European Banks: All In On Bailing-In?

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Agenda

- Rating trends
- Government support and Additional Loss Absorbing Capacity
- Other regulatory themes
Rating Trends
1. Macroeconomic and system-wide industry risks are central to bank creditworthiness.

2. We capture these risks in our Banking Industry Country Risk Assessments (BICRAs), which set the anchor or starting point for each and every bank rating.

3. Western Europe shows a wide distribution, with some of the strongest banking sectors and some that are much weaker.
1. A majority of WE banking sectors (10 of 19) have stable trends, which relate to our stand-alone assessment of banks’ creditworthiness.

2. Some (6) banking sectors have negative trends, related to credit growth and/or the real estate market (Germany, Belgium, Norway), structural weaknesses in the economy (Finland), increased competitive pressure (Austria) or sovereign stress (Greece).

3. Spain, Portugal and Iceland have positive economic risk trends, as they have been working through the fallout from their respective crises.

Data as of 9 June 15
1. The Eurozone recovery is still fragile, and this has implications for banks’ revenues and provisions. Whereas the ECB QE likely provides a backstop for the economy, ultra-low (and sometimes even negative) interest rates add to the pressure on banks.

2. The multi-year balance sheet strengthening and business model repositioning processes continue, consistent with stricter regulatory requirements.

3. The EU Bank Recovery and Resolution Directive is set to introduce senior bail-in powers from January 2016, with potential implications for future government support for banks’ senior creditors. Some member states (Austria, Germany and the UK) are forerunners and implemented this already as of January 2015.

4. The Eurozone banking union moves steadily forward: single supervisory mechanism, single resolution mechanism, single rulebook.

All data as at: 16 June 15.
Earnings Development
Top 50 Rated European Banks

- Pretax Profit-To-Operating Revenues
- Impairment Charges-To-Operating Revenues
Ongoing Credit Challenges For European Banks

• Further deleveraging and restructuring
• Continued clean-up of legacy and non-performing assets
• Litigation charges and regulatory fines
• Revenue pressures from uneven economic recovery and a prolonged period of ultra-low (sometimes even negative) interest rates
• The impact of QE on ultra-low government bond yields will continue to help reduce capital market funding costs for banks
Government Support And Additional Loss Absorbing Capacity
Resolution powers could have implications for the notches of government support currently included in ratings on systemically important banks

- We could re-classify the governments’ tendency to support (to “supportive” from “highly supportive” or to “support uncertain” from “supportive”)
- We could re-classify banks as being less systemically important
- There may be specific risks associated with particular classes of debt (e.g. subordinated)
- Parental support for foreign subsidiaries and branches may be less certain

Changes to business and funding models could affect SACPs

- Cost and availability of unsecured funding could be affected
- Incentive for banks to increase reliance on secured funding
- Potential arbitrage in favour of items excluded from bail-in
### Outcome Of This Review

<table>
<thead>
<tr>
<th>Scope</th>
<th>EU-wide systemic bank Operating Companies</th>
<th>UK systemic bank Holding Companies</th>
</tr>
</thead>
<tbody>
<tr>
<td>S&amp;P View</td>
<td>Extraordinary government support could well become less predictable when BRRD implemented in full, but important issues remain unresolved.</td>
<td>Government support for holdco senior creditors probably unlikely when resolution authority gain direct bail-in powers</td>
</tr>
<tr>
<td>Rating Action</td>
<td>Place the issuer credit ratings on negative outlooks, conclude by end-2015 at the latest.</td>
<td>Place the issuer credit ratings on negative outlooks, conclude by January 2015.</td>
</tr>
</tbody>
</table>

- Recognition by Standard & Poor’s that the Bank Recovery and Resolution Directive could be a game-changing piece of legislation
- Gives resolution authorities wide-ranging powers, but also potentially heavily constrains governments from bank bail-outs - shifting losses of failing banks from taxpayers to creditors
- 8% rule could force bail-in of senior unsecured operating company creditors before government support / use of resolution funds

- Same action taken on systemic banks in Switzerland, Liechtenstein, Norway - not bound by the BRRD, but expected to have similar frameworks in place by end-2015 that could credibly reduce predictability of support.
# Outcome Of This Review

## UK, Swiss Holding Companies
- Government support for holdco senior creditors now unlikely
- Remove any assumption of government support, so lower the issuer credit ratings and senior unsecured debt ratings, outlooks generally stable

## UK, German, Austrian Operating Companies
- Extraordinary government support will likely become less predictable in the near term under the new legislation, but important issues remain unresolved.


