The Royal Bank of Scotland Group plc Issuer Rating Report

STABLE

A

Overview

Scope rates various entities and securities of the RBS group. The Issuer Rating of The Royal Bank of Scotland Group plc is A. The ratings on the group's senior unsecured MREL debt and AT1 securities are A- and BB, respectively. All ratings have a Stable Outlook.

Scope also assigns an Issuer Rating of A with Stable Outlook to NatWest Holdings Limited, the ring-fenced bank intermediate holding company containing the core retail and commercial banking businesses of the RBS group.

Further, Scope assigns an Issuer Rating of A- to NatWest Markets plc (previously The Royal Bank of Scotland plc). The rating agency also rates the institution's senior unsecured non-MREL debt at A- and short-term debt at S-1. All ratings have a Stable Outlook.

Note: 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.

Highlights

- The Royal Bank of Scotland Group's ratings reflect its strong franchises in UK retail and commercial banking. These core businesses demonstrated resilience throughout the group's restructuring and provide a solid basis for future earnings. After ten years of losses, the group returned to profitability in 2017 and remains focused on improving returns. This will not be straightforward due to ongoing industry changes and the uncertain UK macroenvironment.
- Management has successfully re-focused the group, disposing of non-core assets and businesses as well as foreign franchises. Further, several major legacy issues have been addressed, reducing uncertainty about the group's financial soundness. Prudential metrics are at reassuring levels.
- Meanwhile, the group has spent about GBP 7bn over the last five years on its core systems, non-ring-fenced bank changes, technology transformation and innovation. The investments have resulted in improved operational resilience, and simplified technology platforms and customer journeys as well as reduced costs. Over time, the emphasis has been shifting from mandatory and regulatory investments to more discretionary and strategic spend.
- Due to the group's domestic focus, we cautiously regard the still uncertain consequences of the UK's planned exit from the EU. However, considering the significant steps that have been taken to restructure and de-risk the group, we see RBS being in a much better position to withstand potential headwinds.
- The Issuer Rating of NatWest Markets plc is one notch below that of RBS Group and NatWest Holdings. The rating differential is due to its more markets-focused business profile and potentially lesser significance to the group.

Ratings & Outlook

Issuer Rating	A
Senior unsecured MREL debt rating	A-
Additional Tier 1 securities rating	BB
Senior unsecured non-MREL debt rating (NatWest Markets plc)	A-
Short-term debt rating (NatWest Markets plc)	S-1
Outlook	Stable

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Rating drivers (summary)

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

- Strong UK-focused retail and commercial banking franchise.
- Management's track record in reducing risks and strengthening the group's prudential metrics to reassuring levels.
- Uncertain UK macro environment due to ongoing Brexit discussions.

Rating change drivers

Inability to effectively manage potential consequences stemming from Brexit. The group's profitability continues to strengthen, however, weakness in the UK economy would pose a headwind. In addition, the group is exposed to Ireland where it is a significant market participant through its Ulster Bank subsidiary.

Improved and consistent earnings generation. As legacy issues have largely been addressed, the group is working on improving returns. A sustained improvement in earnings underpinned by a focused strategy would be viewed positively.

Due to challenging market conditions, management recently communicated that the group is unlikely to achieve the target RoTE of more than 12% and a cost income ratio below 50% in 2020. They remain, however, strategic targets for the medium term.

A change in strategy which materially increases the risk profile of the group. Management has clearly acknowledged mistakes made in the past such as aggressive expansion in riskier businesses and various geographies as well as inadequate pricing for credit risks. With the focus now on higher returns, we would consider it negatively if this were achieved by substantially increasing risks.

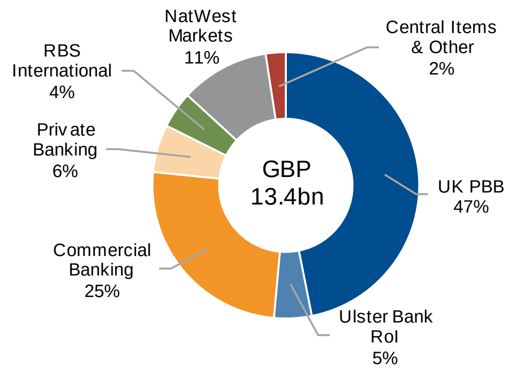
Rating drivers (details)

Strong UK-focused retail and commercial banking franchise

RBS is primarily a UK domestic retail and commercial bank, having materially reduced international operations as well as investment banking activities in the post crisis years. Throughout the group's restructuring, the core UK Personal and Business Banking (UK PBB) and Commercial Banking divisions have demonstrated resilience as evidenced by the positive development in operating profit (Figure 2).

