BANK+INSURANCE HYBRID CAPITAL
MAR-APR 2014
WWW.BIHCAPITAL.COM
NUMBER 2

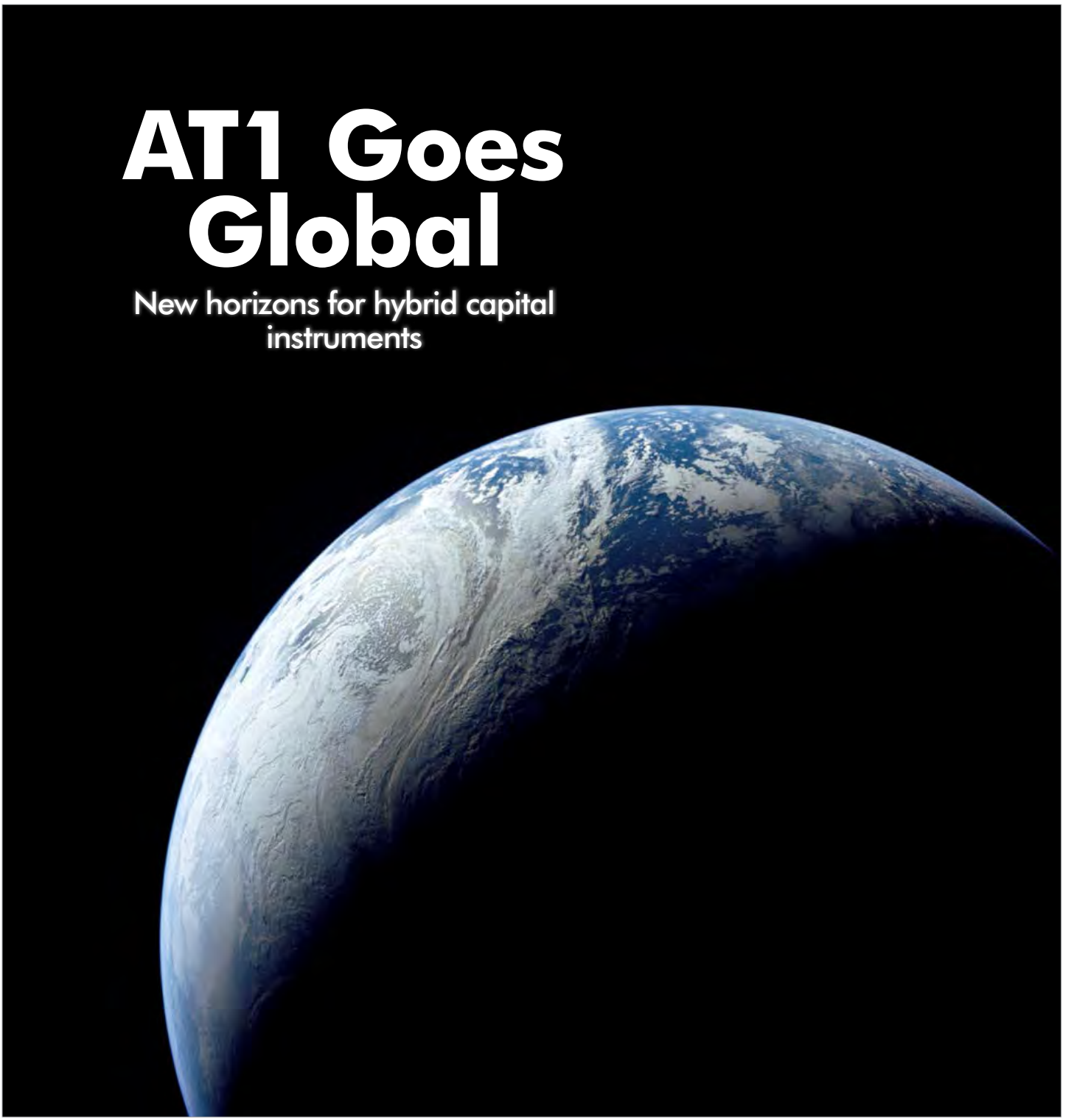
# Bank+Insurance Hybrid Capital

Mar-Apr 2014



## AT1 Goes Global

New horizons for hybrid capital instruments



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Bank+Insurance HybridCapital

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# Nobody said it was easy

Nobody said it was easy, as Coldplay's Chris Martin sang. And he should know.

