The Royal Bank of Scotland Group PLC Issuer Rating Report

SCOPE

STABLE OUTLOOK

A

Overview

On 11 July 2018, Scope took positive rating actions on the long-term ratings of various The Royal Bank of Scotland Group PLC (RBS Group) entities due to improved credit fundamentals. In addition, Scope removed the one-notch of rating uplift which was incorporated in the Issuer Rating and the senior debt ratings (but not the AT1 ratings) due to majority ownership by the UK government. The agency considers that this rating uplift is no longer warranted, given the UK government's medium-term plan to gradually exit the RBS ownership.

The rating on senior unsecured debt (TLAC/MREL eligible) issued by RBS Group was upgraded to A- from BBB+. The rating on AT1 securities issued by RBS Group was upgraded to BB from B+.

The Issuer Rating of A- on NatWest Markets PLC (formerly The Royal Bank of Scotland PLC) was affirmed. The A- rating on senior unsecured debt (not TLAC/MREL eligible) issued by NatWest Markets PLC (formerly The Royal Bank of Scotland PLC) was also affirmed.

Over the coming months, the group is expected to complete the necessary changes to implement UK ring-fencing requirements. Consequently, Scope has assigned first-time Issuer Ratings of A to RBS Group and NatWest Holdings Limited (NatWest Holdings), the recently created ring-fenced bank intermediate holding company containing the core retail and commercial banking businesses of the group. For further details on Scope's views on ring-fencing, please refer to the report "UK Bank Ring-Fencing: Credit and Rating Implications" (February 2018).

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 have demonstrated resilience throughout the group's restructuring and provide a solid basis for future earnings. The group returned to profitability in 2017 after ten years of losses and is focused on improving returns. This will not be straightforward as the industry and customer behaviour are undergoing considerable change and the operating environment continues to be uncertain due to Brexit.
- 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 now at reassuring levels.
- The Issuer Rating of NatWest Markets PLC is one notch below that of RBS Group and NatWest Holdings. This rating differential is due to its more markets-focused business profile and lesser significance to the group (accounting for about 15% of RWAs).

Ratings & Outlook

Issuer Rating	A
Senior unsecured debt (MREL/TLAC eligible) rating	A-
Senior unsecured debt (not MREL/TLAC eligible) rating (NatWest Markets PLC)	A-
Additional Tier 1 securities rating	BB
Short-term debt rating (NatWest Markets PLC)	S-1
Outlook	Stable

Lead Analyst

Pauline Lambert
p.lambert@scoperatings.com

Associate Analyst

Hannes Merlecker
h.merlecker@scoperatings.com

Team Leader

Sam Theodore
s.theodore@scoperatings.com

Scope Ratings GmbH

Suite 301
2 Angel Square
London EC1V 1NY

Phone +44 203-457 0 4444

Headquarters

Lennéstraße 5
10785 Berlin

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

info@scoperatings.com
www.scoperatings.com

Bloomberg: SCOP

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 addressing legacy issues and strengthening the group's prudential metrics to reassuring levels.
- Uncertain consequences of the UK's exit from the EU, particularly on the UK economy and housing market.

Rating change drivers

Improved and consistent earnings generation. As legacy issues have largely been addressed, the group is now working on improving returns. For 2020, RBS targets a ROTE above 12% and a cost income ratio below 50%. A sustained improvement in earnings underpinned by a focused strategy would be viewed positively.

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 incurred. With the focus now on higher returns, we would consider it negatively if this were achieved by substantially increasing risks.

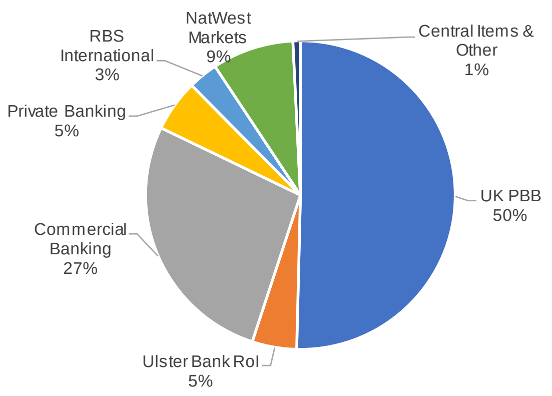
Failure to effectively manage potential consequences stemming from Brexit. The group's return to profitability is in its early stages and potential weakness in the UK economy could pose a headwind.