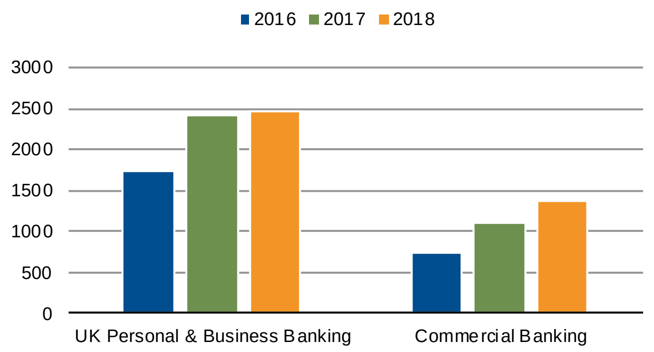
During 1H 2019, management highlighted the hesitancy of large corporate customers to make significant investment decisions in light of Brexit uncertainty, with this reflected in the group's business. Nonetheless, net lending growth across the retail and commercial businesses was 2.5% on an annualised basis, in line with the aim of 2-3% growth for the year.

Figure 1: Income by division, 2018



Source: Company data, Scope Ratings

Figure 2: Operating profit of key divisions (GBP m)



Source: Company data, Scope Ratings

Risk profile of commercial portfolio has improved

RBS is the largest UK commercial bank, serving start-ups to large corporates. In recent years, the group has worked to reduce risks and use capital more efficiently through portfolio sales, securitisation and credit risk insurance. Commercial real estate (CRE) exposures have been reduced by 55% since 2013 (Figure 3). Meanwhile, this has been replaced with exposures to higher returning SMEs and mid-corps and selected large corporates as the group manages concentration and scenario risks.

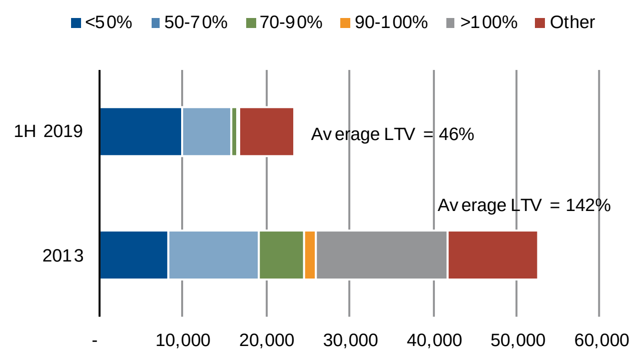
From 1 January 2019, the Business Banking business (start-ups and SMEs with up to GBP 2m turnover) was transferred to the Commercial Banking division from the UK PBB division. At the same time, UK PBB has been renamed UK Personal Banking.

Residential mortgages account for over half of loan book

In the personal market, the group's primary exposure is to mortgages, with limited exposure to unsecured lending (Figure 4). RBS has been growing its mortgage business, with flow share of about 12% while the stock share is approximately 10%. As of 30 June 2019, the average LTV of the portfolio was 57% while on new lending it was 70%. The proportion of interest only mortgages has declined to 17% from 29% in 2013 while buy-to-let mortgages with an average LTV of 54% account for a moderate 11% of the mortgage portfolio.

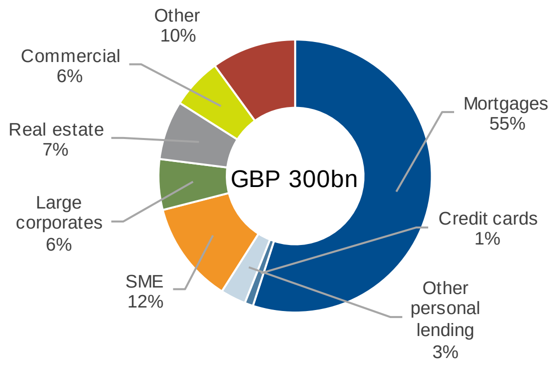
Management has noted that while they are not seeing material changes in the underlying performance of the loan book, they are recognising some signs of strain and single name impairments. As of 30 June 2019, stage 3 loans amounted to GBP 7.3bn, accounting for 2.3% of total loans (2018: 2.7%); of which, GBP 4.1bn were related to the personal portfolio and the remainder to the wholesale portfolio. The loan impairment rate was 21bps during 1H 2019 (1H 2019: 9bps), below the group's expectation of an across the cycle rate of 30-40 bps.

