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ABN AMRO Bank NV: Still in Recovery Mode Ahead of Its Privatisation

The group's restructuring was completed in 2012 but adverse macroeconomic conditions and intense competition pose challenges

RATINGS

ABN AMRO Bank N.V.

LT bank deposits	A2
Senior unsecured	A2
Subordinate	Baa3
Junior subordinate	Ba2
Short-term rating	Prime-1

KEY INDICATORS

ABN AMRO Bank N.V. (EUR mn)

	2012	2011	2010
Total assets	393,425	407,015	379,398
Tang. Common Equity	14,672	15,333	12,988
Net interest margin	1.3%	1.3%	1.3%
Tier 1 ratio	12.9%	13.0%	12.8%
Cost/income ratio	65.0%	69.2%	81.4%

Analyst Contacts:

LONDON +44.20.7772.5454

Andrea Usai +44.20.7772.1058
Vice President - Senior Analyst
andrea.usai@moodys.com

PARIS +33.1.7070.2229

Stephane Herndl +33.1.5330.1071
Assistant Vice President - Analyst
stephane.herndl@moodys.com

Alain Laurin +33.1.5330.1030
Associate Managing Director
alain.laurin@moodys.com

FRANKFURT +49.69.70730.700

Carola Schuler +49.69.70730.766
Managing Director - Banking
carola.schuler@moodys.com

Summary

» **ABN AMRO Bank N.V. ('ABN AMRO', A2 negative Prime-1; C-/baa2 negative) has successfully completed the first phase of its recovery, strengthening its overall credit profile.** Formed from the merged remnants of two banks in 2010, the bank has undergone a complex reorganisation process, which was completed in 2012 within the targeted timeframe and within budget. In addition, management has refocused ABN AMRO's strategy on domestic retail & corporate banking and in selected activities internationally. During this period, ABN AMRO has improved some of its key credit fundamentals, such as liquidity and capital.

» **The bank nevertheless still faces considerable challenges including difficult macroeconomic conditions at home and increasing competition both domestically and internationally.** These factors have the potential to delay the full recovery, that is necessary to achieve a viable franchise with sustainable profitability - a precondition for successful privatisation in our view. The bank's activities are mostly based in the Netherlands, which has a very concentrated banking sector. We believe that ABN AMRO is more sensitive to the deteriorating domestic economy than its Dutch peers because it has a lower degree of geographical diversification. Despite a low interest rate environment that constrains banks' net interest rate margins, ABN AMRO has been able to restore its margins over the recent quarters owing to a proactive management of its loan portfolio. It remains to be seen whether or not this outcome will last going forward, against the background of intense competition, both inside and outside the Netherlands, which weighs on ABN AMRO's franchise.

» **We view the bank's return to private ownership, now expected from 2015 onwards, as a positive development for its creditors, although it is not immune from downside risks.** The privatisation of ABN AMRO, which the Dutch government expects to execute via an IPO, would point to the bank's improved fundamentals and positive prospects. It would also increase the options available to its management to raise any additional capital it may require to implement its strategy, particularly in selected international markets. Full privatisation will likely take time to be achieved as this type of divestments are executed in tranches over a period of time. However, it carries potential risks to creditors, including a departure from its low-risk strategy and the appointment of a new management team, which could prove disruptive and offset some of the progress achieved thus far. A bid by management to boost the bank's profits so as to deliver a higher return for private shareholders could result in a higher risk profile.