Almost as quickly as the love affair with new-style bank capital blossomed, it hit a rough patch in mid-March when a Eu1.4bn AT1 debut from Belgium's KBC caught the market in a contrary mood and sentiment soured.

Only days earlier activity had reached a peak, with two deals hitting the market on the same day for the first time — inaugural trades for Danske and Santander — and those only a day after the first sterling AT1, for Nationwide Building Society, had been executed. But just a few weeks later all but one of the recent euro AT1s were trading below par.

This reality check could be seen as a healthy growing-up lesson for the young asset class. Indeed, when UniCredit reopened the market two weeks after KBC, albeit in dollars, the quality rather than the quantity of orders was highlighted. The $24.5bn order book of Crédit Agricole's January AT1 may be a thing of the past, but no-one will be too concerned if better performance is a corollary.

Only time will tell if issuers have learned their lesson and behave less greedily in the face of heaving order books and tempting low yields, but investors have certainly sobered up, promising more balanced supply and demand. Meanwhile, a hiatus going into the Easter break has further supported spreads.

Will the next move be up or down?

One thing is a near certainty: supply will be boosted by the arrival of German issuers on the scene, following confirmation of the tax-deductibility of certain AT1 structures by the Federal Ministry of Finance. While Deutsche Bank's capital plans have been splashed across the front pages of the financial press, its name has been whispered incessantly in relation to an inaugural AT1 from the country.

Longer term, the ECB's Asset Quality Review will be an increasingly important consideration. But with market participants trying to second guess issuers and regulators, only time will tell what its ultimate consequences are in an asset class that already has enough devilish variables and calculations.

As the Coldplay frontman said: "I was just guessing at numbers and figures."

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**Bank+Insurance Hybrid Capital**

**Published by Newtype Media**

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# Market news

## KBC, Santander debuts give AT1 a reality check

Banco Santander and KBC Group made their AT1 debuts in early March with new issues that came up against the limits of a market that had previously gone from strength to strength, although bankers on the deals defended their execution.

Santander was out first, launching its transaction during what turned out to be the busiest week for European hybrid issuance yet and one that captured the frenzy in the nascent euro AT1 market well.

The Spanish issuer was in the market at the same time as Danske Bank, which was making its debut with a Eu750m perpetual non-call six, and came after Nationwide Building Society had the day before opened the sterling AT1 market.

Opening order books on 5 March on the back of an upgrade the day before by Moody's, from Baa2 to Baa1, and a recovery of sentiment after the onset of the Ukraine crisis, leads Bank of America Merrill Lynch, Citi, Santander and UBS gathered some Eu15bn of orders for the Santander deal and priced it at 6.25%, the tight end of guidance of 6.25%-6.50%.

The hybrid instrument provides for loss absorption by converting into equity if CET1 falls below 5.125%.

A week later, on 12 March, Belgium's KBC Group sold its inaugural CRD IV-compliant AT1 issue, a Eu1.4bn deal that would free up capital via a temporary write-down if a low CET1 trigger is breached.

Leads Goldman Sachs, JP Morgan, KBC, Morgan Stanley and UBS built an order book of around Eu7bn — five times oversubscribed — with some 369 accounts participating, according to a banker on the deal. The AT1 security was priced at a yield of 5.625%, stealing the record for the tightest euro AT1 to date from Danske, which had the week before sold its deal at 5.75%. KBC's deal, however, was priced at the wide end of revised guidance, of 5.5%-5.625%.

The deal marked a turning point in the short history of the young CRD IV-compliant AT1 market, with the Belgian issuer alongside Santander a week earlier being seen by some as having pushed pricing too far and taken too much out of the market, leading to a disappointing performance in the secondary market and a weaker primary market as investors reassessed their views on and involvement in the market.

**KBC,** Brussels

Indeed, KBC's deal was the last of what has been referred to as a flood of AT1 issuance in the first two-and-a-half months of the year, with a two week hiatus after its deal before new issuance resumed.

A trader said that KBC's transaction, which was tightly priced and increased, was one of the triggers for a sell-off in the AT1 market and that, at the time of writing, its AT1 was the only one of the recent batch of euro issues to be trading below par despite the market having recovered from a weakening that had dragged many deals to below par in the secondary market.