Figure 3: CRE LTVs (2013 vs. 1H 2019)



Note: In 1H 2019, "Other" includes GBP 3.5bn related to business banking, rate risk management products and unsecured corporate lending; and GBP 3.2bn to the development of commercial and residential properties.
Source: Company data, Scope Ratings

Figure 4: Gross loans breakdown, YE 2018



Note: Gross loans at amortised cost.
Source: Company data, Scope Ratings

NatWest Markets, the markets business of the group, provides investment banking services to the group's corporate and institutional clients, focusing on rates, currencies and financing. The business continues to restructure, with the aim of reducing costs and generating returns of 8-10% (2018: operating loss of GBP 70m). As well, the banking license of the Dutch subsidiary, NatWest Markets N.V. has been expanded to serve EEA customers in preparation for the UK's departure from the EU.[1]

IT investments have yielded positive results

Over the last five years, RBS has invested in its technology platforms with a focus on resilience, simplification, more efficient outcomes for customers and employees, and innovation. We note positively the improvement in the group's IT resilience, with the number of technology related "critical 1" incidents (defined as having an adverse impact on customers, employees or third parties) dropping to 13 in 2018 from over 300 in 2014.

Further, the number of IT applications and systems has been reduced to 2,100 from around 5,000 in 2014, with a goal to reach about 1,500. Management states that the group's capabilities have considerably increased while the technology estate has been rationalised. At the same time, ongoing operating technology costs have decreased to GBP 0.9bn in 2018 from over GBP 1.1bn in 2014.

Management's track record in reducing risks and strengthening the group's prudential metrics to reassuring levels

Profitability is improving

Since 2009, management has re-focused the group to become a much simpler and smaller UK-centric bank, disposing of non-core assets and businesses as well as foreign franchises. RBS successfully closed its non-core bank in 2017 and from 2018 stopped reporting its financial performance on an "adjusted basis". After ten years of losses, the group returned to profitability in 2017 although earnings can be improved. Management recently deferred its 12% plus RoTE target to beyond 2020 citing the challenging revenue environment (1H 2019: 7.5% excluding Alawwal related gains).[2]

Financial soundness has materially strengthened as evidenced by the group's capital, liquidity and funding positions. As well, major legacy issues have been resolved reducing uncertainty about the group's financial soundness. These include resolving state aid

[1] In 2H 2019, NatWest Markets N.V. is expected to become a subsidiary of NatWest Markets subject to regulatory approvals.
[2] In June 2019, the merger of Alawwal bank and Saudi British Bank was completed. Previously, RBS held an aggregate 40% stake in Alawwal bank and after the merger now holds a minority equity holding in Saudi British Bank.

obligations, settlements with the US DOJ (USD 4.9bn) and FHFA (USD 4.8bn) relating to US subprime mortgages and addressing the funding deficit in the group's main pension fund.

Conduct costs should be much lower in the future

While outstanding conduct and litigation matters remain, they are of a much smaller magnitude. As of 30 June 2019, the group held provisions of GBP 2.3bn, including GBP 443mm for payment protection insurance (PPI), GBP 419m for other customer redress and GBP 727m for litigation and other regulatory matters (including RMBS). To date, RBS has made provisions totalling GBP 5.3bn for PPI claims and believes that they are currently sufficiently covered as the 31 August 2019 complaint deadline approaches. Management, however, continues to see potential conduct costs coming through and on an ongoing basis earmarks about GBP 200m per annum in conduct costs.

