Financial Institutions Ratings
Swedbank AB – AT1 rating report

Security ratings

Outlook	Stable
5.5% USD 750m perpetual fixed rate reset AT1 convertible notes (Feb-2015)	BB+
6.0% USD 500m perpetual fixed rate reset AT1 convertible notes (Dec-2016)	BB+

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

Rating rationale

Scope rates Swedbank's above-referenced Additional Tier 1 securities BB+, with Stable Outlook.

The ratings are based on the following considerations:

- Senior unsecured debt rating: A, Stable outlook
- Minimum notches down from senior unsecured debt rating: 4
- Additional notches: 1

In accordance with our rating methodology, the starting point for notching down when rating capital instruments is the senior unsecured debt rating rather than the Issuer Rating. Please refer to Scope's *Bank Capital Instruments Rating Methodology* published in May 2018 for more details.

The minimum 4 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 following considerations:

- The presence of a double trigger, of which the one based on group CET1 is a high trigger of 8%
- The very low asset risk intensity of Swedbank's balance sheet, which could add volatility to the capital ratios.

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The release of this rating report does not constitute a rating action. Last rating action was assigned on 24 May 2018. For further information on the last rating action and regulatory information please click here.

Issuer credit profile

Swedbank has an Issuer Rating of A+, with a Stable outlook. Swedbank's ratings reflect the bank's strong and low-risk franchise in Sweden, enjoying a low level of both impaired loans and credit impairment charges.

Swedbank is Sweden's largest mortgage lender, with a 23% market share, and one of the country's leading banks. It is also the market leader in the Baltic states. It has a very strong capital position and minimal problem assets, as well as a high level of profitability, supported by strong cost efficiency. The long-term ratings also reflect a degree of caution about Swedbank's reliance on the real estate sector in Sweden for revenue and balance-sheet growth.

Like other Swedish banks, Swedbank depends on wholesale markets and corporate deposits for a considerable proportion of its funding. This is mitigated by access to the stable and well-tested covered bond market in Sweden, accounting for nearly one third of Swedbank's funding.

Summary terms

Issuer	Swedbank AB
Issue Date	**19 February 2015**
Amount	USD 750m
Coupon	• Paid semi-annually (17/9 and 17/3) • 5.5% from 09/2015 to 03/2020 • then: 5 year US Mid-Swap Rate + Margin (3.767%)
Format	• Perpetual Non-Call Additional Tier 1 Notes • Redeemable by the issuer on first reset date (17 March 2020) and every five years thereafter, subject to regulator's approval. • Redeemable upon occurrence of Tax Event or Capital Event, subject to regulator's approval
ISIN	XS1190655776

Issuer	Swedbank AB
Issue Date	**16 December 2016**
Amount	USD 500m
Coupon	• Paid semi-annually (17/3 and 17/9) • 6.0% from 03/2017 to 03/2022 • then: 5 year US Mid-Swap Rate + Margin (4.106%)
Format	• Perpetual Non-Call Additional Tier 1 Notes • Redeemable by the issuer on first reset date (17 March 2022) and every five years thereafter, subject to regulator's approval. • Redeemable upon occurrence of Tax Event or Capital Event, subject to regulator's approval
ISIN	XS1535953134

Main Risks	
Coupon Cancellation	• Fully discretionary • Mandatory in case of: (i) lack of available distributable items (ADI) (ii) subject to Maximum Distributable Amount (MDA) upon Combined Buffer Requirement breach (iii) request from the supervisory authority
Principal Loss Absorption	Conversion to Equity: • Upon occurrence of a trigger event, due to a CET1 breach, in the case of the Issuer of 5.125% or in the case of the Group 8.00%. • By the supervisory authority at the point of non-viability
Trigger for Principal Loss Absorption	• 5.125% in relation to the CET1 Ratio of the Issuer on a solo basis and • 8% in relation to the CET1 Ratio of the Group on a consolidated basis.

Source: Prospectuses, Scope Ratings

Key risks

A. Coupon cancellation

Key risk: Coupon cancellation

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

Available distributable Items

The concept of Available Distributable Items (ADI) is defined in the CRR (Art.4.1-128) as "the amount of the profits at the end of the last financial year plus any profits brought forward and reserves available for that purpose before distributions to holders of own funds instruments less any losses brought forward, profits which are non-distributable pursuant to provisions in legislation or the institution's by-laws and sums placed to non-distributable reserves in accordance with applicable national law or the statuses of the institution, those losses and reserves being determined on the basis of the individual accounts of the institution and not on the basis of the consolidated accounts".

