bank to post improving levels of profitability since 2012. In addition, the bank has been successfully de-risking – a process still under way.

Capital securities' yields (Chart 4):

- The positioning of the Swiss T2 securities looks appropriate in light of their relative risks compared to AT1 securities. The T2 securities are written down if the sum of the CET1 ratio and the High Trigger Capital ratio is below 5%. However, we view this risk as being highly theoretical as both banks face much higher bank specific requirements and do not believe the Swiss regulator would permit them to reach levels of 5% before intervening. For both banks, we estimate that they must maintain combined CET1 and Higher Trigger Capital ratios above 9% in 2015 with this increasing to over 12% by 2018.
- Société Générale. It is our view that the bank continues to be penalized by investor concerns related to past liquidity problems during the 2011 EUR crisis. Since then, the funding structure of the bank has changed materially and its de-risking has been comprehensive. We rate the bank single-A with a stable outlook while the AT1 securities are rated BBB-. For the bank's AT1 securities, we do not perceive additional risk factors which would warrant further notching beyond the minimum 4 notches as per our rating methodology.

Chart 1: Scope Ratings vs. Senior Unsecured Asset Swap Spreads



Notes:

(a) Data as of 09.07.2015

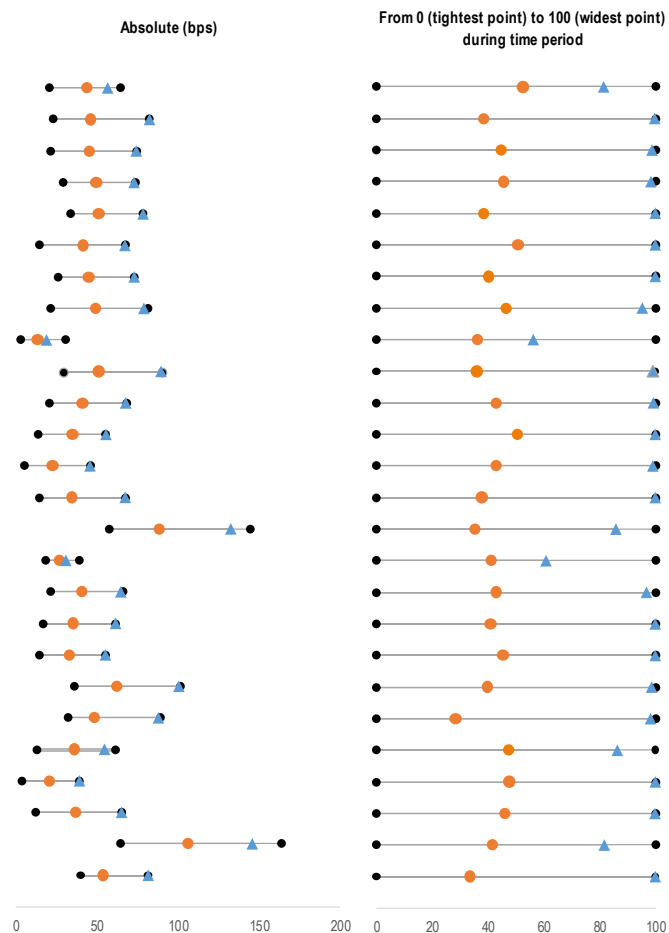
(b) Constituents of iBoxx EUR Senior Financial index.