Detailed Discussion

ABN AMRO was formed in 2010 from the remnants of two former banks, ABN AMRO N.V. and Fortis Bank Nederland N.V. and followed the breakup of the old ABN AMRO Group in 2009. It is the third largest bank in the Netherlands, with a market share of 18% in mortgage lending, 23% in savings[1] and a balance sheet of €402 billion as at end-June 2013. The Dutch government owns 100% of the bank, as a result of financial support provided in 2008.[2]

ABN AMRO has successfully completed the first phase of its recovery

Management has made material progress over the past three years…

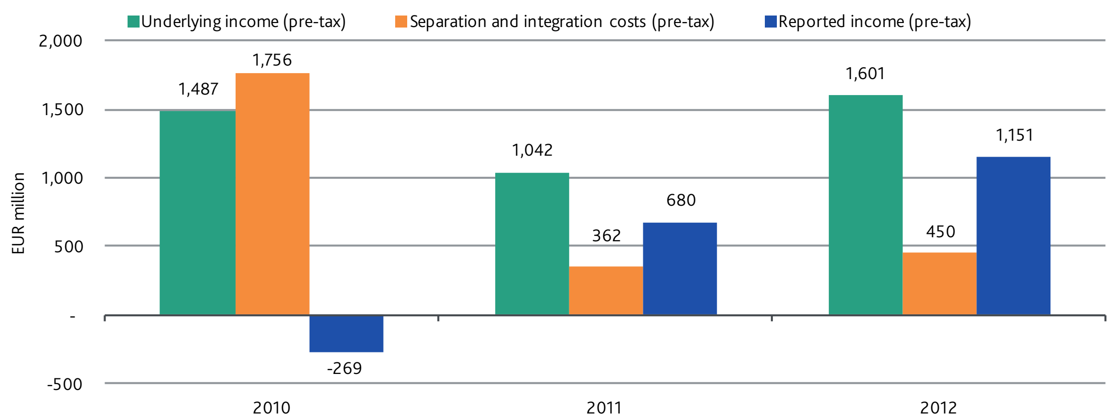
Following the bank's creation in July 2010, management has undertaken a complex and costly project, separating the newly combined bank from the former dismantled group. It also has put in place a remedial plan imposed by the European Commission as a result of the state-aid that led to the nationalisation of ABN AMRO. This included the sale of part of its corporate banking operations to Deutsche Bank.[3] In addition, management has completed the operational integration of the two former banks to rationalise ABN AMRO's activities and achieve synergies.

These projects were completed on budget by 2012, within the targeted timeframe at a total cost of €2.6 billion (pre-tax). These charges weighed heavily on the bank's profitability during 2010-2012 (Exhibit 1), but we believe that these initiatives will yield long-term benefits.

EXHIBIT 1

Profits during 2010-2012 were depressed by separation on integration costs

Underlying vs. reported pre-tax profits



Source: ABN AMRO Annual Accounts and Investors Presentations

…and has refocused the bank on its domestic and selected international markets

ABN AMRO has refocused its activities on domestic retail, private, corporate and merchant banking. The bank has maintained a limited international network in selected countries outside the Netherlands, which allows it to maintain a footprint (amongst others) in the main global financial centres. In these countries, it operates in selected market segments, primarily to support the international activity of its corporate customers but also to leverage its expertise in certain niche products, such as Energy, Commodity and Transportation (ECT). In addition, ABN AMRO enjoys

1 Source: ABN AMRO H1 2013 Results Roadshow presentation, 23 August 2013.

2 Preference shares totalling €210 million at end-2012 were called during Q1 2013.

3 Hollandsche Bank Unie N.V. (HBU), two corporate client departments, 13 'Advieskantoren' and ABN AMRO's Dutch factoring activities to a large international bank.

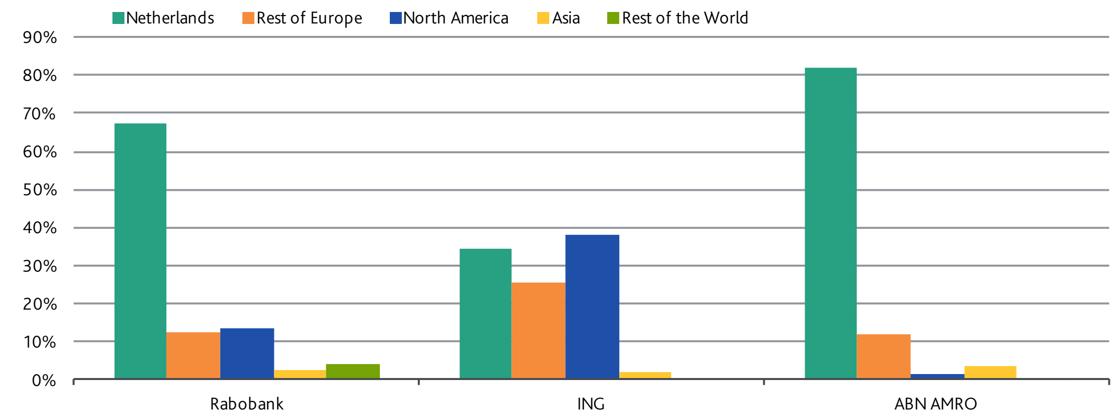
good brand recognition in private banking outside the Netherlands, particularly in the main euro area countries, as well as in some Asian countries.

