Financial Institutions Ratings

UBS Group AG – AT1 rating report

Security Ratings (assigned 17 March 2015)	
Outlook	Stable
5.75% EUR 1bn Tier 1 Capital Notes Contingent convertible on 5.125% trigger	BBB-
7.00% USD 1.25bn Tier 1 Capital Notes Contingent convertible on 5.125% trigger	BBB-

Lead Analyst

Jacques-Henri Gaulard
j-h.gaulard@scoperatings.com

Team Leader

Sam Theodore
s.theodore@scoperatings.com

The ratings have not been solicited by the issuer; the analysis is based solely on public information.

Rating rationale

We have assigned a rating of BBB- to UBS Group AG (UBS)'s 5.75% EUR 1bn and 7.00% USD 1.25bn Tier 1 capital notes based on the following:

- ICSR: A, Stable outlook
- Minimum notches down from the ICSR: 4
- Additional notches: 0

Please refer to Scope's Bank Capital Instruments Rating Methodology published in September 2014 for more details about the minimum notching for AT1 securities.

Scope decided not to add any additional notch beyond the four minimum notches stipulated by the capital instruments methodology. This is due to the following:

On coupon cancellation risk, even if UBS Group AG is a new company and does not seem to have built free reserves yet, the company makes very clear in its Q4 2014 financial report that "as of the balance sheet date, UBS Group AG estimates that the amount of reserves possibly available for distribution to shareholders under Swiss corporate law was approximately CHF 36.7bn". This amount can only be reached if share premium is included in the Available Distributable Items (ADIs), and since share premium is included in the capital reserves (as per the Directive on the Establishment of Accounts (DEC-CFB) of 14 December 1994 (lastly amended on 21 December 2006) and also per Article 671-2-1[1] of the Swiss Code of Obligations), we believe it is safe to include it in UBS Group AG's ADIs as of YE 2014. Our understanding of Swiss corporate law is that share premium is not formally attached to share capital, contrary to the way it is presented in other European countries. In addition, (1) UBS is not submitted to as drastic a restriction on discretionary distributions as European banks abiding by CRD 4-CRR; and (2) the issuer is severely restricted on its ability to pay dividend on ordinary shares if an interest payment on the Tier 1 Capital Notes is cancelled. All these factors in our view add some degree of protection to Tier 1 Capital Notes holders, justifying no extra notching on coupon cancellation risk.

With regards to principal loss absorption, Scope perceives the trigger of the two securities (sum of CET1 ratio and Higher Trigger Capital ratio below 5.125%) to be extremely low, not only in absolute terms, but also with regards to the minimum capital requirements of UBS Group under Swiss regulation. Since the trigger is below UBS's Swiss minimal requirements, we view the possibility of these notes being permanently written-down as highly theoretical (except in resolution).

[1] "Even after it has reached the statutory level, any share issue proceeds in excess of the nominal value […] must be allocated to the general reserve".

ICSR

The ICSR of A with a Stable Outlook is driven by the bank's significant downsizing during the crisis and acceptable levels of underlying profitability from core franchises over the past five years. At the same time, the ratings reflect the uncertain outcome of several high-profile litigation cases as well as what we perceive as the low level of risk-weighted asset intensity of the bank – partly linked to the build-up of significant reserves of cash and highly liquid assets in the post-crisis years.