Source: Bloomberg, Markit, Scope Ratings

Chart 2: Senior Asset Swap Spreads, Data period: 9 July 2014 – 9 July 2015

Issue	ISIN	High	Low	Average	Last	Change
BARC 2.125% '21	XS1035751764	64.8	20.4	43.8	56.6	18.7
BBVA 2.375% '19	XS1016720853	82.5	23.2	46.0	82.4	43.3
BNP 2.25% '21	XS1014704586	74.8	21.0	45.1	74.2	33.9
BPCE 2.125% '21	FR0011781764	73.5	29.4	49.5	72.8	29.0
CBK 4% '20	DE000CZ302M3	78.4	33.9	51.1	78.4	40.8
ACA 2.375% '20	XS0997520258	67.2	14.3	41.2	67.2	28.6
CMUT 2.625% '21	XS0954928783	72.9	26.1	45.0	72.9	28.0
CS 1.375% '22	XS1115479559	81.7	21.1	49.2	78.9	30.7
DANSKE 3.875% '17	XS0751166835	30.9	3.2	13.3	18.8	8.3
DB 1.25% '21	DE000DB7XJB9	90.0	29.2	51.1	89.5	35.3
DNB 4.375% '21	XS0595092098	68.0	20.6	40.9	67.7	23.8
SHB 4.375% '21	XS0693812355	55.5	13.7	34.8	55.5	18.9
HSBC 4% '21	XS0526606537	46.0	4.8	22.5	45.6	22.2
ING 4.875% '21	XS0579847673	67.4	14.5	34.5	67.4	32.7
ISP 2% '21	XS1077772538	144.8	57.8	88.5	132.5	35.1
KBC 2.125% '18	XS0969365591	39.0	17.9	26.6	30.7	8.4
LLOY 1% '21	XS1139091372	66.1	21.7	40.7	64.6	18.7
NDA 2% '21	XS1032997568	61.5	17.1	35.3	61.5	27.5
RABO 4.375% '21	XS0256967869	55.2	14.4	32.9	55.2	22.4
RBS 5.5% '20	XS0496481200	101.3	36.0	61.9	100.5	49.2
SAN 4% '20	XS0877984459	88.8	32.2	48.3	87.9	37.2
GLE 4.75% '21	XS0596704170	61.1	13.3	36.0	54.6	28.7
SWED 1.5% '19	XS1045283766	39.1	3.6	20.6	39.1	18.3
UBS 1.25% '21	XS1105680703	65.2	12.2	36.6	65.1	29.1
UCG 3.25% '21	XS1014627571	164.1	64.1	105.8	145.8	36.0
iBoxx € Banks Senior	DE0007670416	81.6	39.8	53.8	81.6	26.7

Notes: Circle is average for period. Triangle is last.



Notes:

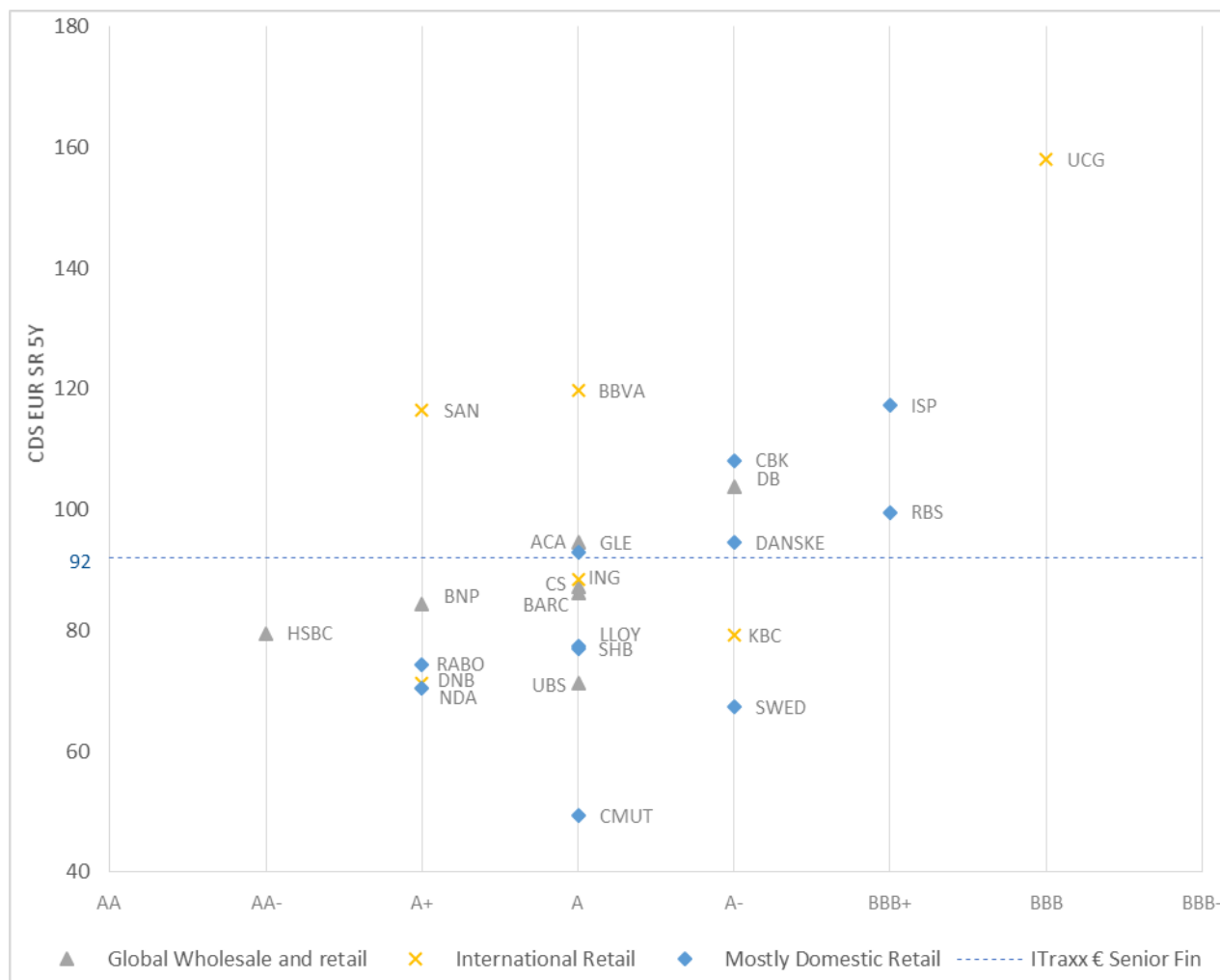
(a) Data as of 09.07.2015.