With 83% of operating income for the first six months of 2013 coming from its domestic market, the bank has the lowest level of geographical diversification amongst its Dutch peers (Exhibit 2). This means that its performance is largely correlated to the domestic economy, which has slipped back into recession. This correlation is explained in more detail below.

EXHIBIT 2

ABN AMRO has the lowest degree of geographical diversification amongst large Dutch banks

Operating income geographical breakdown for 2012



Source: ABN AMRO Annual Accounts

ABN AMRO has improved its liquidity and funding position as a result of higher deposits and lower market borrowing

Since 2010, the bank has reported marked improvements in two main areas.

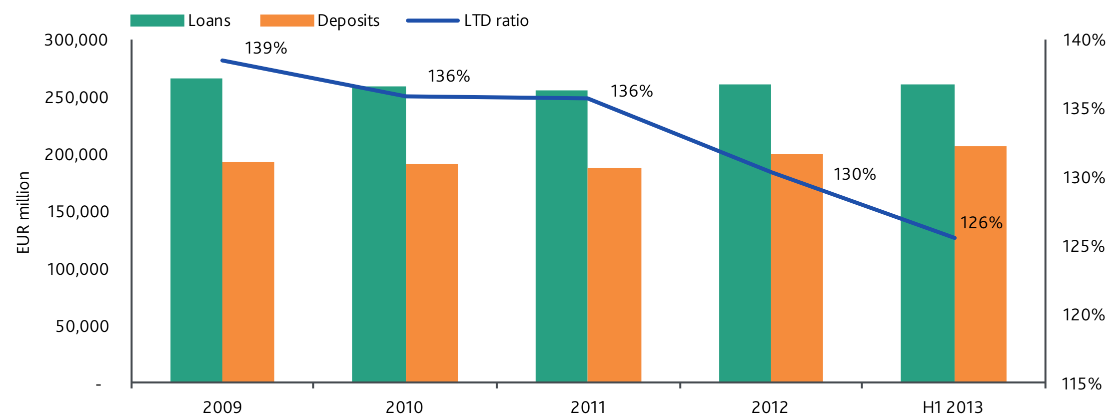
On liquidity and funding, ABN AMRO has reduced its reliance on volatile market funding, mainly as a result of a larger customer deposit base (Exhibit 3).

Between December 2010 and June 2013, the bank's loan-to-deposit ratio, which can roughly show the extent of a bank's reliance on confidence-sensitive market funding, fell to 126% from 136%, reducing its funding gap by €15 billion to €53 billion. Nevertheless, we believe that ABN AMRO's wholesale funding needs, as well as those of its Dutch peers, remain relatively high by international comparison.

EXHIBIT 3

ABN AMRO has reduced its reliance on wholesale funding by increasing its deposit base

Loans vs. deposits (left Y axis) and loan-to-deposit ratio (right Y axis)



Source: ABN AMRO Annual Accounts and Investors Presentations

During the same period the bank also reduced its stock of short-term liabilities and increased its liquidity buffer, thereby improving its short-term liquidity position (Exhibit 4).