We do not expect lack of distributable items to be a limiting factor in the payment of coupons for Swedbank. Swedbank's position is very comfortable regarding payment of annual coupons on the AT1 notes. As of 1Q18 the bank disclosed ADI of SEK 46.9bn (YE17: SEK 56.3bn, before dividends). ADI comprise retained earnings (72% of the total), plus the share premium reserve.

Combined buffer requirement (CBR) and CET1 total requirement

For Swedish banks we need to consider both the current position with regard to capital requirements and the capital calculation, and the likely position going forward, given that the Swedish regulator (FSA) is proposing, as of 31 December 2018, to apply a hard Pillar 1 requirement for Swedish residential mortgages under the provisions of Article 458 of the Capital Requirements Regulation (CRR). This allows a competent home supervisory authority to apply risk-weight measures relating to assessed systemic or macro-prudential risks.

Scope expects the proposal to go ahead as specified. The Pillar 1 requirement will replace the current arrangement. At present the FSA imposes, through Pillar 2 guidance, a risk-weight floor of 25% for Swedish mortgages. This applies on a consolidated basis to Swedish banks which use the IRB approach to calculate residential mortgage exposures.

In Sweden the Pillar 2 add-on is not considered a hard requirement until a formal decision is taken and is rather “strict guidance”. As such, it does not currently affect MDA calculations for Swedbank. The FSA has in the past indicated that it does not intend, in normal circumstances, to take such a formal decision.

The new proposal – which materially reduces the Pillar 2 ‘hard guidance’ for Swedbank – is calibrated such that total capital requirements will remain neutral in absolute terms. Thus, Swedish banks will not be asked to hold additional capital but will also not be expected to reduce current nominal capital. However, reported capital ratios will decrease. In effect the measure is expected to make Swedish banks’ capital calculations more closely comparable to those of most European peers.

It follows that the metrics that most investors in AT1 instruments focus on – the distance to the CBR and CET1 capital requirements and the distance to trigger – will also decrease, both as a percentage of risk-weighted assets (RWAs) and in nominal terms. This is because the denominator in the capital ratio -- i.e. the risk exposure amount (REA) – will rise as a result of an effective increase in risk weights on Swedish residential mortgages. As noted above, historically this has been captured via Pillar 2, but in future a more onerous risk weight floor will be applied through Pillar 1 instead.

In reality, the anticipated fall in reported total capital ratios is a technical effect and does not imply an overall weakening of Swedish banks’ solvency positions. Risk asset intensity ratios, which are currently considered low compared to many international peers (Swedbank’s was 18.5% at YE17), will increase.

The Swedish FSA has provided some estimates of the impact of the new measures on banks’ total reported capital ratios. Based on these, which rely on 4Q17 numbers, we estimate that Swedbank’s headline CET1 ratio will fall by around 790 bps.

Currently, based on the FSA’s quarterly Capital Requirements Memorandum, the capital requirement relevant for Swedbank’s MDA calculation stood at 11.3% at YE17 and 1Q18. This encompassed:

- A minimum Pillar 1 CET1 requirement of 4.5%,
- A capital conservation buffer of 2.5%,
- A Pillar 1 systemic risk buffer of 3%, and
- A countercyclical buffer for Swedish exposures of 1.3%.

These requirements are not expected to change.

On top of the Pillar 1 combined buffer requirement, we calculate Swedbank’s additional CET1 requirement guidance under Pillar 2 at 10.6% based on the 1Q18 FSA Capital Requirements Memorandum. This includes a 1.7% individual requirement, 2% systemic risk buffer, and 6.9% for the 25% risk weight floor imposed for Swedish mortgages. Under the new proposal the latter is expected to disappear.

Including the Pillar 2 add-on, Swedbank’s CET1 minimum capital requirement guidance stood at 22.0% based on the FSA memorandum at the end of March 2018. Under the new proposal (as of YE17) we estimate that this would fall to around 15.3%.