Excess liquidity in place

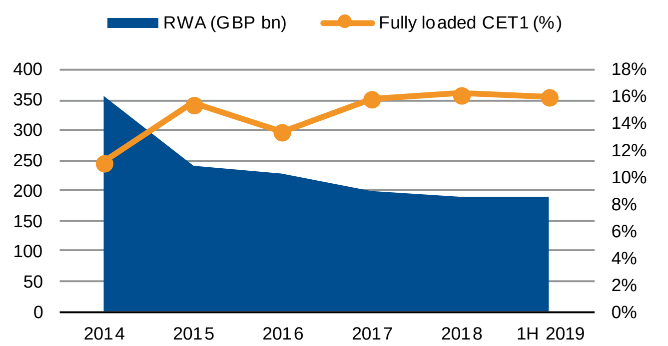
The group's funding profile continues to evolve, reflecting its post ring-fencing structure. Good progress has already been made against the group's 2019 issuance plan, positioning RBS well to adapt issuance as needed during the second half of the year. For example, about GBP 3bn of senior MREL debt has been issued, compared to guidance of GBP 3-5bn and NatWest Markets plc has issued about GBP 3.6bn of senior unsecured debt against guidance of GBP 3-5bn. Due to Brexit uncertainties, RBS intends to maintain excess liquidity. As of 30 June 2019, the group's LCR and NSFR were reassuring at 154% and 140%, respectively.

Well positioned for future MREL requirements

Looking ahead, the group will need to meet estimated loss absorbing capacity requirements of 26.5% (23.2% of MREL plus 3.3% in buffers) in 2022. The corresponding senior unsecured MREL amount would be about GBP 24bn. As of 30 June 2019, the group's holding company had issued GBP 19.2bn in senior unsecured MREL debt, indicating a need for a further GBP 5bn in issuance by 2022. Over the period 2019-2021, approximately GBP 13.5bn of operating company senior debt will come due, providing opportunities to refinance with holding company debt.

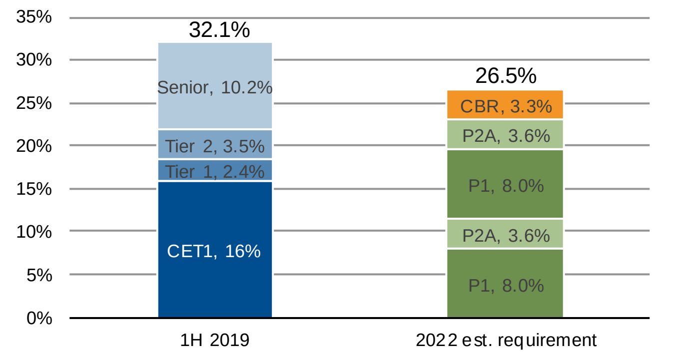
As of 30 June 2019, the group's estimated loss absorbing capacity amounted to more than GBP 60bn, or 32.1% of RWAs on a transitional basis, including GBP 2.3bn in capital instruments issued by operating subsidiaries (Figure 6). Going forward, RBS Group plc will issue external AT1, Tier 2 and MREL securities while the group's subsidiaries will only issue AT1, Tier 2 and MREL internally. In addition, NatWest Bank plc, Ulster Bank Ireland DAC and NatWest Markets plc will issue senior unsecured debt externally.

Figure 5: RWA and CET1 development



Source: Company data, Scope Ratings

Figure 6: Loss absorbing capacity (GBP bn)



Notes: Includes MREL eligible securities issued by operating subsidiaries. P1 = Pillar 1, P2A = Pillar 2A, CBR = combined buffer.
Source: Company data, Scope Ratings

Uncertain UK macro environment due to ongoing Brexit discussions

RBS is now mainly a domestic bank with over 85% of its loan exposure to the UK. Hence, the group's performance is dependent to a large degree on the health of the UK economy. There are still many uncertainties surrounding Brexit, but it is becoming increasingly clear that the UK economy has already suffered, with growth below potential.

Management has acknowledged that income growth will be more challenging in the near term due to the ongoing impact of Brexit uncertainty on the economy, and the associated delays in business borrowing decisions. In 2018, the group made an additional GBP 101m in credit provisions and during 1H 2019, the group increased the weighting of the two combined downside economic scenarios used for determining expected credit loss impairments to 42.4% from 40.2% at YE 2018.

Potential change in policy a risk in light of government's stake

Beyond the issue of whether the UK will leave the EU or not and if so, when and how, the ongoing instability in the UK's political system has particular relevance for RBS due to the government's majority ownership. The HM Treasury's shareholder relationship with the group could change if there were a change in government policy. To date, the commercial decisions of the group have been respected, with the independent board of directors and management team determining its own strategy.

RBS Group’s AT1 securities: key features and risks

We have rated the AT1 securities of RBS Group at BB/Stable.