Rating drivers (details)

Strong UK-focused retail and commercial banking franchise.

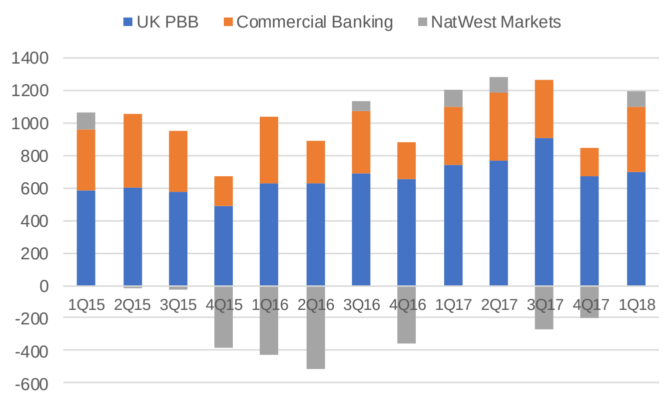
RBS is today primarily a UK domestic retail and commercial bank, having materially reduced international operations as well as investment banking activities in the post crisis years. The group's three core franchises are (1) Personal and Business Banking (PBB) which serves individuals and small businesses (generally up to GBP 2m turnover) in the UK and the Republic of Ireland, (2) Commercial and Private Banking which serves commercial and high net worth customers in the UK and Western Europe, and (3) NatWest Markets which focuses on rates, currencies and financing products. Throughout the group's restructuring, the key UK PBB and Commercial Banking divisions have demonstrated resilience as evidenced by the development in operating profit (Figure 2), loans and deposits (Figure 4).

Figure 1: Adjusted income by division, 2017



Note: Total adjusted income of GBP 12.9bn; reported income of GBP 13.1bn
Source: Company data, Scope Ratings

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



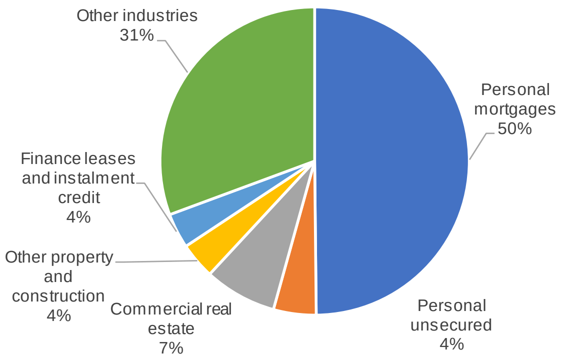
Note: From 2015-2017, on adjusted basis which excludes restructuring and litigation and conduct costs
Source: Company data, Scope Ratings

Operating primarily under the NatWest and RBS brands, the group ranks number one in the business segment, joint number one in the commercial segment and number two in the personal segment.[1] The group has been growing its mortgage business, with new mortgage market share around 12% while the stock share is approximately 10%. In Ireland, RBS operates via Ulster Bank, which is the leading retail and commercial bank in Northern Ireland and the number three bank in Ireland overall.

With the release of YE 2017 results, the group rescinded its absolute cost target while reaffirming the less than 50% cost income target. Management stated that this would allow the group to respond to industry change and evolving customer behaviour, providing flexibility to make needed investments to become less complex, more automated and innovative. The group continues to reduce its physical footprint, the number of systems and applications used, and the complexity of its legal structure. We note positively the consistent improvement in the group's IT resilience. The number of "crit 1" incidents (defined as having an adverse impact on customers, employees or third parties) has dropped to four in 1Q 2018 from 318 in FY 2014.

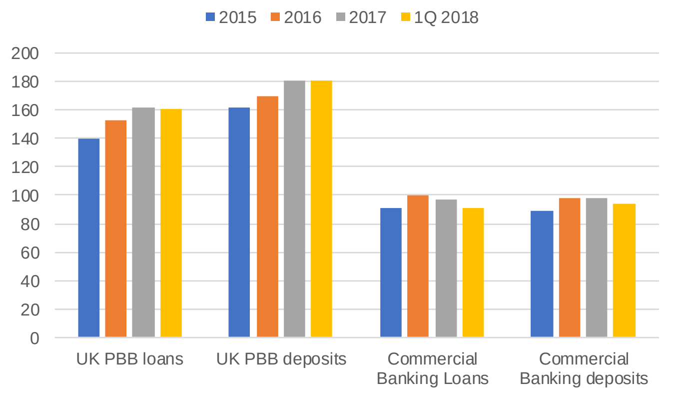
[1] Source: As reported by RBS based on data from Charterhouse Research and GfK as of end 2016.