Summary terms

Issuer	UBS Group AG
Issue Date	19 February 2015
Amount	EUR 1.0bn
Coupon	• 5.75% until first call date, and thereafter at a rate equal to the Mid Market Swap Rate plus 5.287% • If any, payable annually in arrear on 19 February of each year, commencing on 19 February 2016
Format	Perpetual Tier 1 capital notes, callable 19 February 2022 and every year after that.
ISIN	CH0271428309
Issue Date	19 February 2015
Amount	USD 1.25bn
Coupon	• 7.00% fixed until first call date, and thereafter at a rate equal to the Mid Market Swap Rate plus 4.866% • If any, payable annually in arrear on 19 February of each year, commencing on 19 February 2016
Format	Perpetual Tier 1 capital notes, callable 19 February 2025 and every year after that.
ISIN	CH0271428333
Capital Treatment	Tier 1 and low-trigger Loss-absorbing capital – Progressive Component
Coupon Cancellation	• Fully discretionary • Mandatory if (1) there are insufficient distributable items or (2) if UBS Group AG is not in compliance with all applicable minimum capital adequacy requirements of the National Regulations on a consolidated basis and/or (3) the FINMA has requested the issuer not to make such interest payment.
Principal Loss Absorption	• Following the occurrence of a Trigger Event or a Viability Event, a contingent write-down will occur and the full principal amount of the Notes will automatically and permanently be written down to zero on the write-down date. • A Trigger Event refers to the sum of the CET1 ratio and the High-Trigger Capital Ratio of UBS Group to be less than 5.125%; • A Viability Event refers to (1) the FINMA has notified UBS that conversion or write-off of all Basel 3-compliant capital instruments is an essential requirement to prevent the Group Holding Company from becoming insolvent, bankrupt, unable to pay a material part of its debt or ceasing to carry on its business; or (2) the Group Holding Company has received irrevocable commitment of extraordinary support from the public sector without which the Group Holding Company would have become insolvent, bankrupt, unable to pay a material part of its debts as they fall due or unable to carry on its business.
Trigger for Principal Loss Absorption	CET1 + Higher-Trigger <5.125% transitional basis

Source: Prospectuses, Scope Ratings

Historically UBS has not issued a lot of Basel 3-compliant AT1 products as the bank decided to build up its 10% CET1 capital requirement and its 3% buffer requirement exclusively through CET1. As a result, the bank privileged low-trigger Tier 2 issues to the market, and high-trigger Tier 2 issues to employees as part of its compensation program (DCCP). UBS started only recently to issue AT1 notes from the group holding company to both employees (for 2014 compensation) and the market (in February 2015). The AT1 notes rated in this report are also part of the progressive capital component, and therefore they live in the same capital bucket as the Low-Trigger Tier 2 products (all rated A- by Scope Ratings) that the group issued between 2012 and 2014. We note that according to UBS's capital requirements as defined by Swiss regulation, low-trigger loss absorbing capital should represent 5.4% of UBS's Risk Weighted Assets (RWAs) by 2019.

Key risk: coupon cancellation

Coupon payments on the security are fully discretionary and are subject to distribution restrictions.

Additionally, if a coupon is cancelled, UBS Group shall not recommend to ordinary shareholders that any dividend or other distribution in cash or in kind be paid or made on any ordinary shares. Capital returns (such as share buy-backs) are also not possible.

We also note that by virtue of interest payment being non-cumulative, coupon cancellation or non-payment does not constitute a default for any purpose. However, this provision contradicts the "Events of Default" section of the Terms & Conditions (T&C) whereby an event of default will occur if UBS Group fails to make any payment of interest in respect of the Tier 1 Capital Notes. There is probably a difference between a discretionary willingness to cancel the coupon (which is distinct from the coupon payment being prohibited by distribution restrictions) and "classical" default whereby the Issuer does not have the possibility to honour its interest payments. One cancellation is proactive (discretionary coupon cancellation on AT1 instruments) while the other is completely passive (Event of Default) but identifying the difference may be the source of some difficulty for investors.

Moreover, the T&Cs make clear the fact that any default claim with regards to non payment (either interest of principal) would be superseded by the occurrence of a contingent write-down.

Coupon payment: analysing the distribution restrictions

While for many banks in the rest of Europe and in the UK coupon payment is dependent upon the Capital Buffer Requirements as defined by CRD4-CRR, themselves triggering a "Maximum Distributable Amount" that is restricting coupon payment, the restrictions on Tier 1 coupon distribution seem a bit less restrictive in Switzerland. Indeed, in the case of the two securities under consideration, UBS Group is prohibited from making coupon payment in three circumstances.

- First, when UBS Group AG has an amount of distributable items which is less than the sum of (i) the amount of such interest payment plus (ii) all other payments (except redemptions) made by UBS Group AG on the notes and on any parity obligations or junior obligations, plus (iii) all payments payable by UBS Group AG on any parity obligations or junior obligations, excluding any portion of such payments already accounted for in determining the amount of such distributable items. This latter clause enables to avoid double-counting for AT1 coupons already provisioned and paid for – other European banks re-integrate these coupons in their distributable profits.