In accordance with our rating methodology for capital instruments, the starting point for notching down when rating capital instruments is the senior unsecured MREL debt rating of A-. The minimum four notches reflect the deeply subordinated status of AT1 capital instruments in the priority of claims, their going-concern loss-absorbing features and investors’ exposure to coupon-cancellation risks.

The additional notch for these securities reflects the relatively demanding stance of the UK regulator; e.g. requesting 7% fully loaded CET1 triggers on AT1 securities, explicit reference to the conversion of AT1 securities in bank stress tests as needed, and comparatively high Pillar 2 requirements.

Figure 7: RBS Group’s CRD IV compliant AT1 instruments rated by Scope

ISIN	Coupon %	Currency	Issue amount	Issue date	Next call date	Trigger level
US780099CJ48	7.5	USD	2,000	10.08.15	10.08.2020	7%
US780099CK11	8	USD	1,150	10.08.15	10.08.2025	7%
US780097BB64	8.625	USD	2,650	15.08.16	15.08.2021	7%

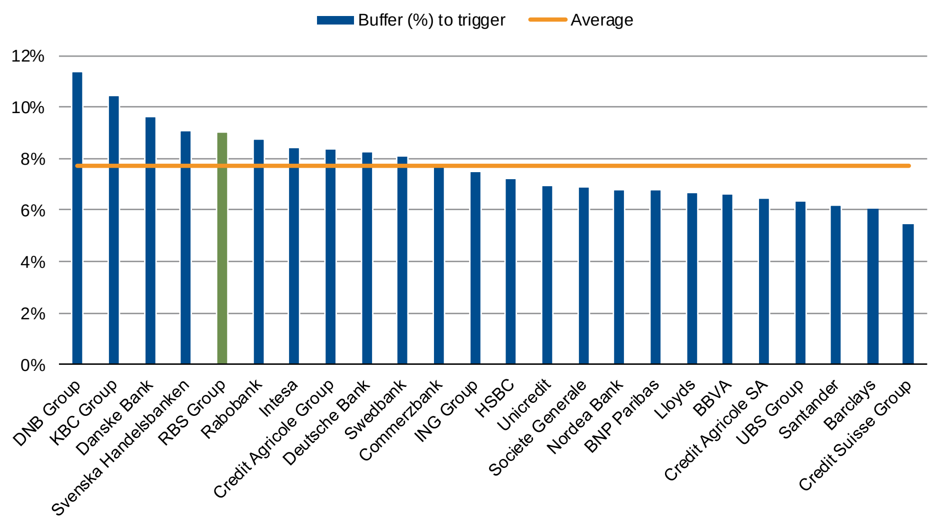
Source: Company data, Scope Ratings

As of 2Q 2019, the group’s CET1 capital ratio was 16%, post interim and special dividends of GBP 1.7bn. Consequently, RBS’s gap to the 7% write-down trigger was 9%, above the average for large European banks (Figure 8).

Meanwhile, the distance to the current MDA trigger of 10.7% was 5.3%, again above the average for large European banks (Figure 9). From 1 January 2020, the group will no longer be subject to a 1% G-SIB buffer. However, the group’s ring-fenced bank sub-group (NatWest Holdings) will be subject to a 1.5% systemic risk buffer, with no material change expected in the group’s overall capital requirements.

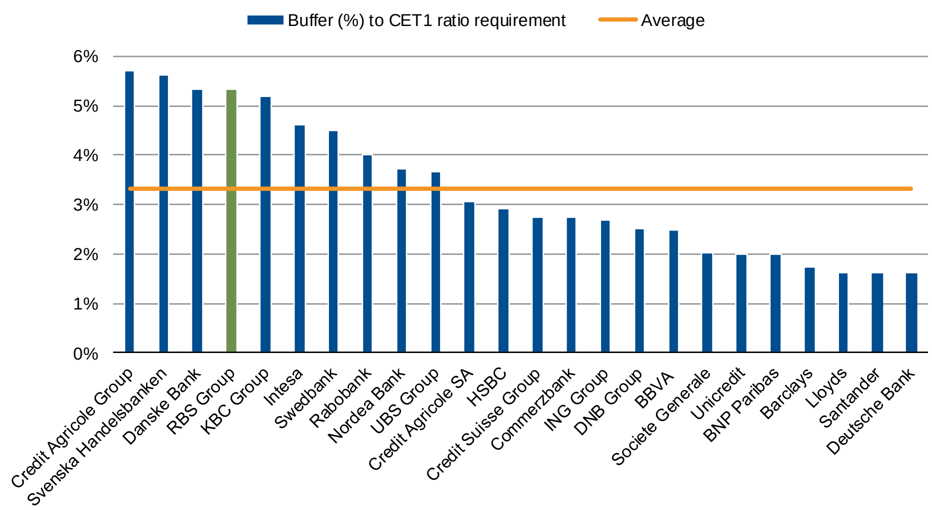
By the end of 2021, management targets a CET1 capital ratio around 14%. At this level of capitalization, RBS should remain solidly positioned against the write-down and MDA triggers.