- The Bank Recovery and Resolution Directive aims to shift losses from failing banks from taxpayers to creditors
- Austria, Germany, and the U.K. have fully applied the new **bail-in rules** on banks from Jan. 1, 2015, **ahead of others in the EU**
- The new bail-in powers conferred under the BRRD could affect the predictability of government support as a factor in our ratings
- We therefore reviewed our ratings on systemic banks in these countries and relevant affiliates
- We expect other EU countries will remain on the current timeline to fully implement the BRRD by January 2016
- Switzerland is not bound by the BRRD and has no explicit holding company bail-in power yet, but resolution powers are already wide-ranging. If used, they may lead to holding company insolvency.

## Rating Action
- Place the issuer credit ratings and senior unsecured debt on **CreditWatch with negative implications**, resolve by early May 2015.

## S&P View
- Government support for holdco senior creditors now unlikely
Publication on Apr. 27, 2015 of our ALAC criteria

What is Additional Loss-Absorbing Capacity?

• ALAC consists of certain bank hybrid capital instruments and, in specified circumstances, other liabilities (such as NOHC debt in some jurisdictions) that can absorb losses of a bank at or near non-viability (for example, in the event of resolution) in a way that reduces the risk of the bank defaulting on its senior unsecured obligations

• ALAC can raise the ICR of a bank above the SACP (stand-alone credit profile) where it reduces the likelihood of default

• ALAC can include instruments not recognized as regulatory Tier 1 or Tier 2 capital

• We also include in ALAC some liabilities that are already included in our measure of capital for a bank (TAC – i.e. common equity and hybrids) up to the amount by which they exceed (the "excess amount") the minimum threshold needed to maintain our assessment of that institution's capital and earnings

• Beyond the "excess amount," ALAC consists of instruments that we expect will absorb losses through equity conversion or write-down within a resolution process

• In certain circumstances, instruments issued by an NOHC are eligible for inclusion in ALAC alongside qualifying instruments issued by the operating bank. The ICR on an NOHC can also benefit from uplift due to ALAC in specific circumstances.
Illustration of ALAC Concept

- Amount required for next ALAC notch
- Meets requirements for 1 or 2 ALAC notches

Ratio of Capital To S&P RWA

- Very weak
- Weak
- Adequate
- Moderate
- Strong
- Very Strong

Bank A
- Anchor: bbb
- C&E Score: 0
- SACP: bbb
- # ALAC Notches: +1
- ICR: BBB+

Bank B
- Anchor: bbb
- C&E Score: +1
- SACP: bbb+
- # ALAC Notches: +1
- ICR: A-

Bank C
- Anchor: bbb
- C&E Score: +1
- SACP: bbb+
- # ALAC Notches: +2
- ICR: A

Bank D
- Anchor: bbb
- C&E Score: +2
- SACP: a-
- # ALAC Notches: +1
- ICR: A

Hybrids not in TAC
Hybrids in TAC
ACE

SACP RAC Ranges
Summary of the ALAC Criteria

• ALAC raises the ICR above the SACP only if
  1. We believe the resolution framework that governs the issuing entity is sufficiently effective and
  2. The projected ALAC amount meets one of the thresholds.