- Second, when UBS Group AG is not in compliance with all applicable minimum capital adequacy requirements if the bank pays the interest on the notes;
- Third, when FINMA has required the Issuer not to make such interest payment.

We note that under the Swiss Code of Obligations, "distributable profits" refers to the aggregate of net profits carried forward and freely available reserves (other than reserves for own shares) less any amounts that must be contributed to legal reserves under applicable law.

According to the terms and conditions (T&C) of the notes, the distributable items will be calculated based on the non-consolidated audited financial statements of the Issuer in accordance with the Swiss Code of Obligations. Since The Issuer UBS Group AG was only incorporated on 10 June 2014, no Distributable Items will be available until and unless the Issuer's first set of audited financial statements is approved by the annual meeting of shareholders which is scheduled for 7 May 2015.

A quick look at UBS Group AG's parent company 2014 financial statement shows that the holding company reports total shareholders' equity of CHF 37,154m (CHF 37,942m as of Q1 2015). As per UBS's Q4 2014 financial report, "UBS Group AG estimates that the amount of reserves possibly available for distribution to shareholders under Swiss corporate law was approximately CHF 36.7bn" (this number was not updated in the Q1 2015 financial report).

However, considering that UBS Group AG is a brand new company, the bulk of these CHF 36.7bn can only be share premium. Swiss corporate law is quite clear on share premium and we found three documents that confirm the inclusion of share premium in general capital reserves, therefore validating their status as ADI.

- The Directive on the Establishment of Accounts of banks dated 14 December 1994 (and lastly modified on 21 December 2006). The directive specifically includes share premium into capital reserves.
- The Banking Ordinance of 30 April 2014 uses the classification above by separating share capital from "capital reserves" and "earnings reserves" but does not segregate share premium (which is therefore included in the "capital reserves" as per the Directive above).
- The Swiss Code of Obligations is even more explicit as Article 671-2-1 states that "Even after it has reached the statutory level, any share issue proceeds in excess of the nominal value […] must be allocated to the general reserve".

As a result of all the above, we believe that UBS Group AG has ample ADIs to support the estimated cumulative coupons to be paid on all the group's AT1 instruments issued to date (around a maximum of CHF 300m, which we believe is a very small amount to distribute overall).

Even if UBS is not in the strictest sense submitted, like other European banks, to Combined Buffer Requirements to be able to pay interests, the bank must nonetheless abide by the Swiss capital requirements. Systematically important banks in Switzerland benefit from an "ad hoc" supervision with individual requirements. Table 1 summarises the capital requirements for UBS.

Table 1: Swiss capital requirements of UBS Group

	2014	Q1 2015	2015	2016	2017	2018	2019
Combined buffer:							
- Low-trigger capital instruments	2.5%	3.4%	3.4%	4.1%	4.6%	5.1%	5.4%
- High-trigger capital instruments	1.8%	2.3%	2.3%	2.6%	2.9%	3.0%	3.0%
- Countercyclical[1]							
Minimum CET1	6.9%	7.5%	7.4%	8.1%	8.8%	9.4%	10.0%
Capital Adequacy Requirement associated with distribution restrictions	**11.2%**	**13.2%**	**13.1%**	**14.8%**	**16.3%**	**17.5%**	**18.4%**
UBS Transitional CET1 ratio (%)	19.4%	18.6%					13.0% target
CET1 Gap (%)	12.5%	11.1%					3.0%
CET1 Gap (CHF bn)	27.6bn	24.3bn					6.0bn

1) Up to 2.5% of CET1.

Source: Company data, Scope Ratings

Table 1 shows the three layers of capital requirement that UBS Group has to abide by. As far as the low-trigger and high-trigger components are concerned, they reflect issuing potential. As of Q1 2015 (and on a fully applied basis), the low-trigger capital ratio of UBS stood at 5.7%, above its 2019 requirement of 5.4%.

However, the bank still has a lot of issuing capability as far as the High-Trigger component is concerned, since the fully-applied High-Trigger capital ratio stood at 1.2% as of Q1 2015, still leaving UBS with quite a lot of leeway (estimated at around CHF 3.6bn on the basis of 2019 estimated RWAs) to abide by its 2019 capital requirements, and keeping in mind that the High-Trigger requirement is currently filled with CET1.