Figure 8: Buffer to trigger, selected European banks



Note: Data as of 2Q 2019. For banks with securities containing different trigger levels, the highest is used.
Source: Company data, Scope Ratings

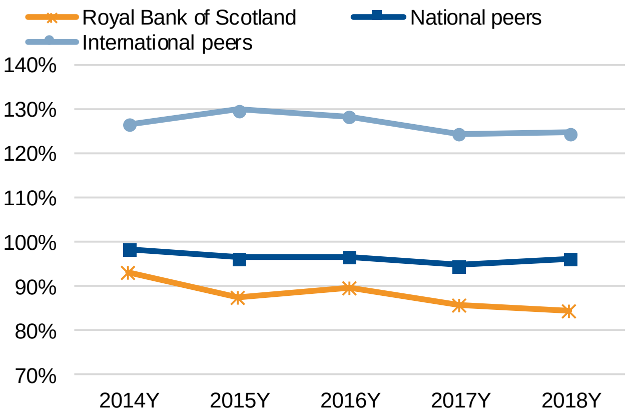
Figure 9: Buffer to MDA level, selected European banks



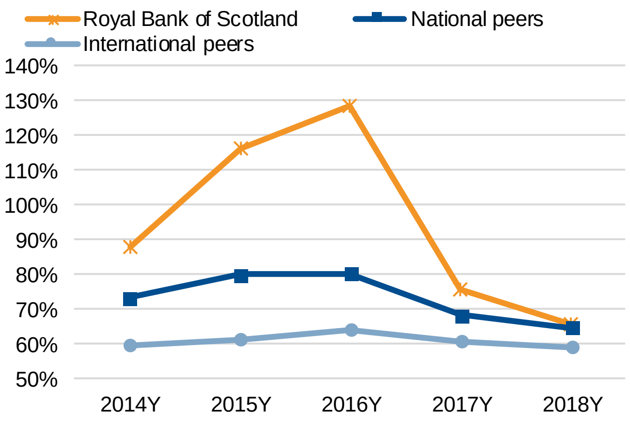
Note: Data as of 2Q 2019.
Source: Company data, Scope Ratings

