Financial Institutions Ratings Svenska Handelsbanken AB – AT1 rating report

Security ratings

Outlook	Stable
5.25% USD 1.2bn perpetual AT1 notes (Feb 2015) temporary write-down	BB+

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

Rating rationale

Scope rates Handelsbanken's Additional Tier 1 notes issued in February 2015 at BB+, with a Stable Outlook. The rating is based on the following considerations:

- Senior unsecured debt (eligible for MREL): A, stable outlook
- Minimum notches down from the senior unsecured debt rating: 4
- Additional notches: 1

Please refer to Scope's Bank Capital Instruments Rating Methodology published in May 2018 for more details. 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. 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 low average risk intensity of Handelsbanken's balance sheet, which may cause volatility in the bank's capital ratios.

The release of this rating report does not constitute a rating action. Last rating action was assigned on 17 May 2018. For further information on the last rating action and regulatory information please click here.

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Issuer credit profile

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.

Summary terms

Issuer	Svenska Handelsbanken AB
Issue Date	**25 February 2015**
Amount	USD 1.2bn
• Coupon	• Paid annually in arrears on March 1 • 5.25% from 3/2016 to 3/2021 • then: 5 year US Mid-Swap Rate + Margin (3.335%)
• Format	• Perpetual Non-Call Additional Tier 1 Notes (issued under USD50bn EMTN Program) • Redeemable by the issuer on first reset date (2021) and every subsequent reset date thereafter, subject to regulator approval. • Redeemable at any date, subject to regulator's approval, in case of change in capital or tax treatment
ISIN	XS1194054166

Main Risks	
Coupon Cancellation	• Fully discretionary • Mandatory in case of: (i) lack of available distributable items • (ii) payment causing the Maximum Distributable Amount (MDA) to be exceeded • (iii) request from the supervisory authority
Principal Loss Absorption	Temporary write-down: • Upon occurrence of a trigger event, by an amount sufficient to restore the CET1 ratio(s) to the trigger level(s), or, if insufficient, write down to USD0.01 • by the supervisory authority at the Point of non-viability Reinstatement, if a Positive net profit at Issuer and Group level is recorded
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 securities 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 Handelsbanken.

We estimate the available distributable reserves of Handelsbanken based on Handelsbanken AB unconsolidated accounts at YE17. Calculations assume the item "Other funds" does not include any reserve which is deemed "non-distributable". Our calculations point to the availability of SEK 112bn in distributable items, including SEK 104bn in the form of retained and current earnings, which give ample comfort that AT1 coupon payments would not be restricted by the lack of available ADIs.

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 he 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-weighting 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 Handelsbanken – 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 (Handelsbanken’s was 18.4% 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 Handelsbanken’s headline CET1 ratio will fall by around 620 bps.

In relation to Handelsbanken’s current position, based on the FSA’s Capital Memorandum for 1Q18, the capital requirement relevant for MDA calculation at Handelsbanken stood at 11.2%:

- A minimum Pillar 1 CET1 requirement of 4.5%
- A capital conservation buffer of 2.5%
- A Pillar 1 systemic risk buffer of 3%
- A countercyclical buffer of 1.2%

These requirements are not expected to change.

On top of the Pillar 1 buffers, Handelsbanken is subject to additional CET1 requirement guidance under Pillar 2, which we calculate at 8.4% (based on 1Q18 FSA memorandum - this includes 2% own fund requirement, 2% systemic risk buffer, 4.4% for Swedish and Norwegian Mortgages). Under the new proposal the FSA’s estimates assume that both will disappear.

Including the Pillar 2 add-on, we estimate Handelsbanken's CET1 minimum capital requirement guidance to stand at 19.6% at the end of March 2018.

Table 1: Combined buffer requirements

	2016	2017	Q4 2017 Estimate under Article 458	Q1 2018
Required CET1 associated with distribution restrictions under Pilar 1:	**10.9%**	**11.2%**	**11.2%**	**11.2%**
Combined buffer (CBR)				
- Capital conservation	2.5%	2.5%	2.5%	2.5%
- Systemic	3.0%	3.0%	3.0%	3.0%
- Countercyclical	0.9%	1.2%	1.2%	1.2%
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)	10.5%	9.0%	4.5%	8.4%
CET1 Capital Requirement and hard guidance (incl. Pillar 2)	21.4%	20.2%	15.7%	19.6%
Svenska Handelsbanken Group CET1, fully loaded (SEK bn)	115.2	115.8	115.8	117.7
Svenska Handelsbanken Group CET1, fully loaded (%)	25.1%	22.7%	16.5%	21.6%
Distance to CET1 requirement incl. CBR (%)	**14.2%**	**11.5%**	**5.3%**	**10.4%**
Distance to CET1 requirement incl. CBR (SEK bn)	**65.1**	**58.5**	**33.4**	**56.8**
RWAs (SEK bn)	459	509	630	546

Source: Company data, Scope Ratings

Handelsbanken's CET1 ratio was 22.7% at the end of 2017. This offers ample distance to the Pillar 1 Combined Buffer Requirement, with a buffer of 11.5%. It also comfortably covers the total CET1 requirement, including Pillar 2 elements, which are not relevant to the MDA 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 Handelsbanken's CET1 ratio as of 31 December 2017 would be 16.5%. CET1 requirement including the Combined Buffer Requirement to 5.3%, which is materially lower, but still well in line with many European peers. The estimated increase in RWA is by almost one quarter reflecting Handelsbanken's position as one of Sweden's largest mortgage lenders (see Table 1).

Handelbanken's Board has set a target for the bank to maintain a management buffer of 100-300bps over the CET1 requirement, which was therefore comfortably met at YE17. Handelsbanken 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 temporary write-down	The rated securities have double triggers: • 5.125% 5.125% based on Svenska Handelsbanken AB unconsolidated • 8% based on Handelsbanken Group consolidated accounts

In our view, the existence of a double trigger generally represents a factor of risk, partly offsetting the benefits of Handelsbanken's diversification, a key factor supporting the Issuer Rating of the group. The difference between the two capital ratios trigger reference entities relates to Handelsbanken subsidiaries, including the covered bond issuer (Stadshypotek), the life insurance subsidiary (Liv), the fund management company (Fonder) and the public finance unit (Finans). As of year-end 2017, Svenska Handelsbanken AB's CET1 ratio stood at 21.4%, a reassuring gap to trigger of over 13%.

For the parent company reference trigger to become relevant, one has to assume a marked divergence between the performances of the subsidiaries businesses and the parent as well as a regulatory ring-fencing of the former with respect to capital. While this is a possibility, we deem it unlikely.

Distance to trigger

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%
Svenska Handelsbanken Group CET1, fully loaded (SEK bn)	115.2	115.8	115.8	117.7
Svenska Handelsbanken Group, CET1, Fully loaded (%)	25.1%	22.7%	16.5%	21.6%
Distance to trigger (%)	**17.1%**	**14.7%**	**8.5%**	**13.6%**
Distance to trigger (SEK bn)	**78.5**	**74.8**	**53.6**	**74.2**

Source: Company data, Scope Ratings

At the end of 2017, the gap to trigger at group level was 14.7%, or SEK 74.8bn. As of 1Q18, after dividend payments, the gap was 13.6%, or SEK 74.2 bn. We view this as ample, although we note that the 8% trigger at the group level is considered a high trigger – even in the context of current Swedish high 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 8.5% 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 Handelsbanken to other European bank peers.

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