MOODY'S
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# Credit Opinion: ING Bank N.V.

Global Credit Research - 24 Mar 2015

*Amsterdam, Netherlands*

## Ratings

| Category | Moody's Rating |
|---|---|
| Outlook | Rating(s) Under Review |
| Bank Deposits | *A2/P-1 |
| Baseline Credit Assessment | baa1 |
| Adjusted Baseline Credit Assessment | baa1 |
| Senior Unsecured | **A2 |
| Subordinate | Baa2 |
| Commercial Paper | P-1 |
| Other Short Term | (P)P-1 |
| **ING Bank A.S. (Turkey)** | |
| Outlook | Negative(m) |
| Bank Deposits | Baa3/P-3 |
| NSR Bank Deposits -Dom Curr | A1.tr/TR-1 |
| Baseline Credit Assessment | ba3 |
| Adjusted Baseline Credit Assessment | baa3 |
| **ING Bank Eurasia** | |
| Outlook | Negative |
| Bank Deposits -Fgn Curr | Ba2/NP |
| Bank Deposits -Dom Curr | Baa3/P-3 |
| NSR Bank Deposits -Dom Curr | Aaa.ru/-- |
| Baseline Credit Assessment | ba3 |
| Adjusted Baseline Credit Assessment | baa3 |

* Rating(s) within this class was/were placed on review on March 17, 2015
** Placed under review for possible upgrade on March 17, 2015

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## Key Indicators

**ING Bank N.V. (Consolidated Financials)[1]**

| | [2]**6-14** | [3]**12-13** | [3]**12-12** | [3]**12-11** | [3]**12-10** | **Avg.** |
|---|---|---|---|---|---|---|
| Total Assets (EUR million) | **818,705.0** | **757,725.0** | **834,433.0** | **961,572.0** | **931,836.0** | [4]**-3.2** |
| Total Assets (USD million) | **1,120,930.2** | **1,044,101.0** | **1,100,109.4** | **1,248,259.8** | **1,250,098.6** | [4]**-2.7** |
| Tangible Common Equity (EUR million) | **29,895.7** | **29,952.0** | **30,998.5** | **32,007.2** | **29,752.6** | [4]**0.1** |
| Tangible Common Equity (USD million) | **40,931.8** | **41,272.1** | **40,868.2** | **41,550.0** | **39,914.4** | [4]**0.6** |

| | | | | | | |
|---|---|---|---|---|---|---|
| Problem Loans / Gross Loans (%) | – | 3.1 | 2.7 | 2.3 | 2.3 | [5]2.6 |
| Tangible Common Equity / Risk Weighted Assets (%) | 10.2 | 10.6 | 11.1 | 9.7 | 9.3 | [6]10.2 |
| Problem Loans / (Tangible Common Equity + Loan Loss Reserve) (%) | – | 44.1 | 40.9 | 36.2 | 39.5 | [5]40.2 |
| Net Interest Margin (%) | 1.6 | 1.5 | 1.5 | 1.5 | 1.6 | [5]1.5 |
| PPI / Average RWA (%) | 2.4 | 2.5 | 1.9 | 2.1 | 2.4 | [6]2.4 |
| Net Income / Tangible Assets (%) | 0.6 | 0.4 | 0.6 | 0.5 | 0.6 | [5]0.5 |
| Cost / Income Ratio (%) | 54.8 | 55.4 | 62.6 | 59.5 | 55.2 | [5]57.5 |
| Market Funds / Tangible Banking Assets (%) | 32.1 | 28.9 | 34.4 | 35.7 | 36.0 | [5]33.4 |
| Liquid Banking Assets / Tangible Banking Assets (%) | 33.5 | 28.3 | 22.6 | 22.1 | 26.2 | [5]26.5 |
| Gross Loans / Total Deposits (%) | 106.4 | 102.7 | 110.8 | 106.2 | 102.2 | [5]105.7 |