Figure 3: Gross loans breakdown, 2017



Note: Gross loans of GBP 327bn, of which GBP 305bn was UK related.
Source: Company data, Scope Ratings

Figure 4: Development of loans and deposits (GBP m)



Note: Loan figures are on net basis.
Source: Company data, Scope Ratings

Management's track record in addressing legacy issues and strengthening the group's prudential metrics to reassuring levels.

Since 2009, management has re-focused to become a much simpler and smaller UK-centric bank, disposing of non-core assets and businesses as well as foreign franchises. The group successfully closed its non-core bank in 2017 and from 2018 no longer reports its financial performance on an "adjusted basis". The group returned to profitability in 2017 after ten years of losses, generating a pre-tax profit of GBP 2.2bn.

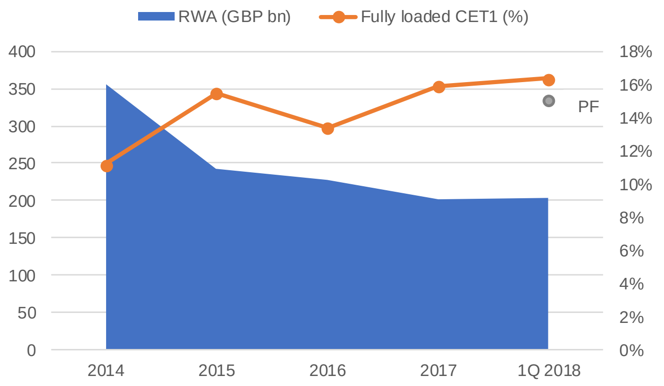
Financial soundness has materially strengthened as evidenced by the group's capital, liquidity and funding positions. Importantly, major legacy issues have been resolved reducing uncertainty about the group's financial soundness. These include resolving State Aid obligations, settlements with the US 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. While there remains other outstanding conduct and litigation matters, their scale is of a much smaller magnitude.

The group's funding profile continues to evolve, reflecting its post ring-fencing structure. In 2017, debt issuance totalled around GBP 7bn, including GBP 3.6bn in senior holding company debt, GBP 1.1 bn in senior operating company debt and GBP 2.4 bn in covered bonds (re-entering the market).

Looking ahead, the group will need to meet estimated loss absorbing capacity requirements of 28% (MREL plus buffers) in 2022.[2] As of YE 2017, total MREL-eligible securities stood at GBP 54.5bn, or 27.1% of RWAs. To meet requirements, RBS estimates that it will need to issue GBP 4-6bn of MREL debt each year. Between 2018 and 2022, approximately GBP 13bn of operating company senior debt will come due providing opportunities to refinance with holding company debt.

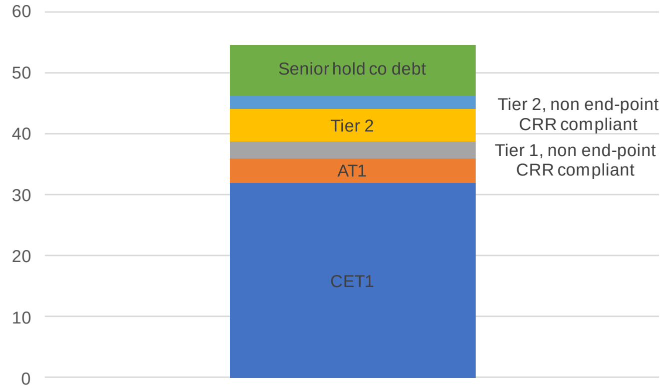
[2] The Bank of England as resolution authority is implementing TLAC via MREL. UK G-SIBs do not have separate TLAC requirements.

Figure 5: RWA and CET1 development



Note: Grey dot is the CET1 ratio proforma the impact of the US DOJ settlement relating to RMBS and the accelerated pension deficit payment. Source: SNL

Figure 6: Loss absorbing capacity, YE 2017 (GBP bn)



Source: Company data, Scope Ratings

Uncertain consequences of the UK's exit from the EU, particularly on the UK economy and housing market.