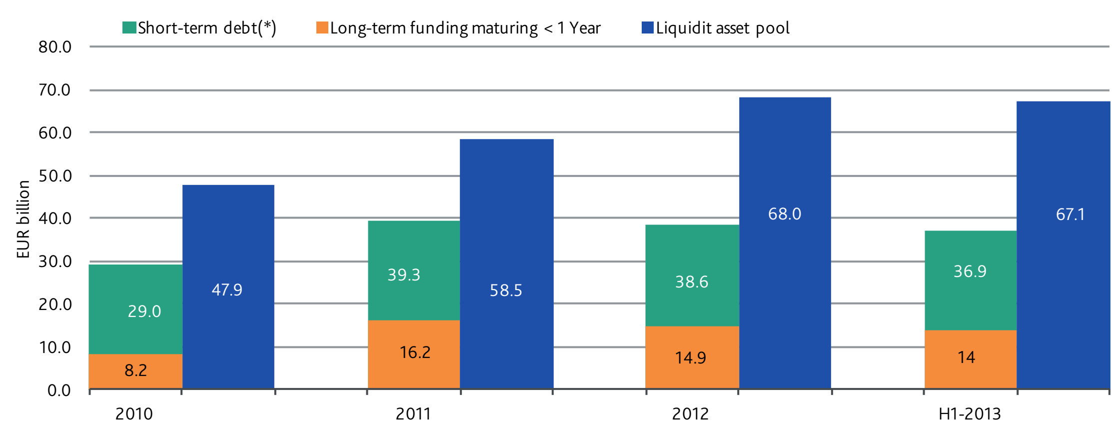
We note that around half of ABN AMRO's liquidity buffer comprises retail mortgage-backed securities (RMBSs) generated by the bank itself. Although these assets can be used for accessing central bank funding if needed, they are considered to be of lower quality than other instruments, such as government bonds. The proposed eligibility criteria for liquid assets under the European regulation on liquidity will only be finalised at the end of 2013.[4] Until the list of eligible securities is validated, there is a material risk that ABN AMRO will have to replace a large portion of these assets, which could prove costly.

Despite this risk, we view ABN AMRO's liquidity position as sound as shown by a pro-forma Basel III Liquidity Coverage Ratio of 91% and a Net Stable Funding Ratio of 101%, which the bank reported as at end-June 2013.

EXHIBIT 4

Short term liabilities have reduced and its liquidity buffer has increased since 2010

Short term liabilities vs. liquidity buffer



(*) Short-term debt includes certificates of deposits, savings certificates, commercial papers and gross interbank exposures

Source: ABN AMRO Annual Accounts and Investors Presentations

4 See European Commission press release "CRD IV/CRR – Frequently Asked Questions", published on 21 March 2013.

ABN AMRO has strengthened its regulatory capital position…

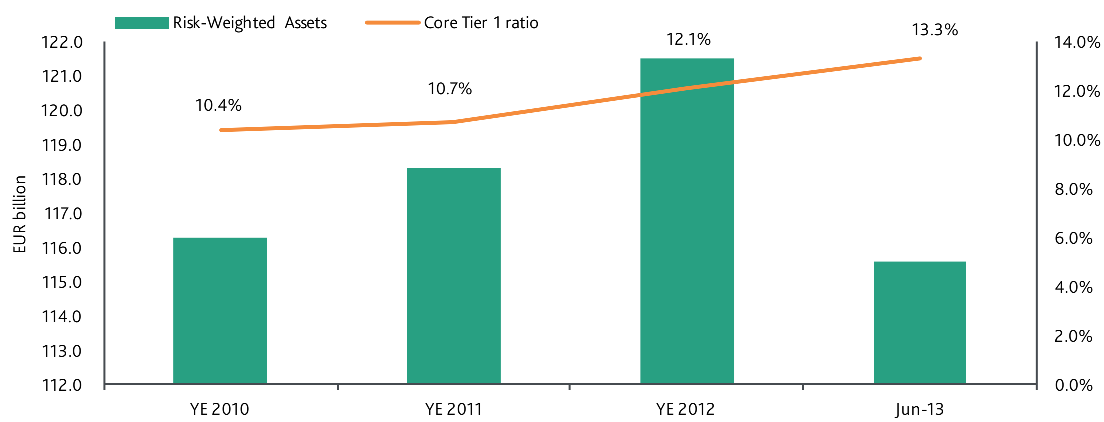
Since 2010, ABN AMRO has improved its capital position through a combination of retained earnings and a reduction in risk-weighted assets, as shown in Exhibit 5. More in particular, the drop in RWAs reported in the first half of this year is the result of the migration of some of its portfolios from the standardized to the advanced approach, as part of the process to integrate the Internal Risk Based (IRB) models of the two former banks.