"Santander was very heavily hit," he said. "It was priced too tight versus BBVA's issue before and there was also some technical trading between the two."

"The market has settled now, though, mainly because there hasn't been much supply. It will be interesting to see where Deutsche comes out."

Germany's finance ministry in early April clarified the tax regime for certain contingent capital, paving the way for the country's banks to raise CRD IV-compliant hybrid capital, and a debut issue from Deutsche Bank has been widely anticipated. *(See article on page 36 for more.)*

### KBC 'at the right price'

A lead banker on KBC's deal said that it allowed the issuer to meet the regulatory requirement for 1.5% of risk weighted assets to be covered by AT1 capital, and that there "was a clear desire from top management to do this in one shot".

The issuer noted that the AT1 provides more efficient funding of its capital base and that it will use it to replace legacy Tier 1 instruments upon the next possible call dates.

The lead banker said that, at 5.625%, the AT1 issue came "at the right price".

"We were convinced the deal was a great one," he said. "It was a big success and the market response was fantastic, reflecting the quality of KBC Group. It was very well appreciated by a big investor community — 369 different accounts in the book is not peanuts."

Viet Le, FIG syndicate manager at Crédit Agricole CIB, said the outlook for KBC's paper was better.

"The issuer is not supposed to come back to the AT1 market, so things could settle down in the secondary market sooner rather than later," he said, "and a kind of scarcity effect should push the

price up, unless further quality supply reprices the market at a wider level."

A lead banker on Santander's deal meanwhile acknowledged that it was followed by a softening in the market, but said that this was more a reflection of a shift in sentiment rather than of the deal itself.

"It's hard to separate the two of course, but at the time it seemed the obvious place to price it with an order book that big, and no-one complained," he said. "In the aftermarket it actually traded quite well, but a week later everything fell."

He cited the trading of a well-received BBVA euro AT1 issue from mid-February to highlight that no bond was exempt from the change in sentiment, noting that BBVA's deal also fell to below par in late March. He said that the new issue premium on Santander's AT1 was "small", suggesting that its performance has lagged that of BBVA's partly because the latter offered a larger concession as the inaugural Spanish euro AT1. However, he noted that Santander's AT1 issue has "slowly improved" from a low of 97.5 bid in late March to reach 100.75 at the time of writing.

## UniCredit taps sobered market

In spite of the weaker turn in sentiment, two weeks after KBC's deal UniCredit showed that the AT1 market remained open for business — albeit with more sensitivity to the freshly discovered limits of investor appetite necessary and order books being smaller than earlier in the year.

The issuer on 27 March sold the first AT1 from an Italian bank, a US$1.25bn (Eu905m) Reg S perpetual non-call 10 that was priced at 8% on the back of some $8bn of orders.

Citi, HSBC, Société Générale, UBS and UniCredit were bookrunners. The issue provides for loss absorbency via a temporary writedown if CET1 falls below 5.125%.

Waleed El Amir, head of strategic funding and portfolio at UniCredit, said

**Banco Santander,** Santander

that the issuer is happy with the response to the bank's offering given its Reg S, undated non-call 10 format and the market's comedown from the heady heights reached earlier in the year.

"I thought our AT1 was absolutely critical because it was the first deal to hit the market after what I see as a big paradigm shift in the market," he says. "It became clear that that order books were inflated, some deals were pushed too hard and didn't trade well, and then more supply was being anticipated.

"We were very careful in the allocation of our AT1 and it traded up nicely after to demonstrate that it is about quality rather than quantity, so we are very pleased with the result."

*(See Southern Europe feature on page 38 for more.)*

## SG hits hat-trick after delay

Société Générale priced its third AT1 issue in less than a year, a day after UniCredit's transaction, a Eu1bn perpetual non-call seven with a low trigger, temporary writedown structure.

The issuer had gone out with initial price thoughts (IPTs) two days earlier, but put the deal on hold after it was notified of a pending rating action.

"We felt we had no other option but to be transparent and so delayed further marketing of the transaction," said a syndicate official at one of the leads — Banca IMI, Deutsche Bank, Crédit Agricole CIB and SG.

"It was extremely unfortunate in terms of the timing, but there was nothing that the issuer could do about it."

