Introducing Scope's Short-Term Ratings for European Banks: Focus on Funding and Liquidity

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Scope is publishing short-term ratings for the 18 large European banks which were assigned long-term ratings last month. In this way, Scope is widening the rating and analytical coverage across the financial institutions sector, in line with its strategy to become an active participant in providing timely and insightful ratings and credit opinions across the European financial sector and beyond.

Below is the complete list with ratings and rating outlooks for the 18 European banks:

Scope Ratings				
Financial Institution	**Short term Rating**	**Short-term Rating Outlook**	**Issuer Credit Strength Rating (ICSR)**	**ICSR Outlook**
Banco Santander SA	S-1	Stable	A	Stable
Barclays Bank plc	S-1	Stable	A	Stable
BBVA SA	S-1	Stable	A	Stable
BNP Paribas SA	S-1	Stable	AA-	Stable
BPCE SA	S-1	Stable	A+	Stable
Commerzbank AG	S-2	Positive	BBB+	Positive
Credit Agricole SA	S-1	Stable	A	Positive
BFCM SA (Credit Mutuel)	S-1	Stable	A	Stable
Credit Suisse AG	S-1	Stable	A+	Negative
Deutsche Bank AG	S-1	Stable	A-	Positive
HSBC Holdings plc	S-1+	Stable	AA-	Stable
ING Bank NV	S-1	Stable	A	Stable
KBC Group NV	S-1	Stable	A-	Stable
Lloyds Bank plc	S-1	Stable	A	Stable
Rabobank	S-1	Stable	A+	Stable
Royal Bank of Scotland plc	S-2	Stable	BBB+*	Stable
Societe Generale SA	S-1	Stable	A	Stable
UBS AG	S-1	Stable	A	Stable

**Note: Ratings benefit from a one-notch rating uplift due to the UK government's majority ownership*

Scope's short-term bank ratings

Short-term bank ratings apply to debt with a maturity of 13 months or less – such as commercial paper or certificates of deposit – as well as for other short-term financial commitments. As much of this debt is being issued on a rolling basis, Scope's short-term ratings express a credit opinion on the issuing bank's capacity to preserve unimpeded its debt-rolling ability, which is based to a large extent on investors' and other market participants' view of its timely debt-repayment capacity.

Scope uses five short-term rating levels, defined as follows:

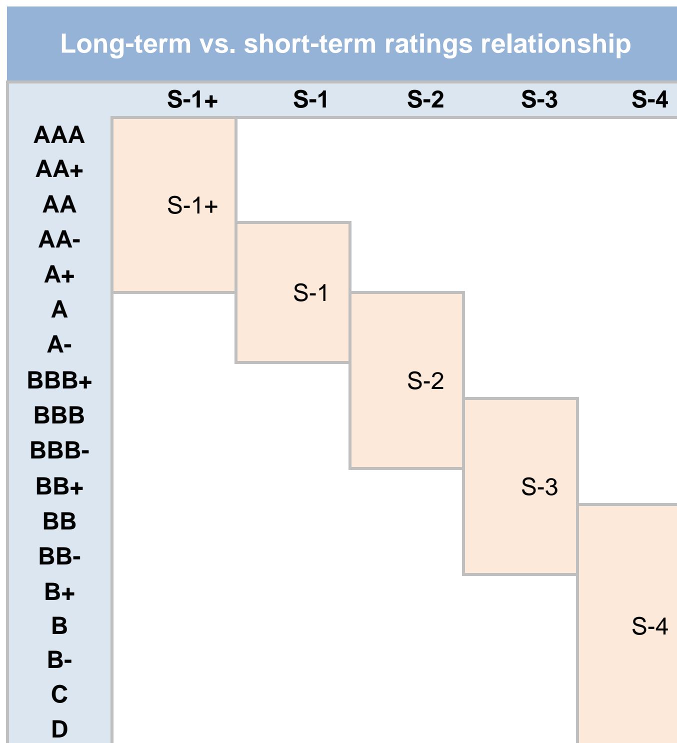
S-1+	Ratings at the S-1+ level reflect an opinion of the highest capacity to repay short-term obligations with the lowest credit risk on a short-term basis.
S-1	Ratings at the S-1 level reflect an opinion of high capacity to repay short-term obligations with very low credit risk on a short-term basis.
S-2	Ratings at the S-2 level reflect an opinion of good capacity to repay short-term obligations with low credit risk on a short-term basis.
S-3	Ratings at the S-3 level reflect an opinion of fair capacity to repay short-term obligations with acceptable credit risk on a short-term basis.
S-4	Ratings at the S-4 level reflect an opinion of comparatively lower capacity to repay short-term obligations, with comparatively higher credit risk on a short-term basis.

