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Jan-Feb 2014

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Q&A
BBVA

Crédit Agricole
Points to AT1 future

Nordics
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<p>JANUARY 2014</p> <p> CRÉDIT AGRICOLE S.A. CRÉDIT AGRICOLE S.A.</p> <p>USD 1,750,000,000</p> <p>7.875% PerpNC10 Additional Tier 1 Notes</p> <p>Joint Dealer Manager & Global Coordinator</p>	<p>JANUARY 2014</p> <p> AXA S.A.</p> <p>GBP 750,000,000</p> <p>5.625% 2054 NC 2034 Subordinated Notes</p> <p>Joint Bookrunner</p>	<p>DECEMBER 2013</p> <p> BARCLAYS BARCLAYS PLC</p> <p>EUR 1,000,000,000</p> <p>8.0% Additional Tier 1 Contingent Convertible Perp NC 2020 Notes</p> <p>Joint Lead Manager</p>	<p>NOVEMBER 2013</p> <p> Raiffeisenlandesbank Niederösterreich-Wien RAFFEISENLANDESBANK NIEDERÖSTERREICH-WIEN AG</p> <p>EUR 300,000,000</p> <p>5.875% Tier 2 Subordinated Notes due 2023</p> <p>Joint Bookrunner</p>
<p>OCTOBER 2013</p> <p> ALLIANZ SE ALLIANZ SE</p> <p>EUR 1,500,000,000</p> <p>4.75% Subordinated Notes Perp NC 2023</p> <p>Joint Bookrunner</p>	<p>OCTOBER 2013</p> <p> RUSSIAN AGRICULTURAL BANK RUSSIAN AGRICULTURAL BANK</p> <p>USD 500,000,000</p> <p>8.5% Tier 2 Subordinated Notes due 2023</p> <p>Joint Bookrunner</p>	<p>OCTOBER 2013</p> <p> ICBC (ASIA) ICBC (ASIA)</p> <p>USD 500,000,000</p> <p>4.5% Tier 2 Subordinated Notes due 2023</p> <p>Joint Bookrunner</p>	<p>SEPTEMBER 2013 REMARKETING</p> <p> CITIGROUP CITIGROUP</p> <p>USD 1,420,000,000 5.5% Subordinated T2 Notes due 2025 USD 1,000,000,000 6.675% Subordinated T2 Notes due 2043 Joint Bookrunner</p>
<p>SEPTEMBER 2013</p> <p> CRÉDIT AGRICOLE S.A. CRÉDIT AGRICOLE S.A.</p> <p>USD 1,000,000,000</p> <p>8.125% 20NC5 Contingent Capital Subordinated Notes</p> <p>Joint Dealer Manager & Global Coordinator</p>	<p>FEBRUARY 2013</p> <p> UBS UBS</p> <p>USD 1,500,000,000</p> <p>4.75% 10NC5 Subordinated Notes due 2023</p> <p>Joint Bookrunner</p>	<p>FEBRUARY 2013</p> <p> ZURICH AQUARIUS + INVESTMENTS</p> <p>EUR 787,522,000</p> <p>4.25% 30NC10 Subordinated Notes due 2043 NC 2023</p> <p>Joint Bookrunner</p>	<p>JANUARY 2013</p> <p> AXA S.A.</p> <p>EUR 1,000,000,000 5.125% 30NC10 Sub. Notes Joint Bookrunner & Global Coordinator USD 850,000,000 5.5% PerpNC6 Sub. Notes Joint Bookrunner</p>

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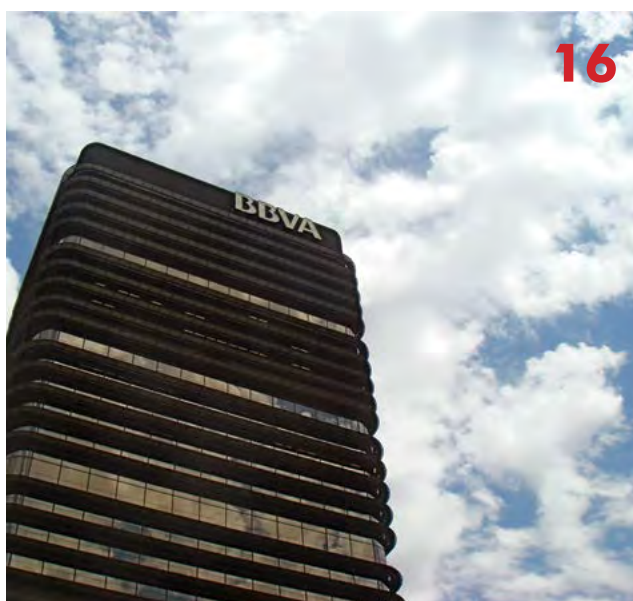
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Solvency II is finally becoming concrete. While insurers have long been preparing for its arrival, the final details of it and other international standards could yet affect their capital planning. How are market participants positioning themselves in light of this and the increased room for hybrids under the emerging framework? Neil Day sought the views of all sides of the market.



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From the moment Svenska Handelsbanken reopened the market for 2014, forecasts of the asset class being the one to watch have come good. The only obstacle to Nordic banks joining the action in hybrid form appears to be regulatory uncertainty. *Susanna Rust* reports.

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Welcome



Welcome to the first edition of *Bank & Insurance Hybrid Capital*, a new publication dedicated to the asset class that we are delighted to be bringing you in association with our partners at Crédit Agricole CIB.

Our inaugural issue comes out as the post-crisis regulatory framework is becoming sufficiently detailed to allow a host of financial institutions to seriously consider capital instruments. At the same time, investors' concerns and restrictions regarding buying the innovative structures that are being developed appear to be falling away.

Taken together, these developments have seen a surge in demand for a growing volume of issuance in late 2013 and the first weeks of 2014, culminating in a record \$24.5bn order book for a \$1.75bn AT1 transaction for Crédit Agricole in January.

Since then, UBS has shown the euro route to be open and, as our first issue was going to press, BBVA followed this up with a Eu1.5bn AT1, its choice of currency showing the development of the investor base since the Spanish bank pioneered the new instrument in US dollars in April 2013.

Nordic banks have meanwhile demonstrated their standing among investors by setting progressively tighter post-crisis record levels in the Tier 2 market. Once regulatory questions are answered it can be only a matter of time before the AT1 market welcomes some of the credits that have fared best through the crisis.

Insurance companies can watch the pace of change in the bank sector from a somewhat relaxed position. Wise from previous crises and with Solvency II having evolved since before the onset of the latest financial crisis, Europe's insurers have long been adapting their business models and optimising capital structures.

The finalisation of their framework's detail is nevertheless expected to be the catalyst for new hybrid activity from the sector and we hear from representatives of leading players in a roundtable.

It's early days, but just over a month into the new year the asset class looks like the one to watch in 2014 and we look forward to accompanying you through the year.

Enjoy the ride!

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Market news

Investors rush to first UBS euro CoCo

UBS priced the first euro CoCo transaction of the year on 6 February, a Eu2bn 12 year non-call seven low trigger Tier 2 that was more than five times oversubscribed to underscore the growth in demand among the euro investor base for the new type of subordinated debt.

The deal is the Swiss bank's fourth contingent capital issue but its first in euros, with CoCos rare in the single European currency overall as issuers have favoured the US dollar market.

Only a handful of banks including Barclays and Credit Suisse had previously tapped the euro market with contingent capital instruments, the Swiss bank having done so in September with a Eu1.25bn low trigger Tier 2 and the UK bank in early December with a Eu1bn AT1 issue.

UBS launched its deal two days after announcing its fourth quarter results, which were better than expected. An 11-strong lead manager line-up first marketed the deal at 345bp-350bp over mid-swaps, with more than Eu10bn of orders placed and the size and spread fixed at Eu2bn and 340bp over, respectively, for a coupon of 4.75%.

UBS acted as global co-ordinator, alongside bookrunners BBVA, Deutsche Bank, Commerzbank, Crédit Agricole CIB, Lloyds, RBS, Santander, Société Générale, UniCredit and VTB.

At 340bp over, the deal was priced at the tightest spread to swaps ever for a CoCo, noted Vincent Hoarau, head of FIG syndicate at Crédit Agricole CIB.

"This is excellent news for the euro market and we have more clear evidence that CoCos do not need to be US dollar denominated," he said. "The euro market investor base is getting more mature every day, with UK accounts leading the pack thanks to their capacity to buy in US dollars but also in euro for size."

"The growing participation of some key French real money accounts is also very encouraging for the growth of the asset class in euros."



Some 550 accounts participated in the transaction. The UK took 46%, France 11%, Switzerland 11%, Germany and Austria 11%, southern Europe 6%, Nordics 6%, the Benelux 6%, Asia 2%, and others 1%. Managed funds bought 63% of the securities, private banks 11%, insurance companies 11%, hedge funds 9%, banks 3%, corporates 1%, and others 2%.

The deal was the first of any type from a financial borrower that week, with volatile market conditions having kept any new issue projects at bay before UBS broke the ice, tapping the market before a monthly European Central Bank meeting and US non-farm payrolls the following day.

The timing of UBS's transaction was arguably therefore not obvious, but its relevance was superseded by the demand overhang for high yielding low beta supply, according to Hoarau.

"Too many are just sitting on a mountain of cash, which is costly, and are therefore forced to buy in," he said. "It's a high quality signature from a safe haven country with a very nice coupon, so you can't miss out on such an opportunity."

UBS's 12 year notes feature a contingent writedown that is triggered at the earlier of a breach of 5% Common Equity Tier 1 (CET1) or the point of non-

viability. The buffer to the 5% trigger was 13.9% or Sfr31.7bn (Eu25.91bn) at the end of the last quarter, which Crédit Agricole CIB financials analysts said was a "very comfortable" cushion, including CET1 and high-trigger CoCo securities.

As of the fourth quarter of 2013, UBS has a Basel III CET phase-in ratio of 18.5% and a Basel III phase-in total capital ratio of 22.2%. The Tier 2 hosted CoCos count as "progressive capital", according to the leads, assisting UBS in meeting new Basel III and Swiss requirements for systemically relevant banks in 2019.

According to a syndicate official on the deal, secondary market levels for Credit Suisse's low trigger 2020 Tier 2 issue were the main pricing comparable for UBS's inaugural euro CoCo, and were trading at around 330bp over. The curve extension and a new issue premium together called for some 15bp additional spread, with a few basis points deducted for the credit spread differential between the two Swiss banks, he said.

As BIHC was going to press, Spain's BBVA on 11 February priced its inaugural euro Additional Tier 1 (AT1), a Eu1.5bn perpetual non-call five low trigger CoCo that was swamped with Eu14bn of orders from some 600 investors. ●

Allianz gets tight pricing in hybrid Swissie

Allianz achieved the smallest coupon ever for an insurance hybrid issue in the Swiss franc market in January when it sold a Sfr500m (Eu408m) perpetual non-call five-and-a-half-year issue, according to a lead syndicate banker.

The transaction was launched on 22 January, with the German insurer having laid the groundwork for the deal with presentations and one-on-one meetings in Zurich and Geneva the preceding two days, for which investors turned out in strong numbers, according to the syndicate official.

Deutsche, UBS and Zürcher Kantonalbank soft-sounded the resettable fixed rate transaction at a coupon of 3.375%-3.625% in the afternoon on 21 January, with a positive response from investors allowing the leads to officially open order books for a Sfr500m deal the following day with price guidance of the 3.25% area.

The order books were closed after



20 minutes and the issue was priced at 3.25%, equivalent to 257.3bp over mid-swaps. This is the lowest coupon achieved on a hybrid issue in the Swiss franc market by an insurer, according to the syndicate official.

He said that a larger deal would have been possible based on the level and quality of demand, but that the issuer

opted to size it at Sfr500m for the sake of good secondary market performance.

The deal was Allianz's first subordinated deal ever in the Swiss franc market, according to the banker.

Swiss investors were allocated 92% of the bonds, and others 8%. Banks took 57%, asset managers 26%, and insurance companies 12%. ●

NEWS IN BRIEF

RBC sells C\$200m preferred shares

Royal Bank of Canada launches debut Basel III-compliant Canadian Tier 1: Royal Bank of Canada announced on 21 January a domestic public offering of C\$200m Perpetual Reset Preferred Shares. The notes carry a deferrable non-cumulative quarterly fixed dividend at a 4% yield until the first call date in May 2014. Thereafter, the dividend rate will reset every five years at a rate equal to 2.21% over the five year Government of Canada bond yield.

The notes, which will count as Tier 1 capital, contain a contractual point of non-viability clause, based on which the bond would be automatically converted into common equity if determined by the Canadian regulator. The issue has been rated Baa3 (hyb) by Moody's, four notches below the adjusted BCA.

Gazprombank announces consent results: Gazprombank announced on 17 January the success of a consent solicitation on its outstanding PerpNC2018 US\$1bn 7.875% Tier 2, formerly structured to meet the then-current Standard & Poor's RAC requirements.

The accepted amendments will move the first call date to

year 10 to capture the grandfathering treatment as legacy Tier 1, and insert a contractual loss absorption mechanism to allow the grandfathered part to be treated as new Basel III Tier 2.

Sberbank starts roadshow for USD T2 transaction: Russian lender Sberbank on 10 February started a series of investor meetings across Europe and the US. The issuance of a Reg S/144A US dollar Tier 2 Loan Participation Note should follow, subject to market conditions.

Cattolica Assicurazioni brings new Eu100m 30NC10 T2: Italian insurer Cattolica Assicurazioni issued new Eu100m 7.25% 30NC10 Tier 2 Notes on 12 December in order to finance the acquisition of FATA Assicurazioni.

Citi announces tender offer on EUR and GBP sub notes: On 3 February, Citigroup announced a tender offer under the Modified Dutch Auction format on its outstanding Eu1.25bn 4.25% 2030NC2025 and £500m 4.5% 2031 subordinated notes, for up to US\$285m equivalent. ●

BPCE, SG welcomed back in Yankee Tier 2s

French banks BPCE and Société Générale were warmly received in the Yankee market when they launched Tier 2 subordinated capital issues on two consecutive days in the middle of January.

BPCE was out first, selling a \$1.5bn (Eu1.1bn) 5.15% 10.5 year deal on 13 January, its third Tier 2 since July, with Société Générale pricing a \$1bn 5% 10 year issue a day later, only five weeks after it raised \$1.75bn of Additional Tier 1 (AT1) hybrid debt in December.

The new issues were part of a busy week for French Yankee supply, with Crédit Agricole launching an inaugural AT1 deal and Banque Fédérative du Crédit Mutuel tapping the senior unsecured market.

SG's Tier 2 was its fourth subordinated bond issue since 2013, with BPCE also having been active in the bank hybrid market, tapping euros with a Tier 2 last July and then the US market in October.

A funding official at a French bank placed the spurt of French issuance in January partly in the context of the rehabilitation of the country's banks in the eyes of investors, after they had been hit by the euro-zone sovereign crisis, and added that limited supply of high yielding debt from stable credits plus supportive market conditions also lured issuers into the market. Either needing Tier 2 capital to meet regulatory requirements or seeking to exceed those levels to protect senior unsecured bondholders will have been drivers behind this kind of issuance, he said.

Bernard Delpit, chief financial officer of the Crédit Agricole Group, meanwhile said that a change in the French regulator's stance on issuance of hybrid capital instruments since 2012 also helps explain the growth of new style subordinated securities. (*See CASA AT1 case study for more.*)

Officials at BPCE and Société Générale said that their Tier 2 issuance in January goes toward meeting total capital ratio targets as set out in recently communi-



cated guidance to the market.

Société Générale is aiming for a total capital ratio of 14%-15% by the end of 2015 under Basel III rules, said Vincent Robillard, head of group funding at the issuer, and it launched its \$1bn 5% 10 year Tier 2 issue on 14 January on the back of its AT1 in December.

"After the success of the AT1 we felt that there would be good appetite from US investors for a Tier 2 and that liquidity was sufficiently high to return to that market, and it was the right decision," he said.

Leads Bank of America Merrill Lynch, BNP Paribas, Société Générale and Standard Chartered priced the Tier 2 at 225bp over US Treasuries, the tight end of guidance of the 230bp over area. Around 150 accounts placed some \$3bn of orders.

Robillard noted that the spread is the tightest for a US dollar Tier 2 issue from a French bank since the collapse of Lehman Brothers, and that it was positive to see other French supply that week also being successful.

He said that in euros Société Générale has only been active on the "classic" Tier 2 market so far, and that it will continue at the moment to be focused on both classic Tier 2 and AT1 markets.

US investors took 76% of Société Gé-

nérale's \$1bn 5% 10 year Tier 2 bonds, and European accounts 24%. Fund managers were allocated 76%, insurance companies and pension funds 11%, hedge funds 6%, banks 4%, private banks 2%, and others 1%.

BPCE builds bail-in buffers

BPCE priced its \$1.5bn 5.15% 10.5 year Tier 2 issue at 235bp over US Treasuries on the back of \$6.1bn of demand. The deal followed a euro subordinated Tier 2 transaction in July and a \$1.5bn 10 year 5.7% Tier 2 in October.

"It was a great outcome," said Roland Charbonnel, director, group funding and investor relations at BPCE. "In October we priced our deal at Treasuries plus 300bp over so we were able to tighten the spread quite substantially."

The reception from North American investors was similarly positive to that for BPCE's October transaction, he added, with the main difference in terms of the geographic composition of demand being that BPCE was this time able to target Asian investors with its Tier 2 offering.

"Because of the debt ceiling crisis in the US at the time of our October deal we waited until the last minute to go ahead with the deal, and it was too late to be able

to market the deal to Asian investors so the distribution there on that occasion was very limited.”

US investors took 68% of BPCE's latest Tier 2, Europe 21%, Asia 8%, Latin America 2%, and others 1%. Asset managers were allocated 71%, insurance companies and pension funds 12%, hedge funds 10%, private banks 6%, and others 1%.

In tapping the subordinated bank capital market in January, BPCE was aiming to further boost its total capital ratio in pursuit of its target of a ratio in excess of 15% in 2017 at the latest, hopefully sooner, according to Charbonnel.

He said that guidance was announced to the market in November last year when

the new strategic plan of Groupe BPCE for 2014-2017 was presented.

“We are building a total capital ratio buffer to protect our senior unsecured investors from the risk of bail-in,” he said, “and at the same time we are building a buffer to protect our Tier 2 issues from bail-in through our Common Equity Tier 1 (CET1) ratio.”

The issuer is targeting CET1 in excess of 12% by 2017.

Raising loss-absorbing capital in the form of AT1 capital is not a top priority for BPCE at the moment since the issuer already exceeds the required level of 3%, said Charbonnel.