<table>
<thead>
<tr>
<th>Uplift thresholds expressed as percent of S&amp;P RWA</th>
<th>Cumulative Thresholds for ICR Uplift*</th>
</tr>
</thead>
<tbody>
<tr>
<td>Anchor of ‘bbb-’ or higher</td>
<td>One notch (%) 5.0</td>
</tr>
<tr>
<td>Anchor in ‘bb’ range</td>
<td>Two notches (%) 8.0</td>
</tr>
<tr>
<td>Anchor of ‘b+’ or lower</td>
<td>One notch (%) 4.0</td>
</tr>
<tr>
<td></td>
<td>Two notches (%) 7.0</td>
</tr>
<tr>
<td>Anchor of ‘b+’ or lower</td>
<td>One notch (%) 3.0</td>
</tr>
<tr>
<td></td>
<td>Two notches (%) 5.0</td>
</tr>
</tbody>
</table>

• Banks that regulators consider to be systemically important, and that are subject to a well-defined bail-in resolution process, are the most likely to meet the conditions.

* Note:
• The headline thresholds can be adjusted up or down due to qualitative factors.
• If the SACP is ‘a-’ or higher, then uplift is subject to limits. RWA—Risk-weighted assets.
Instruments Eligible for Inclusion as ALAC

• Primarily consisting of hybrid capital instruments subject to conversion or write-down at a bank’s entry into resolution – can include instruments not in regulatory Tier 1 or Tier 2 capital

• To raise an issuer’s ICR, must be able to absorb losses without triggering a default of the issuer’s senior unsecured obligations (noting that our definition of default is not the same as a legal event of default)

• For an operating bank, may also include financial obligations issued by a non-operating holding company (NOHC)

✓ Only includes amounts in excess of what contributes to the SACP via the Capital and Earnings assessment

✓ A forward-looking assessment focused on a two-year projection period apart from certain situations where an extended projection period may apply in the early years of the regulatory transition period

✓ Residual maturity of one year if subject to specific regulatory requirements; otherwise, residual maturity standards aligned with intermediate equity content hybrids
Jun. 9, 2015 Rating Actions – Factoring in ALAC

• We now consider the prospect that the U.K., German and Austrian governments would provide extraordinary support to their banking systems to be uncertain, meaning that we now include no such uplift in the ratings on systemic commercial banking groups domiciled in these countries

• However, we recognize that these countries' bank resolution frameworks are now well advanced, and we now include notches of uplift for systemic banks that we expect will hold or build sizeable volumes of bail-in capital in the coming years

• At the same time, we have recognized the strengthening intrinsic creditworthiness of a few banks that have, for example, materially strengthened their capitalization and lowered their exposure to unexpected losses

• The outlook on most of these banks is now stable, but we have assigned negative outlooks where, for example, we see a risk that their building of core or bail-in capital may fall short

• Our rating actions on the Austrian banks also take into account our view of their weakening operating environment
### Jun. 9, 2015 Rating Actions: Summary