With a core Tier 1 ratio of 13.3%, its capital position is the strongest among its domestic peers (Exhibit 6). This corresponds to a pro-forma fully loaded Basel III Common Equity Tier 1 capital ratio of 11.5%, one of the strongest internationally. However, we note that these ratios are not perfectly comparable across banks in different jurisdictions.

EXHIBIT 5

Capital position has improved over time

RWAs (left Y axis) vs. capital ratios (right Y axis)

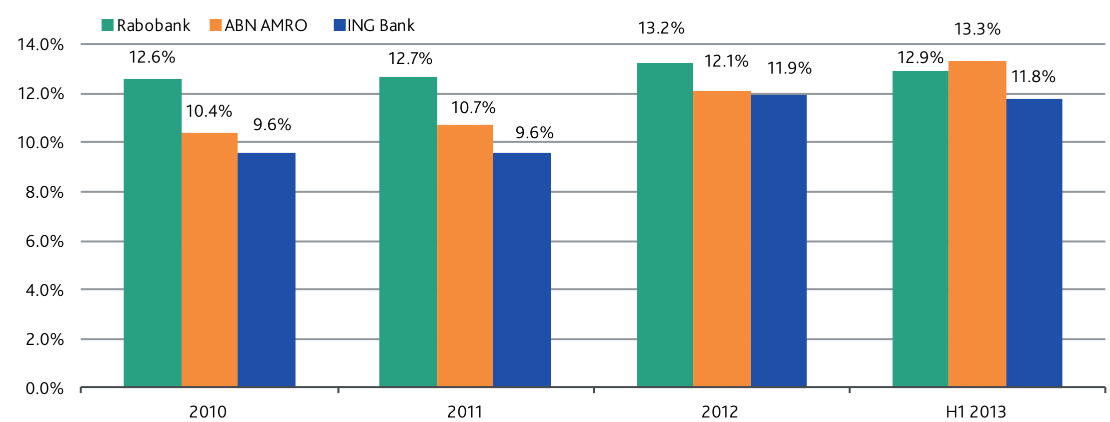


Source: ABN AMRO Annual Accounts and Investors Presentations

EXHIBIT 6

ABN AMRO's capital ratios are the strongest amongst large Dutch banks

Core Tier 1 capital ratios of large Dutch banks(*)