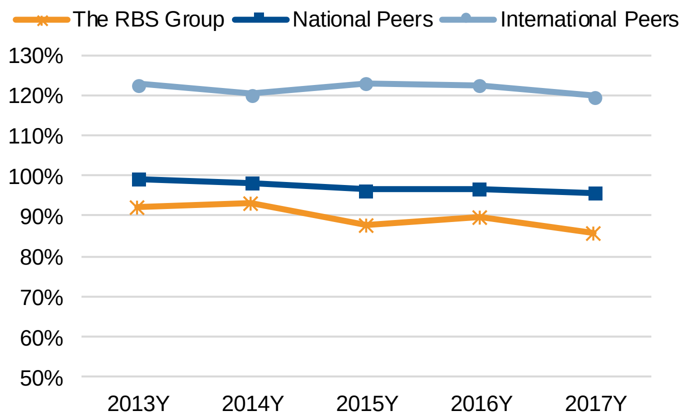
RBS is now largely a domestic bank with over 90% of its loan exposure to the UK. Hence, the group's performance is dependent to a large degree on the health of the UK economy. As the Brexit process is still in the early stages, the ramifications are only likely to be evident over time.

To date, the economy has shown relative resilience and the large UK banks, including RBS, have not seen a deterioration in domestic asset quality. The impact has been more material on future business investment and consumer confidence. In its June 2018 Financial Stability Report, the Bank of England (BoE) highlighted the risks that highly indebted households could augment any economic downturn and that a decline in foreign investor sentiment for UK assets (commercial real estate and leveraged loans were noted for having a large foreign investor presence) could lead to falls in UK asset prices. At the same time, the BoE judged that apart from those related to Brexit, domestic risks remained in the "standard region overall" and decided to set the UK countercyclical buffer rate at 1%, unchanged since November 2017.

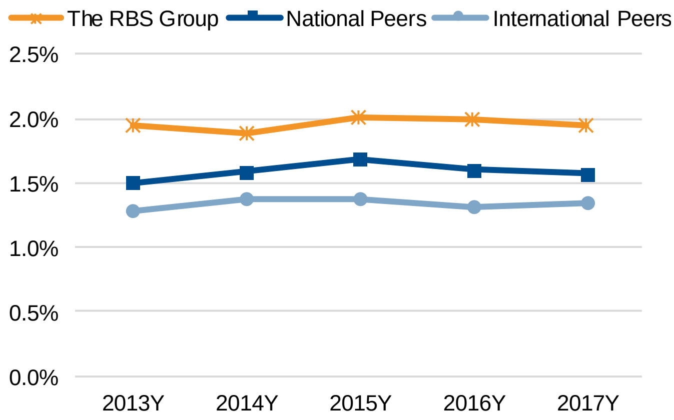
With the continuing uncertainty, management has commented that they remain cautious and expect the group's lending growth to be in line with UK GDP growth.

I. Appendix: Peer comparison

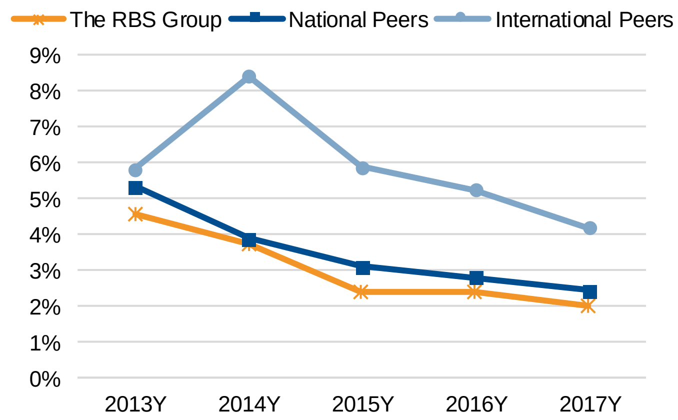
Amortised loans % Deposits



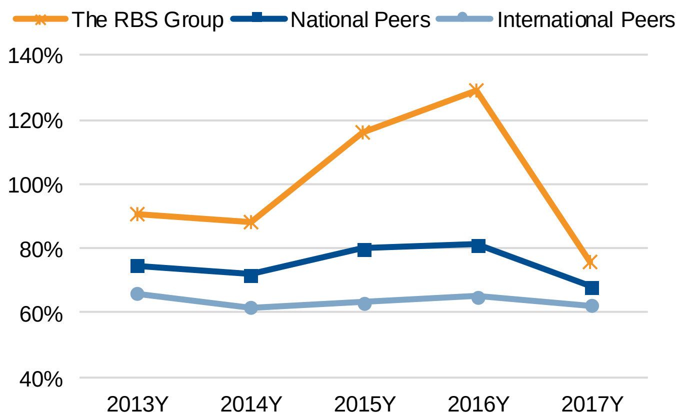
Net interest margin (%)