The CET1 metrics are the most demanding but since UBS's capital requirements are on a transitional basis until 1 January 2019, we do not expect any problem for the bank to abide by these requirements, at least in the short-term. As of YE 2014, the gap between UBS's capital requirements and the bank's transitional CET1 ratio stood at 12.5%, or close to CHF 28bn (the gap stood at CHF 24.3bn as of Q1 2015). In the long-term though, if we compare the long-term CET1 targets of UBS Group with the minimum required CET1 of 10%, the gap narrows considerably to about 3%. Based on the 2016 RWA target of CHF 200bn, the gap would still amount to a very sizeable CHF 6bn. This gap would still represent more than 20x the coupons payable to all current AT1s outstanding.

However, we re-iterate that the T&Cs (and Swiss capital regulation) do base distribution restriction on distributable items (and not on capital buffer requirement).

Key risk: principal loss absorption

The T&Cs of the two securities are very consistent with similar T&Cs published by other Swiss banks on similar products.

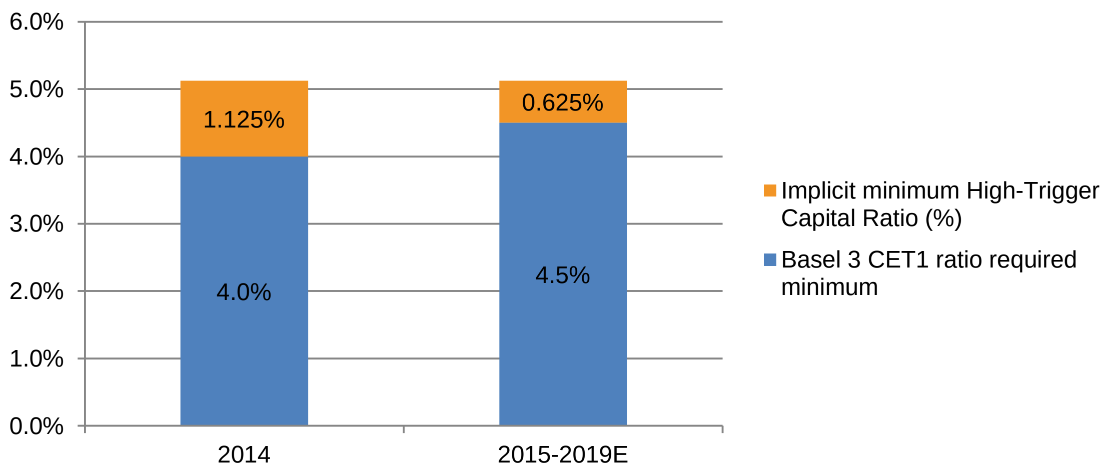
What is more surprising though is to see Swiss G-SIBs continuing to issue very low-trigger loss-absorbing capital instruments with very little chance of being triggered (except in resolution and/or determination by the FINMA that the bank has reached its "point of non-viability" – itself very likely to be above the 5.125% trigger of the two securities being reviewed).

Scope is indeed of the opinion that the permanent write-down risk that is attached to the 5.75% EUR 1bn and the 7.00% USD 1.25bn Tier 1 Capital Notes is of a highly theoretical nature.

The reason for this is that the trigger upon which a permanent write-down occurs is very low in two respects.

- **First, with regards to the definition of the capital metric under which the trigger is measured.** The sum of the CET1 ratio and the Higher-Trigger ratio is highly unusual. This sum must be below 5.125% for the 5.75% EUR 1bn and the 7.00% USD 1.25bn Tier 1 Capital Notes to be permanently written-down. Since UBS Group's minimum transitional CET1 requirement under Basel 3 was 4% in 2014 and must be 4.5% from 2015 onwards, this means by difference that the minimum Higher-Trigger capital ratio for UBS to remain above the trigger defined by the Terms & Conditions (T&C) of the Tier 1 Capital Notes should have been 1.125% in 2014 and should be 0.625% from 2015 onwards (Chart 1).