The assessment underpinning short-term ratings for banks

To a significant extent, the underlying analysis for banks' short-term ratings is a sub-set of the overall analysis which supports the long-term ratings of the same issuer. As the recent crisis showed, funding and liquidity shortages could sink a bank rapidly, even if it continued to comply with regulatory solvency and other related prudential ratios. To the extent that banks rely on wholesale funding to support and grow their balance sheet – which is the case notably for the larger firms – market sentiment represents a crucial element for funding stability. Banks which no longer enjoy market confidence find themselves in a grave situation even if their capital remains within regulatory boundaries.

The analysis of a bank's funding and liquidity is thus a key element which is properly highlighted by Scope's bank rating methodology (published in February 2014). For long-term ratings, it is part of a multi-pronged analysis, alongside other risks which may present more of a medium-term threat, rather than very short-term – doubtful business models, more aggressive risk cultures, deteriorating trends in asset quality, erosion of capital, challenges in keeping pace with regulatory changes, etc. For short-term ratings, however, the assessment of a bank's funding and liquidity characteristics – including the role played by changed market sentiment – is paramount.

Given these aspects, a certain degree of short-term/long-term rating correlation must exist, which indeed is the case. However, Scope does not establish strict mechanistic correlations between the two rating scales. The table below shows a certain degree of analytical discretion in assigning short-term ratings compared to the banks' long-term ratings.



Long-term vs. short-term ratings relationship

	S-1+	S-1	S-2	S-3	S-4
AAA	S-1+				
AA+	S-1+				
AA	S-1+				
AA-	S-1+	S-1			
A+	S-1+	S-1			
A		S-1	S-2		
A-		S-1	S-2		
BBB+			S-2		
BBB			S-2	S-3	
BBB-			S-2	S-3	
BB+				S-3	
BB				S-3	S-4
BB-				S-3	S-4
B+					S-4
B					S-4
B-					S-4
C					S-4
D					S-4

The paradox of bank liquidity

On an average-sector basis, banks display materially ampler liquidity metrics than non-financial corporations. This is due to (i) bank-specific regulatory requirements and market expectations – which have both become significantly more demanding and complex during the crisis – and to (ii) banks' inherent role of creating liquidity in the market for the economy as part of their activities (payments, savings-credit intermediation, financial flows and transactions). Consequently, this aspect should justify short-term ratings being invariably positioned at the highest end of the correlation range associated with specific long-term ratings (see table above).

The above was a widely accepted argument before 2007-08. The financial crisis however revealed the Achilles' heel of banks, often in a very painful way. It showed how (i) negative news headlines, (ii) tighter regulations, policies and supervision, as well as (iii) sudden rating downgrades can lead to a sharp negative turn in market sentiment. This in turn impacted negatively the quality and marketability of categories of liquid assets and evaporated sources of market funding, especially short-term. Examples are the collapse of securitized instruments as sources of liquidity at the onset of the crisis (2007-08), the impact on debt issued by financially stressed governments (especially in 2010-12), the sudden but ultimately temporary drying out of US money-market funding for European banks, and the breakdown of the cross-border interbank market within the EU at the height of the crisis. For these reasons, Scope is and will remain particularly cautious with respect to short-term ratings for banks. In this respect, the S-1+ rating, which is the highest short-term rating, would be assigned essentially (although not uniquely) to banks which carry very high long-term Issuer Credit-Strength Ratings (ICSRs) and in addition display limited reliance on funding sources vulnerable to market sentiment not only to survive but also to grow profitably.

Strengthening trends in funding and liquidity

The crisis years saw a marked strengthening of both the level and the quality of banks' liquidity cushions as well as a reduction of funding risks – primarily in the form of less reliance on short-term confidence-sensitive wholesale funds. This was the direct result of (i) more demanding regulatory policies and more intrusive supervision, (ii) heightened market appetite for safety in bank funding and liquidity, and not least (iii) firms' own streamlined funding, liquidity and ALM risk strategies and management. In addition, refinancing needs for the larger firms have been shrinking as a consequence of balance-sheet deleveraging.