The rating action in question was a Fitch revision of the outlooks of 36 EU banks to negative, including that of Société Générale, on the evening of Wednesday, 26 March. With UniCredit in the market on Thursday with its inaugural AT1 and Crédit Agricole anticipated the following week, Société Générale proceeded with its deal on the Friday. It picked up where it had left off, with IPTs of the 6.75% area. More than Eu5bn of orders were placed, with the leads setting the final coupon at 6.75%, the middle of guidance.

"It went well," said the lead banker. "The book was more modest, but that was no surprise given the volatility there had been during the week, with some deals underperforming.

"It traded on the break at 100.5-101, which is the performance you want."

The deal is Société Générale's first euro AT1, after two dollar issues in August and December last year, and fills the issuer's 1.5% AT1 bucket under CRD IV. The issuer did not go on a roadshow before the transaction because it had already priced two deals and felt that investors understood the structure, said the lead syndicate official, adding that the transaction did not suffer from that decision. ●

# Crédit Agricole in euro/sterling AT1 first

Crédit Agricole broke new ground in the hybrid market in early April, selling a Eu1.61bn equivalent dual tranche transaction that was the first multi-currency AT1 benchmark and the first time a non-UK financial institution raised the new-style hybrid capital in the public sterling market.

Coming less than three months after the French bank sold an inaugural, record-breaking US dollar AT1 on 15 January, the dual tranche transaction comprised a £500m (Eu608m) perpetual non-call 12 and a Eu1bn perpetual non-call seven, and used the same dual-trigger structure as for the dollar trade — loss absorbency via a temporary write-down if the bank's CET1 falls or remains below 5.125% or if the Group's CET1 falls or remains below 7%.

The deal makes Crédit Agricole the only issuer to have sold AT1 benchmarks in US dollars, euros and sterling. It laid the groundwork with a roadshow, even though it had already met investors in January before the dollar AT1, which was a key decision, according to Vincent Hoarau, head of FIG syndicate, at Crédit Agricole CIB.


"Investors appreciated our commitment and it made a difference," he said.

Crédit Agricole CIB was structuring advisor, global coordinator and bookrunner on both tranches.

The seed of the dual tranche transaction was planted when the issuer met investors before its dollar AT1 in January, with a large number of UK accounts having at that time shown an interest in sterling supply from the French bank, and the new roadshow in March confirmed such appetite.

"That interest, plus the size of the demand attracted by Nationwide for its inaugural AT1 in sterling, made the sterling tranche an easy decision," said Hoarau. "The dual currency format was validated when we received evidence from investors that there was no risk of cannibalisation between the two offerings."

Nationwide Building Society opened the sterling AT1 market with a £1bn perpetual non-call 5.25 on 4 March.

Launched into a market that had shed some of the exuberance that characterised it earlier in the year following the underperformance of certain deals, Crédit Agricole was sensitive to recent investor disappointment and criticisms, and tailored the execution to reflect these, said Hoarau.

"We said we would be reasonable in terms of the size and the pricing, and we were only going to do two tranches if we were confident we could ensure secondary performance," he said.

The issuer also skipped IPTs to avoid frustrating investors with too much movement on the pricing, he added.

A dual tranche deal was announced on

EUROPE

## NordLB in dollars, plus euro Tier 2 returns

**NordLB issues US dollar T2 notes:** On 3 April – after a roadshow taking in London, Singapore, Hong Kong and Switzerland – Norddeutsche Landesbank issued a US dollar 10 year bullet Reg S-only Tier 2 transaction. The $500m 2024 notes were priced at 6.25%, from IPTs of the low to mid 6%.

**BBVA prices EUR T2 bond:** On 2 April, BBVA ended a seven year hiatus from the Tier 2 market and issued a Eu1.5bn 3.5% 10NC5 Tier 2 bond. The final order book reached Eu8bn with 450 investors participating, allowing the second largest Spanish bank to price the notes at mid-swaps plus 255bp, from revised guidance of mid-swaps plus 255bp-260bp.

**RBS prices first euro T2 since 2008:** On 20 March, Royal Bank of Scotland issued its first euro-denominated Tier 2 transaction since 2008. The Eu1bn 3.625% Reg S 10NC5 deal came out with official guidance of mid-swaps plus 270bp and was priced at mid-swaps plus 265bp.