<table>
<thead>
<tr>
<th>Banks</th>
<th>Systemic Importance</th>
<th>Long-term rating (opco)</th>
<th>Short-term rating (opco)</th>
<th>Outlook</th>
<th>No. of notches of government support</th>
<th>No. of notches of ALAC support</th>
<th>Additional Adjustm.</th>
<th>Operating company* ICR rating action</th>
<th>Holding company ICR rating action</th>
</tr>
</thead>
<tbody>
<tr>
<td>Commerzbank AG</td>
<td>High</td>
<td>BBB+</td>
<td>A-2</td>
<td>Neg</td>
<td>bbb</td>
<td>0</td>
<td>1</td>
<td>LT rtg down 1 notch, ST affirmed</td>
<td></td>
</tr>
<tr>
<td>Deutsche Bank AG</td>
<td>High</td>
<td>BBB+</td>
<td>A-2</td>
<td>Stable</td>
<td>bbb+</td>
<td>0</td>
<td>0</td>
<td>LT rtg down 2 notches, ST rtg down</td>
<td></td>
</tr>
<tr>
<td>Deutsche Pfandbriefbank AG</td>
<td>Moderate</td>
<td>BBB</td>
<td>A-2</td>
<td>Dev</td>
<td>bbb-</td>
<td>0</td>
<td>0</td>
<td>LT/ST rtg affirmed, unchanged outlook</td>
<td></td>
</tr>
<tr>
<td>UniCredit Bank AG</td>
<td>High</td>
<td>BBB</td>
<td>A-2</td>
<td>Neg</td>
<td>bbb+</td>
<td>0</td>
<td>0</td>
<td>LT rtg down 2 notches, ST rtg affirmed</td>
<td></td>
</tr>
<tr>
<td>Barclays PLC</td>
<td>High</td>
<td>A-</td>
<td>A-2</td>
<td>Stable</td>
<td>bbb+</td>
<td>0</td>
<td>1</td>
<td>LT rtg down 1 notch, ST rtg down</td>
<td>No change</td>
</tr>
<tr>
<td>HSBC Holdings PLC</td>
<td>High</td>
<td>AA-</td>
<td>A-1+</td>
<td>Stable</td>
<td>a+</td>
<td>0</td>
<td>1</td>
<td>LT &amp; ST rtg affirmed</td>
<td>No change</td>
</tr>
<tr>
<td>Lloyds Banking Group PLC</td>
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<td>A-1</td>
<td>Stable</td>
<td>a-</td>
<td>0</td>
<td>1</td>
<td>LT &amp; ST rtg affirmed</td>
<td></td>
</tr>
<tr>
<td>Nationwide Building Society</td>
<td>High</td>
<td>A</td>
<td>A-1</td>
<td>Stable</td>
<td>a-</td>
<td>0</td>
<td>1</td>
<td>LT &amp; ST rtg affirmed</td>
<td></td>
</tr>
<tr>
<td>RBS Group PLC</td>
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<td>BBB+</td>
<td>A-2</td>
<td>Stable</td>
<td>bbb</td>
<td>0</td>
<td>2</td>
<td>LT rtg down 1 notch, ST rtg affirmed</td>
<td>No change</td>
</tr>
<tr>
<td>Santander UK PLC</td>
<td>High</td>
<td>A</td>
<td>A-1</td>
<td>Neg</td>
<td>bbb+</td>
<td>0</td>
<td>2</td>
<td>LT &amp; ST rtg affirmed</td>
<td>No change</td>
</tr>
<tr>
<td>Standard Chartered PLC</td>
<td>Moderate</td>
<td>A+</td>
<td>A-1</td>
<td>Stable</td>
<td>a</td>
<td>0</td>
<td>1</td>
<td>LT rtg affirmed</td>
<td>No change</td>
</tr>
<tr>
<td>Erste Group Bank AG</td>
<td>High</td>
<td>BBB+</td>
<td>A-2</td>
<td>Neg</td>
<td>bbb</td>
<td>0</td>
<td>1</td>
<td>LT rtg down 1 notch, ST affirmed</td>
<td></td>
</tr>
<tr>
<td>Raiffeisen Zentralbank</td>
<td>High</td>
<td>BBB+</td>
<td>A-2</td>
<td>Neg</td>
<td>bbb+</td>
<td>0</td>
<td>0</td>
<td>LT rtg down 1 notch, ST affirmed</td>
<td></td>
</tr>
<tr>
<td>UniCredit Bank Austria AG</td>
<td>High</td>
<td>BBB</td>
<td>A-2</td>
<td>Neg</td>
<td>bbb</td>
<td>0</td>
<td>0</td>
<td>LT rtg down 1 notch, ST affirmed</td>
<td></td>
</tr>
<tr>
<td>Credit Suisse Group AG#</td>
<td>High</td>
<td>A</td>
<td>A-1</td>
<td>Stable</td>
<td>a-</td>
<td>2</td>
<td>-1</td>
<td>LT/ST rtgs affirmed, outlook to Stable from Neg</td>
<td>No change</td>
</tr>
<tr>
<td>UBS Group AG#</td>
<td>High</td>
<td>A</td>
<td>A-1</td>
<td>Stable</td>
<td>a-</td>
<td>2</td>
<td>-1</td>
<td>LT/ST rtgs affirmed, outlook to Stable from Neg</td>
<td>No change</td>
</tr>
</tbody>
</table>