(*) capital ratios exclude Basel I transitional floors

Source: ABN AMRO Annual Accounts and Investors Presentations

The deteriorating Dutch economy and intense competition pose challenges

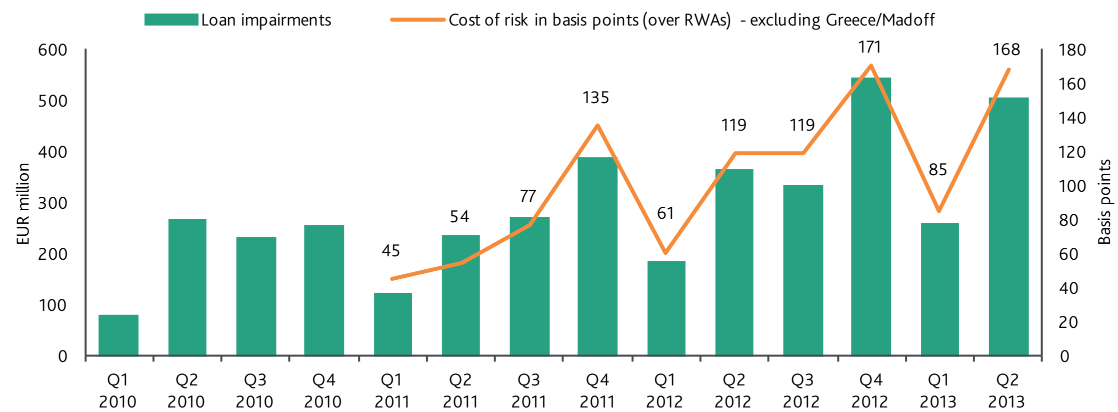
The progress that ABN AMRO has achieved to date on its credit fundamentals has to be set against the challenges posed by a significant deterioration in the Dutch economy which entered into recession towards the end of 2011. The macroeconomic outlook for the country, still one of the strongest economies in Europe, remains unclear, and this affects the credit fundamentals of domestic banks, particularly ABN AMRO, which has the greatest exposure to the Dutch economy.

In particular, reductions in activity and higher credit costs (Exhibit 7) have continued to constrain ABN AMRO's profitability, delaying its full recovery.

EXHIBIT 7

ABN AMRO's credit costs have increased since 2012

Loan impairment charges (left Y axis) vs. credit costs as a percentage of RWAs (right Y axis)



Source: ABN AMRO Annual Accounts and Investors Presentations

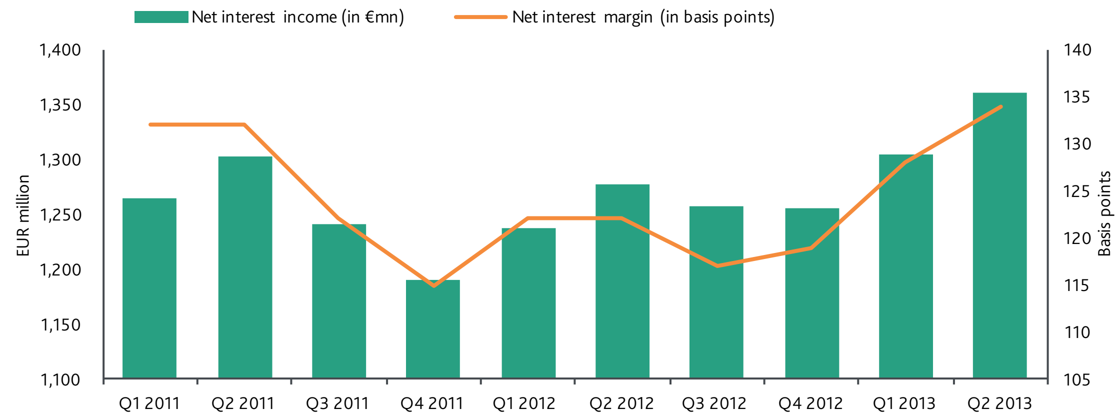
Competitive pressures in the concentrated Dutch banking sector are increasing, as domestic banks compete for a falling volume of business. Competitive pressures are also increasing in Asia, where ABN AMRO has ambitions to expand, particularly in the private banking arena. In recent months, many other European banks have targeted selective expansion in Asia, including a number of jurisdictions structurally rich in deposits such as Hong Kong and Indonesia, in an attempt to ease some of the challenges from their domestic markets. We expect that increasing competition both domestically and internationally will continue for ABN AMRO in the quarters to come, adding further pressures on the bank's revenues.

The prolonged low interest-rate environment in the euro area also continues to pressurise European banks' net interest margins, putting further strains on their overall profitability. Exhibit 8 shows that ABN AMRO was able to restore its margins at 134 basis point in Q2 2013, primarily through the active management of its loan portfolio aimed at preserving loan margins. Despite the positive impact of this policy, the increase in net interest rate margins may not be sustainable in the current environment, which could result in lower margins going forward.