“It would become more of a priority

if leverage ratio regulatory requirements increase to more than 3% or if there is a market consensus for more than 3%, but at the moment we exceed that level,” he said. “We aren't ruling out AT1 completely, but the decision has not been made yet and if we did issue the purpose would be first to replace at least part of our old Tier 1 instruments issued a few years ago.”

The issuer also indicated that the risk-adjusted capital ratio (RAC) of Groupe BPCE that has been calculated by Standard & Poor's is well above an important threshold, added Charbonnel, and BPCE does not see a need for AT1 issuance from this perspective. ●

NEWS IN BRIEF

Bendigo, Santander Mexico in regional firsts

Bendigo & Adelaide Bank brings first institutional Australian Basel III-compliant T2: Bendigo & Adelaide Bank launched an A\$300m Tier 2 at BBSW+280bp on 21 January. The transaction was 2.5 times oversubscribed, with more than 35 investors participating, marking the first institutional offering of a Basel-III compliant subordinated bond from an Australian bank. The notes, which include a non-viability clause in accordance with APRA's regulations, were rated Baa2 by Moody's, BBB by S&P, and BBB+ by Fitch.



Santander Mexico prints first Latam Basel III Tier 2: On 18 December, Santander's Mexican subsidiary issued the first Basel III-compliant Tier 2 bond from Latin America. The US\$1.3bn 10NC5 subordinated notes were priced at 460bp over US Treasuries, at a yield of 6.125%.

Maybank issues Basel III-compliant Tier 2: Maybank, Malaysia's largest bank by assets, issued Basel III-compliant MYR1.6bn (US\$479.76m) 10 year Tier 2 notes on 27 January. The bond carries a 4.9% coupon.

Dah Sing Bank, Bank of Jinzhou issue Basel III-compliant Tier 2s: Hong Kong-based Dah Sing Bank issued \$225m

10NC5 Basel III-compliant Tier 2 notes at 375bp over Treasuries on 22 January. The notes carry a fixed coupon of 5.25% up to the call date, with a reset thereafter. The bond contains a contractual point of non-viability clause, based on which it could be written down in full or in part if the Hong Kong Monetary Authority considers this step necessary to

maintain the bank's viability. The final book was US\$1.9bn, with 111 accounts. In terms of allocation, 29% of the transaction went to private banks, 19% to banks and 9% to insurance companies. By investor type, 88% of the notes were placed with investors in Asia and 12% in Europe.

Bank of Jinzhou followed suit on 24 January with a CNY1.5bn (US\$248m) 10NC5 Tier 2 at a yield of 7%. It is the second bank from mainland China to issue a Basel III-compliant bond.

RBS announces results of tender offer: Royal Bank of Scotland announced on 16 January the results of the any-and-all tender offer on six Australian dollar, euro and US dollar Tier 2 bonds, with first call dates in 2012 and 2013. The exercise achieved a 70.25% acceptance rate.

On 16 December RBS completed the issuance of a new 10 year bullet US\$2bn Tier 2, priced at 325bp over US Treasuries. The bond carries a coupon of 6.0%. ●

Regulatory & rating updates

Concerns over SRM differences, delays

Following the meeting of the Eurogroup of 27 January, Jeroen Dijsselbloem, Dutch finance minister and the Eurogroup's president, was reported to have said: "On the SRM, our aim is to finalise the negotiations ... in time for the April plenary session of the European Parliament, including the intergovernmental agreement on the Single Resolution Fund (SRF). That is currently being prepared and we will come to that in February in the Eurogroup-plus meeting."

According to a press release of the European Parliament, current negotiations on the Single Resolution Mechanism (SRM) show wide differences with the Council, with the possibility of no deal before the European elections in May. The delay could have negative consequences on the Recovery & Resolution Directive (RRD), scheduled to be voted on in February. In a previous letter to the Greek Presidency of the EU, the ECON committee stated its divergence with the substance of the intergovernmental agreement (IGA) on the functioning of the SRM, due to the following reasons: (1) the lack of a truly single fund which is the cornerstone of the SRM; (2) the infringement of the principle of equal treatment of all banks in the participating Member States, irrespective of their place of establishment (the non-discriminatory use of all the resolutions tools, including use of the single fund, has to be ensured); (3) serious impediments to the speed and efficient functioning of the decision making process.

S&P proposes new bank hybrid rating criteria: Standard & Poor's published on 6 February a Request for Comment on proposed changes to bank hybrid capital instruments rating criteria. Comments can be submitted in written form by 21 March. The "Equity content" of the instruments is not affected. According to the rating agency, the proposed changes reflect the increasing bail-



Jeroen Dijsselbloem

in risk. The main modification is the concept of "additional notching", which leads to a greater flexibility on the hands of the rating agency, and will be applied when the standalone credit profile (SACP) or the standard notching do not capture the higher relative risk of a default. This includes one to three notches down for non-payment clauses (e.g. mandatory cancellation linked to distributable items) and further notching or rating caps based on the buffer to going-concern, capital-based triggers (statutory or contractual) resulting in non-payment, write-down, or conversion.

RRD latest compromise text released: The final compromise text released of the Recovery & Resolution Directive (17958/13) confirms the developments already outlined in December. However, the text also shows a new addendum of Art. 43 (Sequence of write-down and conversion in bail-in): "(4b) EBA shall provide guidelines for any interpretation relating to the interrelationship between the provisions laid down in this Directive and those set out in [CRD] and [CRR]". This could finally address the potential misalignment between the AT1 contractual loss absorption and the

statutory application. The Indicative plenary sitting date of the European Parliament on the RRD has been moved to 16 April. The movement likely came on the back of the delay in the finalisation of the SRM regulation, which intertwines with several aspects of the directive.

EBA announces key components of the 2014 EU-wide stress test:

On 31 January, the European Banking Authority (EBA) announced the key components of the forthcoming 2014 EU-wide stress test. This exercise will be conducted by all competent authorities across the EU, responsible for assessing the reliability and robustness of banks' assumptions, data, estimates and results. CRR-complaint trigger-linked Additional Tier 1 and Tier 2 CoCos will be reported as a separate item if the conversion trigger is above the Common Equity Tier 1 ratio in the adverse scenario (>5.5% Transitional CET1).

EU Commission presents banking structural reform draft regulation:

On 29 January, the European Commission released the proposed Regulation on structural measures to improve the resilience of EU credit institutions, which follows up the report by the High-Level Group chaired by Finnish central bank governor Erkki Liikanen, presented in October 2012. The European Banking Federation expressed its discontent with the draft, calling it "an untimely proposal for banks' structural reform at the expense of financing the economy".

EBA updates Q&A on grandfathering, and holdings of FI own funds instruments:

On 31 January, the EBA provided a new set of answers, including the following:

- Grandfathering of Tier 1 instruments with incentive to redeem post-January 2013 (2013_48): The

EBA has clarified that, in order for legacy Tier 1 instruments with an incentive to redeem to be included in fully eligible Tier 2 items after the first call date, the frequency of subsequent calls is not a relevant criterion. This is because a capital instrument with an incentive to redeem is still considered to have an incentive to redeem where it has future calls, even if it is not called at the first call date. Thus, it would not meet all the conditions of Art. 63 of the CRR.

- **Holdings of FI own funds instruments (2013_268):** Where institutions do not deduct holdings of own funds instruments issued by financial sector entities included in the scope of consolidated supervision as per Art. 49(2) of the CRR, those holdings are risk-weighted in accordance with Art. 49(4). Where those institutions use the standardised approach for credit risk, investments in equity or regulatory capital instruments issued by institutions shall be classified as equity claims and receive a risk weight of 100%, unless they are treated as high risk items in accordance with Art. 128.

- **Outflows associated with shorts (2013_189):** If an institution has sold short a security on terms requiring delivery within the 30 day horizon, and the institution at the same time owns or has borrowed the very same security for more than 30 days, the institution should not report an outflow as per Art. 423 CRR, provided the security owned or borrowed is not already reported as a liquid asset.

BCBS releases capital planning guidelines:

The Basel Committee has issued guidelines to foster overall improvement in banks' capital planning practices. Some of the observed weaknesses reflected processes that were not sufficiently comprehensive, appropriately forward-looking or adequately formal-



Erkki Liikanen

ised. According to the Basel Committee, some banks underestimated the risks inherent in their business strategies and, in turn, misjudged their capital needs.

FPC publishes policy statement on powers to supplement capital requirements:

The UK Financial Policy Committee (FPC) released a Policy Statement describing the countercyclical capital buffer (CCB) and sectoral capital requirements (SCR) tools, the core indicators with respect to each tool and their likely impact on financial stability and growth. More specifically: (1) the SCR tool allows the FPC to change capital requirements, over and above their microprudential level, on exposures to specific sectors judged to pose a risk to the system as a whole; (2) the CCB tool allows the FPC to change capital requirements, over and above their microprudential level, in relation to all loans made by banks to borrowers in the UK. The Government previously stated its intention to use the flexibility in the legislation to give the FPC powers over the CCB as soon as practicable after 1 January 2014.

EBA RTS on Own Funds officially adopted by Council:

The Council of the EU has officially adopted the Regulatory Technical Standards (RTS) on Own

Funds. The text will be applicable after the publication in the EU Journal.

Basel III leverage ratio framework, disclosure requirements issued:

The Basel III Committee refined its leverage ratio definition to "overcome differences in national accounting frameworks" and amend several controversial aspects of its June 2013 proposals.

Key takeaways include:

- **Minimum requirement** (Tier 1 divided by total exposures) remains 3%.

- **On-balance sheet exposures:** Instead of using a uniform 100% credit conversion factor (CCF), the leverage ratio will use the same CCFs that are used in the Basel framework's Standardised Approach for credit risk under the risk-based requirements, subject to a floor of 10%.

- **Written credit derivatives:** The effective notional amounts included in the exposure measure may be capped at the level of the maximum potential loss, with netting permitted where the bank purchases credit protection on the same reference name and assuming: (a) the credit protection purchased is pari passu or senior to the written obligation; and (b) the remaining maturity of

credit protection purchased is greater than the remaining maturity of the written credit derivative.

- **Central clearing:** To avoid double-counting of exposures, a clearing member's trade exposures to qualifying central counterparties (QCCPs) associated with client-cleared derivatives transactions may be excluded when the clearing member does not guarantee the performance of a QCCP to its clients.

- **Securities financing transactions (SFTs)** (ie, repos): Limited netting with the same counterparty is now allowed (under the usual conditions such as legally enforceable right to set off, intention to net settle or net settlement mechanism in place).

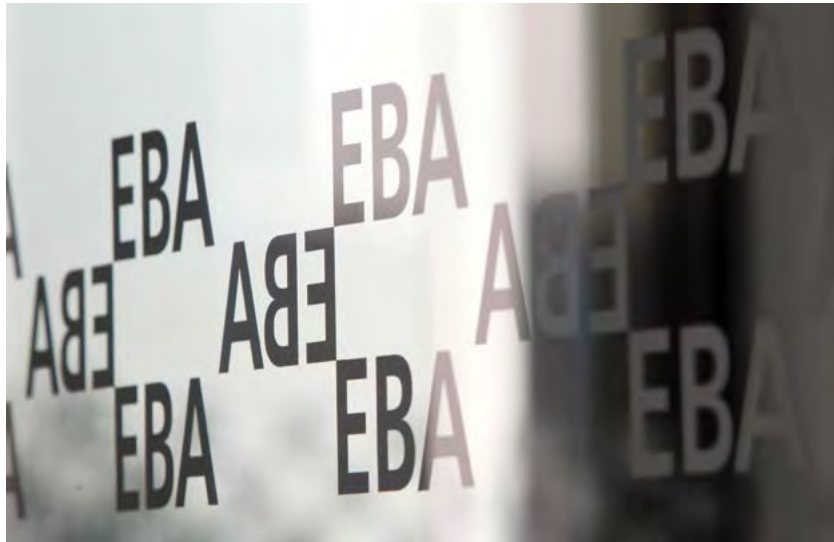
- **Implementation schedule:** 1) publication from January 2015, 2) Final calibration by 2017, and 3) Pillar 1 from January 2018.

Basel Committee issued proposed revisions to the Basel framework's Net Stable Funding Ratio (NSFR). The revisions include:

- Reducing cliff effects within the measurement of funding stability;
- Improving the alignment of the NSFR with the Liquidity Coverage Ratio (LCR);
- Altering the calibration of the NSFR to focus greater attention on short term, potentially volatile funding sources.

The Committee has issued final requirements for banks' LCR-related disclosures. These requirements will improve the transparency of regulatory liquidity requirements and enhance market discipline. Banks will be required to comply with these disclosure requirements from the date of the first reporting period after 1 January 2015.

EBA publishes final draft RTS on market risk and CVA risk: On 20 December



the EBA published its final draft RTS on the definition of market and its final draft RTS on Credit Valuation Adjustment (CVA) risk. The latter is supplemented by an Opinion on CVA risk, which further elaborates on the approach taken by the EBA in determining a proxy spread.

BCBS publishes revised framework for equity investments in funds: On 13 December the Basel Committee published a final standard that revises the treatment of banks' equity investments in all funds that are not held for trading purposes. The revised policy framework is scheduled to take effect from January 2017.

UK PRA releases final implementation of CRD IV: The UK Prudential Regulation Authority (PRA) published the final statement of policy (PS 7/13), rules and supervisory statements required to implement CRD IV in the UK, also providing feedback on the responses to Consultation Paper 5/13. In particular, on Pillar 2:

- The PRA has decided that Pillar 2A risks should be met with the same quality of capital as Pillar 1 risks, ie, with at least 56% in CET1, no more than 44% in AT1 and at most 25% in Tier 2 capital;
- The PRA is currently reviewing its approach to setting Pillar 2A capital

and, as part of that review, the PRA will consider whether and, if so, to what extent firms should disclose Pillar 2A;

- Individual Capital Guidance (ICG) may be set on an individual basis where firms are not able to demonstrate that capital is adequately allocated between the different parts of the group or where there are impediments to the transfer of capital within the group;

- The PRA expects to consult on its approach to Pillar 2 during the course of 2014. The consultation will also cover the transition to the PRA buffer and the relationship between the PRA buffer and the concurrent stress-testing exercise proposed by the FPC in March 2013.

Banking Reform Bill receives Royal Assent: The UK Banking Reform Bill has received Royal Assent, now becoming an Act of Parliament. It implements the recommendations of the Independent Commission on Banking.

Jonathan Blondeau,
Cyril Chatelain, Stefano Rossetto
DCM Solutions
Crédit Agricole CIB
Capital.Structuring@ca-cib.com

League tables

Bookrunners all European insurance hybrids (EUR & USD)
01/01/2013 to 31/12/2013

	Managing bank or group	No of issues	Total EUR m	Share (%)
1	BNP Paribas	11	1,402	13.3
2	HSBC	11	1,328	12.6
3	Citi	8	1,226	11.6
4	Crédit Agricole CIB	4	817	7.8
5	Deutsche Bank	4	768	7.3
6	RBS	6	754	7.2
7	Commerzbank	3	682	6.5
8	JP Morgan	5	567	5.4
9	Natixis	4	481	4.6
10	Barclays	4	444	4.2
11	BAML	3	360	3.4
12	Société Générale	3	336	3.2
13	UBS	3	306	2.9
14	Erste Group Bank	1	167	1.6
15	Lloyds	1	140	1.3
	Total	21	10,541	

Includes Euro, USD, Insurance, Region of Operation Europe
Source: Bloomberg, Thomson Reuters, Crédit Agricole CIB

Bookrunners all financials (EUR)
01/01/2014 to 10/02/2014

	Managing bank or group	No of issues	Total EUR m	Share (%)
1	BNP Paribas	15	4,202	12.4
2	Crédit Agricole CIB	7	3,126	9.2
3	Barclays	8	2,128	6.3
4	Natixis	5	2,059	6.1
5	Goldman Sachs	6	1,810	5.3
6	Société Générale	8	1,651	4.9
7	Citi	5	1,572	4.6
8	Sumitomo Mitsui	1	1,400	4.1
9	Rabobank	2	1,373	4.1
10	Deutsche Bank	7	1,231	3.6
11	HSBC	5	1,133	3.3
12	Morgan Stanley	5	1,098	3.2
13	Nomura	5	983	2.9
14	Credit Suisse	3	948	2.8
15	BAML	3	885	2.6
	Total	55	33,856	

Includes banks, insurance companies and finance companies. Excludes equity-related, covered bonds, publicly owned institutions.

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NORDIC FIs & COVERED

Thursday, 18 January 2014 Issue 30

EC stresses EU-specific factors for raised Level 1 LCR hedges

The European Commission will take into account a range of specific factors when assessing EU banks' liquidity risk, EC Banking regulator and European Central Bank President Mario Draghi said today. In addition to European Banking Authority (EBA) issued and international standards, he said, the Commission will also take into account EU-specific aspects.

The Commission announced its discussion paper yesterday and Friday (17-18 January). Draghi highlighted specific factors for the European Commission, EC Internal Market and Services, said the Commission President. He said the Commission President said the Commission will take into account a range of specific factors when assessing EU banks' liquidity risk, EC Banking regulator and European Central Bank President Mario Draghi said today. In addition to European Banking Authority (EBA) issued and international standards, he said, the Commission will also take into account EU-specific aspects.

The EC has confirmed ongoing central bank to be up to date with the latest developments in the market, he said. He said the Commission will take into account EU-specific aspects. He said the Commission will take into account EU-specific aspects.

The Commission will consider these factors when assessing EU banks' liquidity risk, EC Banking regulator and European Central Bank President Mario Draghi said today. In addition to European Banking Authority (EBA) issued and international standards, he said, the Commission will also take into account EU-specific aspects.

Topics:

- How to respond to EBA's new rules on liquidity risk
- How to respond to EBA's new rules on liquidity risk
- How to respond to EBA's new rules on liquidity risk
- How to respond to EBA's new rules on liquidity risk

DNB responds Samrairs for European banks, increases granularity

The Danish National Bank (DNB) has responded to the European Central Bank (ECB) and the European Banking Authority (EBA) regarding the new rules on liquidity risk. DNB has increased the granularity of its liquidity risk management framework. DNB has increased the granularity of its liquidity risk management framework.

The DNB has responded to the European Central Bank (ECB) and the European Banking Authority (EBA) regarding the new rules on liquidity risk. DNB has increased the granularity of its liquidity risk management framework. DNB has increased the granularity of its liquidity risk management framework.

Latest Nordic FIs breakdown:

Country	Assets	Liabilities	Capital	Reserves
Denmark	100%	100%	100%	100%
Sweden	100%	100%	100%	100%
Norway	100%	100%	100%	100%
Finland	100%	100%	100%	100%
Iceland	100%	100%	100%	100%

1/2014

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Nykredit finds strong demand in opening ARMs offering

Nykredit's Swedish branch closed its annual fundraising in London today (Thursday), with the company's first "interest covering" offer to clearing of any new bank bonds, according to an official of the issuer. Although it would have the highest rate in the market, the offering was well received.