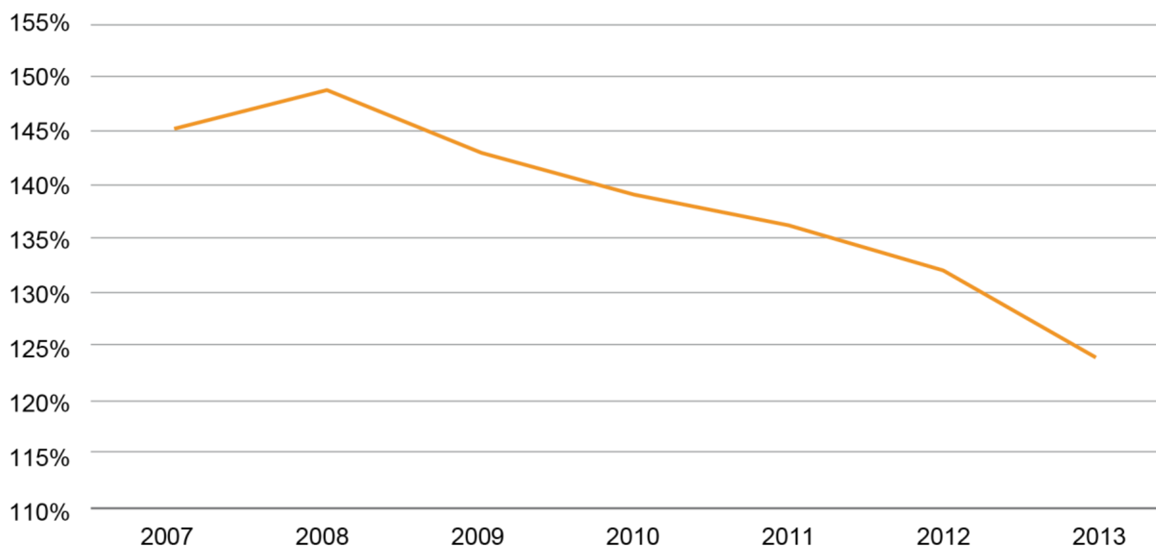
The positive trend during the crisis in reducing funding risk and building liquidity for European banks has already been highlighted by Scope research (see *Safer Ground for European Banks in 2014*, December 2013) and is often a rating driver highlighted in Scope's individual research on the 18 banking firms rated so far.

The first two graphs below show a positive trend in two metrics which Scope considers as very important for funding and liquidity (and for which proper bank disclosure also exists, which is less the case with other funding metrics): the loan-deposit ratio and the wholesale funding ratio. The trends are shown for an aggregate of 44 large European banks.

The third graph shows the asset deleverage going on in European banking during the latter years of the crisis. Scope expects the trend to flatten in 2015, following the disclosure of the results of the ECB's Comprehensive assessment.

