Svenska Handelsbanken AB Issuer Rating Report

STABLE
AA-

Overview

Scope Ratings has assigned an Issuer Rating of AA- and a short-term rating of S-1+ to Svenska Handelsbanken AB ('Handelsbanken'), each with a stable outlook.

The Issuer Rating was upgraded by one notch on 17th May 2018. This uplift was based on Handelsbanken's ability to weather weakness in Sweden's housing market, prudent growth strategy, and reassuring financial fundamentals, which Scope expects the bank to preserve.

The ratings were not solicited by the issuer. Both ratings and analysis are based solely on publicly available information. The issuer has participated in the process. The ratings are not applicable to unguaranteed subsidiaries of the rated parent.

Highlights

- Our ratings reflect Handelsbanken's reassuring financial fundamentals, to some extent supported by a positive macroeconomic cycle but also by company-specific factors, such as a well-tested risk culture and incentive structure.
- In addition to its strong domestic franchise, Handelsbanken's degree of international diversification offers some additional protection against potential domestic asset quality shocks, as Sweden's housing market has undergone a degree of correction since late 2017. We note that international revenues have grown strongly in recent years, with the UK and Dutch franchises driving the growth.
- The ratings also reflect the concentrated exposure to the real estate sector in Sweden, an economy with very high levels of household borrowing. We also note that the Swedish banking sector is vulnerable to shocks due to its size, interconnectedness and reliance on wholesale funding. In Handelsbanken's case this is somewhat mitigated by a large portfolio of liquid assets and the substantial level of unencumbered mortgage assets together with overcollateralization of its covered bond issuance.

Rating drivers (summary)

The rating drivers, in decreasing order of importance in the rating assignment, are:

- Strong franchise in Sweden, with growing international presence that could help provide a buffer against domestic downturns
- A well-calibrated incentive structure underpinning a conservative risk culture, which has led to strong, resilient earnings and asset quality metrics over time
- Large liquidity reserves to cover for potentially less stable wholesale funds
- Large exposure to Swedish real estate, albeit balanced by a long track record of keeping credit losses low and loans to property companies being concentrated in lower-risk buckets

Ratings & Outlook

Issuer Rating	AA-
Outlook	Stable
Senior unsecured debt	A+
Additional Tier 1 rating	BBB-
Short term debt rating	S-1+
Short term debt rating outlook	Stable

The ratings are not applicable to debt issued by unguaranteed subsidiaries of the rated parent.

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Bloomberg: SCOP

Rating change drivers

Continued convincing execution of the bank's international diversification through measured expansion and demonstrated control of credit risks and the expenses associated with expansion. Sufficiently stable performance and growth in the bank's established international operations over time would reaffirm that these provide a reassuring hedge against any domestic downturn.

Any indication that the bank's culture of low-risk decision-making has changed or become ineffective could have a negative impact on our rating view. Handelsbanken's track record of weathering negative economic conditions to date has been impressive. Compared to peers the bank has generally reported lower loan losses on average, dating back to the 1990s banking system crisis, and the bank's market reputation and rating benefit from this reassuring track record.

Given the bank's concentrated exposure to Swedish real estate, a severe decline in real estate prices could be a rating negative. This is more likely if such a deterioration were to lead to significantly higher non-performing loans, sustained earnings erosion or lower capital adequacy. The interconnected nature of the Swedish banking sector also means that larger falls in housing prices could also affect market confidence and the cost of funding for all banks.

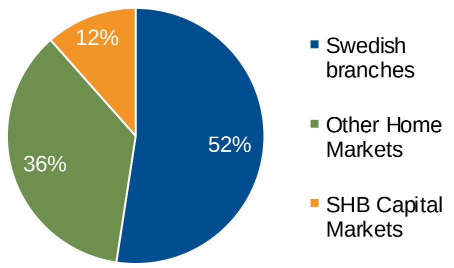
Maintaining or improving already sound prudential and financial fundamentals, especially if the economy deteriorates more than expected. A normalization of the domestic credit cycle could provide some challenges. We believe the bank is well positioned to deal with this, primarily by absorbing higher losses through current strong earnings while maintaining a strong and liquid balance sheet. Demonstrating this would further confirm our view that the bank is focused on maintaining its solid financial profile.

