Financial Institutions Ratings
The Royal Bank of Scotland Group PLC – AT1 rating report

Security ratings

Outlook	Review Positive
7.5% USD 2bn perpetual subordinated contingent convertible AT1 capital notes	B+
8% USD 1.15bn perpetual subordinated contingent convertible AT1 capital notes	B+
8.625% USD 2.65bn perpetual subordinated contingent convertible AT1 capital notes	B+

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

Rating rationale

Scope Ratings assigns a rating of B+, Review Positive to the above referenced perpetual subordinated contingent convertible AT1 capital notes issued by The Royal Bank of Scotland Group PLC. The ratings are based on the following considerations:

- Senior unsecured debt rating (MREL/TLAC eligible): BBB+, Review Positive
- Minimum notches down from senior unsecured debt rating: 4
- Additional notches: 2

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

The two additional notches for these securities reflect several factors, including important conduct and litigation costs, the inclusion of a notch of support in the senior unsecured debt rating due to the UK government's majority ownership and the relatively demanding stance of the UK regulator. The rating on the AT1 securities as well as the long-term ratings of various RBS group entities are currently under review for possible upgrade. As part of the review, Scope will assess whether the two additional notches are still warranted.

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.

Lead Analyst
Pauline Lambert
p.lambert@scoperatings.com

Associate Analyst
Alvaro Dominguez Alcalde
a.dominguez@scoperatings.com

Team Leader
Sam Theodore
s.theodore@scoperatings.com

Scope Ratings GmbH
Suite 301
2 Angel Square
London EC1V 1NY

Phone +44 20 3457 0452

Headquarters
Lennéstraße 5
10785 Berlin

Phone +49 30 27891 0
Fax +49 30 27891 100

info@scoperatings.com
www.scoperatings.com

Bloomberg: SCOP

Issuer credit profile

On 24 May 2018, Scope placed on review for possible upgrade the long-term ratings of various RBS group entities. The Issuer Rating of A- reflects the group's strong and resilient UK retail and corporate franchise as well as the progress in restructuring which has yet to translate into reliable and sustainable earnings. Potential conduct-related costs and resolving state-aid obligations were also important issues for the group's financial soundness.

There has now been a visible and reassuring improvement in prudential and conduct risk fundamentals, as well as a return to profitability. The review will focus on the sustainability and further upward trajectory of these fundamental improvements.

The Issuer Rating of A- and senior debt ratings (but not the rating for AT1 securities) incorporate a one-notch uplift due to majority ownership by the UK government. As part of the review, Scope will assess whether this rating uplift is still warranted, given the UK government's medium-term plan to gradually exit its ownership in RBS.

Summary terms

Issuer	The Royal Bank of Scotland Group PLC
Issue Date	**August 2015**
Amount	USD 2bn
Coupon	• 7.50% fixed until first call date, reset every 5 years thereafter • From first call date at Mid-Market Swap rate plus 5.8% • Payable quarterly in arrear
Format	• Perpetual subordinated contingent convertible AT1 capital notes, callable August 2020 and every five years thereafter
ISIN	US780099CJ48

Issue Date	August 2015
Amount	USD 1.15bn
Coupon	• 8.0% fixed until first call date, reset every 5 years thereafter • From first call date at Mid-Market Swap rate plus 5.72% • Payable quarterly in arrear
Format	• Perpetual subordinated contingent convertible AT1 capital notes, callable August 2025 and every five years thereafter
ISIN	US780099CK11

Issue Date	August 2016
Amount	USD 2.65bn
Coupon	• 8.625% fixed until first call date, reset every 5 years thereafter • From first call date at Mid-Market Swap rate plus 7.598% • Payable quarterly in arrear
Format	Perpetual subordinated contingent convertible AT1 capital notes, callable August 2021 and every five years thereafter
ISIN	US780097BB64

Main Risks	
Coupon Cancellation	• Fully discretionary • Agreement with interest cancellation • Mandatory if there are insufficient distributable items to pay coupons on these securities, parity securities and any junior securities or the solvency condition is not satisfied in respect of such coupon payment
Principal Loss Absorption	• Automatic and full conversion into ordinary shares upon trigger breach at conversion price • Agreement with automatic conversion and exercise of UK bail-in power • Write-down, cancellation or conversion stemming from the UK regulatory authority's power to bail-in or write-down and convert capital instruments
Trigger for Principal Loss Absorption	• Consolidated group CET1 ratio < 7% on fully loaded basis

Source: Prospectuses, Scope Ratings

Key risks

A. Coupon cancellation

Key risk: Coupon cancellation

Coupon payments are fully discretionary and are subject to distribution restrictions

Coupons are mandatorily cancelled if there are insufficient distributable items (based on issuer accounts on an unconsolidated basis) to pay coupons on these securities, parity securities and any junior securities. In June 2017, the group completed a capital re-organisation (transfer of amounts in the share premium account and capital redemption reserve to retained earnings) which increased distributable reserves by over GBP 30bn. As of end-2017, RBS Group PLC had a reassuring GBP 38bn in distributable reserves.

The issuer must also remain solvent immediately after making payments related to the AT1 securities. The issuer is considered solvent if it can pay debts owed to senior creditors as they fall due and if the value of its assets is at least equal to the value of its liabilities.

Combined buffer requirement (CBR)

Article 141 of CRD IV imposes certain restrictions on discretionary distributions (dividends, variable remuneration and payments on AT1 securities) when the combined buffer requirement (CBR) is not met. The CBR is comprised of the capital conservation buffer, the countercyclical buffer and systemic risk buffers as applicable.