Download the last issue

Thursday, 15 August 2013

NORDIC FIs & COVERED

AN INVESTMENT BANK REPORT

THE NORDIC FINANCIAL INSTITUTIONS' STRATEGIES FOR GROWTH IN THE UK MARKET

BY JAMES M. HARRIS

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WELCOME

Sweden's debt offer back in prospect seen as credit negative by Moody's

A Swedish National Debt Office (NDO) official (on loan to investment bank BNP Paribas) said credit enhancement in Sweden is a credit negative for the entire continent and of the country's credit, particularly, in the morning, Moody's said today (Thursday).

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WELCOME

General Bond Purchase Programmes:
Should the ECB roll in the next issue?
Suppliers and investors in the market of the covered bond market for the 2013, issuance has

DISCOVER

Inside deep Moody's, citing methodology and negative Nordic view

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Solvency II

Back on track, but hurdles remain

In November 2013, the Trilogue agreement on the Omnibus II Directive was welcomed by the market as it clearly paves the way for the implementation of Solvency II in 2016.

By Michael Benyaya of *Crédit Agricole CIB*

The agreement is undoubtedly a major step forward, but calibrations and technical details — notably in relation to the practical implementation of the long term guarantee package — are yet to be discussed and finalised in the Level 2 measures (Implementing Technical Standards).

The “long term guarantee” package buys time

The scope of the Omnibus II Directive was originally limited, but as time passed it drifted to address and soften the impact of Solvency II on certain insurance businesses. These discussions led to an agreement on the so-called “long term guarantees” (LTG) package included in Omnibus II, notably in relation to the following:

- Transitional arrangements for existing life insurance business to adjust to Solvency II over a period of 16 years. This will take the form of a gradual convergence towards Solvency II specifications of discounting rates and computation of technical liabilities.
- Matching adjustment to be applied to the discount rate used to value annuity-style liabilities.
- Volatility adjustment to be applied to the discount rate used to value all other businesses, in the form of two modules: one will be permanent by currency area, while the other will be automatically implemented at the national level in case of a crisis.
- “Provisional” third country equivalence for an initial period of 10 years followed by a review and potential extension, meaning that insurance companies headquartered in the EU will be allowed to use local solvency rules of “equivalent” jurisdictions when calculating the group solvency position.

The LTG package gives the industry time to adapt to the new Solvency rules, especially for smaller companies operating with high guarantee levels. Consolidation is nonetheless expected among the smaller players and in the mutual insurance sector.

Large insurance companies will also benefit from the LTG,

but are not expected to raise capital to meet Solvency II requirements. However, their solid level preparation will certainly not prevent them from actively participating (and continuing their lobbying efforts) during the finalisation of the Level 2 measures.

All eyes on the grandfathering rules

“Notwithstanding Article 94, basic own-fund items that (...) (c) would not otherwise be classified in Tier 1 or Tier 2 in accordance with Article 94 (...) shall be included in Tier 1 basic own funds for up to 10 years after 1 January 2016.”

This new provision inserted in Article 308b (grandfathering rules for instruments eligible to meet the Solvency I margin up to 50%) of the agreed Omnibus II text has stirred up the market. Indeed it suggests that an undated security structured to meet the Solvency II Tier 2 criteria will be directly classified in Tier 2 and not grandfathered in Tier 1. This goes against issuers’ initial expectations.

EIOPA’s timeline for the delivery of Solvency II ITS and Guidelines

- ITS Set 1: Approval processes (public consultation April-June 2014)
- ITS Set 2: Pillar 1 (quantitative basis), Pillar 2 (qualitative requirements), Pillar 3 (enhanced reporting and disclosure) and supervisory transparency (public consultation December 2014 to March 2015)
- Guidelines Set 1: Guidelines relevant for approval processes, including Pillar 1 (quantitative basis) and internal models (public consultation June-September 2014)
- Guidelines Set 2: Guidelines relevant for Pillar 2 (qualitative requirements) and Pillar 3 (enhanced reporting and disclosure); public consultation December 2014 to March 2015

The first filter would hence be compliant with the Solvency II own funds criteria, regardless of treatment under Solvency I. Only if an instrument is not Solvency II-compliant will it then be treated as per the grandfathering rules.

It remains to be seen if and how this provision will affect the issuance format for subordinated securities. For example, would it possible to issue a Solvency I undated bond to target grandfathering in Tier 1? Only regulators know the answer, until the cut-off date (the earliest of January 2016 and the entry into force of level 2 measures on own funds) puts an end to any sort of speculation.

The main area of uncertainty is the treatment of old perpetual non-cumulative deeply subordinated bonds, which include a reference to a minimum Solvency Margin level which triggers the mandatory non-payment of interest. The classification of those bonds would primarily depend on the interpretation of this minimum level in the context of Solvency II: Does it refer to the Minimum Capital Requirement or the Solvency Capital Requirement (SCR)? If it is deemed consistent with the SCR, then such a bond could potentially be treated as eligible in the Tier 2 bucket. That said, those instruments were structured at a time when the Solvency II criteria were not available and hence could be grandfathered in Tier 1.

In any event, the current grandfathering rules should generally pose little risk to the total level of eligible capital of insurance companies. The size of the Tier 2 bucket under Solvency II (maximum 50% of the SCR) should generally be large enough to host all outstanding bonds.

Solvency II unlikely to lead to rating changes

In the same vein, the grandfathering rules are unlikely to affect the bonds' eligibility in the Standard & Poor's capital model, which will remain the primary measure of an insurer's capital position in the S&P rating methodology (even under Solvency



Michael Benyaya, CACIB

II). Although S&P has not reacted since the announcement of the Omnibus II agreement, the rating agency stated in the past (in the context of Basel III implementation) that a bond's eligibility in Total Adjusted Capital (TAC) is ensured until the regulator removes it from regulatory capital (and if it also meets S&P's criteria).

Moody's and Fitch have not commented recently on the topic, but these rules should not change the rating agencies' opinions on capital position.

More generally, the implementation of Solvency II is unlikely to trigger a wave of rating changes as the largest issuers have already anticipated well the requirements of the new Solvency regime. ●

For further discussion of related issues, please read our insurance roundtable.

Analysis of the potential treatment of selected subordinated formats under the grandfathering rules

Example of subordinated bonds	Solvency I Treatment bucket	Key features considered for the Grandfathering rules	Potential Solvency II (SII) Classification
Dated SII-compliant Tier 2 (e.g. 30nc10)	"25%"	Presence of the Solvency II features (e.g. mandatory deferral in relation to the SCR, maturity lock-in)	Tier 2 Eligible
Undated SII-compliant Tier 2	"50%"		
Dated, non-deferrable	"25%"	No Solvency II features	Tier 2 Grandfathered
Undated, deferrable, cumulative	"50%"	No Solvency II features	Tier 1 Grandfathered
Undated, deferrable non-cumulative	"50%"	Could potentially fulfil the Tier 2 SII criteria depending on the interpretation of the "minimum Solvency Margin" level which triggers the mandatory non-payment of interests Not compliant to the SII Tier 1 criteria	Tier 1 Grandfathered or potentially Tier 2 Eligible

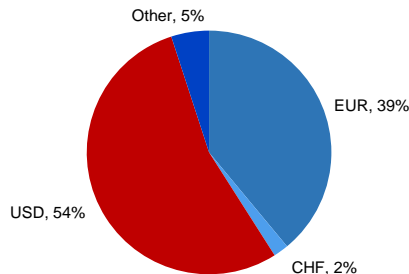
"50% bucket": instrument eligible to meet up to 50% of the required Solvency I margin: typically undated, deferrable, and cumulative

"25% bucket": instrument eligible to meet up to 25% of the required Solvency I margin typically dated, non-deferrable

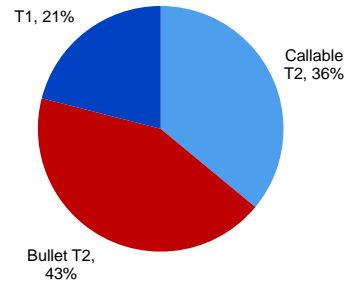
Source: Crédit Agricole CIB

Hybrid data: currencies, structures and spreads

Bank hybrid issuance by currency (2013-2014 ytd)

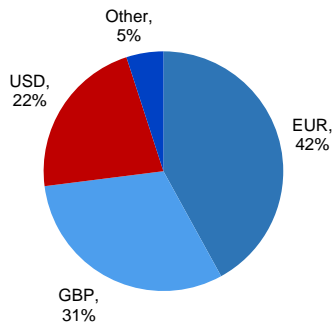


Bank issuance by instrument/structure (2013-2014 ytd)

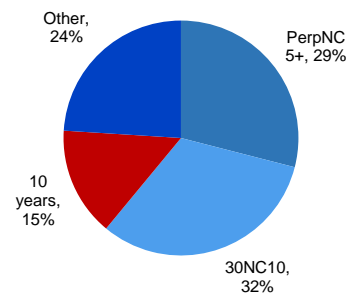


Source: Crédit Agricole CIB

Insurance hybrid issuance by currency (2013-2014 ytd)

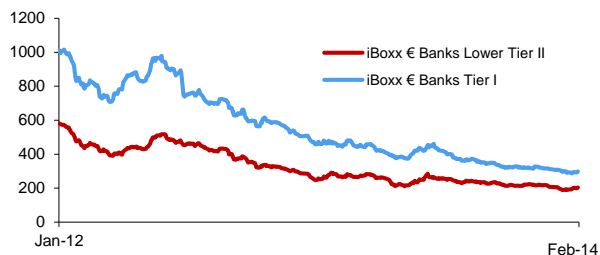


Insurance issuance by instrument/structure (2013-2014 ytd)



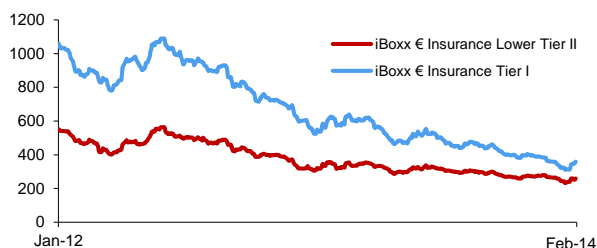
Source: Crédit Agricole CIB

Secondary bank subordinated indices



Source: Markit, Crédit Agricole CIB

Secondary insurance subordinated indices



Source: Markit, Crédit Agricole CIB

Most recent bank and insurance issuance (as at 3/2/14)

BANK					
Date	Security	Currency	Amt (m)		
26-Nov-13	DANBNK 4.75 06/05/24	SEK	900		
26-Nov-13	DANBNK Float 06/05/24	SEK	1,600		
26-Nov-13	DANBNK Float 12/06/23	NOK	700		
26-Nov-13	DANBNK 4.125 12/09/25	DKK	1,150		
26-Nov-13	DANBNK Float 06/06/24	DKK	1,700		
27-Nov-13	NWIDE 10.25 06/29/49	GBP	500		
02-Dec-13	DANBNK 3.125 12/18/25	CHF	150		
04-Dec-13	BACR 8 12/15/49	EUR	1,000		
04-Dec-13	CS 7.5 12/11/49	USD	2,250		
11-Dec-13	SOCGEN 7.875 12/31/49	USD	1,750		
16-Dec-13	RBS 6 12/19/23	USD	2,000		
07-Jan-14	SHBASS 2.656 01/15/24	EUR	1,500		
13-Jan-14	BPCEGP 5.15 07/21/24	USD	1,500		
14-Jan-14	SOCGEN 5 01/17/24	USD	1,000		
15-Jan-14	ACAFP 7.875 01/29/49	USD	1,750		
INSURANCE					
Date	Security	Currency	Amt (m)		
10-Sep-13	ISPVIT 5.35 09/18/18	EUR	500		
10-Sep-13	SCOR 5 11/30/49	CHF	250		
30-Sep-13	SRENVX 7.5 09/01/45	CHF	175		
01-Oct-13	VIGAV 5.5 10/09/43	EUR	500		
17-Oct-13	ALVGR 4.75 12/31/49	EUR	1,500		
22-Nov-13	RLMI 6.125 11/30/43	GBP	400		
04-Dec-13	PRUFIN 5.7 12/19/63	GBP	700		
12-Dec-13	CASSIM 7.25 12/17/43	EUR	100		
08-Jan-14	AXASA 5.625 01/16/54	GBP	750		

Hybrid data: deals, performance and investors

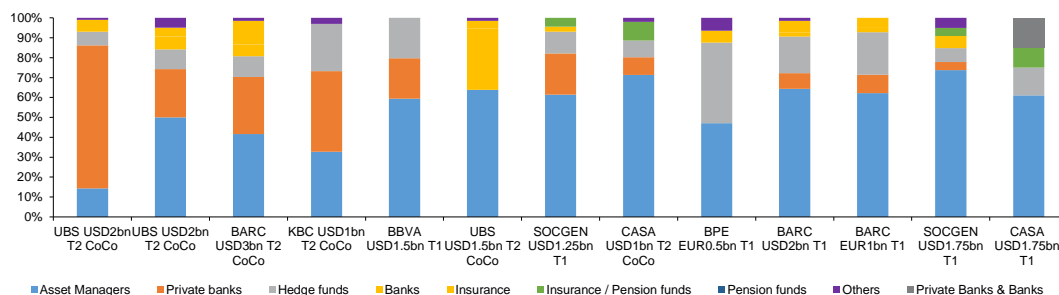
AT1 performance monitoring (as at 3/2/14)

Issuer	ISIN	Amount	Coupon	Call	Trigger	Loss absorption	YTC %	Price	ASW	CDS sub
BBVA	XS0926832907	USD1.5bn	9.0%	2018 (NC5)	CET1 fully loaded < 7%	Equity conversion	7.55	105.3	600	193
SG	XS0867614595	USD1.25bn	8.25%	2018 (NC5)	CET1 below 5.125%	Temporary write-down	6.30	108.0	499	159
SG	USF8586CRW49	USD1.75bn	7.875%	2023 (NC10)	CET1 5.125%	Temporary write-down	7.56	102.1	479	159
CSG	XS0989394589	USD2.25bn	7.5%	2023 (NC10)	CET1 ratio + higher trigger Cocos < 5.125%	Permanent write-down	6.73	105.5	243	114
BPE	XS0979444402	EUR0.5bn	11.5%	2018 (NC5)	CET1 below 5.125%	Equity conversion	8.93	109.7	832	298
Barclays	US06738EAA38	USD2bn	8.25%	2018 (NC5)	CET1 below 7%	Equity conversion	7.26	104.0	577	144
Barclays	XS1002801758	EUR1bn	8.00%	2020 (NC7)	CET1 below 7%	Equity conversion	7.54	102.4	616	144
CASA	USF22797RT78	USD1.75bn	7.88%	2024 (NC10)	CET1 < 5.125% (CASA) or CET1 < 7% (Group)	Temporary write-down	7.55	102.3	478	157
Average							7.43	104.9	540	171

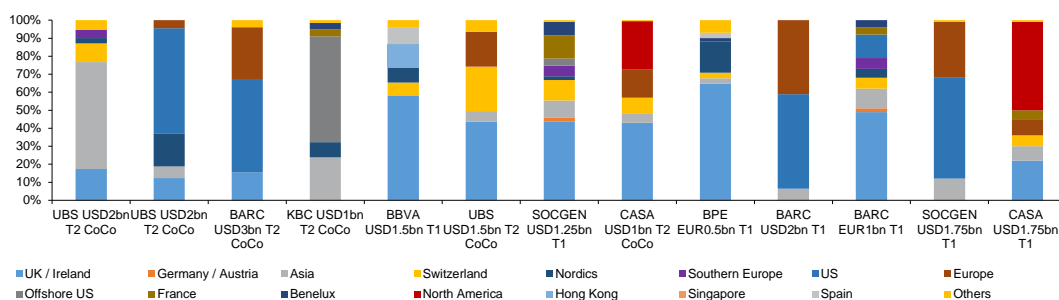
T2 CoCo performance monitoring (as at 3/2/14)

Issuer	ISIN	Amount	Coupon	Call/Maturity	Trigger	Loss absorption	YTC %	Price	ASW	CDS sub
Barclays	US06740L8C27	USD3bn	7.625%	2022	CET1 ratio below 7%	Permanent write-down	6.97	104	443	144
Barclays	US06739FHK03	USD1bn	7.75%	2018 (NC5)	CET1 ratio below 7%	Permanent write-down	5.35	109	423	144
Lloyds	XS0459088794	EUR662m	6.385%	2020	CT1 ratio below 5%	Equity conversion	5.30	106	408	131
Lloyds	XS0459088281	EUR710m	6.439%	2020	CT1 ratio below 5%	Equity conversion	5.36	106	414	131
CASA	US225313AC92	USD1bn	8.125%	2018 (NC5)	CET1 ratio below 7%	Permanent write-down	5.94	109	464	157
CSG	CH0181115681	CHF750m	7.125%	2017 (NC5)	CET1 ratio below 7%	Equity conversion	4.11	109	411	114
CSG	XS0957135212	USD2.5bn	6.5%	2023	CET1 ratio below 5%	Permanent write-down	5.58	107	296	114
CSG	XS0972523947	EUR1.25bn	5.75%	2020 (NC7)	CET1 ratio below 5%	Permanent write-down	4.60	106	332	114
KBC	BE6248510610	USD1bn	8%	2018 (NC5)	CET1 ratio below 7%	Permanent write-down	5.57	109	451	261
UBS	XS0747231362	USD2bn	7.25%	2017 (NC5)	CT1 ratio below 5%	Permanent write-down	4.47	108	376	109
UBS	US90261AAB89	USD2bn	7.625%	2022	CT1 ratio below 5%	Permanent write-down	5.37	115	309	109
UBS	CH0214139930	USD1.5bn	4.750%	2018 (NC5)	CT1 ratio below 5%	Permanent write-down	4.82	100	342	109
Average							5.29	107.2	389	136

Distribution by investor type (up to 3/2/14)



Distribution by geography (up to 3/2/14)



Source: Crédit Agricole CIB



BBVA, Madrid

Photo: Álvaro Ibáñez/Flickr

BBVA

Euro shows recovery

After in April 2013 becoming the first European bank to price an AT1 — in US dollars — BBVA on 11 February priced a Eu1.5bn 7% perp non-call five AT1 CoCo. Erik Schotkamp, director, capital and funding management, at BBVA, spoke to *Susanna Rust* about the key takeaways from the transaction, which he said leaves no doubts about the existence of a euro CoCo market.

Why did you opt for euros for this transaction and did you consider the US dollar market?

The most important thing here is that we have a euro-denominated capital base, predominantly, which means that in terms of filling the Additional Tier 1 requirements it is natural for us to do that in euros. The second reason is that when we did our first AT1 transaction in April last year it was unclear whether there was an existing euro market and until that moment issuance had predominantly been in US dollars. Since at that point we were doing a transaction that was the first CRD IV compliant issue we considered that it would be better to use available liquidity pools whose existence had been proven.