Rating drivers (details)

Strong franchise in Sweden, with a growing international presence that could help buffer domestic asset quality downturns

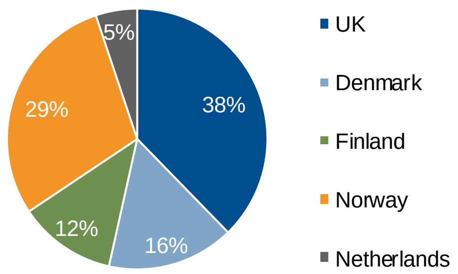
While Sweden represents by far the most important market for the group, accounting for 52% of 2017 revenues, a still significant 36% of revenues were generated outside Sweden, primarily in other Nordic countries but also in the UK and Netherlands. The capital markets division is responsible for most of the remaining revenues (see Figure 1).

Figure 1: Revenues split by division (2017)



Source: Company data, Scope Ratings

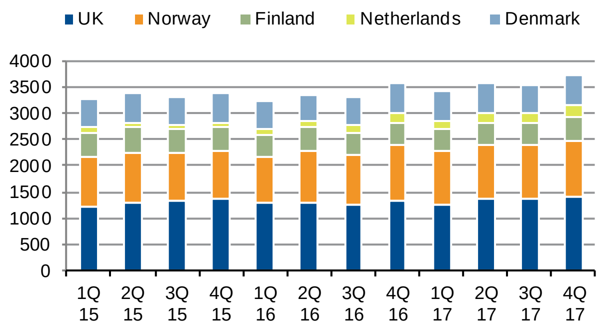
Figure 2: Other retail markets revenue split (2017)



Source: Company data, Scope Ratings

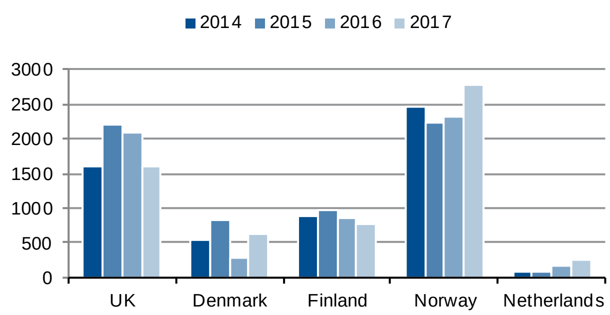
Handelsbanken focuses on providing services to personal customers and businesses, with a particular focus on SMEs, and has been expanding internationally in recent years, largely through organic growth, driven especially by the UK business. However, some international businesses saw their profits fall in FY17. UK profits were hit by a full write-down of a single unsecured exposure (GBP 50m) to the bankrupt British developer Carillion. This almost wiped out 4Q17 UK profit, despite healthy growth in corporate lending, deposits and wealth management fees. The Carillion exposure arose from Handelsbanken's untypical participation in a syndicated loan. The original exposure was higher, but credit concerns led Handelsbanken to reduce the amount. In 4Q17 the bank also bore the cost of restructuring a single exposure in Denmark. In Finland pre-tax profit fell due to higher costs.

Figure 3: International branches' revenues (SEKm)



Source: Company data, Scope Ratings

Figure 4: International branches pre-tax profits, (SEKm, 2013-2017)



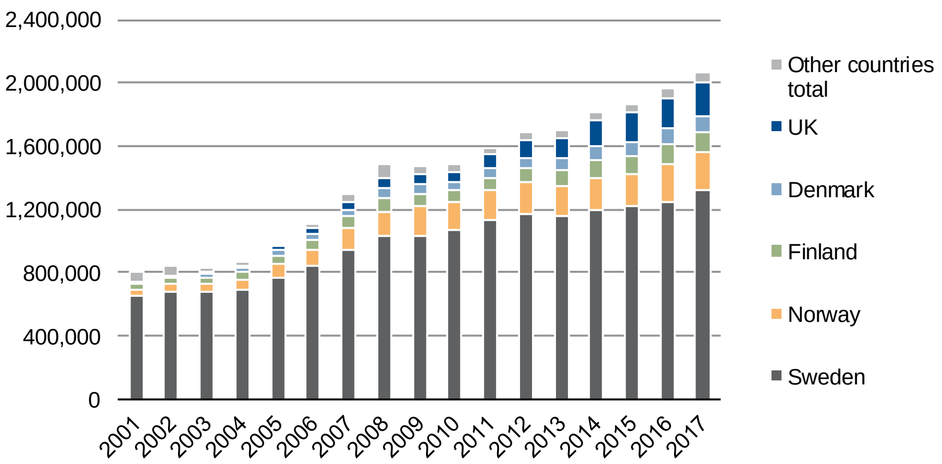
Source: Company data, Scope Ratings

Handelsbanken's international operations utilize the bank's well-established business model and are run with a tight grip on costs, with some necessary investment in growth markets – at present especially in the UK. After c. SEK 104m of additional expenditures there in 2017, in 2018 the bank expects to spend an extra SEK300m. Handelsbanken is working to set up a subsidiary to house its UK operations post-Brexit, and is in communication with regulators to achieve this. Handelsbanken's UK retail operations are currently the UK's largest amongst foreign banks operating via branches. Assuming a hard Brexit, this drives the near-term need for a subsidiary, to conform with the PRA's published guidance for foreign banks post-Brexit. Handelsbanken says a subsidiary would have been necessary at some stage in any event, expecting that it will come to exceed the GBP 25bn deposit threshold beyond which a ring-fenced UK bank is required.