Source: Moody's

[1] All figures and ratios are adjusted using Moody's standard adjustments [2] Basel III - fully-loaded or transitional phase-in; IFRS [3] Basel II; IFRS [4] Compound Annual Growth Rate based on IFRS reporting periods [5] IFRS reporting periods have been used for average calculation [6] Basel III - fully-loaded or transitional phase-in & IFRS reporting periods have been used for average calculation

## Opinion

### SUMMARY RATING RATIONALE

On 17 March 2015, we placed ING Bank's A2 long-term debt and deposit ratings on review for upgrade. The most likely outcome of the review is that both these ratings be upgraded by one notch to A1. The bank's junior instruments and the Prime-1 short-term ratings were unaffected by this rating action. The review for upgrade on the long-term debt and deposit ratings reflects the introduction of our new methodology, and specifically our advanced Loss Given Failure (LGF) analysis, which applies to ING Bank given that it is subject to an operational resolution regime under the Bank Recovery and Resolution Directive (BRRD). We believe that ING bank's deposit and senior unsecured ratings are likely to benefit from a very low loss-given-failure, which could result in a two-notch uplift from the unchanged baseline credit assessment (BCA) of baa1, to a Preliminary Rating Assessment (PRA) of a2. Furthermore, our assumption of moderate support from the Dutch government (Aaa stable) is likely to lead to a one-notch uplift for systemic support, to A1.

ING Bank (Netherlands) is the second-largest Dutch domestic bank by total assets and ING Bank (including its international branches and subsidiaries) is one of the largest financial institutions in Europe and globally. The current baa1 BCA reflects the bank's (1) strong franchise in the Benelux region, which is rooted in a robust retail presence; (2) good degree of geographical diversification provided mainly by its ING Direct franchise and global Commercial Banking network; (3) sound profitability, despite elevated credit costs; (4) adequate capital position; and, (5) sound liquidity. These strengths are partly offset by the downside asset quality risk caused by the challenging operating environment in the Netherlands, which is ING Bank's home market.

ING BANK'S BCA IS SUPPORTED BY ITS STONG+ MACRO PROFILE

The `Strong+' Macro Profile for ING Bank is mainly driven by its exposure to the Netherlands, accounting for around 30% of its total economic exposures. Dutch banks benefit from operating in a wealthy and developed country with a very high degree of economic, institutional and government financial strength as well as very low susceptibility to event risk. The main risks to the banking system stem from the households sector, which has high leverage due to substantial amount of mortgage debt that exceeds 100% of GDP. However, we also consider that Dutch households also have substantial amounts of savings, which are locked in their pensions.

The Dutch banking system is highly reliant on wholesale funding, which we consider a credit weakness. Compared to other European countries, it has a relatively low stock of bank deposits because of the incentives offered to Dutch households to invest large portions of their savings in pension funds.

### Rating Drivers

- ING Bank has a leading franchise in the Netherlands, Belgium, Germany and in some other key markets

- Profitability has remained sound in recent years despite elevated, albeit reducing, credit costs

- High reliance on wholesale funding mitigated by management's ongoing efforts to lengthen debt maturities and to implement a group-wide asset-liability management strategy

- Capital is adequate to the bank's risk profile and provides satisfactory loss absorption capacity

- Weak operating environment in the Netherlands weighs on the ING Bank's asset quality

- Large volume of deposits and senior debt resulting in deposit ratings benefiting from a very low-given - failure and two-notch uplift from the BCA

- Moderate probability of government support resulting in a one-notch uplift from BCA for deposits and senior debt

**Rating Outlook**

The review for upgrade on ING Bank's long-term debt and deposit ratings was triggered by the introduction of our new methodology, and specifically the advanced Loss Given Failure (LGF) analysis. This applies to ING Bank because it is subject to an operational resolution regime under the Bank Recovery and Resolution Directive (BRRD). The review will focus on the firm's liability structure, in particular the amount of senior long-term debt outstanding, and the amount of debt that is subordinated to it.

We therefore expect both ING Bank's long-term debt and deposit ratings to be upgraded by one notch to A1, depending on the final outcome of the LGF analysis. Furthermore, we expect to include one notch of government support, reflecting a moderate probability of systemic support from the government of the Netherlands.