Chart 1: Estimates of minimum transitional Basel 3 requirements for UBS's CET1 + Higher-Trigger capital ratios 2013-2019 (in %)



Source: Scope ratings, company data

Projecting ourselves from 2015 onwards (when the minimum required CET1 ratio of 4.5% is "fully-loaded"), the sum of CET1 + Higher Trigger Capital means in effect: (1) a CET1 ratio of at least 4.5% and (2) a Higher-Trigger capital ratio of at least 0.625%. This is the only minimum combination of the two metrics that is theoretically possible under Basel 3 regulation. In our view, it is highly unlikely that UBS's supervisor would let the CET1 and Higher Trigger capital ratios of the bank to fall below these levels before intervention. Therefore, we identify UBS Group's Point of Non Viability (PONV) higher than these 4.5%/0.625% thresholds. As a result, bar in resolution, a trigger event for these notes is unlikely.

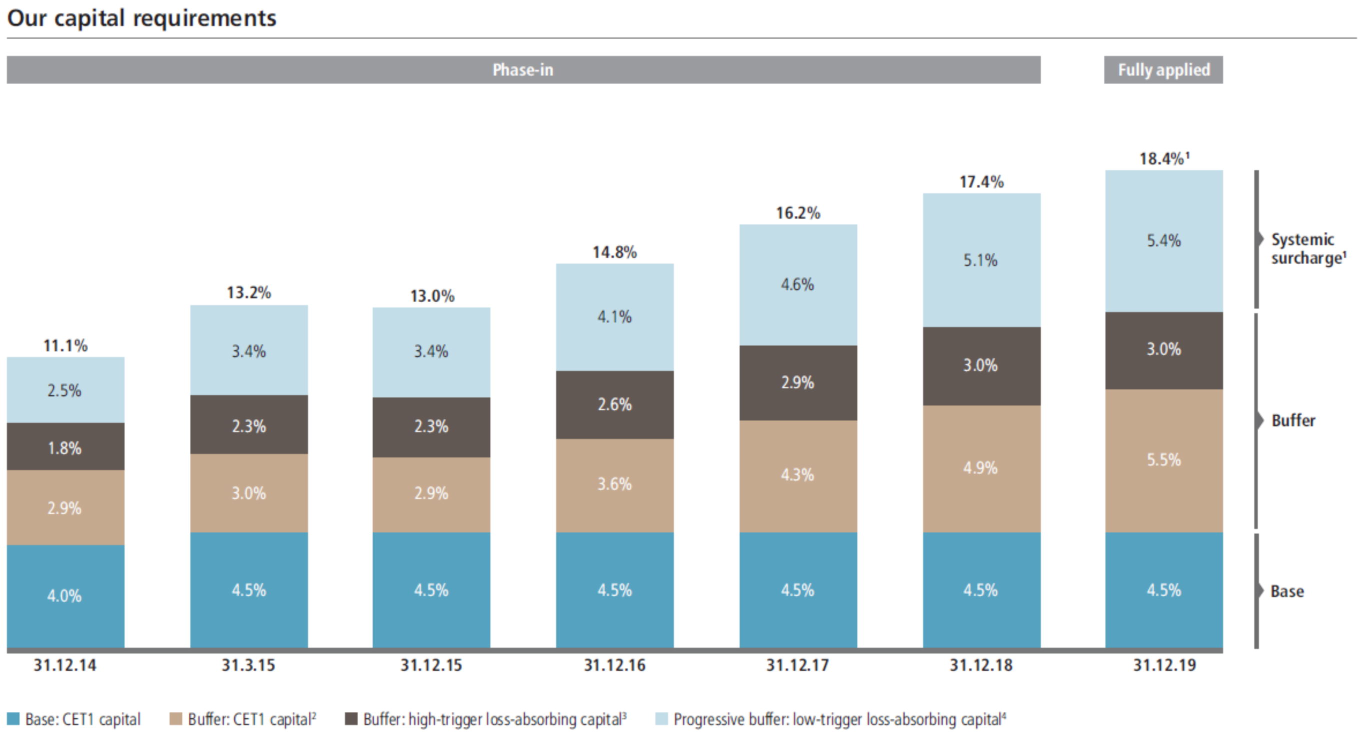
We note that a trigger combining CET1 with Higher-Trigger capital ratio is not presented as such in the sections of the Capital Adequacy Ordinance (CAO) dedicated to the Progressive Capital Component of global systemically important Swiss banks. According to Article 130-2 of the CAO, "The Progressive component must be covered by convertible capital which conversion is triggered at the latest when the CET1 ratio falls below 5%". In the case of the two securities under consideration, the conversion is triggered only when the CET1 ratio **and** the Higher Trigger Capital Ratio fall below 5.125%.