We also note that the press coverage concerning regulators' request for improvement to the bank's anti money-laundering controls in the UK resulted from a leak concerning a confidential communication after a routine inspection, rather than any kind of public warning or criticism.

Despite the challenges faced in FY17, the international businesses continue to contribute a positive and substantial earnings flow to the group, and as such could provide a buffer should the domestic business face a downturn.

Figure 5: Evolution of loan book - distribution by geography (SEKm)



Source: Company data, Scope Ratings

The dominance of Swedish exposures in the loan book has decreased from 81% in 2001 to 64% in 2017 (see Figure 5). Whether the asset quality track record seen in Sweden can be replicated in other countries throughout the cycle is more of an open question – although so far credit losses in the international operations have generally remained low.

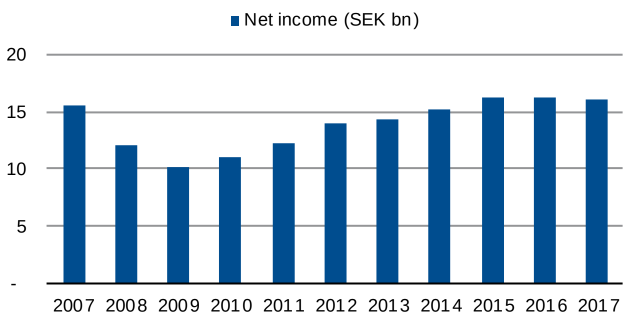
A well-calibrated incentive structure underpinning a conservative risk culture and enabling an effective, decentralized decision-making model, all of which help to explain a track record of sound profitability and low credit losses

Svenska Handelsbanken has an impressive track record of profits underpinned by low levels of credit losses and non-performing assets throughout the cycle. The bank's strong cost/income ratio, especially in Sweden, helps to support its investment in new digital channels.

Handelsbanken's ROAE (12.3% in FY17) consistently remained above 12% throughout the financial crisis and subsequently. The bank reported FY17 net earnings of SEK16.10m, marginally lower than in FY16, but still above the pre-crisis peak of 2007 (Figure 6). Net interest income rose by 7% to SEK 29.8bn, largely on the back of increased lending and deposit volumes and lower funding costs. These offset increased resolution fund fees accounted for within net interest income and a negative impact due to exchange rate movements.

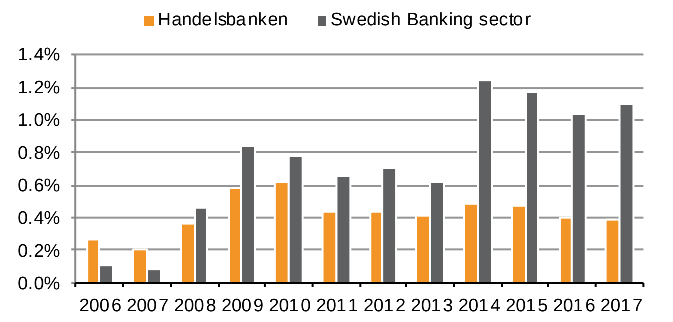
The impaired loans ratio stood at 0.4% at YE17 and has been remarkably stable, at negligible levels, throughout the crisis. The cost of risk in 2017 was also negligible at 8bps, having reached just 23bps at the height of the crisis in 2009.

Figure 6: Net earnings (SEKbn)



Source: Company data, Scope Ratings

Figure 7: NPL ratio (%)



Source: Company data, World Bank, Scope Ratings

Cyclical factors, including the benign credit environment in Sweden, partly explain Handelsbanken's more recent performance. We also believe that its strong track record is driven by factors specific to the bank, including its conservative strategy and incentive scheme, which in our view contributes to a healthy, low-risk corporate culture. Over a long period Handelsbanken has been focused on sustaining profitability rather than immediate growth or boosting market share. The bank has not paid cash bonuses in 40 years. Instead employees have a stake in the bank via the Oktogonen foundation (which owned 10.1% of shares at YE17). These shares are only cashed out when an employee turns 60.