We believe that the probability of government support for the subordinated debt instruments issued by ING Bank will continue to remain low, leading to no systemic support uplift for these instruments, as currently is the case.

**What Could Change the Rating - Up**

Upward pressure on ING Bank's baa1 BCA could develop if a material improvement in the operating environment in the Netherlands and indeed in the rest of Europe, to which ING Bank is mostly exposed, were to lead to substantially improved asset quality and higher profitability levels. A reduction in reliance on wholesale funding could also be positive for the BCA. A positive change in ING Bank's BCA would likely affect all ratings.

The long-term deposit and senior debt ratings of ING Bank are on review for upgrade, driven by our review of the likely loss-given-failure faced by these securities. If we conclude that the group's liability structure is in line with our current understanding, then we will upgrade these ratings by one notch. ING Bank's long-term debt and deposit ratings could also be upgraded if the holding company ING Groep (A3 on review for downgrade) were to issue a significant amount of long-term debt.

**What Could Change the Rating - Down**

Rating downgrades are unlikely over the next 12-18 months, given that the bank's long term debt and deposit ratings are currently on review for upgrade. However, downward pressure on ING Bank's ratings could materialise as a result of a reduction in the bank's baa1 BCA, for example in case of higher-than-expected deterioration of its credit fundamentals.

**DETAILED RATING CONSIDERATIONS**

The financial data in the following sections are sourced from ING Bank's financial statements unless otherwise stated.

ING BANK HAS A LEADING FRANCHISE IN THE NETHERLANDS, BELGIUM, GERMANY AND IN SOME OTHER KEY MARKETS

ING Bank has a robust franchise in the core retail and corporate banking of the regions in which it operates. The bank has preserved good pricing power and steady earnings generation capacity both in the markets where it is a leading player (i.e., retail Benelux and Germany) and in those where it is a second-league player with strong expertise in niche areas (i.e., ING Direct, commercial banking).

The Netherlands is ING Bank's home market, where it holds a strong position in both commercial banking (with a

20%-30% share in the SME and mid-size corporate market segments) and retail banking (20% market share).

ING Bank also has a solid universal banking franchise in Belgium through ING Belgium (deposit ratings A2 on review for upgrade/Prime-1; BCA baa1), which ranks fourth in the local market with market shares in excess of 15%. ING Belgium also consolidates the activities of ING Luxembourg (unrated), which is a wholly owned subsidiary involved in the local retail, corporate and private banking businesses.

ING Bank's retail banking operations contribute to around 60% of the bank's results and display a good degree of geographical diversification. ING Bank maintains significant presence in Australia, France, Germany, Italy and Spain through its ING Direct franchise, where its market share is smaller in comparison with its two home markets but in which the bank is, nevertheless, a lead provider of internet banking and mobile banking services. ING Bank's position is particularly strong in Germany where it operates through ING DiBa (A2/Prime-1 on review for downgrade, BCA a3 on review for upgrade), which accounts for more than half of total deposits gathered through ING Direct. Furthermore, ING Bank has significant presence in Poland, Turkey and Romania, which management consider as growth markets.

ING Bank's commercial banking business accounts for around 40% of the bank's earnings. Activities undertaken within this business line include financial markets, structured finance (i.e., corporate credit including energy, transport and infrastructure, specialised financing, trade and export finance), general lending, payment and cash management, leasing and factoring, and real estate. ING Bank has maintained a leadership position in these business segments in both Benelux and Central & Eastern Europe.

PROFITABILITY HAS REMAINED SOUND IN RECENT YEARS DESPITE INCREASED, ALBEIT REDUCING, CREDIT COSTS

ING Bank's recurring profitability has remained robust since mid-2011, despite deterioration in its asset quality profile which has, in turn, given rise to higher credit costs. The bank's recurring earnings base has proven resilient and operating efficiency is good, as indicated by a cost-to-income ratio of 59% in 2014 (our calculation). Whilst credit costs have trended down in recent quarters, we expect that challenging operating conditions will continue to weigh on earnings in the coming quarters.