Now in the course of the six to nine months that have gone by since then we have clearly seen an increase in appetite among investors for the product and in the context of recent developments in the euro market with respect to order books and the success of transactions it proved to be the right decision to opt for euros.

Your first US dollar AT1 had multiple triggers — how did you simplify the structure for the euro CoCo and why?

The simpler structure is the direct result of the fact that as of today in Spain we are operating under the CRR. On 5 February, a day before we announced the transaction, the Bank of Spain effectively announced that all regulation previous to CRR/CRD IV had become void, so that made it very straightforward to do this under a simplified structure that is the standard going forward if I am not mistaken.

This made it possible to cancel effectively the transitional triggers that we had in the previous instrument and simplify that instrument, as well to create a situation where both instruments are more comparable with each other in terms of what they offer and what the structure is.

Your euro AT1 has the same non-call five structure as the US dollar notes. Did you consider a 10 year call?

No, we did not consider a 10 year call, the reason being that although the headline coupon has come down significantly we still believe that over time there are improvements to be expected on the credit spread. We figure that the situation going forward, not only with respect to Spain but also in terms of the credit rating of the group, is on the path

of improvement, which means that there is no economic sense to lock in current spreads for a period longer than necessary from a regulatory point of view.

You roadshowed in Asia despite the deal being euro denominated — why is that?

For our transaction in dollars we made a big effort in Asia. With respect to the international profile of BBVA and having access to various funding sources it is good to see fixed income investors around the globe. This was a good opportunity to reinforce those efforts.

The second reason is that we have understood that there is still a decent holding of the previous transaction and also, as we saw in the case of Barclays, there is a reasonable take-up of euros in Asia. It's probably not as spectacular as the first CoCos we saw about a year-and-a-half ago that were dollar denominated and Asia oriented, but there is still a good take-up.

We distributed around 10% of the deal to Asian accounts so roadshowing there was really worthwhile. You can see from the feedback from the Asian accounts that they do follow the credit and we obviously have an interest in raising the profile of the group and leveraging that interest.

BBVA non-step-up non-cumulative contingent convertible perpetual preferred Tier 1 securities

Rating: -/-/BB-

Amount: Eu1.5bn of additional tier one capital. Equity conversion

Maturity: perpetual

Call option: 19 February 2019

Distribution restrictions: mandatory cancellation upon: i) insufficient Available Distributions Items; ii) breach of any Applicable Banking Regulations; iii) upon the Regulator requesting the Bank to cancel the

relevant Distribution in whole or in part; iv) Distributions exceed the Maximum Distributable Amount

Loss absorption trigger: CET1

Ratio of the Bank or the Bank Group falling below 5.125%

Fixed/re-offer price: 100.00

Coupon: 7% p.a. until call date; thereafter reset every five years over the prevailing five year mid-market swap rate plus initial spread (615.5bp)

Launched: Tuesday 11 January

Payment date: 19 February 2014

The 5.125% CET1 trigger will have to be applied at both bank and consolidated group level. What is the reason for that and does it reflect any current uncertainty about exactly how much of deferred tax assets will be reclassified?

These are two separate items. The reclassification of the deferred tax assets is purely related to core capital and so there is no interaction between AT1 and the deferred tax assets as such. What is the case is that BBVA SA is the issuing entity and is regulated in Spain as a Spanish bank and owner of the operations outside of Spain, further we are regulated at the consolidated level. So it's a result of the structure of the group and about achieving maximum regulatory computability and complying with AT1 both at consolidated level and the bank (issuer) level.

The euro AT1 was seen as offering a fairly "healthy" new issue premium, with some market participants seeing fair value in the high 6% — what influenced the approach to pricing?

There's a mixture of things going on. BBVA wants to be a repeat issuer and it is therefore important that you build up a good base of investors, particularly a number of key and anchor accounts in these transactions. Obviously we had a fantastic book of over 600 lines of subscription. But although the book was

spectacular what you need is the participation of a group of core accounts. And it's around their sensitivity to pricing that you need to anchor the transaction. It's about finding a compromise between a successful deal, repeated access to markets in the future, getting anchor investors on board, and taking into account their price sensitivity and our obvious desire to be minimising costs.

What are the key takeaways from your euro CoCo in your opinion?

The first key takeaway is massive sponsorship for the group and its fundamentals. There is a group of followers of BBVA that not only from a perspective of static capital ratios appreciate our strength but also appreciate BBVA for

our capacity to generate operating earnings and as such our capacity to effectively protect bondholder interests.

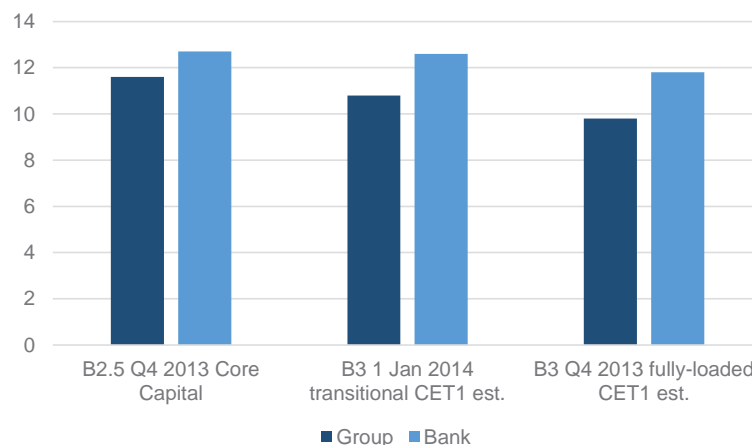
The second key takeaway is that with respect to the discretionary nature of the coupon payments it is important that we made a commitment and we've explained as clearly as possible our philosophy with respect to how we see the discretionary distributions taking place.

And thirdly what I think with this transaction has become very clear is that if you look at the book what we see is a lot of so-called long only money that a year ago or half year ago would not even have had the mandate or been willing to consider CoCos, that somehow have become confident with the structures, that have mandates in place. I take a lot of encouragement from the fact that the big learning point here is that a euro CoCo market does exist, it absolutely does.

And what are your impressions about sentiment toward the Spanish banking sector?

I think a broad consensus has been building up in the last few months that Spain is bottoming out. Work still needs to be done, but the biggest deal risks have been removed. And in the context of relative value that means that many institutions such as ourselves, national champions, offer an enormous amount of value, certainly for the investors we were talking about. ●

BBVA group and bank capital positions



Source: BBVA

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The Covered Bond Investor Conference

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Crédit Agricole, Montrouge
Photo: Crédit Agricole/Flickr

Crédit Agricole points to AT1 future

Crédit Agricole's \$1.75bn perpetual non-call 10 Additional Tier 1 transaction in January got the CoCo market off to a pioneering start for 2014. *Neil Day* spoke to Bernard Delpit, Crédit Agricole Group CFO, and Olivier Bélorgey, head of the financial management department, Crédit Agricole SA (CASA), about how the transaction fits into the French group's broader capital plans.

How long had you been considering this inaugural CRD IV AT1, and what were the major obstacles that had to be overcome before issuance?

Bernard Delpit: We've been working on new hybrid capital for one year. In September, CASA issued a CoCo Tier 2 and the disclosure of our fully-loaded ratio on 7 November paved the way for our inaugural AT1. We therefore actively worked on it from November, and the only other hurdles were technicalities that we solved from a legal perspective and from a structuring perspective in December.

How did the "dual-trigger" affect the marketing of the trade?

Olivier Bélorgey: When we first released the structure in the market, the syndicate of course had some feedback from investors asking: what is this dual-trigger, where is it coming from, and so on. But we began the roadshow just after releasing the structure and all the answers we provided investors with were very quickly accepted and well understood.

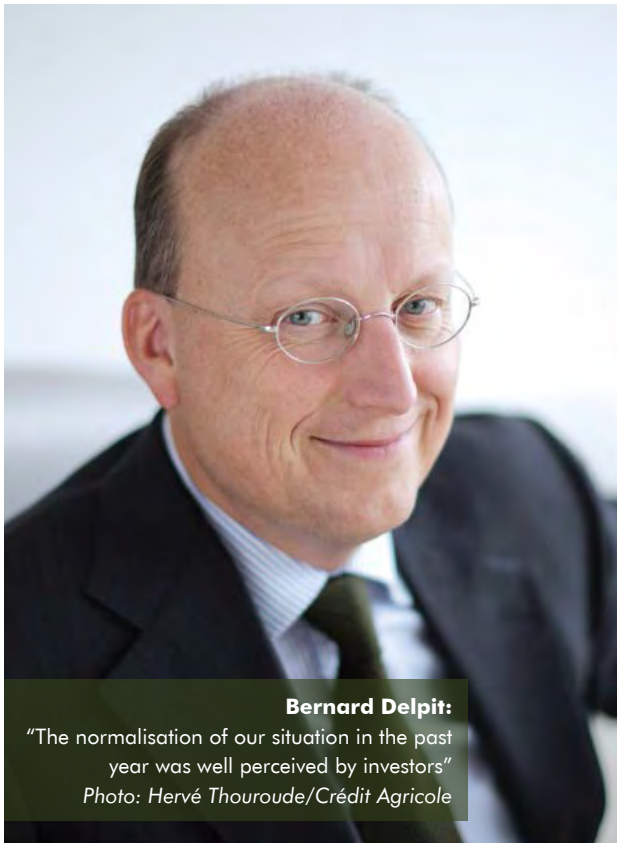
In fact the dual trigger has a very strong relationship with the rationale for the deal. We had to include a trigger at CASA level due to legal requirements: it's an issuance made by Crédit Agricole SA, so, according to CRD IV, we had to introduce a trigger at the level of CASA. But — as we have been explaining to the market for many years now — when you are assessing the solvency of Crédit Agricole, you first have to look at the group level, so on top of this regulatory constraint we wanted

to add something linking this AT1 issue with the group level. Concerning the group, we wanted firstly to be consistent with the Tier 2 issue's trigger at 7% CET1, and secondly, we wanted to position Crédit Agricole Group clearly within the best market standard when it comes to G-SIB institutions and the going-concern framework. It was not the same for Crédit Agricole SA — due to all the internal support mechanisms we only intend to put Crédit Agricole SA at an adequate level in terms of capital.

At the beginning of the transaction our advisers were telling us that perhaps the trigger and its complexity could cost us something between 25bp and 50bp, but at the end of the day it didn't cost anything.

During the roadshow, did investors ask a lot about Crédit Agricole as a credit? What did they focus on most?

Bernard Delpit: Indeed questions from investors tackled both the features of the instrument and the credit of Crédit Agricole. The somewhat unique structure of the group was discussed. The normalisation of our situation in the past year was well perceived by investors, Credit issues were quite easily answered and people focused on the features of the instrument. Credit was not really, I think, at the heart of this transaction since we've done a lot to demonstrate that Crédit Agricole is back on track in terms of liquidity, profitability and earnings visibility.



Bernard Delpit:

"The normalisation of our situation in the past year was well perceived by investors"

Photo: Hervé Thouroude/Crédit Agricole

What was your rationale for the non-call 10 choice?

Olivier Bélorgey: In fact we indicated to the market that we were ready to issue non-call five or non-call 10, and we were waiting for the market's answer. The market was mainly in favour of a non-call 10, so that element of the structure depended on investors.

And on the other hand, from a pure ALM point of view, given the total size of AT1 we should have as a target in our capital structure we are more at ease with a non-call 10 instrument, with implicit pressure from the market to refinance the instrument at 10 years rather than five years even if it is of course a perpetual instrument.

Did you consider going down the euro issuance route?

Olivier Bélorgey: We are totally open to it, but obviously in the current market high yield instruments are better appreciated by US dollar investors rather than euro investors. So it was not a strong preference on our side, but clearly we follow market appetite.

What can you say about how you plan to use the variety of hybrid instruments available?

Olivier Bélorgey: It was also part of the rationale of the transaction — which we clearly explained to the market — to follow the capital plan we released to the market in November, which is for Crédit Agricole Group to reach a total solvency ratio of 16.5%, 13% consisting of Common Equity Tier 1 — which is a very high level — and the remaining part consisting of 1.5% of Tier 1 and 2% of Tier 2.

Given our starting point, with 1% of Tier 1 and 3% of Tier 2, we clearly have an initial focus on Additional Tier 1, so that's why we began 2014 with AT1, and we indicated to the market that it will remain our main focus for the coming months.

Bernard Delpit: If I may elaborate on that: we are definitely in the category of banks that will structurally accumulate Core Tier 1 for two reasons. The first one is that at the heart of Crédit Agricole are co-operative banks, which basically pay no dividends, and since 56% of the listed entity is owned by the regional banks 56% of what it pays out stays within the group. So thanks to our structure, and thanks also to our business model, retained earnings will drive us to this high level of Core Tier 1. So that explains why we have a high level of Core Tier 1 in our capital planning.

And, as Olivier said, we want to add 1.5% AT1 at the group level for different reasons, including regulatory reasons, and going from 1% to 1.5% at the end of 2015 means that we will be an active player on this AT1 market. On top of that we have to offset the grandfathering of old-style Tier 1, so although we have not disclosed the amount we will issue, it will be quite significant, and we will be coming back to the market every year to raise AT1.

Olivier Bélorgey: We did not provide the figures publicly, because we want to retain flexibility on amount and timing, but we clearly indicated that we would come back. And we also indicated that the structure of the instrument is built to be more or less reused in further issuance, perhaps with some minor evolution due to regulations.

What are the major challenges for the Crédit Agricole Group over the next few years?

Bernard Delpit: Most of the adaptation has already been undertaken in terms of business, geographic scope and capital planning. We are now working more on leverage size. We will focus on reducing the total size of Crédit Agricole's balance sheet, and we will focus on the bail-in issue. And from both points of view — leverage and bail-in — AT1 is a key element of our strategy.

We have seen French banks making up a high proportion of Tier 2 and AT1 issuance in Europe as the market has taken off. Is this a coincidence or is there a trend?

Bernard Delpit: From 2011 to 2012 our supervisor was not really eager to see French banks issuing hybrid capital instruments. The key message was to focus on Core Tier 1. But you can't build a comprehensive capital structure with only Core Tier 1.

In 2012, for rating reasons — to support our RAC ratio from S&P — and for regulatory reasons, the French supervisor gave a green light to the issuance of new instruments. That's why we saw French issuers very active in the market. ●

CASA hits target with dual-trigger

Crédit Agricole's AT1 transaction carried new structural features and targeted multiple investor bases. *Neil Day* spoke to Vincent Hoarau, managing director, head of FIG syndicate, Crédit Agricole CIB, about the challenges of pricing and executing the innovative structure and handling a record US\$24.5bn order book.

How challenging was it to value this inaugural temporary write-down loss-absorbing instrument?

The market has evolved constructively since BBVA printed the first CRD IV-compliant multi-trigger AT1 trade in April 2013, but there are still a lot of controversies in the price discovery exercise. It was therefore a fairly iterative process.

Whether the second trigger requires a premium of 15bp, 25bp, 50bp... or nothing... was one of the key elements we needed to find out. We obviously looked at the distance to triggers, the coupon payment and cashflow schedule, as well as the nature of the callability structure to take a view on pricing.

But there was no scientific recipe for coming up with the right number for initial price thoughts (IPTs). It was a slow process, while the parameters can also change dramatically in dynamic markets.

Above all, people had to understand the structure of the Crédit Agricole Group and how the issuer, Crédit Agricole SA (CASA) is positioned. And the logic says that if, as an investor, you think that the bank has a more than significant probability of hitting the trigger you don't buy the AT1 instrument whatever the parameters and coupon level look like. So it is all about the relative value scheme and analysis.

In terms of pricing references, the direct comparables in the secondary market were the Société Générale single-trigger (5.125%) US dollar perpetual non-call 10 issued at 7.825% in December 2013 and the perpetual non-call five issued at 8.250% in August 2013.

In terms of pricing rationale, apart from Société Générale, did you look at anything else?

Some investors, mainly some UK hedge funds, worked on a pricing rationale from outstanding old-style Tier 2-hosted subordinated issues. Looking at various reference points in

the market, they saw plain vanilla Tier 2 with five year call protection trading at around 350bp over US Treasuries. Using old-style Tier 2 and AT1 relationships, they came to the conclusion that the add-on in yield was around 200bp. Going from perpetual non-call five to perpetual non-call 10 means another 100bp extra. Then, while they think coupon deferability is priced in the 200s, they valued the dual premium at 20bp or so. This implied a yield in the low 8% area or thereabouts for the inaugural Crédit Agricole US dollar AT1 in perpetual non-call 10 format.

Elsewhere, it was impossible to rely on the relationship between US dollar Tier 2 CoCos and AT1s in the market to construct a useful pricing rationale. The spread differential between Barclays US dollar Tier 2 hosted CoCos (BACR 7 ¾ 04/10/23) and Barclays US dollar AT1s (BACR 8 ¼ 12/29/49) was around 100bp including some curve and loss-absorbing feature adjustment. Crédit Agricole Tier 2 hosted CoCos (ACAFP 8 ½ 09/19/33) were trading at around 5.30% ahead of bookbuilding. Using the above relationship, Tier 2 to AT1, we would have come up with something completely inconsistent with Société Générale's trading levels.

How does the dual-trigger structure play into valuations?

Crédit Agricole Group is a co-operative banking group. Its 39 regional banks and central body, Crédit Agricole SA, benefit from a cross-support mechanism. This was the central element for the valuation of the dual-trigger. The low trigger at issuer level cannot be breached before the high 7% trigger at Group level gets hit. These mechanisms were emphasised in the investor presentation. This was also a focal point during the 52 face-to-face meetings and various group meetings the funding teams ran across Asia, Europe and the US between 8 and 14 January.



The buffer of equity that CASA would have to consume before its 5.125% trigger is hit is Eu10bn, or 3.2%. At the Group level the buffer is Eu21bn, or 4%, before the 7% trigger is breached. That compares with a 5.7% buffer for Société Générale's two AT1s in dollars with 5.125% triggers. The equity buffer of Société Générale is Eu18bn. So we looked at the instrument at the Group trigger level, and outlined systematically the greater equity buffer compared with that of Société Générale.

What other relevant features are there in the structure?

The structure offered many other investor-friendly features that you might not notice at first glance. The CASA AT1 cannot be called before it has been fully written up in the unlikely event of a writedown.

In addition to that, the coupon structure is fixed rate per annum, but in each case payable quarterly, so the cashflow schedule looks better for investors and offers an add-on in yield compared with semi-annual payments. Furthermore, the instrument offered a one notch better rating than Société Générale from Fitch.