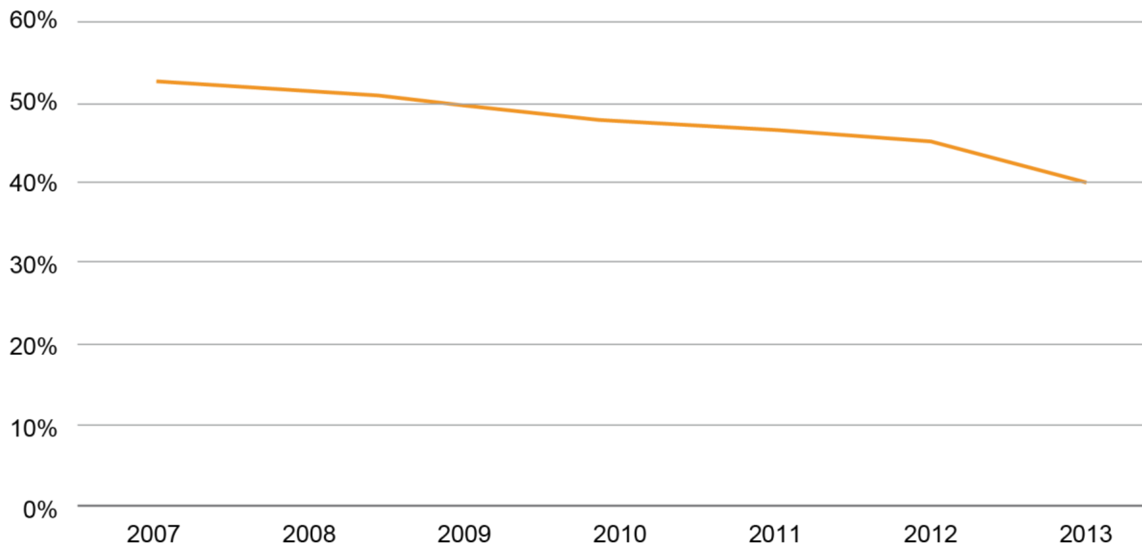
Gross Loans % Total Deposits

44 large European Banks



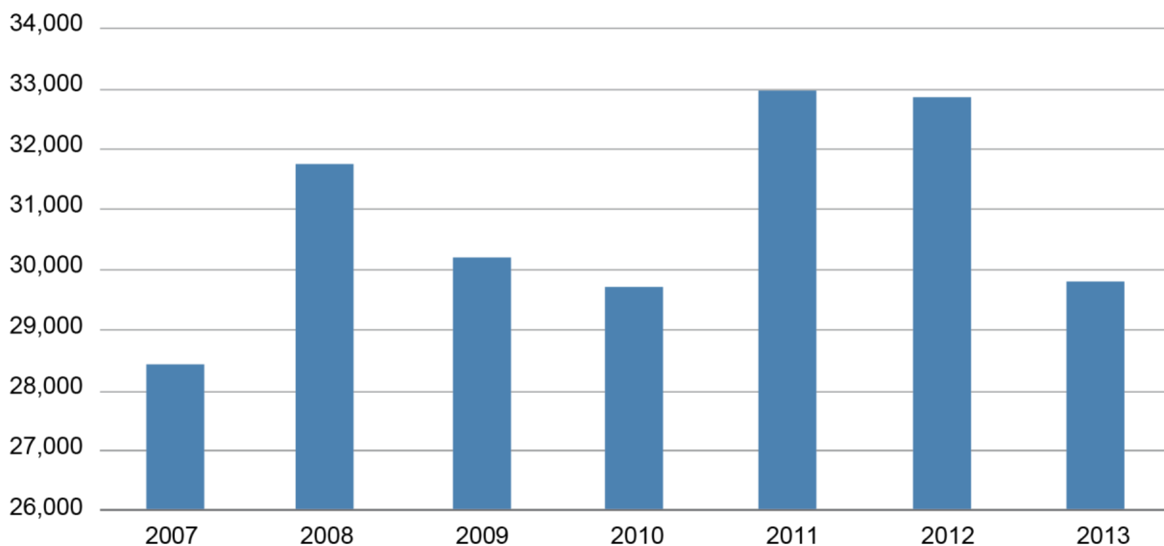
Wholesale funds % Total Funds

44 large European Banks



Total Assets (EUR bn)

44 large European Banks



Source: SNL, Scope Ratings
Ratios are calculated by Scope based on SNL raw data

Noting that the new regulations (both Basel 3 and CRD 4-CRR) have already set strict parameters to the composition of high-quality liquid assets, Scope nevertheless expects the criteria to be softened going forward, to encourage more funding and loan growth flexibility for the European banking sector. Specifically, it is likely to see more acceptance of high-quality covered bonds and asset-backed securities (with proper limits and haircuts) in the

high-quality liquid asset categories – to ease funding constraints for banks which engage into lending to the real economy (especially SMEs).

Below we show the liquidity coverage ratio (LCR) and net stable funds ratio (NSFR) for the 18 banks rated by Scope, as disclosed publicly by these banks. We note that the parameters for these prudential metrics on liquidity and funding are yet to be finalized by regulatory authorities.

Rated Banks			
	Latest disclosure on Basel 3 liquidity position*		
Financial Institution	**Liquidity Coverage Ratio (LCR)**	**Net Stable funding ratio (NSFR)**	**Short Term Rating**
Banco Santander SA	>100% in both Group and main units (vs 60% required in 2015)	n/a	S-1
Barclays Bank plc	102%	110%	S-1
BBVA SA	n/a. Compliant with regulatory requirements	n/a	S-1
BNP Paribas SA	n/a. Compliant with regulatory requirements	Under Study	S-1
BPCE SA	n/a	n/a	S-1
Commerzbank AG	n/a	n/a	S-2
Credit Agricole SA	>100% at YE 2013 (based on calculation process designated for declaration to French Prudential supervisory and resolution authority (ACPR) with effect from 31 March 2014. CA Group aims at >100% by end 2014	n/a	S-1
BFCM SA (Credit Mutuel)	n/a	n/a	S-1
Credit Suisse AG	n/a	>100%	S-1
Deutsche Bank AG	107%	n/a	S-1
HSBC Holdings plc	n/a	n/a	S-1+
ING Bank NV	>100%	expects to be >100% in 2015	S-1
KBC Group NV	131%	111%	S-1
Lloyds Bank plc	n/a. Expects to meet ahead of implementation (2015 for the UK)	n/a.	S-1
Rabobank	125%	114%	S-1
Royal Bank of Scotland plc*	102%	122%	S-2
Societe Generale SA	>100% under current Basel 3 assumptions	n/a	S-1
UBS AG	110%	109% based on phase in	S-1

Source: Company data
Note: 2013 year end disclosure.

The 44 large European banks

ABN AMRO
Allied Irish Banks
Banca Monte dei Paschi di Siena
Banca Popolare di Milano
Banco Espírito Santo
Banco Popolare
Banco Popular Español
Banco Sabadell
Bank of Ireland
Bankia
Bankinter
Banque Federative du Credit Mutuel
Barclays
BBVA
BCP
BNP Paribas
CaixaBank
Caixa Geral de Depositos
Commerzbank
Credit Agricole Group
Credit Suisse
Danske Bank
Deutsche Bank
DNB
Erste Bank
Groupe BPCE
Handelsbanken
HSBC
ING Groep
Intesa Sanpaolo
KBC
Lloyds Banking Group
Nordea
Nykredit
Rabobank
RBS
RZB
Santander
SEB
Societe Generale
Swedbank
UBI
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