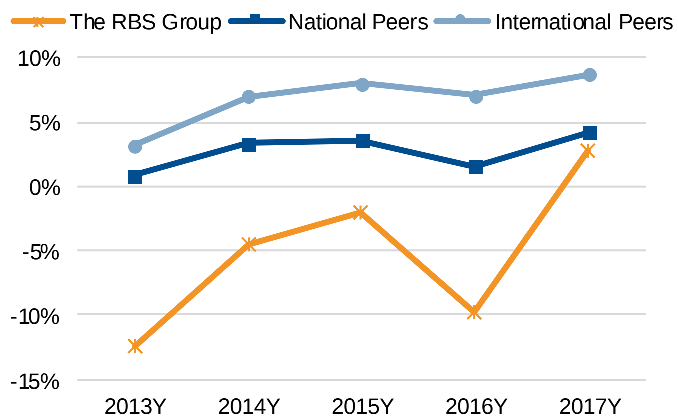
NPLs % Loans



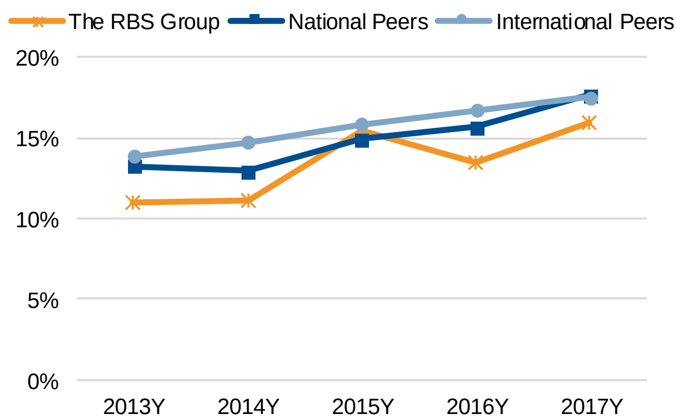
Costs % Income



Return on average equity (%)



CET1 ratio (%, transitional)



National peers: RBS Group, Lloyds Banking Group, HSBC Holdings, Barclays PLC, Nationwide Building Society.
International peers: RBS Group, Lloyds Banking Group, Nationwide Building Society, BPCE, Banque Postale, 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

	2013Y	2014Y	2015Y	2016Y	2017Y
Balance sheet summary (GBP m)					
Assets					
Cash and interbank assets	136,730	118,607	110,050	104,388	128,588
Total securities	410,449	445,874	345,972	320,206	240,226
of which, derivatives	288,039	353,590	262,514	246,981	160,843
Net loans to customers	440,722	378,238	333,892	351,950	349,919
Other assets	39,977	108,300	25,494	22,112	19,323
Total assets	**1,027,878**	**1,051,019**	**815,408**	**798,656**	**738,056**
Liabilities					
Interbank liabilities	63,979	60,665	38,296	38,556	46,898
Senior debt	67,819	50,280	31,150	27,245	30,559
Derivatives	285,526	349,805	254,705	236,475	154,506
Deposits from customers	470,880	391,639	370,298	380,968	398,036
Subordinated debt	24,012	22,905	19,847	19,419	12,722
Other liabilities	56,447	117,016	46,965	46,589	46,242
Total liabilities	**968,663**	**992,310**	**761,261**	**749,252**	**688,963**
Ordinary equity	53,450	50,666	47,480	41,462	41,707
Equity hybrids	5,292	5,097	5,951	7,147	6,623
Minority interests	473	2,946	716	795	763
Total liabilities and equity	**1,027,878**	**1,051,019**	**815,408**	**798,656**	**738,056**
Core tier 1/Common equity tier 1 capital	42,165	39,649	37,630	30,623	31,957
Income statement summary (GBP m)					
Net interest income	10,981	9,258	8,767	8,708	8,987
Net fee & commission income	4,518	3,539	2,933	2,535	2,455
Net trading income	3,334	1,489	1,486	1,058	959
Other income	924	864	-263	15	837
Operating income	**19,757**	**15,150**	**12,923**	**12,316**	**13,238**
Operating expense	17,850	13,336	15,021	15,862	9,996
Pre-provision income	**1,907**	**1,814**	**-2,098**	**-3,546**	**3,242**
Credit and other financial impairments	8,432	-1,352	-727	478	493
Other impairments	1,403	523	1,332	159	29
Non-recurring items	-315	0	0	101	-481
Pre-tax profit	**-8,243**	**2,643**	**-2,703**	**-4,082**	**2,239**
Discontinued operations	148	-3,445	1,541	0	0
Other after-tax Items	0	0	0	0	0
Income tax expense	382	1,909	23	1,166	824
Net profit attributable to minority interests	120	60	409	10	35
Net profit attributable to parent	**-8,597**	**-2,771**	**-1,594**	**-5,258**	**1,380**