Elsewhere, the dual-trigger adds a lot of consistency in the hierarchy of the capital structure. It was important to be in line with the CASA Tier 2-hosted 20 non-call five high 7% trigger CoCo launched in September.

Finally, many investors also considered the retail footprint and the limited level of exposure to the CIB business.

How else did investors' views play into the transaction?

During the roadshow we purposely didn't say whether we were looking at a perpetual non-call five or a perpetual non-call 10 until the day before pricing, because we wanted that to be determined by investors. And we told them that.

We are seeing a general hunt for yield and this logically crystallises throughout investor meetings. The preference was for the perp non-call 10.

With regards to the main feature of the trade, many buy-side accounts said that we introduced complexity with the dual-trigger and that we had to pay a premium for that. This was not a surprise, so the challenge was to compress that premium through convincing meetings and calls, emphasising all the above-mentioned selling points.

In meeting after meeting investors gave feedback via quantified indications of interest on perpetual non-call five and perpetual non-call 10. Numbers surfaced in the context of high 6% and low 8%, respectively. The main two secondary reference points, Société Générale 8.250% 11/49 and Société Générale 7.875% 12/49, were trading at around 6.45% and at around 7.75%, respectively. This implied a new issue premium of 15bp-20bp and a dual trigger premium of 15bp-20bp, including some minor credit adjustments.

How did pricing evolve during bookbuilding?

The roadshow ended on Tuesday 14 January and we formally announced the call format that day with a view to starting bookbuilding on Wednesday morning in Asia first. We avoided announcing guidance before Asia opened because we wanted to communicate the biggest possible book when marketing into the US started. We already had a shadow order book of US\$4.5bn from about 150 accounts out of the UK and US on Tuesday.

The IPT level was set at 8.125%-8.375% ahead of Asia opening. We decided to give a hard number although we could have started at "low 8%". It's all semantic, but that way we could respond to some criticisms from investors over the lack of guidance in pricing definition during some other bookbuilding. With IPTs of 8.125%-8.375% we demonstrated that we would consider all pricing indications reflected by institutional accounts during the roadshow. At this guidance the door was also technically open to pricing inside the 8% mark.

When we opened books in Europe, we were in a position to communicate a US\$7bn book very quickly and we fed demand

Reference points (bid levels week of 13/01/2014)

Securities	Issue	Yield to Call	I-Spread	Features
SOCGEN 7.875 12/49 (PNC10)	11/12/2013	7.75%	470	5.125% low trigger
SOCGEN 8.25 11/49 (PNC5)	29/08/2013	6.45%	471	5.125% low trigger
ACAFF 8.125 09/33 (PNC5)	12/9/2013	5.30%	365	Dual trigger 5.125%/7%

Source: Bloomberg, Crédit Agricole CIB

further in Europe. When the US session opened, US\$20bn was already in the book. So few US investors were willing to miss out on the extraordinary performance in primary and the book enjoyed another key round of momentum.

Guidance was refined smoothly to the 8% area and we announced that the deal would price within a plus or minus 0.125% range. We closed with an order volume of US\$24.5bn and nearly 900 different participating accounts on board. Half of the orders were made with tickets of US\$10m or lower, showing an exceptional level of granularity.

The pricing level was set at 7.875%, suggesting that nobody demanded a premium for the dual-trigger — not because there is no differentiation between structures, but because market participants ignored the CASA AT1 low trigger. In the meantime they valued the fact that the buffer to trigger in absolute terms was higher for the Crédit Agricole 7% Group trigger than for Société Générale's 5.125% trigger.

The margin for the reset after five years and every five years thereafter if not called was fixed at 489.8bp during the pricing call. The final size was discussed at length as the Group cares about secondary market performance. But the book supported a good size, so we decided to go for US\$1.75bn.

How did you go about allocations given the size of the order book?

Allocation was challenging given the number of individual orders in the book and the level of oversubscription: Crédit Agricole enjoyed one of the biggest order books for a contingent capital trade, if not the biggest. But if everyone was made equally unhappy, people recognised the strong performance of the deal and enjoyed two full points of profit straight off the break.

The performance of the trade in the secondary market was another key objective achieved by the group — it was Crédit Agricole Group's inaugural CRD IV-compliant AT1 and it had to be a success in primary as well as in the secondary market.

US and Canada-based accounts took half of the total, with the UK taking 22%, and Asia 8%. Asset managers bought 61%, banks and private banks 15%, hedge funds 14%, and insurance companies and pension funds 10%. The deal enjoyed a phenomenal number of new investors for the asset class. More traditional asset managers got engaged because their mandates now enable them to buy any type of deeply subordinated transaction. They are all betting on further strong compression across the capital structure in a context of a normalisation of the markets post-crisis while interest rates remain low.

How do you expect the investor base for AT1 transactions to evolve?

Looking ahead, as we go from one deal to another, the level of oversubscription is becoming misleading. Investors now expect AT1 transactions to be heavily oversubscribed and to perform in the secondary market. There is a greater number of investors who are inclined to inflate orders. The contribu-

CASA USD RESETTABLE CALLABLE NOTE PERPNC10

Rating: -/BB+/BB+

Amount: \$1.75bn of additional tier one capital. Principal writes down (but can be written back up)

Maturity: perpetual

Call option: 23 January 2024

Capital Ratio Event: "Capital Ratio Event" will be deemed to have occurred if (i) Crédit Agricole SA's CET1 Capital Ratio falls or remains below 5.125%, or (ii) the Crédit Agricole Group's CET1 Capital Ratio falls or remains below 7%

Fixed/re-offer price: 100.00

Coupon: 7.875% p.a. until call date; thereafter reset over the prevailing five year USD mid-market swap rate plus initial spread (489.8bp)

Yield at re-offer: 7.875%

Launched: Wednesday 15 January

Payment date: 23 January 2014

Joint bookrunner and global co-ordinator:

Crédit Agricole CIB

tion of Asian investors pre-allocation was 15% (US\$3.6bn). But you need to take into account the level of inflation coming from Asian private banks, although there was no rebate offered on that deal. Staying with the distribution into Asia, it represented 135 different participating accounts and 80 tickets of US\$10m or less.

So this was an excellent outcome given the fact that the participation of Asian investors in deeply subordinated instruments was fairly volatile in 2013. The Asian bid tends to be determined more by absolute yields, which dropped significantly in 2013, while the European and US bids are driven by swap spread and relative value analysis.

Looking at the demand more globally, the UK investor base remains instrumental for the growth of this asset class, because of their capacity to buy dollars as well as euros in size. The euro market investor base is getting more mature every day, but in terms of investor liquidity and depth of the market for this instrument, the US dollar market is the biggest. It will remain that way for a while even if issuers can get success and print in size in euros. And Crédit Agricole seriously considered the euro road.

One of the reasons why the dollar market is bigger is also because you cannot rely on German demand being there in size and granular for a deeply subordinated transaction. This will change and it's just a question of time and education. Only 30 German/Austrian accounts participated in the Crédit Agricole AT1 trade for a total allocated amount of US\$37.8m. In contrast, US demand is highly developed — roughly 50 high profile real money accounts with pretty chunky orders in the CASA AT1. ●

CASA & CoCos

View from the buy-side

With standardisation of contingent capital structures such as Crédit Agricole's AT1 still some way off, pricing the new instruments is by no means easy. Here, *Michel Baud*, portfolio manager at BNP Paribas AM, shares his view on Crédit Agricole's transaction and explores how investors can value the new structures being developed.

By the time the new Crédit Agricole AT1 was issued, there had already been a number of AT1 CoCos from various European banks during the end of 2013, including deals from Société Générale, Barclays, Credit Suisse and even some Spanish banks.

This new issue was an opportunity to get an attractive yield (close to 8%) on the issuer, far above the existing "old-style" Tier 1 (at best 4.7% yield to call, or 6.1% yield to maturity for the existing Tier 1 callable in 2019), and also above the existing Lower Tier 2 CoCo high trigger issued in September (5.4% yield to call, or 7% yield to maturity).

CoCos are complex instruments that require more detailed analysis than standard bonds. In addition to the classic fundamental credit analysis of the issuer, it is key to review the structure of the bond, since each instrument has its own features. This consists of analysing:

- The risk of hitting the trigger, which depends on the solvency of the bank and its risk profile;
- The risk of reaching a "point of non-viability" — where the regulator takes control of the bank;
- The risk of non-payment of coupons — for AT1 CoCos, coupons are discretionary, but cancellation could become mandatory below a certain level of solvency;
- The jurisdiction risk;
- The risk of modification of the prospectus, under tax or regulatory events;
- And any other specific element.

As far as the trigger is concerned, the new Crédit Agricole AT1 was different from the existing securities: while AT1s are usually classified as "low" or "high" trigger, this new bond came with a "dual trigger" structure — a capital ratio event could oc-

cur if a low trigger is reached at the issuing entity (CASA), or a high trigger is reached at the group level.

Unlike for other banks, we understood this constraint was included because of the regulator, given the specific structure of the Crédit Agricole entities.

This dual trigger structure adds complexity to the perceived risk and the pricing of the structure. In theory, the dual trigger increases the probability to breach the ratios.

However, this should be put in perspective.

First, the level of capital is far more comfortable at the group level than in CASA, so under a worst case scenario, the most likely scenario is the latter being hit before the former.

In addition, the intra-group guarantees are expected to work before, contributing positively to the distance to trigger at CASA level.

Based on third quarter 2013 figures, the current distance to trigger at CASA is 4.275 percentage points (9.4 vs 5.125) and at the group level 4.6 percentage points (11.6 vs 7), but the projected amount is lower.

Indeed, the transition into Basel III further adds to the complexity, as a lower 7.8%-8% Basel III ratio is expected as of 1 January 2014 (mainly due to the impact on RWA). As a result, the adjusted distance to trigger (Basel III phase-in) is currently only 1.3 percentage points, before increasing back to reach 2 percentage points at year-end (based on the issuer's projections).

The loss absorption language of the new Crédit Agricole AT1 is more investor friendly than some other CoCos, which have a permanent full write-down.

In the case of Crédit Agricole's AT1, under a breach of one of the capital ratios a loss absorption would occur in the form of a partial and temporary write-down of principal. In the event of a return to financial health, a gradual write-up could occur under certain conditions (a positive consolidated net income

is recorded, subject to minimum distributable amount), at the issuer's sole discretion.

Coupon risk is an additional important part of the risk on AT1 instruments, which can be measured by the distance to coupon restriction (7% ratio on CASA, based on 4.5% minimum CET1 ratio plus capital conservation buffer). This distance will decrease to 2.5 percentage points as of 2019 (but will keep being more than 4 percentage points until 2016 in the transitional regime). The constraints at the group level are less stringent than for CASA: at the group level the distance to coupon restriction level (8.5% including the additional systemic buffer) will decrease to 4.5 percentage points in 2019, but will remain above 7.5 percentage points until 2016.

Quantifying each of the risks listed above and pricing accordingly such a security is not easy. As CoCos are complicated securities with embedded options, it is complex to tackle their valuations in a straightforward way. There is no standardised pricing methodology that is unanimously recognised. Nevertheless, the following approaches could be used.

As a starting point, a basic approach based on relative value could be applied: as there is a nascent market of CoCos (especially in US dollars), existing CoCos are compared to other bonds.

In order to better quantify the loss absorption mechanisms of those instruments, some more advanced pricing methodologies are required, the more efficient adopting either a credit derivatives approach or an equity derivatives approach.

Only a few market participants have developed such "in-house" tools so far.

For this new issue, the best comparable was the Société Générale AT1 (which has almost the same call date, and similar absorption language), trading with 7.4% yield to call, or a 7.1% yield to maturity. However, this security does not have dual trigger characteristics, having a single low trigger (at 5.125%).

For Société Générale, the distance to trigger is 4.775 percentage points (9.9% Basel III vs 5.125%) — i.e. more than Crédit Agricole — while the distance to coupon restriction will decrease to 1.9 percentage points in 2019, i.e. less than Crédit Agricole (but will stay above 4.5 until 2016). These items could only be quantified by using advanced pricing methodologies (as mentioned above).

Despite the limitations some investors can face on such

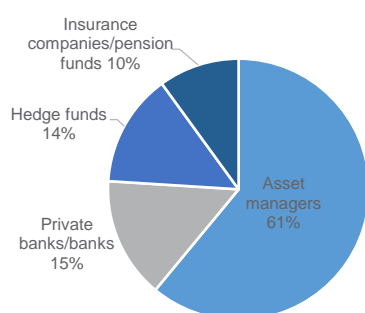


securities — such as low or no ratings, exclusion from benchmarks, regulatory capital treatment, etc — this new issue was particularly well received by the market. Total orders were more than \$25bn for a deal size of \$1.75bn.

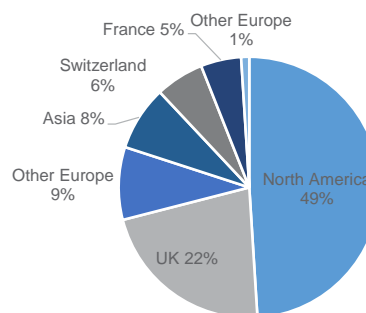
Initially announced in a range of 8.125%-8.375%, the final yield was 7.875%, equivalent to a spread of 489bp, and the following day the price was almost 3 points higher.

While initial CoCos were placed mainly through Asian private banking networks, asset managers made up more than 60% of Crédit Agricole's book. However, continental Europe is still reluctant to invest in such product (with half of the demand having come from the US and Canada, and 22% from the UK), which still leaves good potential for the development of this asset class going forward. ●

Distribution by investor type



Distribution by geography



Source: Crédit Agricole CIB



Jozef Bala,
Assicurazioni Generali



Michael Benyaya,
Crédit Agricole CIB



Hannes Bogner,
UNIQA Insurance Group AG



Hervé Boiral,
Amundi Asset Management



Marco Circelli,
SCOR SE



Karin Clemens,
Standard & Poor's



Charles de La Rochefoucauld,
Crédit Agricole CIB



Lotfi Elbarhdadi,
Standard & Poor's



Alik Hertel,
Talanx AG



Vincent Hoarau,
Crédit Agricole CIB



Thomas Maxwell,
Standard Life Investments



Neil Day,
Moderator

Life under Solvency II

Solvency II is finally becoming concrete. While insurers have long been preparing for its arrival, the final details of it and other international standards could yet affect their capital planning. How are market participants positioning themselves in light of this and the increased room for hybrids under the emerging framework? *Neil Day* sought the views of all sides of the market.

How do you anticipate your activity in 2014, in financial institutions in general and the insurance sector in particular?

Hervé Boiral, head of Euro credit, Amundi Asset Management: Our credit activity has been quite strong in 2013: although our funds were impacted by outflows in the first half of the year, they registered large inflows in the second half. Therefore we have been very active, both on the primary market to invest our subscriptions, and on the secondary market to adjust and optimise our portfolio positions. Even if we don't anticipate 2014 being as rich and positive for credit as 2013, we should continue to see inflows in the asset class, especially on the lower spectrum of ratings, 5Bs and high yield.

The insurance sector represents a small part of the asset class, but has the benefit of being one of the less volatile among the financial sector. It also offers on average better ratings than classical banks, and is almost the only bucket where you can find subordinated bonds which are still investment grade, thus offering interesting spreads. For all these reasons, we should continue to closely monitor the insurance sector in 2014, as long as we are able to trade and find liquidity on primary or secondary issues.

Thomas Maxwell, investment director, Standard Life Investments: We remain constructive on credit going into 2014. The main themes remain supportive for our asset class. We expect a moderate growth environment in developed markets in 2014, with up to 3% growth in the US and 1% in the Eurozone. This was historically the best environment for investment grade credit. The improving growth picture in southern Europe supports a further normalisation in Spanish and Italian risk premiums. Central bank policy remains supportive. ECB crises management and disinflationary pressures in Europe will keep short term rates depressed for longer, leading to further allocations out of lower yielding bond markets into credit by institutional investors.

We also remain positive on insurance fundamentals in general and in particular see value in the Tier 2 subordinated segment. This being said, following the strong spread performance of the subordinated insurance sector in 2013, valuations are becoming increasingly tested and we expect performance to be increasingly driven idiosyncratically rather than systemically as macro tail risks subside. With this backdrop in mind, we have been selectively adding high quality credits such as Allianz and names where we see credible strategies in place to improve the overall credit quality of the institution, for example, Aviva and Generali. We have been funding this position through reducing names which lack clear catalysts for spread compression and/or see risks of deteriorating credit fundamentals as a consequence of rising risk appetite.

What are the key challenges the insurance sector is facing?

Karin Clemens, managing director and lead analytical manager, insurance, Western Europe, Standard & Poor's: I would like to start with a brief review of 2013. We saw economic conditions improving, albeit slowly. In addition, our sovereign ratings in the euro-zone started to stabilise. These two factors contribute to increased stability of our rated insurers across EMEA. You can also see that from the distribution of the outlooks attached to our ratings: as of the beginning of December over 75% of our rated insurers in EMEA now have a stable outlook — that's up from just about 70% at the start of 2013.

But it is also fair to say that one in seven insurers still remains on negative outlook. Looking ahead, we continue to see two key challenges.

The first are the prevailing low interest rates. Even though we expect a rise in interest rates over the next three years, this will be gradual and compared with historic levels rates remain low. As a result, investment earnings are limited. We therefore expect — particularly on the life insurance side — that insurers will continue



Jozef Bala, Generali:

"There are good reasons to expect further convergence in the future"

to adapt their business models and product offerings. At the same time, we believe that it is really key for companies to maintain underwriting discipline in their non-life insurance businesses.

The second challenge is that there continues to be significant regulatory change. However, the focus is now shifting more to conduct-of-business regulation, which will likely influence companies' future product and distribution strategies.

How do you assess the capital position of the global multi-line insurers?

Clemens, S&P: We consider that overall global multi-line insurers display a higher credit quality than other insurance groups. Their average rating is AA- compared with our global insurance rating universe where the average rating is in the A-range. We view the capital positions of global multi-line insurers as a rating strength, and for most of them we rate this specific factor, capital and earnings, as strong or very strong.

Are insurers in general adequately capitalised?

Charles de La Rochefoucauld, head of insurance coverage, Crédit Agricole CIB: In short, I would say that large insurance companies in Europe are generally already well capitalised, including within the new framework which is taking shape in the form of Solvency II. There might be some exceptions, though.

The overall requirement is increasing under Solvency II versus Solvency I — the SCR is between two and three times the Solvency I requirement on average across the industry based on QIS5 results — but large insurance companies started moving to economic balance sheet and risk-based capital management in line with the requirements of Solvency II some time ago.

It's not only Solvency II that has been driving that trend, but also the markets. Investors — whether shareholders or debt inves-

tors — have been more and more favouring insurers that are well advanced in monitoring risks and shareholder value creation, having an economic balance sheet management, rather than a factor-based approach.