**Aareal Bank issues euro Tier 2:** German lender Aareal Bank issued a new Eu300m 2026NC2021 Tier 2 on 11 March, after a series of investor meetings across Europe. The transaction attracted demand of Eu2.8bn across 250 accounts. The transaction was priced at 290bp over mid-swaps, for a coupon of 4.25%.

**ING Eu1.5bn 12NC7 Tier 2:** ING returned to the sub market with a 12NC7 euro-denominated Tier 2. The deal was priced at 225bp over mid-swaps, down from IPTs of the 235bp area, on the back of a Eu5bn book.

**RBI brings euro Tier 2 to the market:** On 13 February, Raiffeisen Bank International priced a Eu500m 11NC6 Reg S Tier 2 transaction at a re-offer yield of 4.517%. IPTs were 350bp over mid-swaps and the book reached Eu3.5bn, allowing the issuer to tighten the final spread to 330bp over mid-swaps. ●

Monday, 31 March, with the leads officially opening order books the next morning with guidance of the 6.625% area for the euro tranche and 7.625% area for the sterling.

Price thoughts on the euro tranche took into account where Société Générale had two days earlier priced a Eu1bn perpetual non-call seven, at a coupon of 6.75%, with Crédit Agricole widely accepted as trading some 15bp-25bp tighter, said Hoarau.

"As soon as SG priced it was clear that fair value for our deal was 6.5%," he said. "And even though we didn't cap the size on the euro trance from the outset we said we would stick to Eu1bn so there was some scarcity demand."

More than Eu7bn of orders were placed by over 400 investors for the euro tranche, which was priced at 6.5%, the tight end of formal guidance. Orders for the sterling tranche exceeded £5.25bn, with around 360 accounts involved. The £500m tranche was priced at 7.5%, also the tight end of formal guidance.

"There was also a lot of price discovery around the sterling tranche," added Hoarau.

The leads received indications ranging from 7.25%-8%, with some investors coming up with relative value assessments on the basis of Lloyds Bank levels and others only looking at the euro-sterling yield curve differential, he said.

"We took all of this into account, as well as the market tone, and decided to start the process at 7.625%," said Hoarau. "We mirrored the process on the euro tranche, as there was no question of tightening more on one tranche than the other."

A trader noted that the euro AT1 bonds are outperforming the sterling bonds after initially having traded much lower.

"Everyone expected the 7.5% sterling bonds to be trading much higher by now," he said, "but I think it is partly due to some technical trading and UK accounts being away for the Easter holidays.

"The bonds should trade as a pair," he added, "and I think there is potential for catch-up on the sterling bonds."

At the time of writing, the euro tranche was trading at 103.5, or a yield of 6.03%, and the sterling at 102, or 7.32%. ●

**ASIA EX-JAPAN**

## CITIC in AT1 dollar first, plus Basel III-compliant debuts

**CITIC $300m 7.25% perpNC5 AT1:** On 10 April, after a roadshow in Singapore, Hong Kong and London, China CITIC Bank International *(pictured)* printed the first US dollar AT1 bond out of Asia. The $300m perpNC5 Reg S deal was priced at 7.25%, at the tight end of final guidance of 7.375% plus or minus 12.5bp, and 50bp inside initial guidance of the 7.75% area. The books drew $5.7bn of interest from 260 accounts. 80% of the bonds were sold in Asia and 20% in Europe. Asset managers took 52%, private banks 19%, insurance companies 17%, banks 8%, and corporates 4%.

**OCBC completes roadshow:** Overseas-Chinese Banking Corporation completed a roadshow in mid-April for a potential $1bn 10.5NC5.5 144a/Reg S Basel III-compliant Tier 2 deal. A transaction was due to follow, subject to market conditions.

The same week, **Standard Chartered** priced a $2bn 5.7% Reg S/144a 30 year Tier 2 at 210bp over US Treasuries, after announcing IPTs of the Treasuries plus 230bp-235bp area.