Handelsbanken has no sales targets, budgets or central business plan. Instead, it places a high degree of emphasis on the relationships maintained and developed by staff in its branch network with local businesses and private customers. It is supplementing – but not replacing – branches with digital channels. In light of Handelsbanken's international expansion the branch network has continued to grow, numbering over 819 at YE17, compared to 754 at YE12. Branch numbers in Sweden have been reduced, from 461 to 420 over the same period. The bank entrusts branch level managers with credit decisions focused on a combination of knowing the customer and low risk tolerance. While this could lead to increase risk-taking behavior in any institution where employees have a focus on short term profit targets and bonuses, it has proven to be sustainable for Handelsbanken. Decisions on the largest credits are taken at regional or central level, but only with local support. Responsibility for following up problem credits rests at local level.

Large liquidity reserves to cover for potentially less stable wholesale funds.

An important factor in assessing Swedish banks is that Swedish household savings are often tied up in longer term investments rather than bank deposits, typically intermediated by insurance or pension companies. These savings are partly recycled into the banking system in the form of wholesale funds, chiefly covered bonds. By volume Sweden's covered bond market is the world's fifth largest after those of Denmark, Germany, France and Spain, and in size equals around half of GDP, a proportion exceeded only in Denmark. As one of Sweden's largest mortgage lenders Handelsbanken's liability structure reflects this market reality.

Covered bonds are considered a well-tested, stable source of funding for Swedish banks. The market benefits from a strong investor base domestically and to a lesser extent (about one third) internationally. Investors primarily consist of insurance companies, banks and asset managers including pension funds. Covered bonds issued by

Stadshypotek, Handelsbanken's mortgage financing subsidiary, totaled SEK622bn at YE17, equivalent to 24% of total funding.

Handelsbanken's excellent track record and reputation also give it substantial access to diverse unsecured market funding sources. The main wholesale funding currencies are SEK, EUR and USD. Aside from covered bonds, other securities issued (which include long-term senior unsecured debt, commercial paper and certificates of deposit) accounted for 25% of funding at YE17, and interbank borrowings 7%. Subordinated debt made up just 1% of total funding.

The relatively low availability of domestic household deposits in Sweden also gives Handelsbanken significant reliance on corporate deposits, which, along with interbank borrowings and short-term securities are considered inherently more volatile and vulnerable to market sentiment than household deposits. Deposits as a whole amounted to SEK 942bn at YE17, or 37% of Handelsbanken's funding. 47% of the total came from households, with the remainder from corporate sources. Handelsbanken's headline loans to deposits ratio was 219% as of YE 2017, well above that of international peers, This includes corporate deposits. Reflecting their potential volatility, these are not used to fund long term assets. If covered bonds are included the loans to deposits ratio falls to 77%.

From a maturity point of view, Handelsbanken discloses short term liabilities (under one year) at SEK824bn, or 29% of total liabilities. These comprise interbank loans and issued securities (including covered bonds) with less than one year residual maturity. The calculation does not include SEK 890bn of deposits from the public (32% of liabilities) with unspecified maturity. Handelsbanken works on the assumption that under a scenario of liquidity stress, 20% of deposits could disappear, and thus estimates that (as of YE17) liabilities maturing in under one year would be around SEK 944bn.

Set against this, Handelsbanken has an immediate high-quality liquidity reserve totaling SEK 444bn at YE17, comprising cash and balances with central banks, and additionally liquid securities – mainly government bonds and covered bonds. In all, the bank estimates that taking into account interbank balances and loans maturing in less than one year, available short term asset liquidity for the first twelve months is in the region of SEK 1tr. We also note that there is an unutilised issue amount for covered bonds in the mortgage bank subsidiary Stadshypotek of around SEK 61bn (the amount by which the pool is overcollateralised), plus a further SEK277 bn of unpledged mortgage loans, which don't form part of the cover pool.

From a regulatory standpoint, Handelsbanken's funding amply complies with requirements: its LCR stood at 133%[1] in at YE17 and both the LCR in EUR and USD are well above 100%. The NSFR was 102% at year end.

Large exposure to Swedish real estate, albeit balanced by a long track record of keeping credit losses low and loans to property companies being concentrated in lower-risk buckets

A long period of low default rates coupled with inexpensive covered bond funding has supported an expansion in mortgage credit, which so far has proved very profitable for the banks, with low credit losses. Concentrated exposure to domestic real estate is Handelsbanken's largest single asset risk. A bull market lasting more than two decades until the autumn of 2017 saw house prices rise much faster than inflation, more than doubling since 2005, according to the Riksbank's latest Financial Stability Report,[2]. This is much faster than seen in the EU as a whole and was largely uninterrupted by the

[1] According to the Swedish FSA's definition
[2] Published 23rd May 2018.

financial crisis. Several structural factors (including an imbalance between supply of and demand for housing, strong income growth and continued low interest rates) help to explain the long bull market.