Table 1: Combined buffer requirements

	2016	2017	Q4 2017 Estimate under Article 458	Q1 2018
Required CET1 associated with distribution restrictions under Pilar 1:	**11.0%**	**11.3%**	**11.3%**	**11.3%**
Combined buffer (CBR)				
- Capital conservation	2.5%	2.5%	2.5%	2.5%
- Systemic	3.0%	3.0%	3.0%	3.0%
- Countercyclical	1.0%	1.3%	1.3%	1.3%
Pillar 1 CET1 requirement	4.5%	4.5%	4.5%	4.5%
Pillar 2 CET1 guidance including systemic risk buffer (not included in MDA calculation)	10.3%	10.6%	4.0%	10.6%
CET1 Capital Requirement and hard guidance (incl. Pillar 2)	21.3%	21.9%	15.3%	21.9%
Swedbank Group CET1, fully loaded (SEK bn)	98.7	100.5	100.5	101.9
Swedbank Group CET1, fully loaded (%)	25.0%	24.6%	16.7%	24.8%
Distance to CET1 requirement incl. CBR (%)	**14.0%**	**13.3%**	**5.4%**	**13.5%**
Distance to CET1 requirement incl. CBR (SEK bn)	**55.2**	**54.3**	**29.3**	**55.5**
RWAs (SEK bn)	394	408	542	411

Source: Company data, Scope Ratings

Swedbank's CET1 ratio as of 1Q18 was 24.8%. This offers ample distance both to the Pillar 1 Combined Buffer Requirement and also to the total CET1 requirement, including Pillar 2 elements, which are not relevant to the MDA trigger level calculation. We note that in Sweden, the current Pillar 2 add-on is not considered a hard requirement until a formal decision is taken, and is rather a "strict guidance".

Under the expected new measures, we estimate Swedbank's CET1 ratio as of 31 December 2017 would be 16.7%. This reduces the distance to the CET1 requirement including the Combined Buffer Requirement to 5.4%, which is materially lower, but still well in line with many European peers. The estimated increase in RWA is by almost one third, reflecting Swedbank's position as Sweden's largest mortgage lender (see Table 1).

Swedbank has indicated it will maintain a management buffer over the CET1 requirement in order to have operational flexibility. This has been increasing in recent quarters and stood at 280 bps at 1Q18 (1Q17: 250 bps). Swedbank has not indicated any intention to change the level of the management buffer.

As an additional consideration, we highlight that, as for all international banks, Swedish banks will become subject to the 72.5 % capital 'input floor' agreed by the BIS, limiting the differences between risk weights used under internal models and those imposed under the standardized approach. In the near term we expect the negative impact on the banks' capital ratios will be limited, as the measure will not be fully implemented until 2027. Ultimately although average risk weights are likely to rise, we also expect the related Pillar 2 capital requirements to be dropped as a result.

B. Principal loss absorption

Key risk: Principal loss absorption

The mechanism for loss absorption is equity conversion.

The rated securities have two triggers:

- 5.125% based on Swedbank AB parent company accounts
- 8% based on Swedbank's group consolidated accounts

In our view, the consolidated 8% trigger is the main loss-absorption feature of the rated securities. In order for the 5.125% trigger to gain relevance, the following scenarios would need to materialise at the same time:

- A material divergence in the profitability trends of Swedbank AB and its main subsidiaries (Swedbank Mortgage, Baltics, and Asset Management companies)
- Ring-fencing of capital in the main subsidiaries of Swedbank, so that dividends cannot be upstreamed.

We deem the above unlikely: First, we note that most of the operations of the Swedbank group are in Sweden, and that the framework for cooperation in crisis situations between authorities in the Nordic region, including the Baltics, is quite strong, with an established Cross Border Stability Group. Within Sweden, BRRD already shelters covered bonds from resolution, which reduces the risk of Swedbank Hypotek being prohibited from upstreaming dividends. As such, we base our analysis of principal loss absorption on our consolidated estimates for capital and on the group-based trigger. At YE17 the CET1 ratio of Swedbank AB (parent company) stood at 25.2%.

Distance to trigger

The distance-to-trigger for the rated securities stood at 16.6% at YE17 and 16.8% at 1Q18. We view this as ample, although we note that 8.0% is to be considered a high trigger – even in the context of current high Swedish capital requirements and low asset risk intensity.

The distance to trigger under the FSA's new proposals would decline in both percentage and nominal terms (see Table 2), to around 8.7% of RWAs, based on 4Q17 numbers. While the amount involved is sizeable, we continue to view the distance to trigger as being ample, especially when comparing Swedbank to other European bank peers.

Table 2: Distance to trigger

	2016	2017	Q4 2017 Estimate under Article 458	Q1 2018
Trigger level	8.0%	8.0%	8.0%	8.0%
Swedbank Group CET1, fully loaded (SEK bn)	98.7	100.5	100.5	101.9
Swedbank Group, CET1, Fully loaded (%)	25.0%	24.6%	16.7%	24.8%
Distance to trigger (%)	**17.0%**	**16.6%**	**8.7%**	**16.8%**
Distance to trigger (SEK bn)	**67.0**	**67.8**	**47.2**	**69.0**

Source: Company data, Scope Ratings

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