Recurring earnings have remained relatively steady over the past three years. Interest income, which accounts for 75%-80% of the bank's total underlying income, has remained fairly stable despite margin pressure on savings, higher funding costs (as a result of lengthening of the duration of wholesale funding), and lower returns from the investment portfolio (following de-risking operations in 2012). In addition, the protracted low interest rate environment exerts sustained negative pressure on interest margins, which ING Bank mitigates by deposit re-pricing (where possible) and originating new lending at higher margins.

The higher level of credit costs observed since mid-2011, caused by uncertain economic conditions in the Netherlands, continues to weigh on the bank's recurring profit. The main contributors to the increased credit costs are the commercial banking book (including the real estate finance portfolio), the Dutch SME and business portfolio, and - to a lesser extent - the Dutch mortgage portfolio. Loan loss provisions reduced to 32 basis points (bps) of average customer lending in 2014 from 43 bps in 2013 and accounted for approximately one third of ING Bank's pre-provision profit, which leaves room to generate profit. We expect credit costs, particularly from its domestic book, to remain high over the coming quarters.

The average Net Income / Tangible Banking Assets for the last 3 years of 0.5% corresponds to a Profitability score of baa2, which we adjust upwards by one notch to baa1 to take into account the relatively high degree of diversification of its earnings.

HIGH RELIANCE ON WHOLESALE FUNDING MITIGATED BY ONGOING EFFORTS TO LENGTHEN DEBT MATURITIES AND TO IMPLEMENT A GROUP-WIDE ASSET-LIABILITY MANAGEMENT STRATEGY

Despite large a sizeable deposit book, ING Bank's reliance on wholesale funding remains high, reflecting the structural features of the Dutch banking system. However, we consider that the ongoing efforts deployed by the bank over the past few years to mitigate this weakness have proven successful. These measures included (1) the lengthening of the maturity profile of its wholesale funding to reduce refinancing risk; (2) the use of the excess funding available in those foreign cash-rich subsidiaries to fund financially constrained entities through an active group-wide asset-liability management strategy; and (3) the increase in the volume of deposits in the Netherlands. This is reflected in the assigned score of baa2 for Funding Structure, which factors in the elevated reliance on wholesale funding (as indicated by a Market Funds / Tangible Banking Assets ratio of 29%), partly offset by the good quality of its deposit base and term structure of its wholesale funding maturity profile.

Combined with the effects of moderate loan growth, the bank's improved funding profile has contributed to an improved liquidity profile. At year-end 2014, the Basel III liquidity coverage ratio (LCR) was above 100%. We also note positively that the bank significantly improved the liquidity at ING Bank N.V., the Dutch parent company, which, on a standalone basis, used to have the largest customer funding gap within the group. Another positive feature of the bank's balance sheet is the relatively low asset encumbrance, which leaves sufficient amount of loans available to be packaged into central bank eligible securitisations, if required.

The overall sound liquidity and funding position of the bank is reflected in the baa2 combined score for Liquidity, which we assign to ING Bank.

CAPITAL IS ADEQUATE TO THE BANK'S RISK PROFILE AND PROVIDES SATISFACTORY LOSS ABSORPTION CAPACITY

ING Bank reported a fully loaded Common Equity Tier 1 (CET1) ratio of 11.4% at end-2014, from 10.0% at end-2013. This increase was mainly driven by earnings retention but was partly offset by the negative impact from the introduction of Basel III through CRD IV in Europe, the payment of the dividend to the group and the effect of the discontinuation of the staff defined benefits pensions plan. Overall, we consider that the bank's capital base, together with its earnings power, provides it with a satisfactory loss absorption capacity. The bank reported a Tangible Common Equity / RWA ratio of 10.2% at end-June 2014, which we expect to continue to increase mainly driven by earnings retention. However, its Tangible Common Equity / Total Assets (excluding derivatives, our measure of leverage) was 4% as at the same reporting date, which is weaker than many of its global peers, reflecting the large portion of mortgage lending.