The Swedish Finansinspektionen (FSA), the Riksbank and the European Commission have grown increasingly cautious about excessive credit growth and levels of household debt in Sweden. The average debt to income ratio for Swedish households with a mortgage stood at 343% in 2016, compared to 324% in 2010.[3] This had fallen to 338% in September 2017. However, for 31% of households the ratio was in excess of 400%, and for 13% it topped 600%.

In response to concerns over household debt levels, the FSA has implemented some macro-prudential measures designed to put a brake on excess lending growth. As highlighted by the recent gradual reduction in debt to income ratios, these measures have had some impact. They include a mortgage cap limiting the LTV ratio on new loans to 85% from 2010 onwards and raising the risk weight on Swedish mortgages to 25%, applied through a Pillar 2 requirement. Given the traditional Swedish reliance on maintaining long-maturity mortgages, in June 2016 the FSA also introduced an amortisation requirement, forcing households with a mortgage LTV ratio between 50% and 70% to amortise at least 1% of the mortgage's original value every year, rising to 2% for an LTV ratio over 70%.

A further amortization requirement became effective in March 2018, for new mortgage loans with a value exceeding 4.5x household gross income. These will be amortised 1% faster than would otherwise have been the case. Thus, where the income cap is exceeded, loans with an LTV below 50% will amortise at least 1% annually, with the percentage rising to 2% for mortgages with LTVs between 50% and 70%, and to 3% for mortgages with LTVs in excess of 70%.

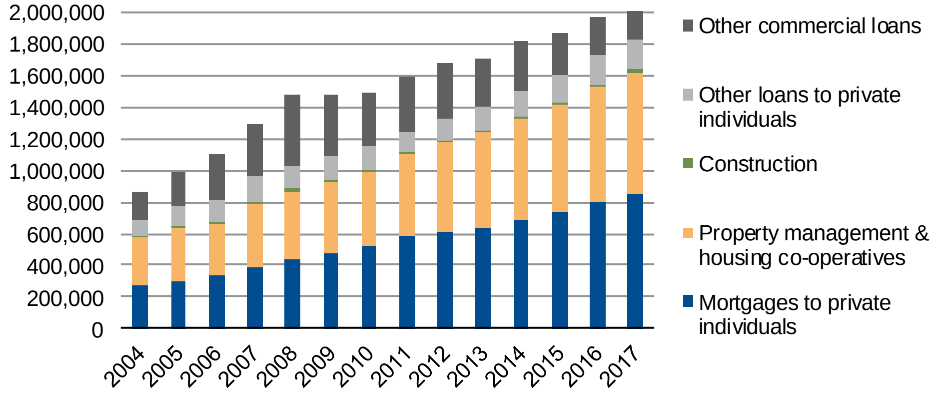
Although we do not see it as the most likely scenario, with the Riksbank predicting stabilization in house prices in 2018, we caution that a serious correction in the real estate market hurting households' wealth levels, or an economic shock leading to a faster-than-expected rise in mortgage interest rates and hitting debt affordability, could hurt Handelsbanken's asset quality and profitability.[4] Most Swedish mortgages are variable-rate, so households are sensitive to rate rises, particularly those that are most indebted.

House prices began falling in September 2017. The downturn may relate to the residential construction boom driving increased supply of new homes, and so far, appears manageable. Borrowers' ability to service debt has remained resilient, and the cost of risk over recent periods has been remarkably low.

As shown in Figure 8, Handelsbanken's property-related lending has expanded more rapidly in recent years than other segments of the loan book and made up 86% of all loans as of YE17. Of this amount, Swedish exposures totalled SEK 1.1tr or two thirds.

[3] Source: Sveriges Riksbank
[4] Our report "Swedish Banks and the Property Market" provides detailed stress test scenarios for Handelsbanken

Figure 8: Handelsbanken - loan book evolution 2004-2017, by sector (SEK m)



Source: Company data, Scope Ratings

The domestic loan book is more concentrated in property than the whole, accounting for 88% of loans in Sweden as of YE17 (YE16: 88%), or about nine times group CET1 capital. Of these, 68% of exposures are residential mortgages, which have a strong track record in Sweden and which we would expect to perform well under most scenarios.