Rating agencies also — even though they are largely relying on factor-based models — make a qualitative assessment of the risk management capabilities of insurance companies.

So it's a whole set of trends in the industry that have moved the insurance sector to economic balance sheet management, not only Solvency II regulation.

The new thing with Solvency II is that there is significant headroom for subordinated instruments within the Solvency Capital Requirement (SCR). Large insurance companies will progressively look into optimising their capital structure within this new framework and taking into account their rating targets.

Will the implementation of Solvency II have any rating implications?

Clemens, S&P: We believe that from a financial strength perspective a holistic and risk-based regulatory framework such as Solvency II can contribute to supporting the credit strength of the insurance sector. 2013 was a very important year, in particular the last quarter because, firstly, the European Commission announced that the implementation date has been delayed one last time, to early 2016. Secondly, the decision-making body finally settled on a package of measures including how to value long term guarantees under Solvency II. The agreement also includes a very long transitional period of 16 years for life liabilities — that gives the industry further time to adjust. Irrespective of the latest agreements, Solvency II has already strongly influenced insurers' capital and risk management strategies.

We also recognise that the insurance industry as a whole has made huge strides in building up their own risk management. Solvency II has been one incentive for that, but companies really took on board the lessons learned during the financial crisis after September 11th 2001. We see the improvements in insurers' risk management practices as a strong contributor to the fact that the insurance industry in Europe has fared relatively well across the most recent financial crisis.

Lotfi Elbarhdadi, director and analytical manager, insurance ratings, S&P: Solvency II has been viewed by us as something that really spurred insurers across Europe to improve their risk management practices, particularly the introduction of the Own Risk Insolvency Assessment (ORSA).

Among the most visible improvements are greater controls of risk appetite and better governance. This has been actually one of the main factors behind our broadly revised ERM (Enterprise Risk Management) scores for a number of insurers.

But to add more to what Karin mentioned with regards to this delay of Solvency II, it could probably prompt some insurers to reduce their efforts to develop their risk management frameworks, which might potentially negatively affect our views if it were to ultimately result in less attention towards ERM and less attention towards developing capital modelling tools in order to steer and manage the business.

How do you expect the SCR to compare with the rating agencies' capital requirements?

Jozef Bala, head of debt management unit, Assicurazioni Generali: At this time key decisions on the Solvency II framework are being taken, preventing a definite answer to the question. Clarity on some fundamental aspects has not yet been achieved (for example, on the level of volatility adjustment, boundary of contracts, etc) so there are still question marks against both value and risk assessments.

More generally, rating agencies' capital requirements rely on a set of assumptions and simplifications that is by far larger than that surrounding SCR calculation, and this makes the comparison quite complex. Yes, in some specific cases and companies the two valuations can differ substantially, but the expectation is that for global and diversified groups the two valuations will not be very different. There are also good reasons to expect further convergence in the future: in recent months rating agencies were active in understanding and monitoring both the standard formula and developments in internal models and frameworks in order to perform a "peer" comparison and even amend their model — also following pressure from the industry to fix some valuation issues.

Alik Hertel, head of group treasury, Talanx AG: According to our experience of comparing the SCR with capital requirements by rating agencies, we know that our internal models tend to show up lower requirements. This is due to the fact that diversification effects are adequately captured. This is according to our analysis the main driver of the difference between internal-based models and those of the rating agencies.

Marco Circelli, head of capital and treasury management, SCOR SE: Solvency II has its own definition of the capital requirements (the SCR and the Minimum Capital Requirement, or MCR) without reference to external ratings. As the SCR is a more economical way of assessing capital needs than the rating agencies' methodologies, it is possible that markets will look more and more at the SCR rather than external ratings when assessing the solvency of insurers.

SCOR is already managed based on its internal model, i.e. on the basis of a Solvency II SCR. Our capital management policy based on the solvency ratio was presented during our recent Investor Day in September. Rating models are another important constraint, and we consider that our current solvency target is commensurate with our current rating level.

Hannes Bogner, member of the board of managing directors, UNIQA Insurance Group AG: A comparison is difficult because of the differences between the methodologies. Therefore for capital management purposes all capital models (Solvency I, Solvency II, internal, rating) are calculated, especially when funding activities are taken.

Loffi Elbarhdadi, S&P: The comparison of the SCR with our model is an interesting one and is a question that has been raised many times. It is very difficult to make a direct comparison.



Thomas Maxwell, Standard Life Investments:
"We have been selectively adding high quality credits"

We can point to some differences. For example, we have regionally specific charges, whereas in general for the SCR charges are applied to all the insurers across Europe.

We can also point to some differences in terms of how the models are built. Our capital adequacy tries to assess the capital deficiency with regard to a target rating — this is different to how the SCR approaches the calculation of target capital and own funds. Our primary measure of own funds capital is the Total Adjusted Capital (TAC), which is a different measure from Solvency II.

But it's very difficult to establish a direct link. There are significant differences with regard to diversification.

There are nevertheless more similarities for example between the requirements for approval of internal models under Solvency II and the strategic risk management component of our ERM assessment.

I would add that our new criteria have introduced new components to the overall measurement of capital, which are the representativeness of modelling and the risk position. The representativeness of modelling is a factor that is designed to adjust the result of our capital model — which will remain our key starting point for analysing insurers' capital and earnings — if we believe that the model does not fully capture the risks specific to an insurer, while the risk position can be used to adjust for additional sources of volatility that are not captured in the model.

To give an example: for the global reinsurers, catastrophe exposure might not be completely or easily captured in the capital model, and in this case we would adjust the risk position to allow for that.

Can you expand upon the diversification issue?

Elbarhdadi, S&P: We include diversification, but the first thing we can say is that we do so more conservatively than in the SCR, be it the standard formula or in comparison to the many groups who

publish their own economic capital valuations. We nevertheless include diversification benefit in our model in two ways.

We assess each risk factor in our capital models on the basis of confidence levels — for example, it's 97.2% for BBB. Taking 97.2% for BBB (a five year cumulative default data, instead of a more onerous one year horizon) already allows for some implicit diversification benefit in the charges. We also allow for an explicit diversification benefit, which is based on diversification correlation matrices between risks. The maximum theoretical diversification benefit would be approximately 18% in our model. We apply a 50% haircut to the explicit diversification benefit in our model because of our cautious view on the diversification benefits in the tail.

Looking at other regulatory developments, will Global Systemically Important Insurers (GSI) designation and the Common Framework (ComFrame) for the Supervision of Internationally Active Insurance Groups have an impact on capital requirements?

La Rochefoucauld, CACIB: They could in theory be a factor, but they are not expected to have a significant impact.

Regarding the nine GSIs that have been designated by the Financial Stability Board (FSB), the outcome is still unclear, but market expectations are that the respective capital add-ons shouldn't change the picture too much.

On the ComFrame side, the new Insurance Capital Standard (ICS) applicable to approximately 40 internationally active insurance groups should not differ too much from the Solvency II SCR, so again, unlikely to really change the picture.

Yes, we do expect an intense debate on Level 2 measures

Does classification of insurers as GSIs have an impact on the rating of them?

Clemens, S&P: We don't see any immediate rating implications from the new G-SII designation. However, in the longer term it could have positive or negative effects, depending on how the insurers will ultimately respond to the new regulations. If, for example, the new regulation requires designated insurers to hold more capital, that could be a positive for ratings, all other things being equal. Another consequence could be higher costs of capital, which are generally a negative for ratings. It remains to be seen what the strategic implications — if any — might be.

It is important to stress that the insurance industry's business model differs significantly from banking. While the difficulties faced by certain banks during the financial crisis included severe liquidity and funding issues, in our experience the insurance business model rarely gives rise to liquidity or refinancing concerns. We currently don't impute extraordinary government support to any pure insurer or insurance group except for government-owned insurers. This reflects our perception of the relative importance of insurers compared with

banks. In contrast, we classify banks by their systemic importance to recognise the likelihood of extraordinary government support. We currently reflect such support in the ratings on a material number of banks.

While insurers have long been anticipating the general shape of Solvency II, recently more details have been decided upon. For example, how will the reporting of insurers' solvency positions be affected by the implementation of the 16-year transition period to existing businesses? Do you feel that you will need to report a "fully-loaded" solvency ratio?

Bala, Generali: Even if further time and analysis is needed for a final decision, we do not expect that the transitional measures will affect our Solvency ratio as we are not planning to use such option in the solvency assessment.

Hertel, Talanx: In the current version of our reporting we differentiate between a regulatory and economic view. The 16 year-transition period is first and foremost a regulatory topic. While the economic view will of course not change, the regulatory perspective will benefit.

However, it is premature to quantify this improvement as of today, as many important Level 2/3 details are yet to be determined. Moreover, these specifications or pre-assessment feedback from BaFin on our regulatory model may also contain additional/partly off-setting instructions.

Circelli, SCOR SE: The transitional measure essentially targets direct life insurers; therefore SCOR has no plans to apply it at this stage.

Bogner, UNIQA: This national option will be used for sure by life insurance companies with endowment contracts with guarantees (classical) and a low solvency ratio to achieve a release in best estimates. The question will be the comparability of Solvency ratios because of the different way of application of the transitional measures.

Do you think that some national regulators would be tempted to gold-plate the Solvency II rules? If yes, on which specific topics?

Bala, Generali: It is difficult to predict the reactions of national regulators. Anyway, we believe that the Solvency II legislative framework (Level 1 Directive, Level 2 Delegated Acts, Level 3 Guidelines) is quite comprehensive and it affects — with a good level of detail — most of the aspects of the insurance business. In the interests of increased transparency and the development of a level playing field across Europe, we hope that national regulators will not go beyond the detailed requirements foreseen in the Solvency II framework.

Hertel, Talanx: The Talanx has since several years been in the so-called pre-application phase. Over the years we have experienced not only a gold-plated Solvency II implementation, but also a plati-

num one. This is true for many aspects of either Pillar 1, Pillar 2 or Pillar 3. This experience is transnational, but not necessarily “equally strong”.

Circelli, SCOR: Yes, national regulators could be tempted to gold-plate Solvency II. The philosophy of Solvency II, though, is to ensure maximum harmonisation, so it should hopefully be limited. The areas where gold-plating could take place are in Pillars 2 and 3, e.g. over-prescriptive requirements on governance or additional reporting requirements (in theory limited to specific national items).

Bogner, UNIQA: We don't have the signs pointing to such a development. We expect that the national FSAs will be more for a conservative interpretation than on the gold-plating side.

Do you anticipate much debate on the Level 2 measures? If so, on which topics?

Bala, Generali: Yes, we do expect an intense debate on Level 2 measures. The Omnibus II Directive represents an important step in the right direction, but a lot of work remains to be done on the technical details of the new regime. The main points are those related to the agreed Omnibus II text and, in particular, the so-called long term guarantees (volatility adjustment, matching adjustment). Another topic may be the calibration of long term investments (changes to SCR design or calibration in order to avoid disincentives for long term investments). Other areas could be contract boundaries and own funds (eligibility, tiering, grandfathering).

Hertel, Talanx: Currently we are faced with a threefold regulatory framework under Solvency II, which is labelled as Level 1, 2 and 3 requirements. The different levels are not only related to different details of the topics they treat; they also differ in chronology. For that reason, they are not perfectly consistent, which opens the door to the need for discussions and clarifications. This is also true for the Level 2 documents.

We sometimes really do miss a certain teleological perspective in regulatory discussions.

Circelli, SCOR: The regulators may intend to limit debate over Level 2 measures as much as possible, so as not to jeopardise the challenging timeline of Solvency II application on 1 January 2016. Hence, the regulators may want to limit debates to the same issues that have been debated over the past few years and which have already delayed the application of Solvency II, i.e. long term guarantees and long term investments. Indeed, insurance regulators should address the spillover impact on insurers of the policy choice of prolonging low interest rates. It would be a pity if the regulators did not use the remaining time for discussion to settle other important technical issues. For instance, rather than focusing purely on investment risks, this would be the time to prepare the rebalancing of life insurance from investment risk to biometric risk, by ensuring the reasonable calibration and design of the corresponding modules.



Hannes Bogner, UNIQA:
“The question will be the comparability of Solvency ratios”

Bogner, UNIQA: We are closely following the debates on the interim measures and in particular here the long term guarantees and the risk free rates. We strongly believe that further discussions will be necessary to address this fundamental topic properly.

How is hybrid issuance likely to develop under Solvency II?

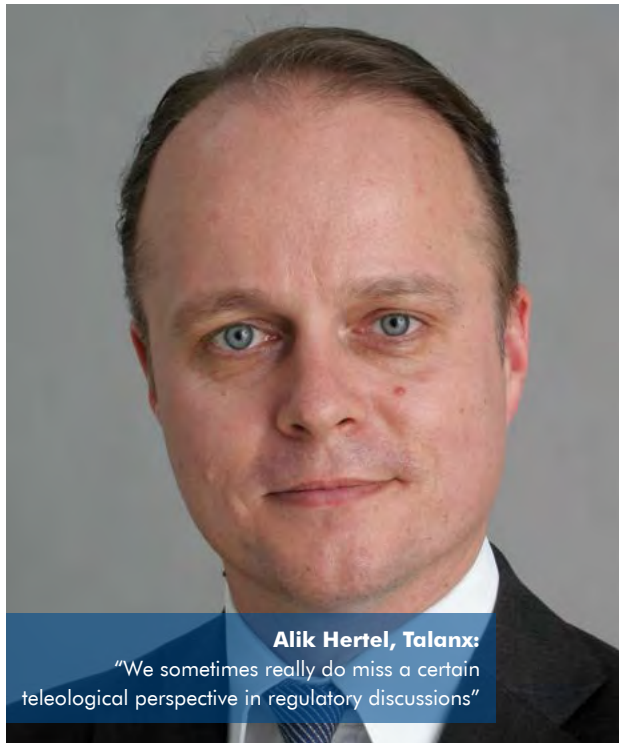
La Rochefoucauld, CACIB: The dust is now settling on Solvency II, which is certainly going to help people to take decisions, even if everything is not yet fixed. We therefore expect capital optimisation to take place and liability management will probably be on the agenda.

In terms of the calendar we are looking at, the European Parliament is expected to vote in early February. Then in May we have the Parliamentary elections, and transposition of Solvency II in each of the member countries is expected to take place early in Q1 2015. Level 2 discussions will take place around Q2, Q3 this year, which will lead to clarification of Tier 1, Tier 2, and new Tier 3, hybrid instruments' characteristics.

What can we say about Tier 1 structures?

Michael Benyaya, DCM solutions, Crédit Agricole CIB: In the banking space the grandfathering rules have been very strong drivers for capital management initiatives, notably in the form of liability management exercises. As currently drafted, the grandfathering rule is much more lenient on the insurance side. Everything that has been issued under the Solvency I format will be grandfathered for 10 years within the limits of the Solvency II capital structure. This means that the grandfathering rules pose little risk to the total solvency position of insurance companies.

There is also another interesting item regarding these grandfa-



thering rules, which is that the cut-off date will probably be very early 2015, in line with the publication of the Level 2 delegated act. This means that issuers, in theory, still have one year in which they can issue old-style Solvency I sub debt to target a grandfathering in Tier 1 under Solvency II — it's a little odd and it will be interesting to see how issuers will approach this rule.

But I think that it's fair to say that for the large issuers that are well established in the market the best practice will probably remain the Solvency II-compliant format, as we have seen recently with Axa sticking to the Solvency II format and not trying to play with these grandfathering rules.

More generally, I think that the overall intention of the regulator is to have a structure that will be similar to the one that exists in the banking sector. And effectively the current Level 2 text shows that the features of the new-style, Solvency II Tier 1 compliant instruments are very close to the bank Additional Tier 1 (AT1). So, in terms of overall structure, I think that the key structuring items are clearly defined.

We are still lacking details regarding the write-up mechanism because in terms of loss absorption the text requires that either we have conversion into equity, which is relatively straightforward, or a write-down of the nominal of the bond, but the question of the write-up mechanism is not addressed in the Level 2 text. That will be part of Level 3, and here we don't know exactly how the regulator will write this rule.

Our hope is that the write-up mechanism will be simpler and more investor-friendly in the insurance space than the one existing in CRD IV, and it's clear that insurance companies will probably wait to have the final Tier 1 rules before they can start issuing or considering issuing Tier 1 instruments.

Maybe just one last word on Tier 1 instruments: the capacity for hybrid Tier 1 is fairly limited in the Solvency II capital structure,

but insurance companies may yet have an interest in this instrument to lower the overall cost of equity.

With the introduction of capital tiering under Solvency II, are investors likely to focus more on Tier 1 capital?

Bala, Generali: A key driver for investors is the clarity of the rules regarding the structure. Therefore investors currently prefer Tier 2 structures for two reasons: the first is the relative stability of the rules of the current Level 2 implementing measures; the second is the fact that the new Tier 2 de facto corresponds to the "Solvency I-style" Tier 1 and therefore the instrument is well known.

Going forward, investors are likely to focus also on Tier 1 capital as we saw in 2013 with the first bank Additional Tier 1 issuances. Nevertheless, we expect the Tier 1 capital market to be more volatile in terms of windows of opportunity.

Boiral, Amundi: We have always closely monitored subordinated debt, whether "old-style" Tier 1 bonds (when they were still fashionable), or new hybrid corporate debt, especially considering the large issuance of 2013. Usually, a new asset class will offer a premium over its fair value in order to attract new investors, a premium that tends to disappear with the development of the bucket. The Tier 1 capital debt of insurance companies, even if not so new, can offer attractive opportunities for our investors, and we stand ready to grab them in our credit funds. So, focus and be ready to invest!

How relevant are alternative sources of capital in your capital planning?

Bala, Generali: For the future, it is our intention to target a reduction in senior debt in favour of a higher percentage of subordinated instruments, while among subordinated tools there is the intention to rebalance the mix.

This strategy will allow us to achieve our capital targets while maintaining the overall quality of our capital position and reducing the overall cost of funding, thanks to a better mix of different debt capital instruments.

In terms of Insurance Linked Securities, we might consider this market as an alternative source of capital in respect to traditional reinsurance, if attractive.

We do not foresee modifying our base capital structure, which will be represented mainly by equity and subordinated tools. Alternative sources of capital could be used, but will remain marginal.

Hertel, Talanx: One of our key aims is to continuously monitor market developments and possibly increase the number of alternative sources of capital in view of the various regulatory and rating agency capital models. So any additional opportunity is regarded as beneficial.

Bogner, Uniqa: At the current time we are only working with traditional instruments (equity and hybrids — 30 non-call 10), and because of our capital position and the funding we did last year we are monitoring the further development of available instruments but do not anticipate any transaction in the near future.