(b) Constituents of iBoxx EUR Senior Financial index.

(c) Change represents change from last report – which included spreads as of 29.05.2015.

Source: Bloomberg, Markit, Scope Ratings

Chart 3: Scope Ratings vs. 5Y EUR SR CDS



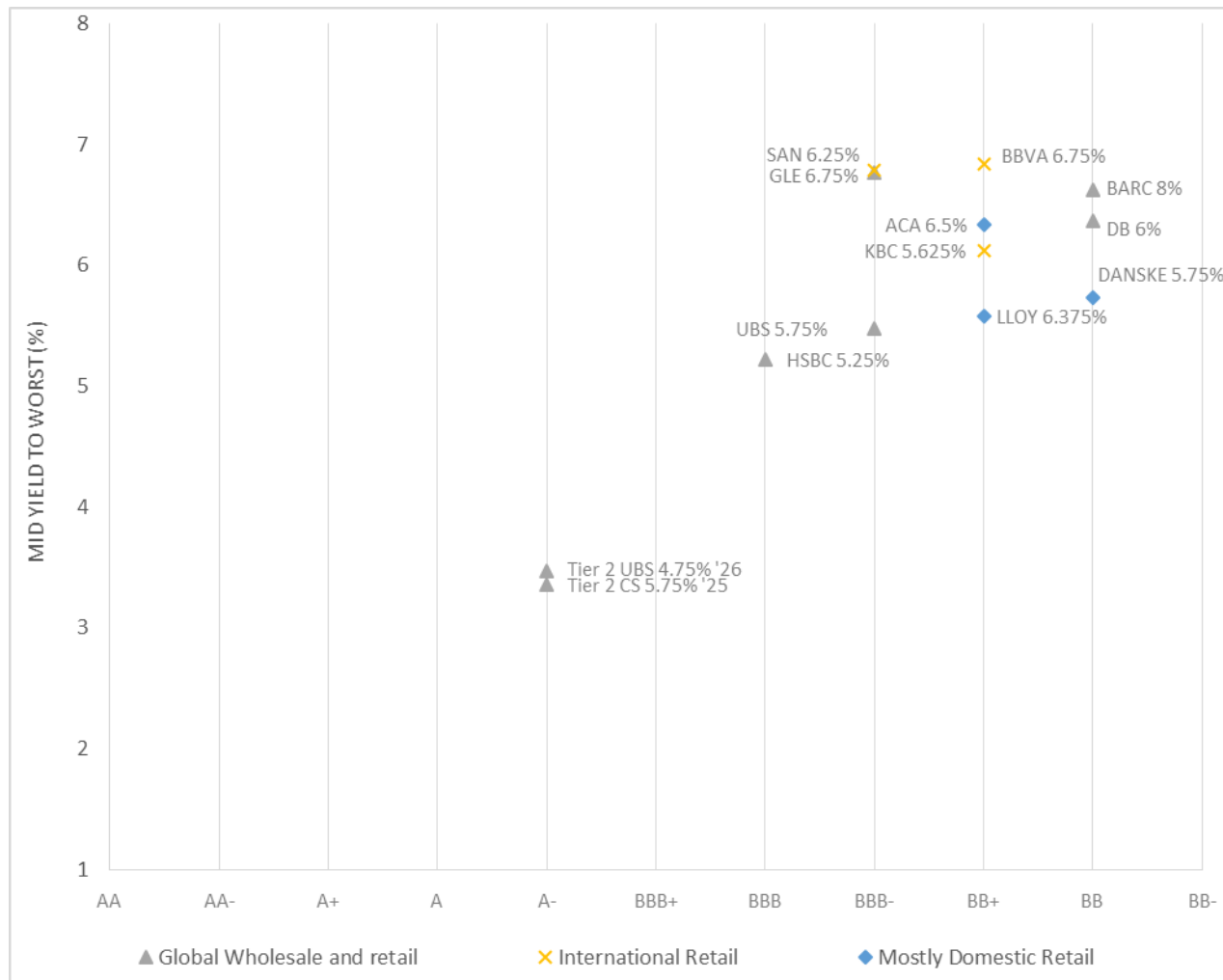
Notes:

(a) Data as of 09.07.2015.

(b) Data for BPCE not available

Source: Bloomberg, Markit, Scope Ratings

Chart 4: Scope Ratings vs. Yields on AT1 and T2 securities



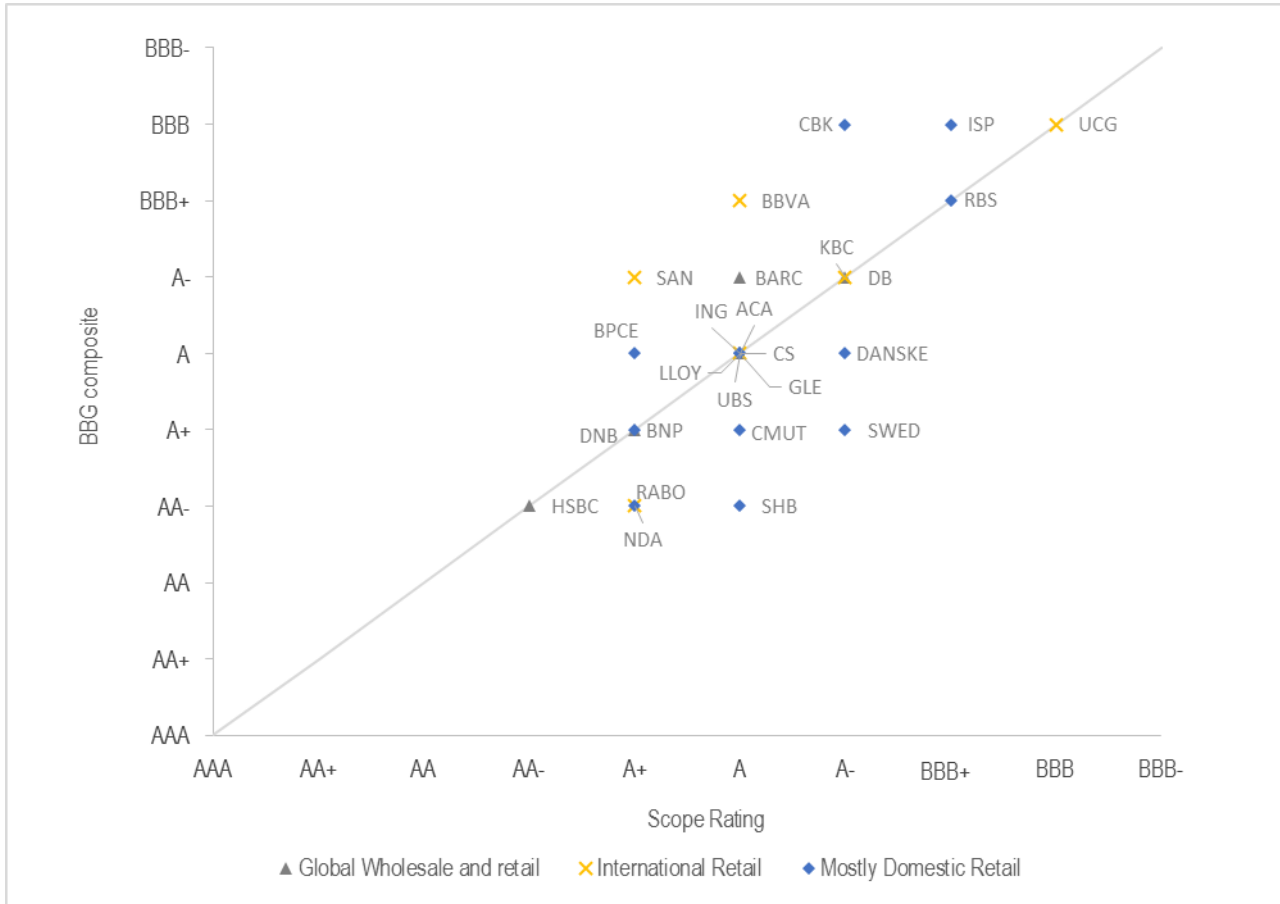
Notes:

(a) Data as of 09.07.2015.

(b) Constituents of iBoxx EUR Contingent Convertible index.

Source: Bloomberg, Markit, Scope Ratings

Chart 5: Scope Ratings vs. Bloomberg Composite Ratings



Data as of 09.07.2015
Source: Bloomberg, Scope Ratings

Banks publicly rated by Scope

(as of 15 July 2015)

Scope Ratings						
Bank	ICSR	Outlook	Short-term Rating	Short-term Rating Outlook	AT1	T2
Banco Santander SA	A+	Stable	S-1	Stable	BBB-	
Barclays Bank PLC	A	Stable	S-1	Stable	BB (<i>Barclays Plc</i>)	BBB+
BBVA SA	A	Stable	S-1	Stable	BB+	
BNP Paribas SA	A+	Negative	S-1	Stable		
BPCE SA	A+	Stable	S-1	Stable		
Commerzbank AG	A-	Stable	S-1	Stable		
Credit Agricole Group	A	Positive	S-1	Stable	BB+ (<i>CASA</i>)	BBB+ (<i>CASA</i>)
Credit Mutuel SA	A	Stable	S-1	Stable		
Credit Suisse AG	A	Stable	S-1	Stable	BBB-, BB+ (<i>CS Group</i>)	A-, BBB (<i>CS Group</i>)
Danske Bank A/S	A-	Stable	S-1	Stable	BB	
Deutsche Bank AG	A-	Stable	S-1	Stable	BB	
DNB Bank ASA	A+	Stable	S-1	Stable	BBB-	
HSBC Holdings PLC	AA-	Stable	S-1+	Stable	BBB	
ING Bank NV	A	Stable	S-1	Stable		
Intesa Sanpaolo SPA	BBB+	Positive	S-2	Stable		
KBC Group NV	A-	Stable	S-1	Stable	BB+	BBB (<i>KBC Bank NV</i>)
Lloyds Bank PLC	A	Stable	S-1	Stable	BB+ (<i>Lloyds Banking Group Plc</i>)	
Nordea Bank AB	A+	Stable	S-1	Stable	BBB-	
Rabobank Group	A+	Stable	S-1	Stable		
Royal Bank of Scotland PLC ^[1]	BBB+	Stable	S-2	Stable		
Societe Generale SA	A	Stable	S-1	Stable	BBB-	
Svenska Handelsbanken AB	A	Stable	S-1	Stable		
Sw edbank AB	A-	Stable	S-1	Stable	BB	
UBS AG	A	Stable	S-1	Stable	BBB- (<i>UBS Group</i>)	A-
Unicredit SPA	BBB	Positive	S-2	Stable		

[1] Ratings benefit from a one-notch rating uplift due to the UK government's majority ownership



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