The riskiest part of the credit book comprises loans secured by commercial real estate (CRE), which represents 15% of loans – not insignificant but not of excessive concern either, especially as the majority are in lower-risk buckets. Due to international expansion, 57% of CRE exposures are outside Sweden, primarily in Norway and in the UK. Direct exposure to real estate construction is relatively small.

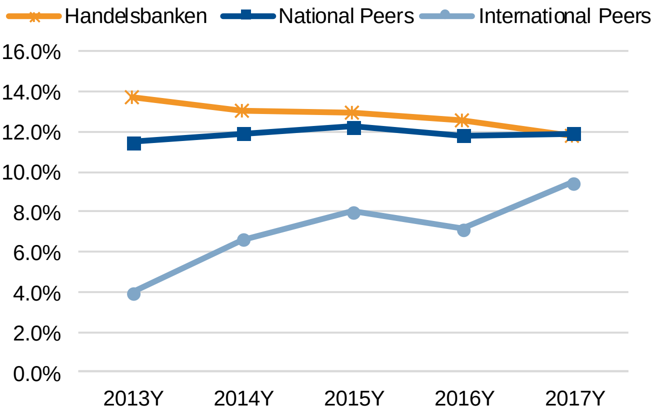
Our view is that over time prevailing low levels of credit losses may not be fully sustainable. Handelsbanken's granular decision-making framework has proved reliable in limiting credit losses in the past, so we expect it to be more able than most to manage through a potentially more challenging economic backdrop.

In this context, we also note that in general Swedish banks' headline capital ratios appear high versus those of international peers. However, they are high for a reason, related to the calculation of risk-weighted assets (RWAs). Handelsbanken's asset risk intensity (RWAs as a percentage of total assets) was 18% at YE17, compared to 24% for its Nordic peers and 30% for international peers.

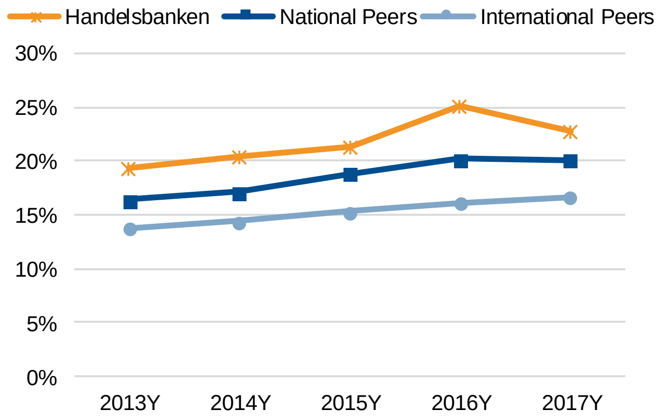
The application of 72.5% output floors as agreed by the BIS, forcing banks' internal risk models to give outputs closer to the standardized approach, may affect Handelsbanken's capital ratios, although we expect the near-term impact to be limited, as full implementation is not due until 2027. A much larger technical impact is due to arise from the FSA's proposed changes to Swedish banks' capital calculations (expected to kick in on 31st December 2018). Effective risk weights on Swedish mortgages will rise and be set via Pillar 1 rather than Pillar 2. This will reduce banks' reported capital ratios and overall capital requirements expressed as a percentage of RWAs. It will also increase asset risk intensity closer to that of international peers. The regulator expects the real effect on capital to be minimal, in that the nominal amount of equity held will remain stable.

I. Appendix: Peer comparison

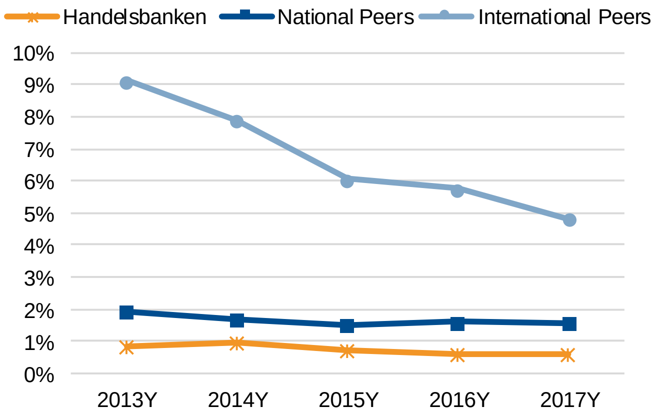
Return on average equity (%)