* LT: long-term, ST: short-term, SACP: standalone credit profile, GCP: group credit profile, CWNeg: CreditWatch with negative implications
  * This column cites the action on the main operating company. In some cases, rated subsidiaries were also affected. In all cases, any existing CW placements were resolved.
  # CS/UBS were not on CreditWatch, so were reviewed separately as part of standard surveillance.
How instrument ratings can be affected by ALAC

<table>
<thead>
<tr>
<th>Issuer Credit Ratings</th>
<th>Issue Credit Ratings</th>
</tr>
</thead>
<tbody>
<tr>
<td>A+</td>
<td></td>
</tr>
<tr>
<td>A</td>
<td>ICR</td>
</tr>
<tr>
<td>A-</td>
<td>Sr Debt</td>
</tr>
<tr>
<td>BBB+</td>
<td>SACP</td>
</tr>
<tr>
<td>BBB</td>
<td></td>
</tr>
<tr>
<td>BBB-</td>
<td>Sub Debt</td>
</tr>
<tr>
<td>BB+</td>
<td></td>
</tr>
<tr>
<td>BB</td>
<td>Tier 1</td>
</tr>
<tr>
<td>BB-</td>
<td></td>
</tr>
</tbody>
</table>

ALAC Uplift (↑ 1 or 2 notches)

Hybrid capital instruments are already notched down for subordination, and for coupon nonpayment, write-down and conversion risks – the introduction of ALAC criteria hasn’t changed Hybrid Capital criteria.

An illustrative example only – the “notching” of subordinated debt and hybrid capital instruments depends on the specific features of the instruments.
### Hybrid Capital Notching Applied to Illustrative NOHC/Bank Structure

<table>
<thead>
<tr>
<th>OPCO</th>
<th>NOHC</th>
</tr>
</thead>
<tbody>
<tr>
<td>A+</td>
<td></td>
</tr>
<tr>
<td>A</td>
<td>ICR Sr Debt</td>
</tr>
<tr>
<td>A−</td>
<td>Sub Debt¹</td>
</tr>
<tr>
<td>BBB+</td>
<td>SACP</td>
</tr>
<tr>
<td>BBB</td>
<td>Sub Debt²</td>
</tr>
<tr>
<td>BBB−</td>
<td></td>
</tr>
<tr>
<td>BB+</td>
<td>Tier 1</td>
</tr>
<tr>
<td>BB</td>
<td></td>
</tr>
<tr>
<td>BB−</td>
<td></td>
</tr>
<tr>
<td>B+</td>
<td></td>
</tr>
<tr>
<td>B</td>
<td></td>
</tr>
</tbody>
</table>

*Notching up from SACP due to ALAC*

The extent of the NOHC notching down from the GCP can vary depending on regulatory restrictions affecting NOHC default risks and can lead to outcomes below the unsupported GCP or the operating bank’s SACP.

**Note:** Nondeferrable subordinated debt may be notched from ICR or from SACP depending on jurisdictional features. GCP – Group Credit Profile.

Also note that the ALAC criteria does not change the starting point for sub debt or NOHC notching.
Resolution and Loss Absorbing Capacity: Key Pending Items

- Final calibration for TLAC (G-SIBs)
- MREL requirements
- Ramp-up trajectory to final TLAC/MREL requirements
- Clarity on pre-positioning requirements
- Mutual recognition of legal/resolution/bail-in frameworks
- Legal certainty on foreign law instruments
Other Regulatory Themes
## Banking Union Update