I. Appendix: Peer comparison

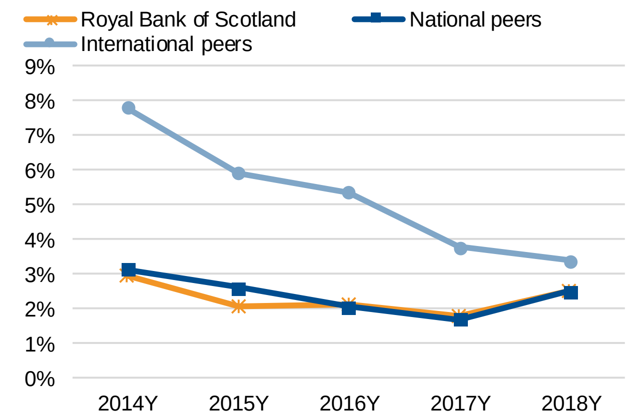
Net amortised loans % Deposits



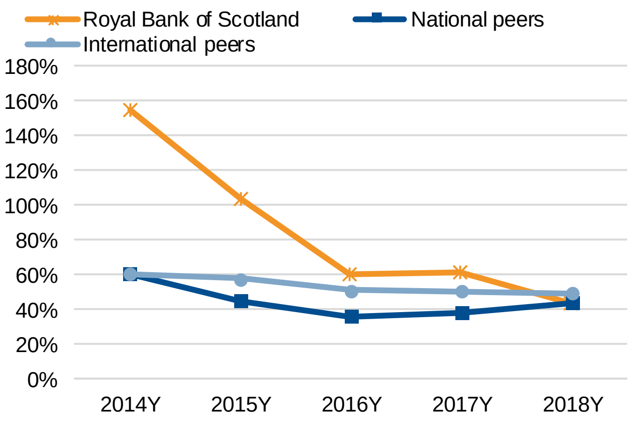
Costs % Income



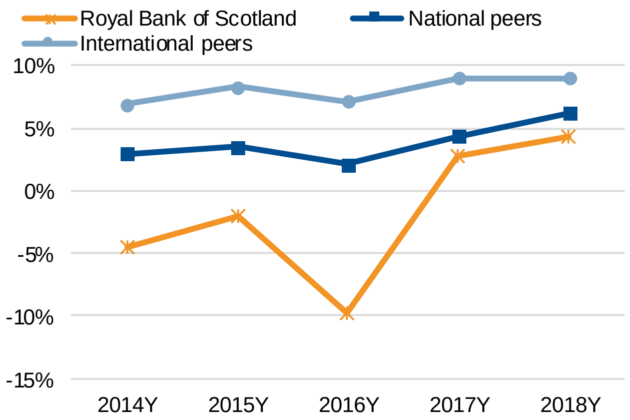
Stage 3 loans % Gross customer loans



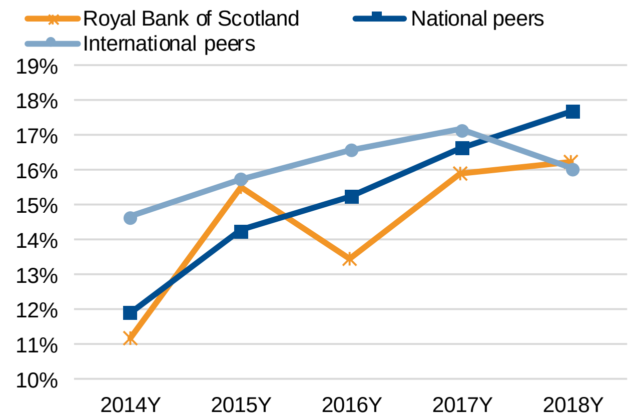
Loan loss reserves % Stage 3 loans



Return on average equity (%)



Common equity tier 1 ratio (%, transitional)



National peers: RBS Group, Lloyds Banking Group, HSBC Holdings, Barclays PLC, Nationwide Building Society.
International peers: RBS Group, BPCE, Credit Agricole, ABN Amro, Rabobank, Intesa, Commerzbank, Danske, CaixaBank, Handelsbanken, SEB, Swedbank, DNB, Bank of Ireland, Allied Irish.
Source: SNL

II. Appendix: Selected Financial Information –The Royal Bank of Scotland Group plc

	2015Y	2016Y	2017Y	2018Y	2019H1
Balance sheet summary (GBP m)					
Assets					
Cash and interbank assets	110,050	104,388	128,588	NA	NA
Total securities	345,972	320,206	240,226	221,946	244,214
of which, derivatives	262,514	246,981	160,843	133,349	145,594
Net loans to customers	333,892	351,950	349,919	NA	NA
Other assets	25,494	22,112	19,323	NA	NA
Total assets	**815,408**	**798,656**	**738,056**	**694,235**	**729,869**
Liabilities					
Interbank liabilities	38,296	38,556	46,898	NA	NA
Senior debt	31,150	27,245	30,559	40,423	47,876
Derivatives	254,705	236,475	154,506	128,897	141,697
Deposits from customers	370,298	380,968	398,036	NA	NA
Subordinated debt	19,847	19,419	12,722	10,535	9,808
Other liabilities	46,965	46,589	46,242	NA	NA
Total liabilities	**761,261**	**749,252**	**688,963**	**647,745**	**683,632**
Ordinary equity	47,480	41,462	41,707	41,182	41,667
Equity hybrids	5,951	7,147	6,623	4,554	4,554
Minority interests	716	795	763	754	16
Total liabilities and equity	**815,408**	**798,656**	**738,056**	**694,235**	**729,869**
Core tier 1/ common equity tier 1 capital	37,630	30,623	31,957	30,639	30,191
Income statement summary (GBP m)					
Net interest income	8,767	8,708	8,987	8,656	4,004
Net fee & commission income	2,933	2,535	2,455	2,357	1,275
Net trading income	928	781	924	1,512	686
Other income	295	292	872	877	162
Operating income	**12,923**	**12,316**	**13,238**	**13,402**	**6,127**
Operating expenses	15,021	15,862	9,996	8,809	3,919
Pre-provision income	**-2,098**	**-3,546**	**3,242**	**4,593**	**2,208**
Credit and other financial impairments	-727	478	493	398	323
Other impairments	1,332	159	29	37	163
Non-recurring items	0	254	481	799	18
Pre-tax profit	**-2,703**	**-4,082**	**2,239**	**3,359**	**2,694**
Discontinued operations	1,541	0	0	0	0
Other after-tax Items	0	0	0	0	0
Income tax expense	23	1,166	824	1,275	194
Net profit attributable to minority interests	409	10	35	-8	260
Net profit attributable to parent	**-1,594**	**-5,258**	**1,380**	**2,092**	**2,240**