Circelli, SCOR: Alternative sources of capital are very important in our capital planning. SCOR is an active issuer of insurance-linked securities. In 2013 SCOR issued a mortality bond providing the Group with \$180m protection against extreme mortality events in the US. In addition, we are a regular issuer of national catastrophe bonds. Over the last few years we have also established our own nat cat fund in SCOR Global Investments, called Atropos. This fund is open to third parties and allows investors to invest in the reinsurance business through a financial instrument (i.e. Luxembourg SICAV SIF). Through our extensive experience and knowledge of the sector, these funds provide very attractive investment opportunities.

In addition, we are always exploring new, innovative capital sources. In December last year we announced an innovative and cost-efficient three year contingent capital facility, which takes the form of a guaranteed equity line, providing the Group with Eu200m coverage in case of extreme natural catastrophe or life events.

Elbarhdadi, S&P: We have argued that insurance linked securities (ILS) will continue to be a complementary product for traditional reinsurers, for example on the property catastrophe market.

The growth of such an asset class is very much dependent on macroeconomic conditions, and it is confined to certain risk. For example, the historically low interest rates we were mentioning earlier had an impact on this market, with investors turning to this kind of asset class for the higher returns it provides in comparison to more traditional asset classes that suffer from low interest rates. If the situation were to revert back to higher interest rates, investors' behaviour might change and perhaps focus on more traditional asset classes, which could result in declining volumes for asset classes such as catastrophe bonds.

The new class of Tier 3 is introduced under Solvency II. How much clarity is there on what role this will play?

Benyaya, CACIB: Tier 3 is a fairly new concept in the insurance sector because it did not exist in the Solvency I text, where we had only dated and undated formats. Tier 3 is in essence short dated sub debt with deferral language in relation to compliance with the MCR. The capacity for Tier 3 items in the overall Solvency II capital structure will be limited to 15% of the SCR, according to the latest draft Level 2 text, but for some insurance companies it could make sense to look at this capacity, most notably to manage the interest coverage ratio. This measure is under pressure and it's fair to assume that Tier 3 items will probably be less expensive, so for some companies it could make sense to look at this bucket in the overall capital structure.

Have insurers been active in the capital markets recently with related issuance and how do you anticipate your activity in 2014?

Bala, Generali: We were active in the subordinated euro market in 2012 with two Solvency II-compliant Tier 2 30 non-call 10 bonds: the first, in July, for refinancing purposes and the second, in December, whose proceeds were used to purchase minorities stakes in our CEE markets.

We decided to elect for the 30 non-call 10 structure in consideration of its "well known" and established structure in the euro market. Both the order books were characterised by a high degree of geographical diversification and with the domination of real money investors which contributed to the success of the deal.

Regarding our funding strategies for 2014, we already issued on 7 January a senior bond to refinance part of our total maturing senior bonds (Eu2.25bn). The issuance, for a total amount of Eu1.25bn, was a six year senior unsecured transaction. The deal was very satisfactory, both in terms of cost for the issuer, with a yield below 3%, and in terms of investor participation, with an order book amounting to Eu9.4bn from high quality investors.

Hertel, Talanx: The last subordinated bond issue was successfully concluded in the year 2012. By 2015 three of the Group's subordinated bonds will have reached their first call dates. We will need to assess to what extent recapitalisation is going to be necessary. The current capital position of the Group is comfortable, so additional capital issues might be driven more by new investments of the Group in future.

Circelli, SCOR: Our new three year strategic plan, "Optimal Dynamics", which was presented to our stakeholders in September 2013, includes no external equity or debt funding. On top of this, SCOR is currently very well capitalised. However, we are always actively managing our capital and liabilities, monitoring capital market activities and analysing opportunities in order to further optimise and enhance our capital efficiency.

The structure issued by Allianz is definitely a format that is of interest to us

Bogner, Uniqa: We did a rights issue and a hybrid debt transaction in 2013. No such activities are planned for 2014.

One of the recent capital trades from the insurance sector was Allianz's perpetual non-call 10 issue. What did you make of this? Are similar transactions of interest to you?

Bala, Generali: We have carefully considered the structure issued by Allianz, and it is definitely a format that is of interest to us.

Hertel, Talanx: From our perspective this has been a very interesting deal, since it was the first perpetual insurance issue in Europe in a longer period and does show that the investors are again being receptive to such issues. Given the developments since 2008, the available capacity of dated issues has been widely used by the industry, including our Group, so there is sufficient unused capacity available on the perpetual side. At the same time, fully Solvency II-compliant perpetual bonds have still not been issued, also due to the ongoing regulatory discussion. Therefore Allianz's issue is regarded as a good combination.

Circelli, SCOR: As previously stated, we don't intend to raise debt for the time being. However, it is indeed very interesting to see that there is an appetite for this type of transaction in the euro market. SCOR likes perpetual debt and today is the largest issuer in the Swiss franc perpetual market.

Maxwell, Standard Life Investments: The Allianz deal is an interesting one as it is structurally subordinated to dated Tier 2 debt and perpetual in nature, yet it is likely to be treated within the Tier 2 capital bucket for Solvency II purposes. This raises questions about the rationale for Allianz issuing such a structure as opposed to the more familiar dated Tier 2 instruments.

In general, we are cautious on rating agency-driven structures given the uncertainty regarding the evolution of rating methodologies, especially when the bonds feature rating agency calls. A fundamentally important issue is the pricing of such instruments, as investors are often complacent in pricing certain structural features in strong credit markets. A good example of this — which may also be explained somewhat by scarcity — is the recent insurance dollar denominated deals marketed primarily to Asian investors, many of which were structurally weaker when compared with the equivalent euro or sterling denominated bonds from the same issuer yet commanded a premium valuation. Adverse structural features can increase the risk of moral hazard (i.e. issuers exercising right not to redeem bonds at first available date, or to call at par due to ratings/accounting/tax event) and hamper bond performance, particularly in times of stress.

I am confident that most investors have learned the lesson

As insurance regulation evolves we expect increasingly innovative capital instruments to emerge, including structures similar to the Allianz perpetual and indeed Solvency II-compliant Tier 1 bonds. Our interest in such deals will be subject to valuations and meeting our investment process.

Boiral, Amundi: This kind of issue can prove interesting, as long as it is fairly priced on the primary market and it is offering an “honest NIP” (new issue premium), and provided that the issue is well placed and not too large. The NIP is not only a reward for investors; it's first of all a premium for not choosing the timing to invest in a specific issuer. It's also a measure to compensate for the given level of interest rates at a certain point in time, imposed on the investor by the issuer. It's a necessary cushion for both secondary market volatility and the bid-offer spread involved.

Unfortunately, the most recent subordinated deals have tended to be a little overpriced, even if primary books appeared to be very well oversubscribed. Secondary market performance may therefore be disappointing, or at least not in line with the risk taken on these deals: they can be very volatile and strongly affected should

the credit market turn bearish. We are ready to take risk, but at a good price!

In the recent Allianz perpetual non-call 10 transaction, the perpetuity element was hardly reflected in the spread, based on where dated bonds were trading. Do you think that is normal?

Maxwell, Standard Life Investments: There are two key structural features which differentiate the recent Allianz perpetual with the existing dated Tier 2 bonds. Firstly, the new instrument is structurally subordinated and secondly it is perpetual in nature. The pricing of such features is often complicated given diverging views across the investor community regarding the premium required. From our perspective the premium we demand depends on how we view the overall credit quality of the company and our assessment of how the instrument's structure impacts on bondholder risk. For example, assessing the probability of a bond not being called at the first available date and what the implications of a non-call would be on valuations. In general we would demand a lower premium for such features when we have a strong overall credit view and the issuer has demonstrated a consistent debt capital management track record. Looking historically, the majority of high quality insurers have honoured bondholder expectations and redeemed bonds at the first available date. However, with the market largely ignoring insurance call risk at present, it is an important dynamic to follow going forward, especially given the increased use of economically driven calls in European banks and expectation of generous grandfathering provisions for subordinated capital instruments under Solvency II.

Boiral, Amundi: In this kind of trade, the problem is less the perpetuity element than the conditions that may trigger the call. The idea is to evaluate the probability of the call being exercised, and then price the bond accordingly. As a good and instructive example, take the former Tier 1 bank bonds. At the time of the launch of these Tier 1 bonds, at the beginning of the 2000s, the market was deeply convinced that the bond would be called, therefore all issues were priced without taking into account the perpetuity. When it appeared that this would not automatically be the case, the asset class went through a deep correction. This is why we have to be aware and keep in mind that the call is an option, it's not mandatory. Once this option is correctly priced, perpetuity is not a problem. But I am confident that most investors have learned the lesson, and are now very concerned with call options.

Vincent Hoarau, head of FIG syndicate, Crédit Agricole CIB: When we kicked-off the bookbuilding process for the Allianz perpetual non-call 10 in October last year, the outstanding Allianz 5.625% 10/17/42 dated issue callable in 2022 was trading at around 220bp over the interpolated swap rate (yield to call). Adding a few basis points for the curve adjustment, we came up with a premium of around 40bp for the perpetuity premium, including the new issue premium. We eventually priced the deal at mid-swaps plus 260bp. So you are right: that's nothing!

But what is valid for Allianz is not necessarily valid for everyone. First of all, it was the first perpetual insurance subordinated deal since 2007. So there was a bit of price discovery around the key element of perpetuity, even if there was an old Allianz perpetual 4.375% 12/29/49 which we used as an anchor in the pricing rationale. But in the end you have to bear in mind that when you are dealing with a transaction for Allianz, either you get it right from the outset on pricing or you go nowhere. The liquidity situation was conducive when we proceeded, there are a lot of positives around the signature, including its outstanding credit profile, strong ratings, scarcity value, etc. So with the right IPTs — we started in the high 200s — and powerful traction from the outset you can build a strong book in a few minutes and leverage off that to compress the NIP and perpetuity premium to the minimum. So the perpetuity premium was not limited per se. We also ended up with a ridiculously low number because the overall new issue process went extraordinary well.

But I agree with Hervé, when you are fine with the call option, and when it is priced in correctly, the perpetuity extension is not a problem at all for investors. Elsewhere, when you look at a name like Allianz the different curves and instruments are really compressed and tend to converge further in a normalising market. At the moment, there is a spread differential of roughly 30bp (including the curve adjustment) between the Allianz 5.625% 10/17/42 and Allianz 4.75% 10/29/49. And this perpetuity premium has been stable since the pricing of Allianz perpetual.

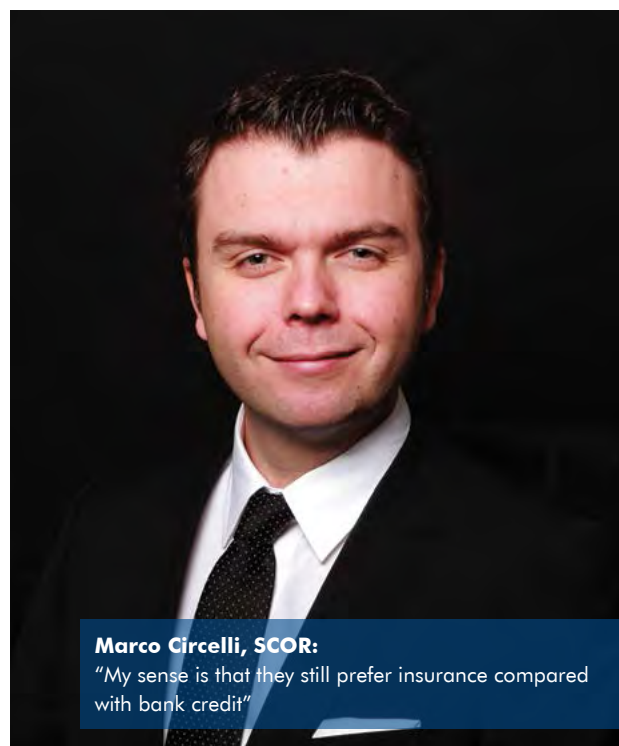
How comparable is demand for undated subordinated instruments from insurers and newly established bank contingent capital trades in perpetual format?

Hoarau, CACIB: Looking at the placement of the Crédit Agricole AT1 in US dollars, we were somewhat astonished by the depth and the breadth of the distribution: a \$24.5bn book, nearly 900 different orders and, more importantly, roughly 450 of \$10m or smaller. So the granularity of the book was exceptional. Several conclusions can be drawn from that.

Everyone is red hot, ready to take duration risk, spread risk and risk with regards to the nature of the instrument because you can't find such return on investment anywhere else. But in CoCos the decision to buy is firstly driven by the belief that the trigger will never be breached, while the instrument is offering an extraordinary coupon. For the rest, it's all about relative value analysis.

CoCo investors are also convinced that issuers cannot fail in primary given the stock of Core Equity Tier 1 they need to accumulate in the coming years. So deals must perform. Therefore there is a lot of inflation in the numbers mentioned above and syndicates must be very careful when sizing transactions and fine tuning the final re-offer yield if they want to protect secondary performance.

I think investors are more sober when looking at subordinated trades issued by insurers. There is less fantasy when it comes to price discovery, the coupons are less irresistible, and the potential for immediate performance in the secondary market more moderate. So you will never see the same degree of delirium and inflation in order volumes. Hedge funds and fast money investors will think twice before getting involved. And when you look at the volatility



Marco Circelli, SCOR:

"My sense is that they still prefer insurance compared with bank credit"

in the secondary market, you can logically observe a greater stability in subordinated insurance paper.

But in the end, we all know that we are not talking about the same type of instruments. CoCos are loss-absorbing instruments and therefore attract some classical high yield and equity investors in addition to very sophisticated hedge funds that you will never find in an insurance perpetual book. Meanwhile lots of European investors, namely German, are still very reluctant to buy such complex and risky instruments as CoCos. German investors were instrumental in the return of Allianz in euro perpetual format, with 23% of the placement. And I am convinced that they would have offered the same type of traction to a non-domestic insurer. In contrast, they contributed only 2% of Barclays' placement when it tested the AT1 market in euro format. But the bid from UK investors is crucial in the end. They took the lion's share of the Allianz perpetual, with 40% of allocations, and drove demand in all the recent contingent capital trades in US dollars as well as in euros.

How interesting for issuers are the levels at which the insurance sector is trading given the compression in spreads?

Bala, Generali: Market conditions improved over the last two years and spreads are currently near their tightest valuations since the financial crisis, therefore the current cost of funding for Generali is at its lowest level since 2008. This is the reason why we decided to take advantage of the positive momentum on 7 January, issuing the six year senior bond. We expect moreover that in the coming months potential tapering in the US and the Asset Quality Review in Europe may drive interest rates higher and increase credit spreads, although we expect the market to remain relatively stable and open during 2014.

Hertel, Talanx: Spread levels are close to all-time lows, this is



Karin Clemens, S&P:

"It is important to stress that the insurance industry's business model differs significantly from banking"

true. Nevertheless, in a low yield environment, they still look attractive for investors. Consequently, we expect them to remain receptive to new issues.

Circelli, SCOR: The levels are still attractive, with people being desperate for yield and searching for diversification. There is still not enough insurance paper in the market and a lot of investors see insurance as a great diversification for their portfolio. My sense is that they still prefer insurance compared with bank credit, especially when you look at the Tier 1 Basel III type of banking structures. Insurers have proven to be very solid counterparties, as clearly demonstrated during the financial crisis.

What do you think about the current spread situation in the financial sector?

Maxwell, Standard Life Investments: Looking at current valuations, we continue to see value in subordinated insurance paper, in particular, the Tier 2 segment of the capital structure, where we see value versus senior bonds, other financials and corporate hybrids. However, as a consequence of a strong spread performance in 2013 valuations are now less compelling and likely to be more driven by single-name stories. A key concern we will be assessing in 2014 will be signs of insurance credit fundamentals weakening, especially given tighter valuations. Furthermore, spread compression may to some extent be constrained by continued investor concerns regarding low interest rates and the impact of various incoming regulations (such as Solvency II; globally systemically important financial institutions; the common framework to analyse international insurance players) on insurer business profiles and capital requirements.

As European macroeconomic sentiment improves, we would expect this to support further spread compression between core

and non-core issuers. However, given the diversity of business profiles exhibited across the insurance debt market we continue to focus on single-name stories where we see fundamental catalysts for credit quality improvements and an individual rationale to drive spread compression.

Boiral, Amundi: At the beginning of 2013, the average spread on the financial sector was much larger than on the industrial sector, by 15%. At the end of 2013, the compression trade has taken effect, and the premium is now closer to 10%. Still, we believe financial issuers remain interesting, considering the improvement of fundamentals for SIFI banks, largely under the pressure of the regulator. In the insurance sector, senior bonds may appear a bit expensive, even if they are an endangered species. We prefer to invest in subordinated securities offering spreads over 200bp with an investment grade rating compared with subordinated bank bonds, which are often cross-over or even high yield.

Looking at the convergence between core and non-core issuers, the development here will most likely be linked to what happens on the government bond market. If you expect Italian and Spanish rates to continue converging towards German rates, core and non-core issuers will also converge. Even if this is clearly Amundi's view, we have to keep in mind that most of the path has already been covered. The idea is now to focus on the fundamentals of these issuers, independent of their nationality. So, yes, the compression trade between core/non-core issuers should continue in 2014, and on European insurers, too, but idiosyncratic risk could alter the global trend.

How do you balance benchmark sized issuance with private placements?

Bala, Generali: Our actual capital structure is already well diversified in this respect, in fact roughly 20% of our hybrid and subordinated debt has been privately placed. The future mix will be driven mainly by market conditions and by the specific interest of some investors in our debt issuances. However, consistent approach of the Group with fixed income investors will be a key driver for both the benchmark sized issuance and possible private placements success.

Hertel, Talanx: Talanx has established its capital markets footprint in the last 24 months and we see it as primarily beneficial at this stage to increase the number of benchmark sized transactions over time. However, under special circumstances we are also open to reviewing bespoke private placements, which we did, for example, in co-operation with Meiji Yasuda in 2010.

Circelli, SCOR: It depends on the use of proceeds. We don't issue debt just for the sake of issuing debt. SCOR follows a thorough process with regard to such decisions, by analysing type, cost, size, investor perception etc within the framework of a well-defined governance process. In certain markets, such as Asian retail, it would be absolutely critical to enter the market with a nice benchmark transaction. Such benchmark transactions open doors to new and interesting financial markets.

Thomas mentioned recent insurance issuance in US dollars — how is demand for such subordinated paper evolving?

Hoarau, CACIB: We have not seen a lot of insurers in the primary market in general recently, including in US dollars, but my feeling is that the demand for US dollar capital instruments is going global for insurers, too. The time when Asian private banks were indispensable and provided a bedrock of demand for capital instruments in US dollar format is over. But the Asian bid remains crucial. The participation of Asian investors is just declining in relative terms because the bid from the UK and to a lesser extent US institutional investors is growing rapidly.