As we expected, ING Bank successfully passed the ECB comprehensive assessment, which consisted of a supervisory judgement on key risks, as asset quality review and a stress test prior to the transition to the euro area single supervisory mechanism on 4 November 2014. The outcome of the asset quality review was a relatively small reduction of 29 basis points on ING Bank's CET1 ratio to 10.1% at end-2013 - mainly due to the pension transaction in the Netherlands. The bank's transitional CET1 ratio under stress was 10.4% in the base case and 8.7% in the adverse scenario, above the respectively minimum requirements of 8.0% and 5.5%.

WEAK OPERATING ENVIRONMENT IN THE NETHERLANDS WEIGHS ON ING BANK'S ASSET QUALITY

Similar to its large domestic peers, ING Bank has experienced deterioration in its asset quality since mid-2011, driven by the uncertain operating environment in the Netherlands, which was reflected in the higher non-performing loan (NPL) ratio of 3.0% at end-2014, from 2.0% at year-end 2011. The main contributors of this increase were the (commercial) Real Estate Finance, the domestic business/corporate and mortgage portfolios. Despite the gradual reduction in credit costs since mid-2013, we expect the overall cost of risk to remain elevated in the coming quarters because of the ongoing economic uncertainty in the Netherlands and the rest of Europe.

The Real Estate Finance portfolio represented around 65% of the bank's Tier 1 capital at end-2014, with the largest concentration in the Netherlands (59%), Spain (9%) and Italy (6%). Credit costs for this portfolio dropped to 22 bps in 2014 from 135 bps in 2013 and 125 bps for full-year 2012 while the NPL ratio decreased to 8.1% at end-2014 from 10.7% at year-end 2013 and 7.5% at year-end 2012. Despite reduction in credit costs in recent quarters, we believe that exposures to this sector, which is cyclical by nature, could give rise to additional credit costs in the future, particularly as long as pressures on the Dutch commercial real estate sector have not visibly abated.

Credit costs related to the bank's Dutch residential mortgage book was 13 basis points (over gross loans), a reduction from the previous year, as a result of better prospects for the Dutch economy. The cost of risk for residential mortgages is very low by European comparison but we note that the Dutch market has some specificities, including very high loan-to-value ratios and the high proportion of bullet loans (a historically tax-driven feature) render ING Bank vulnerable in a scenario of a strong deterioration in the macroeconomic environment. This risk is common to all Dutch retail banks. We positively note that ING Bank has limited exposures to countries that are experiencing geopolitical issues such as Russia and its good overall asset quality profile has also been confirmed by the results from the recent ECB's comprehensive assessment.

We assign an Asset Risk score of baa1 to ING Bank, which reflects the good asset quality profile of the bank but it is constrained by its still large (albeit declining) concentration to the CRE sector.

## Notching Considerations

LOSS GIVEN FAILURE AND ADDITIONAL NOTCHING

ING Bank is subject to the EU Bank Recovery and Resolution Directive (BRRD), which we consider to be an Operational Resolution Regime. We assume residual tangible common equity of 3% and losses post-failure of 8% of tangible banking assets, a 25% run-off in "junior deposits", a 5% run-off in preferred deposits, and assign a 25% probability to deposits being preferred to senior unsecured debt, in line with our standard assumptions.

For ING Bank's deposits, our initial LGF analysis is not conclusive and our review will consider the likely impact on loss-given-failure, due to the loss absorption provided by subordinated debt and, potentially, by senior unsecured debt should deposits be treated preferentially in a resolution, as well as the substantial volume of deposits themselves. Our preliminary analysis indicates a potential outcome of very low loss-given-failure, which would result in a Preliminary Rating Assessment (PRA) two notches above the BCA.

For ING Bank's senior unsecured debt, our initial LGF analysis is also not conclusive and our review will consider the likely impact on loss-given-failure of the combination of its own volume and the amount of debt subordinated to it. We expect this will result in a PRA of two notches above the BCA.