Source: SNL

III. Appendix: Selected Financial Information – The Royal Bank of Scotland Group plc

	2015Y	2016Y	2017Y	2018Y	2019H1
Funding and liquidity					
Net loans/ deposits (%)	87.5%	89.6%	85.8%	84.5%	85.9%
Liquidity coverage ratio (%)	136.0%	123.0%	140.3%	157.6%	156.4%
Net stable funding ratio (%)	121.0%	121.0%	132.0%	141.0%	140.0%
Asset mix, quality and growth					
Net loans/ assets (%)	40.9%	44.1%	47.4%	NA	NA
Problem loans/ gross customer loans (%)	2.0%	2.1%	1.8%	2.5%	2.3%
Loan loss reserves/ problem loans (%)	103.4%	60.2%	61.5%	43.6%	45.1%
Net loan growth (%)	-11.7%	5.4%	-0.6%	NA	NA
Problem loans/ tangible equity & reserves (%)	12.6%	15.6%	13.4%	17.8%	17.1%
Asset growth (%)	-22.4%	-2.1%	-7.6%	-5.9%	10.3%
Earnings and profitability					
Net interest margin (%)	2.0%	2.0%	1.9%	NA	NA
Net interest income/ average RWAs (%)	2.7%	3.6%	4.2%	4.4%	4.2%
Net interest income/ operating income (%)	67.8%	70.7%	67.9%	64.6%	65.4%
Net fees & commissions/ operating income (%)	22.7%	20.6%	18.5%	17.6%	20.8%
Cost/ income ratio (%)	116.2%	128.8%	75.5%	65.7%	64.0%
Operating expenses/ average RWAs (%)	4.7%	6.6%	4.6%	4.5%	4.1%
Pre-impairment operating profit/ average RWAs (%)	-0.7%	-1.5%	1.5%	2.3%	2.3%
Impairment on financial assets / pre-impairment income (%)	NM	NM	15.2%	8.7%	14.6%
Loan loss provision/ average gross loans (%)	-0.2%	0.2%	0.1%	0.1%	0.2%
Pre-tax profit/ average RWAs (%)	-0.8%	-1.7%	1.0%	1.7%	2.8%
Return on average assets (%)	-0.1%	-0.6%	0.2%	0.3%	0.7%
Return on average RWAs (%)	-0.4%	-2.2%	0.7%	1.1%	2.6%
Return on average equity (%)	-2.0%	-9.8%	2.9%	4.3%	10.7%
Capital and risk protection					
Common equity tier 1 ratio (%, fully loaded)	15.5%	13.4%	15.9%	16.2%	16.0%
Common equity tier 1 ratio (%, transitional)	15.5%	13.4%	15.9%	16.2%	16.0%
Tier 1 capital ratio (%, transitional)	19.1%	17.7%	19.7%	19.2%	19.0%
Total capital ratio (%, transitional)	24.7%	22.9%	23.9%	23.4%	22.5%
Leverage ratio (%)	5.6%	5.1%	5.3%	5.4%	5.2%
Asset risk intensity (RWAs/ total assets, %)	29.8%	28.6%	27.2%	27.2%	25.8%
Market indicators					
Price/ book (x)	0.9x	0.8x	0.9x	0.8x	0.8x
Price/ tangible book (x)	0.9x	0.8x	0.9x	0.8x	0.8x
Dividend payout ratio (%)	NM	NM	0.0%	100.0%	NA

Source: SNL

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