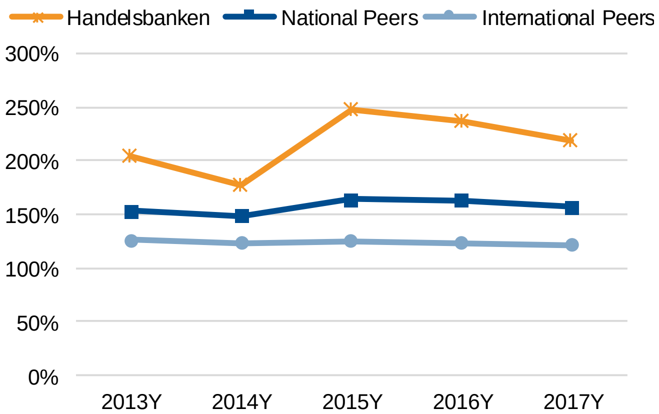
CET1 ratio (%, transitional)



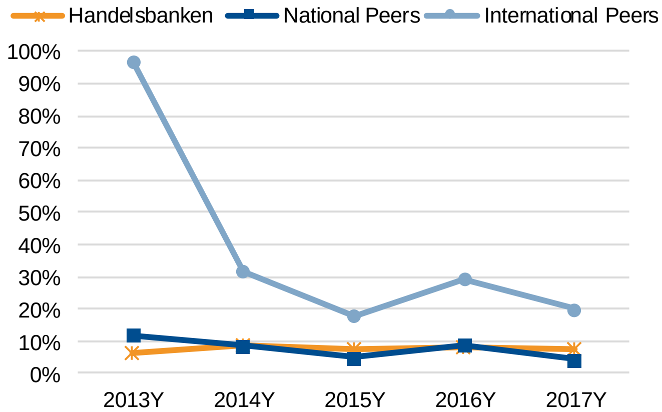
Impaired & delinquent loans % total loans



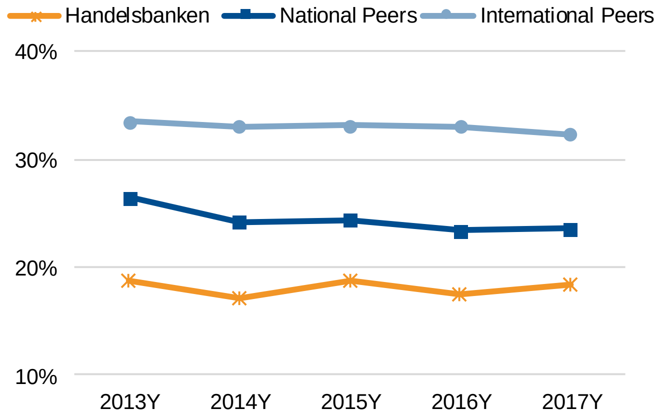
Amortised loans % deposits



Loan loss provisions % pre-provision income



Asset risk intensity (%)



*Nordic peers: Danske Bank, DNB ASA, Nordea, Handelsbanken, Swedbank, SEB
**Cross-border peers: Credit Agricole, BPCE, Credit Mutuel, Lloyds, Nationwide, Rabobank, Intesa Sanpaolo, Commerzbank, Danske Bank, ABN AMRO, CaixaBank, Banco de Sadabell, Handelsbanken, DNB, SEB, Swedbank, La Banque Postale, Bank of Ireland, AIB, Banco BPM, UBI Banca
Source: SNL Financial

II. Appendix: Selected Financial Information – Svenska Handelsbanken AB

	2013Y	2014Y	2015Y	2016Y	2017Y
Balance sheet summary (SEK m)					
Assets					
Cash and interbank assets	432,852	575,918	286,404	256,236	285,484
Total securities	240,228	304,684	235,051	264,194	248,765
of which, derivatives	70,057	116,194	85,374	82,668	56,106
Net loans to customers	1,696,339	1,807,836	1,866,467	1,963,622	2,065,761
Other assets	115,302	128,238	134,211	143,528	166,967
Total assets	**2,484,721**	**2,816,676**	**2,522,133**	**2,627,580**	**2,766,977**
Liabilities					
Interbank liabilities	171,624	200,074	163,770	178,781	174,820
Senior debt	1,150,641	1,212,613	1,245,367	1,261,765	1,276,595
Derivatives	61,529	62,878	40,592	31,738	24,876
Deposits from customers	825,205	1,022,267	753,855	829,336	941,967
Subordinated debt	15,965	30,289	34,216	33,400	32,896
Other liabilities	148,418	161,728	156,065	156,179	174,219
Total liabilities	**2,373,382**	**2,689,849**	**2,393,865**	**2,491,199**	**2,625,373**
Ordinary equity	111,337	126,824	128,264	136,375	141,593
Equity hybrids	0	0	0	0	0
Minority interests	2	3	4	6	11
Total liabilities and equity	**2,484,721**	**2,816,676**	**2,522,133**	**2,627,580**	**2,766,977**
Core tier 1/Common equity tier 1 capital	89,535	98,084	100,535	115,240	115,753
Income statement summary (SEK m)					
Net interest income	26,669	27,244	27,740	27,943	29,766
Net fee & commission income	7,804	8,556	9,320	9,156	9,718
Net trading income	1,357	1,471	1,401	1,330	1,271
Other income	514	743	675	630	933
Operating income	**36,344**	**38,014**	**39,136**	**39,059**	**41,688**
Operating expense	16,989	17,318	18,219	17,737	19,210
Pre-provision income	**19,355**	**20,696**	**20,917**	**21,322**	**22,478**
Credit and other financial impairments	1,195	1,781	1,597	1,724	1,683
Other impairments	2	9	17	1	9
Non-recurring items	-70	306	1,172	1,036	239
Pre-tax profit	**18,088**	**19,212**	**20,475**	**20,633**	**21,025**
Discontinued operations	122	41	145	13	0
Other after-tax Items	0	0	0	0	0
Income tax expense	3,915	4,069	4,277	4,401	4,923
Net profit attributable to minority interests	0	1	1	1	3
Net profit attributable to parent	**14,295**	**15,183**	**16,342**	**16,244**	**16,099**