We have left unchanged the ratings for the junior securities issued by ING Bank as our initial LGF analysis confirms a high level loss-given-failure, given the small volume of debt and limited protection from more subordinated instruments and residual equity. We also incorporate additional notching for junior subordinated and preference share instruments reflecting the coupon features. The resulting PRAs are set out below.

GOVERNMENT SUPPORT

The implementation of BRRD has led us to reconsider the potential for government support to benefit the bank's creditors. We now expect moderate probability of government support for deposits, and senior unsecured creditors, resulting in a one-notch of systemic support uplift. We expect to assign the same probability to the senior unsecured debt ratings, once our review is complete.

For other junior securities, we continue to believe that potential government is low and these ratings do not include any related uplift. Junior securities also include additional downward notching from the BCA reflecting coupon suspension ahead of potential failure.

ABOUT MOODY'S BANK RATINGS

Our Scorecard is designed to capture, express and explain in summary form our Rating Committee's judgment. When read in conjunction with our research, a fulsome presentation of our judgment is expressed. As a result, the output of our Scorecard may materially differ from that suggested by raw data alone (though it has been calibrated to avoid the frequent need for strong divergence). The Scorecard output and the individual scores are discussed in rating committees and may be adjusted up or down to reflect conditions specific to each rated entity.

## Rating Factors

**ING Bank N.V.**

| **Macro Factors** | |
|---|---|
| **Weighted Macro Profile** | **Strong +** |

| **Financial Profile** | | | | | | |
|---|---|---|---|---|---|---|
| **Factor** | **Historic Ratio** | **Macro Adjusted Score** | **Credit Trend** | **Assigned Score** | **Key driver #1** | **Key driver #2** |
| **Solvency** | | | | | | |
| **Asset Risk** | | | | | | |
| *Problem Loans / Gross Loans* | 3.1% | a3 | ←→ | baa1 | Quality of assets | Sector concentration |
| **Capital** | | | | | | |
| *TCE / RWA* | 10.2% | baa2 | ↑ | baa2 | Nominal leverage | Expected trend |
| **Profitability** | | | | | | |

| | | | | | | |
|---|---|---|---|---|---|---|
| *Net Income / Tangible Assets* | 0.5% | baa2 | ←→ | baa1 | Earnings quality | Other |
| **Combined Solvency Score** | | baa1 | | baa1 | | |
| **Liquidity** | | | | | | |
| **Funding Structure** | | | | | | |
| *Market Funds / Tangible Banking Assets* | 28.9% | baa2 | ←→ | baa2 | Deposit quality | Term structure |
| **Liquid Resources** | | | | | | |
| *Liquid Banking Assets / Tangible Banking Assets* | 28.3% | a3 | ←→ | baa1 | Intragroup restrictions | Encumbrance |
| **Combined Liquidity Score** | | baa1 | | baa2 | | |

| | |
|---|---|
| **Financial Profile** | **baa1** |

| **Qualitative Adjustments** | **Adjustment** |
|---|---|
| Business Diversification | 0 |
| Opacity and Complexity | 0 |
| Corporate Behavior | 0 |
| **Total Qualitative Adjustments** | **0** |

| | |
|---|---|
| Sovereign or Affiliate constraint | Aaa |
| Scorecard Calculated BCA range | **a3 - baa2** |
| **Assigned BCA** | **baa1** |
| Affiliate Support notching | **0** |
| **Adjusted BCA** | **baa1** |

| **Instrument Class** | **Loss Given Failure notching** | **Additional notching** | **Preliminary Rating Assessment** | **Government Support notching** | **Local Currency rating** | **Foreign Currency rating** |
|---|---|---|---|---|---|---|
| Deposits | -- | -- | -- | -- | A2 RUR Possible Upgrade | A2 RUR Possible Upgrade |
| Senior unsecured bank debt | -- | -- | -- | -- | A2 RUR Possible Upgrade | A2 RUR Possible Upgrade |
| Dated subordinated bank debt | -1 | 0 | baa2 | 0 | Baa2 | Baa2 |

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