EXHIBIT 8

ABN AMRO has improved its net interest margin in recent quarters, despite the current low interest rate environment

Net interest income and net interest margin in absolute values (left Y axis) and in basis points (right Y axis)



Source: ABN AMRO Annual Accounts and Investors Presentations

ABN AMRO's profitability has improved over time but full recovery will not be achieved while some of its businesses are a drain on profits

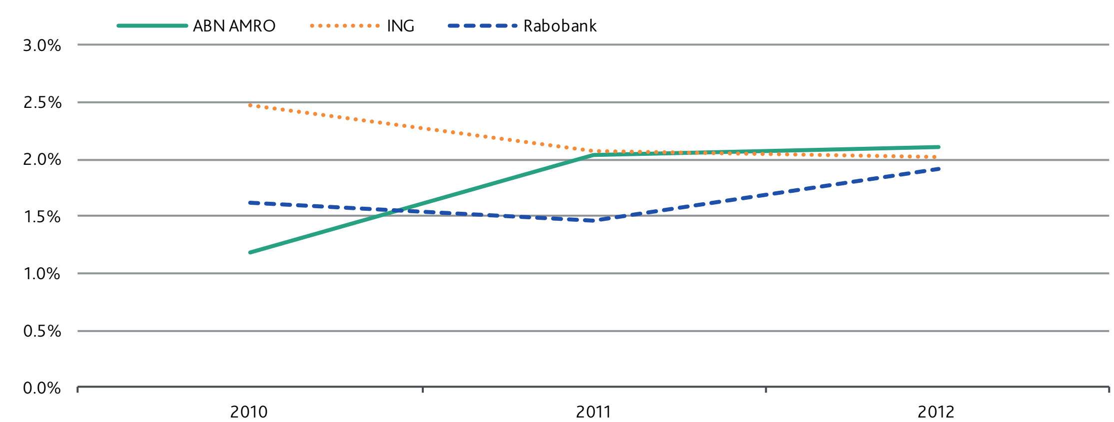
We consider ABN AMRO can only claim full recovery when it fully exploited the potential of its franchise with sustainable profits, which is a precondition of a successful privatisation.

The figure below shows that ABN AMRO's risk-adjusted profits have progressively realigned with those of its domestic peers, with a pre-provision income over average risk-weighted assets of around 2% for 2012. While this figure is in line with the average for European banks, we note that it is largely affected by the relatively low risk weights attached to certain assets classes in the Netherlands, such as mortgages.