To determine whether the maximum distributable amount (MDA) needs to be calculated a bank should meet both Pillar and Pillar 2 requirements as well as the CBR. For UK banks, Pillar 2 requirements are referred to as Pillar 2A requirements. At least 56% of the requirement must be met with CET1 capital and no more than 25% with Tier 2 capital. We note that the Pillar 2 requirements of UK banks are often higher than those of ECB-supervised banks, even when comparing only the CET1 component.

For 2018, RBS's Pillar 2A requirement is 3.8%, of which at least 2.1% should be met with CET1 capital.

RBS's combined buffer is comprised of the 2.5% capital conservation buffer and a 1% global systemically important bank (G-SIB) buffer, both of which are being phased-in between 2016 and 2019. In addition, since June 2018, RBS has been subject to a countercyclical buffer for UK exposures. From November 2018, the UK countercyclical buffer rate is expected to increase to 1% from 0.5%.

By 2019, we estimate that RBS will need to maintain a CET1 ratio above 11%, a Tier 1 capital ratio greater than 13% and a total capital ratio of more than 16% to avoid distribution restrictions on its AT1 securities (Table 1). This assumes that various components of the combined buffer as well as the Pillar 2A requirement do not change.

Table 1: Estimated capital requirements

	2017	Q1 2018	2019
Required CET1 associated with distribution restrictions:	**8.4%**	**10.2%**	**11.1%**
Combined buffer (CBR)			
- Capital conservation	1.25%	1.88%	2.50%
- Systemic	0.50%	0.75%	1.00%
- Countercyclical	0.00%	1.00%	1.00%
Pillar 2A CET1 requirement	2.10%	2.10%	2.10%
Pillar 1 CET1 requirement	4.50%	4.50%	4.50%
RBS Group CET1, fully loaded (%)	15.9%	15.1%	>13% target
Distance to CET1 requirement incl. CBR (%)	**7.6%**	**6.2%**	
Distance to CET1 requirement incl. CBR (EUR bn)	**15.2**	**12.6**	
RBS Group Tier 1, fully loaded (%)	17.9%	18.4%	
Required Tier 1 incl. CBR (%)	10.6%	12.5%	13.4%
Distance to Tier 1 requirement incl. CBR (%)	**7.3%**	**6.0%**	
RBS Group total capital, fully loaded (%)	21.3%	21.6%	
Required total capital, incl. CBR (%)	13.6%	15.5%	16.4%
Distance to total capital requirement incl. CBR (%)	**7.7%**	**6.1%**	
RWAs (GBP bn)	201	203	

Notes: Estimated countercyclical buffer is based on 1% countercyclical buffer rate for the UK. RBS Group's capital figures for Q1 2018 are proforma the RMBS settlement and the accelerated pension deficit payments (~130 bps impact on CET1).
Source: Company data, Scope Ratings

Under the Bank of England 2016 stress test (based on end-2015 balance sheet), RBS met its CET1 ratio hurdle rate of 6.6% only after management actions and the conversion of GBP 2bn in AT1 securities which were outstanding in 2015. The group has since taken steps to significantly reduce uncertainty around its capital position – in particular, resolving state aid obligations, settling legacy conduct issues and addressing a pension deficit.

As of Q1 2018, RBS' fully loaded CET1 ratio was 16.4%. Proforma the impact of the USD 4.9bn US RMBS settlement and a GBP 2bn accelerated pension deficit payment, the group's CET1 ratio would be 15.1%. The resolution of several major legacy issues combined with the strengthening of the group's earnings should support the headroom to requirements going forward. RBS continues to target a CET1 ratio above 13%.

During the years 2016-2018, RBS raised approximately GBP 300m of new ordinary shares to partially offset the impact coupon and dividend payments on CET1 capital. It is our understanding that the group will continue to do so until the PRA gives approval to discontinue.

B. Principal loss absorption

Key risk: Principal loss absorption

The mechanism for loss absorption is full conversion into shares.	The securities have one trigger: • Consolidated group CET1 ratio < 7% on fully loaded basis.

Under the terms of the securities, investors acknowledge and agree to automatic conversion and to any exercise of UK bail-in power. The UK regulatory authority has broad powers and can write-down or convert the securities when the group is considered no longer viable. The bail-in tool can also be used when the group is under resolution.

Distance to trigger

As of 31 March 2018, RBS' fully loaded CET1 ratio was 16.4% or 15.1% proforma the US RMBS settlement and the pension deficit payment, well above the 7% trigger level in the securities. We expect the headroom to the trigger level to remain solid considering the greater than 13% CET1 target and the improved clarity regarding the group's capital position.

Table 2: Distance to trigger

	2017	Q1 2018	2019
Trigger level	7.0%	7.0%	7.0%
RBS Group CET1, fully loaded (%)	15.9%	16.4%	>13% target
Distance to trigger (%)	**8.9%**	**9.4%**	
Distance to trigger (GBP bn)	**17.9**	**19.1**	

Source: Company data, Scope Ratings

Scope Ratings GmbH

Headquarters Berlin
Lennéstraße 5
D-10785 Berlin

Phone +49 30 27891 0

Frankfurt am Main
Neue Mainzer Straße 66-68
D-60311 Frankfurt am Main

Phone +49 69 66 77 389-0

Paris
33 rue La Fayette
F-75009 Paris

Phone +33 1 82885557

London
Suite 301
2 Angel Square
London EC1V 1NY

Phone +44 203-457 0 4444

Madrid
Paseo de la Castellana 95
Edificio Torre Europa
E-28046 Madrid

Phone +34 914 186 973

Milan
Via Paleocapa 7
IT-20121 Milan

Phone +39 02 30315 814

Oslo
Haakon VII's gate 6
N-0161 Oslo

Phone +47 21 62 31 42

info@scoperatings.com
www.scoperatings.com

Disclaimer