- **Second, with regards to the bank-specific requirements which, in our view, are applicable to these Notes**. Indeed, Swiss supervisors have a more conservative approach of the Basel 3 regulatory framework for systemically-important banks. As a result, the Swiss requirements for Core Equity Tier 1 and the High Trigger capital ratios are significantly higher than the theoretical Basel 3 requirements that was were illustrated in Chart 1. Actually, each global systemically important Swiss bank reports publicly its specific, FINMA-defined, capital requirements. The UBS-specific requirements are illustrated on Chart 2 below.

  On a transitional basis, the minimum CET1 ratio requirement of UBS is never lower than 6.9% from 2014 onwards, while the Higher-Trigger capital ratio is never lower than 1.8%. As a result, UBS is bound, by Swiss regulation, to a transitional CET1 + Higher Trigger capital ratio of at least 8.7% in 2014, 9.7% in 2015, 10.7% in 2016, 11.7% in 2017 and 12.4% in 2018. On a fully phased-basis, the minimum level will be 13% for UBS Group in 2019.

  In light of the numbers shown on Chart 2, an implicit permanent write-down CET1 ratio trigger at 4.5% looks even more highly theoretical (except in resolution).

Chart 2: Estimates of minimum transitional Swiss requirements for UBS's CET1 + Higher-Trigger capital ratios 2013-2019 (in %)



1 The total capital ratio requirement for 2019 would be reduced to 17.5% if the progressive buffer capital requirement is reduced as expected, which would result in a proportional reduction of both requirements during the phase-in period. 2 Includes the effect of the countercyclical buffer requirement for 31 December 2014 and 31 March 2015. Capital requirements for 31 December 2015 to 2019 do not include a countercyclical buffer requirement, as potential future developments cannot be accurately predicted and may vary from period to period. 3 CET1 capital can be substituted by high-trigger loss-absorbing capital up to the stated percentage. 4 Numbers for 31 December 2015 to 2019 are based on latest information available and current supervisory guidance from FINMA. High-trigger loss-absorbing capital qualifies as progressive buffer capital until the end of 2017.

Source: Company data

However, despite the low probability of the Notes being written-down, we note that FINMA has significantly increased authority (or broad statutory powers) in case of resolution proceedings involving banks in Switzerland. This resolution authority includes, among other things, the power to cancel outstanding equity, to convert debt instruments and other liabilities of a bank into equity and to cancel such liabilities fully or partially.

We note that this prerogative of the FINMA limits itself to resolution.

Distance to trigger

Unsurprisingly considering the undemanding trigger of the Notes, we expect UBS Group's CET1 and Higher-Trigger capital ratios to remain largely above the 5.125% trigger level required by the T&C of the Notes – even when the CET1 ratio enters its "fully loaded" definition on January 1, 2019.

Table 2: Distance to Trigger – UBS Group AG

	2013	2014	Q1 2015	2019
Trigger level	5.125%	5.125%	5.125%	5.125%
CET1 + Higher-Trigger Capital (%)	18.9%	19.8%	19.8%	13.0% target[1]
Gap (%)	13.7%	14.7%	14.7%	7.9%
Gap (CHF)	31.3bn	32.5bn	32.2bn	15.8bn based on 200bn RWAs

1) Based on the 13% long-term CET1 target ratio of UBS (the 3% minimum requirement for Higher-Trigger Capital Ratio is assumed already covered by CET1 capital).

Source: Company data, Scope Ratings estimates

There is even a case to say that even if UBS's CET1 target stands at 13% by 2019, adding the higher trigger capital that has been issued to date (CHF 2,620m as of Q1 2015) would lift the 13% target to an "equivalent" CET1 + High Trigger ratio of 14.3%. This admittedly theoretical ratio would raise the 2019 gap to more than 9%, or a very sizeable CHF 18.4bn. This, in our view, amply justifies not adding an extra notch for principal absorption.

Methodologies used for this Report

For the rating and analysis within this report, Scope has used the following methodologies which are published on www.scoperatings.com:

"Bank Capital Instruments Rating Methodology" (September 2014)

"Bank Rating Methodology" (May 2015)

Disclaimer