EXHIBIT 9

ABN AMRO's risk adjusted profits are in line with those of its domestic peers

Pre-provision income over average RWAs



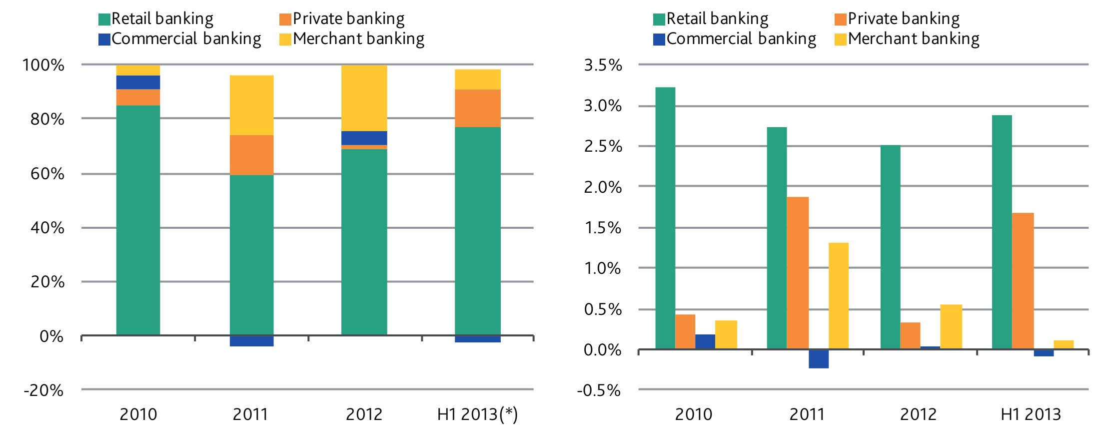
Source: Moody's Banks Financial Metrics

A closer look at the underlying performance of ABN AMRO's business lines (see Exhibit 10 below) shows that the retail banking business, which accounted for 78% of operating income in 2012 (excluding central items), has delivered a relatively high return, with an average pre-provision income over average RWAs of 2.8% since 2010. The remaining business lines continue to be a drain on overall profitability. While private banking and merchant banking are likely to benefit in the short-term from the bank's expansionary ambitions, commercial banking will continue to suffer in the coming quarters. Commercial banking, which includes exposure to domestic SMEs, is the most sensitive to variations in domestic economic sentiment.

EXHIBIT 10

Retail banking provides the greatest contribution to ABN AMRO's underlying profits

Contribution to pre-tax income by business line (left chart) and pre-tax income over Average RWAs (right chart)



(*) annualised

Sources: ABN AMRO annual accounts and investor presentations

The Dutch government intends to return ABN AMRO to private ownership, which we view as a positive development for its creditors…

ABN AMRO is fully owned by the Dutch government following a €22 billion capital injection at the height of the financial crisis. The Dutch authorities have always made it clear, however, that public ownership is meant to be temporary and that they intend to sell the bank, possibly via an initial public offering, as soon as market conditions allow. This is unlikely to be before 2015.

The bank's long term credit ratings incorporate three notches of systemic support, resulting from our assessment of the size and systemic importance of this institution in the Netherlands and, to a much lesser extent, due to its public ownership, given its temporary nature. Consequently, a change in ownership, for example through an IPO, would have little impact on our systemic support assumptions for this institution.

The transfer of ABN AMRO from public to private ownership would indicate that the bank has recovered or is at least showing a promising development. An exit from state ownership would lift a number of conditions imposed by the European Commission to compensate for the state aid the bank received, including a ban on large acquisitions which at present constrains business and franchise expansion. A sale would also give management access to the external capital required to support its expansion, particularly outside the Netherlands.

The Dutch government's decision to further postpone ABN AMRO's privatisation indicates that the required conditions are not yet met

The Dutch authorities reiterated[5] last month that they envisage privatizing ABN AMRO via an initial public offering, subject to three key conditions being met. These are: (1) the bank must be ready; (2) the Dutch banking sector needs to have stabilized; and (3) there must be investor appetite for it.

This statement suggests that these conditions are not yet met, which is in line with our analysis. Regarding the first condition, as we have discussed above, we believe that further progress is required towards achieving a franchise with sustainable profitability, despite the progress that ABN AMRO has made since 2010 - as evidenced by improvement in some of its key credit fundamentals.

We believe that the second condition will be met upon improvement of economic prospects for the Dutch economy, which in turn impacts domestic banks' activities and once the restructuring of the recently nationalized of Dutch bank and insurance group SNS Reaal N.V. (Ba2 on review for downgrade) has been affected in line with EU state aid ruling.

…but this process is not immune from risks for the bank and its creditors

A transfer to private ownership would put different pressures on the bank and its management.

Since 2010, ABN AMRO has been implementing a conservative strategy and its operations are characterised by a moderate risk profile. Although we do not expect privatisation to bring about an abrupt change in strategy, we nevertheless believe that a shift towards riskier and potentially a more profitable strategy is likely over time as a result of pressure from private shareholders. At the same time, we note that the €8 billion loss that the Dutch government expects to suffer as a result of its rescue of ABN AMRO[6] suggest it may place greater scrutiny on ABN AMRO's activities post-privatisation, to avoid any repetition of past mistakes that led to failure at the height of the financial crisis.

5 Reference the PR from the Dutch government published on 23 August 2013.

6 In its communication of 23 August 2013, the Dutch government has indicated that it had invested around €23 billion in ABN AMRO and that it currently expects to recover €15 billion.

Moody's Related Research

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Author
Andrea Usai

Editor
Greg Davies

Production Associates
Eri Watanabe
Shubhra Bhatnagar

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