This is affecting pricing dynamics in US dollars. Historically, the US and UK investor bases are driven by spreads and relative value, while the Asian bid, dominated by private banks, remains driven by the absolute yield level, deal momentum and overall market conditions. This certainly explains why the Asian bid was fairly volatile in 2013 when yields were declining and market volatility was consistently present. But now that we are seeing more and more institutional investors and hedge funds involved in Asia, I think the demand and pricing dynamic will become more and more homogeneous.

So do you recommend going global and adopting the 144A and RegS format?

Hoarau, CACIB: No. For insurers looking at deeply subordinated instruments this topic has to be approached on a case by case basis taking into account how often they tap the market. The 144A format is very heavy in terms of documentation, costly and time consuming. Meanwhile, in non-vanilla products, you can only rely on a handful of US on-shore institutional investors for tickets in size.

Looking ahead, the issuance of insurance paper will remain limited compared with bank paper and the investment in 144A is not worthwhile for everyone. Together with Asia, Europe can satisfy everyone's needs in US dollars. And above all, UK investors are essential because of their capacity to buy dollars as well as euros in size. So the answer to the question is not straightforward.

More generally, wherever investors are based around the globe, they don't want to miss out on the success in the primary market of issuers with powerful name recognition, offering tempting yields and scarcity value, such as core European insurers — particularly when they can enjoy a robust performance in the secondary market.

Across the board, investors are also convinced that European markets are normalising and that European core insurers will never go bust. So when you buy the convergence story you have to buy subordinated instruments issued by insurance companies and offering two or three times the risk-free yield. So for borrowers the liquidity is there across formats. The choice of global or RegS-only format also depends on the aspiration of the issuer in terms of investor diversification.

Is the scarcity effect in the insurance sector playing a role in the relative value analysis? How do you assess fair value on insurers, what are the main criteria you are looking

at? Are liquidity and issue size relevant in your investment decision process?

Maxwell, Standard Life Investments: Scarcity often explains some technically-driven anomalies exhibited in specific bonds, particularly within the senior space. However, the effect does not play a major role in our relative value analysis as the situation can easily change, for example as a consequence of capital management actions and new issuance. Our relative value analysis is predicated on a five factor investment process which we utilise: we identify the key drivers of the credit quality, what is changing, what is priced in by the market, why the market will change its expectations going forward, and finally highlighting the triggers. Furthermore, looking at the structure of debt instruments is paramount to identify embedded risks vis-à-vis each other and whether investors are adequately compensated for this risk. This approach allows comparisons across the capital structure, peers and other sectors.

Liquidity and minimum size certainly form an important component in our investment process as this can impact eligibility for benchmarks, fund mandates and bond performance. We apply a higher illiquidity premium for bonds that are sub-benchmark in size or where the issue size is too large as these unfavourable technicals can adversely impact the performance of bonds.

Scarcity is not a sufficient reason for an asset manager to invest in rich paper

Boiral, Amundi: Insurance issuers' scarcity explains why this sector appears expensive when it comes to senior bonds. Nonetheless, scarcity is not a sufficient reason for an asset manager to invest in rich paper — especially when an abundant primary season may quickly correct this shortage, as we have seen on utilities, for example. Luckily, the CDS market is less influenced by these technical effects, and allows investors to have a more objective view on the spreads. All-in-all, to assess a fair price on these insurance issuers, we will consider in the first place — of course — fundamentals, followed by the size of the issuance, ideally between Eu500m and Eu1.5bn, the level of the CDS, and then the competitors: firstly, among the peer sector, by activity and country, then we broaden the range of comparables. The last important factor to take into account is the syndicate's quality, and we have learned that it can sometimes play a larger role, particularly on more complex, very large transactions.

Hoarau, CACIB: I couldn't agree more. The incorrect sizing of new issues can be devastating in the secondary market. The quality of placement and the level of granularity of the book are also essential to protect performance. So yes, a strong syndicate is a key element, particularly when markets are shaky and issuers need dealers who are ready to put balance sheet to work to support the paper. ●



Photo: Oskar Karlin/Flickr

Nordics await a piece of the AT1 action

From the moment Svenska Handelsbanken reopened the bank capital market for 2014, forecasts of the asset class being the one to watch this year have come good. The only obstacle to Nordic banks successfully joining the action in hybrid form appears to be regulatory uncertainty.

Susanna Rust reports.

If a recent Eu1.5bn (Skr13.2bn) 10 year non-call five Tier 2 issue for Svenska Handelsbanken is anything to go by, Nordic bank capital will be met with open arms this year. Tapping the market on the first day of new issuance in 2014, the Swedish bank drew some Eu5.5bn of orders to allow pricing at 143bp over mid-swaps — the tightest re-offer spread for such a Tier 2 issue since the collapse of Lehman Brothers.

“A screaming success” that fed investors’ appetite for “low beta in sub”, is how one syndicate banker described the trade.

Indeed, with yield-hungry investors showing signs of waning interest in core bank bonds given prevailing tight spreads, core issuers would be better advised to tap the euro market for subordinated funding, according to Alex Sönnnerberg, Nordic DCM origination at Crédit Agricole CIB.

“It’s no surprise that the majority of supply in senior financials this year has come from peripheral banks, which satisfy yield-driven investors,” he says. “Therefore it makes more sense for core issuers with subordinated funding needs to tap the euro market right now given they can offer investors an attractive coupon from a high quality credit with low probability of default whilst still achieving a tight spread.”

Handelsbanken’s deal was its first sale of subordinated debt since 2007 and marked the beginning of what is expected to be a wave of subordinated or hybrid debt issuance from European banks, with a focus on Additional Tier 1 (AT1) but including Tier 2 transactions.

According to Gwenaëlle Lereste and Pascal Decque, financial analysts at Crédit Agricole CIB, AT1, the new category of hybrid capital with contractual loss absorbency mechanisms introduced by the Basel III framework, is expected to be the segment of 2014.

European banks are expected to issue Eu25bn of euro denominated AT1 instruments in 2014, and around Eu59bn-Eu66bn in total including US dollars. Looking further down the line, the euro benchmark market could exceed Eu400bn, according to the analysts.

The outlook for Tier 2 subordinated instruments, the segment that Handelsbanken tapped for the bank capital market’s reopening this year, is also positive, they say, estimating some Eu20bn of issuance in 2014.

“Banks are queuing up: top European names and potentially good second tier names,” say the analysts. “The market has opened to peripherals and there will be more equilibrium in issues between euros and foreign currencies.”

Locked and fully-loaded

As far as regulatory requirements are concerned, Nordic banks are generally deemed to be in a good position, in that they are approaching, meeting, or exceeding the toughest standards in the European Union.

In Sweden, for example, according to rules set out in November 2011, banks are required to have a Common Equity Tier 1 (CET1) ratio of at least 12% by 2015, with a countercyclical buffer addition of up to 2.5%. This compares with a minimum common equity requirement of 4.5% by 2015 under the unadulterated EU bank capital package, the Capital Requirements Directive/Regulation (CRD IV/CRR).

According to Crédit Agricole CIB’s analysts, Swedbank exceeded a fully-loaded Basel III CET1 target ratio of 18% by six percentage points as of the end of 2013, and SEB was two percentage points above the same target ratio.

Indeed, in Sweden “the main story” is dividends, says Sönnnerberg.

“Shareholders want banks to return capital, especially given that levels are above and beyond regulatory requirements,” he says, “but the FSA, Riksbank and the government are trying to force banks to hold on to capital.

“Once there is clarity on the regula-



Hampus Brodén, SEB:

"The decisive factor remains regulatory clarity"

tory requirements banks will know how much they can pay out in dividends or buy-backs, and what they can issue in terms of hybrid capital instruments."

Nordic bank capitalisation also looks good when it comes to metrics such as the Risk Adjusted Capital (RAC) ratio used by Standard & Poor's.

According to the rating agency, the weighted average RAC for the 22 Nordic banks it rates is 9%, compared with an average of 7.4% for the 100 largest banks S&P rates globally. Each of the Nordic banks exceeds the 7.4% level. Among the larger Nordic banks, S&P's assessment of a bank's capital strength has a positive rating impact only on Finland's Pohjola Bank, although in July the rating agency revised its outlook on Swedbank to stable in part because it forecast an improvement in the Swedish bank's capital ratios.

The rating agency noted that Nordic banks significantly increased capital between 2009 and 2012, on an Adjusted Common Equity (ACE) and Total Adjusted Capital (TAC) basis, and that the growth of bank capital slowed this year as banks have reached or are approaching regulatory capital targets.

However, it expects Nordic banks' capital strength to continue to improve.

"We expect that, over the next 18-24 months, the RAC ratios of many large Nordic banks will approach 10%, which is the minimum to qualify as having 'strong' capital according to our criteria," said S&P. "We expect some of the 14 smaller banks to approach the 15% mark in the 'very strong' category."

Fitch also notes that Nordic banks already have high capital ratios, but still sees reasons for them to build on that.

Banks will find more of a balance than what they have now

"Fitch expects Nordic banks to keep a high buffer to maintain investor confidence in the context of the current development of resolution and bail-in legislation," said the rating agency. "This is further driven by some regulatory uncertainty on adequate risk weight floors for mortgages, additional buffers for domestic SIFIs and leverage."

At S&P, the expectation is that Norwegian and Danish banks will continue to accumulate equity capital, but that large banks in Sweden in particular will begin to issue hybrid Tier 1 capital instruments

this year to improve capital efficiency, not least because of growing speculation in the market about increased dividend pay-outs.

"Nordic banks haven't issued AT1, but I don't think that will continue," says Sean Cotton, associate director, financial institutions, S&P. "The Swedish banks in particular used to have a relatively high share of hybrid capital and those banks that are in excess of capital requirements and generating strong earnings will at some point turn to capital optimisation.

"They will look at the cost of capital and how they can better build the capital base, for example by slowing equity accumulation and increasing the share of hybrids. As AT1 instruments are perceived to be loss absorbing, it seems that banks will find more of a balance than what they have now."

Champing at the regulatory bit

Stefano Rossetto, hybrid capital and liability management, Crédit Agricole CIB, says that Nordic banks' non-equity capital issuance plans will be influenced by a range of considerations, such as leverage ratio requirements, changes in risk weights, Pillar 2 requirements, and requirements for bail-inable debt in the context of bank recovery and resolution frameworks.

"All of these relate to the target capital structure for a bank," he says. "Pillar 2 requirements vary from jurisdiction to jurisdiction, and in the Nordics they are something that banks will have to assess as part of their total capital considerations."

He notes that the inherently lower risk weights shown by Nordic banks mean that their capitalisation appears relatively weaker when measures based on total assets or total liabilities are used, and that a leverage ratio higher than 3%, as has been discussed by some European policymakers, could be a potential source of capital need, for example.

Denmark has yet to introduce a leverage ratio, but a government expert group is assessing the need for it to be introduced in addition to risk-based capital requirements, while some analysts note that a "Swedish finish" to the EU lev-

erage ratio would be in line with how policymakers there have acted so far. In Norway regulators have also expressed a need for a leverage ratio.

Another consideration when it comes to the outlook for Nordic bank capital issuance, according to Rossetto, is that there is still uncertainty about the types of instruments that can be used to meet various capital requirements and what hybrid structures will be accepted by regulators.

"What the Nordics have issued so far is generally plain vanilla Tier 2, which is not that different from Basel II," he says. "What will be interesting is what kind of hybrid instruments will be allowed and favoured by local Nordic regulators to cover additional capital requirements to boost major Nordic banks' loss absorbency, or cover specific risk exposures."

Indeed, in Sweden the banks are very eager for the regulator to divulge details about various requirements so that they can get on with fine-tuning their capital structures.

"The standard answer you'll get from most Swedish banks is that we are waiting for regulatory clarification," says Gregori Karamouzis, head of investor relations at Swedbank, "on issues such as what the buffer requirements will be, what type of capital will count toward those buffers, and what structures will be allowed for loss absorbing instruments."

Clarity on these aspects will allow the issuer to calibrate its capital structure and meet its needs in the most economically efficient way, he says, for example by using standard Tier 2 debt, the cheapest bank capital available, to satisfy as many requirements as possible.

Rodney Alfvén, head of investor relations at Nordea, says that Nordea will issue CoCos when Nordic regulators have clarified their requirements and how these can be met.

"We are above our capital targets, but have redemptions in the coming years so will want to replace these with new issuance," he says. "We have the mandate from our AGM to issue CoCos and theoretically could pull the trigger quite quickly, but we are waiting to get clarity from the regulators."

He says that Swedish banks are lacking clarity on what the Pillar 2 requirements will be and what type of capital will count toward these requirements, and how trigger points and other features of CoCos will be treated by the Swedish regulators.

Hampus Brodén, head of group financial management at SEB, says the regulatory uncertainty means that it is difficult to say at the moment whether SEB will be issuing hybrid capital in the early stages of 2014, even though market developments are encouraging.

"The mood seems to be quite upbeat and there is appetite for these kinds of instruments, which bodes well," he says, "but the decisive factor remains regulatory clarity."

"We have high hopes that we will be perceived as more than sufficiently capitalised, but until we have clarity it is too early for us to have a firm view. It's just not possible to tell where things are going to end up and at the moment we are forced to sit on our hands a bit."

Karamouzis, meanwhile, is confident that Swedish banks will still meet with demand even if they are not able to join in the AT1 market straight away.

"In terms of quality, we fill a different bucket, so we will still have a role to play in investors' portfolios because of the lower risk profile we offer," he says.

Bank capital regulation in Finland, notes Sönnerberg, appears to be aligning itself with the Basel III recommendations without "pushing the boundaries", but could follow the direction Sweden is taking,



Alex Sönnerberg, CACIB:
In Sweden "the main story" is dividends

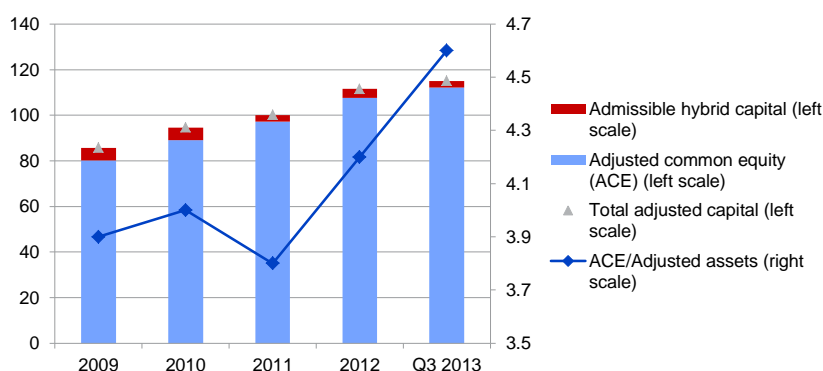
ing, as is often the case.

"The banks there are relatively well capitalised, without having any imminent requirements to fill buffers, so I think they will lay low and wait for further clarity from the regulator," he says.

In Norway, the latest development on the regulatory front was a mid-December announcement from the finance ministry that banks will be required to hold a countercyclical capital buffer of 1% of risk-weighted assets as of July 2015. That move came after the ministry in October increased loss given default (LGD) parameters for mortgages.

Like its Swedish counterparts, Nor-

Nordic Banks: Total Adjusted Capital and Leverage*



*Based on data from the 22 banks S&P rates in Denmark, Norway, Sweden and Finland
Source: Standard & Poor's



way's DNB has meanwhile been able to take advantage of the attractive conditions in the Tier 2 market. When Handelsbanken set the new post-Lehman tight, it took that record away from DNB, which had set the previous tight with a Eu750m (Nkr6.30bn) 10 year non-call five issue in September 2013 at 177bp over mid-swaps.

Thor Tellefsen, senior vice president and head of long term funding at DNB, said that the issuer had been planning for some time to launch a Lower Tier 2 transaction before the end of the year.

"It is part of our regular refinancing of Lower Tier 2 capital that we have called and it goes toward meeting Basel capital requirements," he said.

Danske eyes AT1 after saga

Could Danske Bank end up pricing the first Nordic CoCo? The Danish lender has already issued CRD IV-compliant Tier 2 bonds, but has waited to sell AT1 securities because of uncertainty about two tax matters.

One concerns the treatment of coupons and whether these will be tax deductible, as has been the case for the bank's hybrids since 2004, and the other is whether there would be a tax liability stemming from a potential future write-

down, which could imply lower capital recognition upfront.

The issuer is expecting clarity on the first matter upon the passage of government SIFI legislation, which could be passed this quarter, while the second issue was being looked at by the European Banking Authority in 2013 but has since been referred back to national regulators.

We believe that the tender struck a good balance

"The situation is now much more straightforward because we know the regulators we should talk to about it," says Peter Holm, senior vice president, head of group funding and cover pool management, treasury, at Danske Bank. "We would like clarity on both issues."

Like other Nordic banks, Danske has in the preceding years boosted its capital in anticipation of higher capital requirements heralded by the Basel III framework, but in the Danish bank's case an additional factor has been in play — a Dkr24bn (Eu3.22bn) government hybrid capital loan taken out in 2009 and up for prepayment in April this year.

"Ever since the government hybrid went on our books we have been planning for the prepayment option," says Holm.

In April 2011 the bank raised net proceeds of Dkr19.8bn via an equity issue and in October 2012 it launched a Dkr7bn equity issue, after having a month earlier sold a \$1bn (Eu731m) 25 year non-call five Eurodollar Tier 2 issue aimed at improving its S&P RAC ratio and boosting the quality of the bank's capital.

Developments in 2013, however, threw a spanner in the works, due to the aforementioned tax questions cropping up and changes to S&P's bank hybrid capital methodology. The latter resulted in S&P classifying the so-called RAC issue from September 2012 as having "minimal" rather than "intermediate" equity content, as originally assessed.

"That came as a great problem for us and investors," says Holm, "but we believe that the tender struck a good balance."

After losing the favourable equity treatment for the Tier 2 securities, Danske in September 2013 launched a tender offer for the bonds, achieving a 90% participation rate. In the meantime, it had launched a new Tier 2 issue, a Eu1bn 10 non-call five, and in November and December last year the bank was busy raising Tier 2 capital in Nordic currencies, via a Dkr5.55bn equivalent five tranche deal dubbed "Trekroner" for targeting the three Nordic currencies, and then in Swiss francs.

"The bulk of our Tier 2 issuance is in place for now," says Holm. "There may be some further issuance in 2014, but not of the same size as in Q3 and Q4 2013, and more for small adjustments only."

Instead, the main target from a debt capital perspective is AT1 issuance, which the issuer initially had hoped to be able to execute in the autumn of 2013 but decided against pursuing because it wanted more clarity on the tax issues.

However, a benchmark-sized AT1 issue is on the issuer's agenda for this year. Danske will keep its options open with respect to the currency of such a deal, according to Holm, but has a preference for euros, while in terms of the structure it has been focussing on a temporary write-down mechanism. ●

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