<table>
<thead>
<tr>
<th>Initiative</th>
<th>Objective</th>
<th>Status</th>
</tr>
</thead>
<tbody>
<tr>
<td>Single rulebook</td>
<td>Uniform regulations in all member states</td>
<td>CRD IV package effective Jan. 2014 Supervisory and technical standards in development</td>
</tr>
<tr>
<td>Single Supervisory Mechanism</td>
<td>Common supervision of the about 130 largest banks in the euro area but open to all EU member states</td>
<td>Approved Effective since Nov. 2014</td>
</tr>
<tr>
<td>Single Resolution Mechanism and BRRD</td>
<td>• Centralize resolution decisions and implementation • Create single resolution fund (SRF) • Common legislation on bank resolution (BRRD)</td>
<td>• Approved by European Parliament in April 2014 • BRRD/SRM effective Jan. 2015 • Senior bail-in power Jan. 2016</td>
</tr>
<tr>
<td>Direct bank recapitalization through ESM</td>
<td>Provide financial backstop besides SRF</td>
<td>Agreement announced June 2014 Possible as a last resort</td>
</tr>
<tr>
<td>Common Deposit Guarantee Scheme</td>
<td>Strengthen customer confidence and stability of banks' funding bases</td>
<td>Agreement on harmonised rules for national schemes. Common scheme unlikely in near term</td>
</tr>
<tr>
<td>Structural Reform Measures</td>
<td>• Reduce risk of failure • Facilitate bank resolution • Ease monitoring and supervision</td>
<td>• EC Proposal Jan. 2014 • EP in disagreement on draft text • Prop trading ban Jan. 2017? • Separation other trading July 2018?</td>
</tr>
</tbody>
</table>
Regulation, Supervision, And Legislation Can Affect Ratings In Multiple Ways

**Regulation, Supervision, Legislation:**

- Single Rule Book
- Single Supervisory Mechanism
- Single Resolution Mechanism/BRRD
- Structural reform
- Financial backstops

**Rating factors:**

- **BICRA: Economic and Industry Risks**
- **Business position**
  - Stability, diversity, restructuring needs
- **Capital & earnings**
  - Capital buffers, earnings potential
- **Risk position**
  - Growth, Concentration, Complexity
- **Funding & liquidity**
  - Liquidity buffers, funding mismatches, asset encumbrance
- **Government support**
  - Ability and willingness to support
- **Group support**
  - Fungibility/ring fencing
EU Ring-Fencing Proposals

The October 2012 “Liikanen report” recommended ring-fencing “significant” trading activities, followed by a EC consultation phase

Delay in drafting of the text, with some push-back from certain member states. Disagreement within the European Parliament on core aspects of the proposal
  • could lead to a period of uncertainty for European banks

Of note, BRRD Articles 17-18 give authorities the “powers to address or remove impediments to resolvability”, including the power to require changes to the legal or operational structures of banks
Member States’ Current Ring-Fencing Plans Differ

**UK**

- Authorities want to separate retail and SME deposits from other operations
- This will likely result in "narrow" retail banks and "broad" wholesale banking and trading entities

**France and Germany**

- Focus is on separating elements of trading activity—including in particular proprietary trading and private equity investments—from the rest of the bank
- In comparison to the U.K. approach, this will likely result in "broad" banks and "narrow" trading entities
- Some view French / German rules as more symbolic than effective measures

- Whether the EU will try to achieve a level playing field despite these differing approaches is not clear
- Differences in the way that banking groups are structured across member states add complexity to considerations about a consistent ring-fencing approach
Conclusions
Conclusions

• A number of European banks continue to re-position their business models and strengthen balance sheets, amidst an uneven recovery in the region

• Continued challenges from revenue pressures, legal and regulatory charges, legacy assets

• Growing clarity over future regulatory backdrop but some important features remain unclear

• Extraordinary government support looks set to diminish but the build-up of subordinated buffers may in some cases offer protection to senior creditors
Thank You

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https://www.spratings.com/globalbanking

Themes in Global Banking

European and American policymakers have deliberately sent a strong message to investors not to expect public solvency support if banks fail again. This may be politically expedient, but it could also have wide ranging impacts on banks, their capital and possibly also ratings.

We recently launched an external version of our Risk Adjusted Capital (RAC) Model for Global Banks. The model is the latest in a suite of Financial Services credit tools that we have released, and provides additional insight and transparency into our financial institutions criteria and methodology.

All of our models and tools have been centralized on one page, Financial Service Credit Tools.
Appendix