Source: SNL

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

	2013Y	2014Y	2015Y	2016Y	2017Y
Funding and liquidity					
Net loans/deposits (%)	92.3%	93.0%	87.5%	89.6%	85.8%
Liquidity coverage ratio (%)	102.0%	112.0%	136.0%	123.0%	152.0%
Net stable funding ratio (%)	120.0%	112.0%	121.0%	121.0%	132.0%
Asset mix, quality and growth					
Net loans/assets (%)	42.9%	36.0%	40.9%	44.1%	47.4%
NPLs/Net Loans (%)	4.6%	3.7%	2.4%	2.4%	2.0%
Loan-loss reserves/NPLs (%)	148.0%	155.2%	103.4%	60.2%	61.5%
Net loan growth (%)	-11.9%	-14.2%	-11.7%	5.4%	-0.6%
NPLs/Tangible Equity and Reserves (%)	23.6%	16.8%	12.6%	15.6%	13.4%
Asset growth (%)	-21.7%	2.3%	-22.4%	-2.1%	-7.6%
Earnings and profitability					
Net interest margin (%)	2.0%	1.9%	2.0%	2.0%	1.9%
Net interest income/average RWAs (%)	2.6%	2.4%	2.7%	3.6%	4.2%
Net interest income/operating income (%)	55.6%	61.1%	67.8%	70.7%	67.9%
Net fees & commissions/operating income (%)	22.9%	23.4%	22.7%	20.6%	18.5%
Cost/income ratio (%)	90.3%	88.0%	116.2%	128.8%	75.5%
Operating expenses/average RWAs (%)	4.2%	3.4%	4.7%	6.6%	4.6%
Pre-impairment operating profit/average RWAs (%)	0.4%	0.5%	-0.7%	-1.5%	1.5%
Impairment on financial assets /pre-impairment income (%)	442.2%	-74.5%	n.m.	n.m.	15.2%
Loan-loss provision charges/net loans (%)	2.2%	-0.4%	-0.3%	0.2%	0.2%
Pre-tax profit/average RWAs (%)	-1.9%	0.7%	-0.8%	-1.7%	1.0%
Return on average assets (%)	-0.7%	-0.3%	-0.1%	-0.6%	0.2%
Return on average RWAs (%)	-2.0%	-0.7%	-0.4%	-2.2%	0.7%
Return on average equity (%)	-12.4%	-4.5%	-2.0%	-9.8%	2.9%
Capital and risk protection					
Common equity tier 1 ratio (%, fully loaded)	10.9%	11.2%	15.5%	13.4%	15.9%
Common equity tier 1 ratio (%, transitional)	10.9%	11.1%	15.5%	13.4%	15.9%
Tier 1 capital ratio (%, transitional)	13.1%	13.2%	19.1%	17.7%	19.7%
Total capital ratio (%, transitional)	16.5%	17.1%	24.7%	22.9%	23.9%
Basel III leverage ratio (%)	3.4%	4.2%	5.6%	5.1%	5.3%
Asset risk intensity (RWAs/total assets, %)	37.5%	33.9%	29.8%	28.6%	27.2%
Market indicators					
Price/book (x)	0.7x	0.9x	0.7x	0.6x	0.8x
Price/tangible book (x)	0.9x	1.1x	0.9x	0.8x	0.9x
Dividend payout ratio (%)	0.0%	0.0%	0.0%	0.0%	0.0%

Source: SNL

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

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