Source: SNL

III. Ratios – Svenska Handelsbanken AB

	2013Y	2014Y	2015Y	2016Y	2017Y
Funding and liquidity					
Net loans/deposits (%)	205.3%	176.6%	247.4%	236.7%	219.3%
Liquidity coverage ratio (%)	127.9%	140.4%	137.1%	125.8%	133.5%
Net stable funding ratio (%)	NA	NA	100.0%	102.0%	102.0%
Asset mix, quality and growth					
Net loans/assets (%)	68.3%	64.2%	74.0%	74.7%	74.7%
Impaired & delinquent loans/loans (%)	0.8%	0.9%	0.7%	0.6%	0.6%
Loan-loss reserves/impaired loans (%)	56.2%	47.2%	54.5%	59.9%	64.9%
Net loan growth (%)	0.9%	6.6%	3.2%	5.2%	5.2%
Impaired loans/tangible equity & reserves (%)	6.5%	7.1%	7.1%	5.9%	5.8%
Asset growth (%)	4.2%	13.4%	-10.5%	4.2%	5.3%
Earnings and profitability					
Net interest margin (%)	1.2%	1.1%	1.0%	1.0%	1.1%
Net interest income/average RWAs (%)	5.6%	5.6%	5.8%	6.0%	6.0%
Net interest income/operating income (%)	73.4%	71.7%	70.9%	71.5%	71.4%
Net fees & commissions/operating income (%)	21.5%	22.5%	23.8%	23.4%	23.3%
Cost/income ratio (%)	46.7%	45.6%	46.6%	45.4%	46.1%
Operating expenses/average RWAs (%)	3.6%	3.6%	3.8%	3.8%	3.9%
Pre-impairment operating profit/average RWAs (%)	4.1%	4.3%	4.3%	4.6%	4.5%
Impairment on financial assets /pre-impairment income (%)	6.2%	8.6%	7.6%	8.1%	7.5%
Loan-loss provision charges/net loans (%)	0.1%	0.1%	0.1%	0.1%	0.1%
Pre-tax profit/average RWAs (%)	3.8%	4.0%	4.3%	4.4%	4.2%
Return on average assets (%)	0.6%	0.6%	0.6%	0.6%	0.6%
Return on average RWAs (%)	3.0%	3.1%	3.4%	3.5%	3.2%
Return on average equity (%)	13.7%	13.1%	13.0%	12.5%	11.8%
Capital and risk protection					
Common equity tier 1 ratio (%, fully loaded)	19.2%	20.4%	21.2%	25.1%	22.7%
Common equity tier 1 ratio (%, transitional)	19.2%	20.4%	21.2%	25.1%	22.7%
Tier 1 capital ratio (%, transitional)	21.5%	22.1%	23.8%	27.9%	25.0%
Total capital ratio (%, transitional)	21.6%	25.6%	27.2%	31.4%	28.3%
Leverage ratio (%)	NA	3.7%	4.3%	4.8%	4.6%
Asset risk intensity (RWAs/total assets, %)	18.7%	17.1%	18.8%	17.5%	18.4%
Market indicators					
Price/book (x)	1.8x	1.8x	1.7x	1.8x	1.5x
Price/tangible book (x)	1.9x	2.0x	1.8x	1.9x	1.7x
Dividend payout ratio (%)	74.1%	74.4%	71.5%	60.2%	91.5%

Source: Scope Ratings

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