**ANZ prints first Australian US dollar Basel III-compliant T2:** On 12 March, ANZ priced a $800m 144a 10 year bullet Tier 2 transaction and became the first Australian bank to print an offshore Basel III-compliant bond. The order book closed at $1.7bn, with 120 accounts, and the deal was priced at US Treasuries plus 180bp, from initial guidance of the Treasuries plus 185bp area. US investors accounted for around 60% of the demand, followed by Asian and European accounts, with 25% and 16%, respectively. The bond's loss absorption feature will be triggered if the Australian Prudential Regulation Authority (APRA) deems that ANZ would no longer be viable without a write down. In such an event, the bonds will be converted into 100% common equity, subject to a floor at 20% and based on the volume-weighted share price five days before pricing.

**UOB issues US dollar Basel III-compliant T2:** On 11 March, UOB launched a $800m 10.5NC5.5 Reg S Basel III-compliant Tier 2 bond. The deal was priced at US Treasuries plus 225bp, from initial guidance of the Treasuries plus 250bp area. US offshore accounts took 79%, Asia 21%. Asset managers were allocated 64%, insurers 15%, banks 12%, and private banks 9%.

**DBS Bank to use regulatory call option on outstanding 4.7% perpNC2020 Tier 1:** Singapore-based DBS Bank announced its intention to use a regulatory par call on the outstanding SGD895m 4.7% perpNC2020 legacy Tier 1, issued in 2010. The bond was previously targeted in an exchange offer in November 2013, in which bondholders could switch into new Basel III-compliant securities. ●

# Generali back to the future in Solvency I sub

Generali priced its first subordinated issue in more than a year on 23 April, a Eu1bn 12 year Tier 2 that an official at the issuer said prompted a welcome repricing of its curve and took advantage of anticipated grandfathering of Solvency I bonds.

The Italian insurance company has already sold Solvency II-compliant Tier 2 securities, most recently in December 2012, but opted for a Solvency I-compliant 12 year bullet for its return to the subordinated market given an expectation that the bond will fall under a 10 year grandfathering period for Solvency I bonds.

"We decided to go for the cheapest type of regulatory subordinated capital, which will help us meet our targets of reducing leverage, improving our interest coverage ratio and reducing our stock of Tier 1 and senior debt," said Jozef Bala, head of debt management unit, Assicurazioni Generali.

He said that the transaction went better than expected in that the issuer was able to tighten the spread while retaining strong interest from investors for the bonds.

"Notwithstanding tightening of 25bp, we were able to build a large order book, of Eu7.4bn, and the new issue also allowed us to reprice our curve, which came in by 20bp-25bp," added Bala.

**Jozef Bala,** Generali

The notes had tightened by more than 10bp in the secondary market since pricing at the time of writing, according to a banker away from the trade.

Leads Barclays, Mediobanca, Morgan Stanley, UBS and UniCredit began marketing the Tier 2 notes at initial price thoughts of the 250bp over mid-swaps area, with some Eu6bn of orders placed after one hour. Guidance was subsequently revised to 230bp over plus/minus 5bp, and a Eu1bn 4.125% issue was priced at 225bp over, which Bala said represents fair value.

He said that although the structure of the transaction is relatively simple, with only a subordination clause and no Solvency II-type features, identifying fair value was not straightforward given few comparables.

These were mainly a Eu380m 10 year bullet Solvency I-compliant Tier 2 issued by Coface in March, and a Eu500m five year bullet from Intesa Sanpaolo Vita from last year, according to Bala.

"They are local operators, however, so not really that comparable to us," he said.

However, the issuer had a clear view on pricing.

"We felt that the price differential between this deal and our non-call 30 bonds was around 75bp, and also felt our outstanding bonds were trading too wide compared with the market," he said. "We achieved tight pricing but also a very diversified and high quality order book, which makes it a very successful deal."

He highlighted that Generali, since a change of management in 2012, has been working to establish regular relations with fixed income investors, and that the recent Tier 2, as well as a senior unsecured issue earlier this year, are signs of these efforts paying off. ●

**INSURANCE**

## Aegon adds to Dutch supply after NN hybrid

**Aegon prices 30NC10 T2:** On 17 April, Dutch insurance company Aegon issued a Eu700m 4.0% 30NC10 bond, following a two day roadshow across Europe. The Reg S transaction was announced with initial price thoughts (IPTs) of mid-swaps plus 240bp-250bp, later revised to mid-swaps plus 235bp. The books closed in excess of Eu5bn, allowing the issuer to price at mid-swaps plus 235bp (DBR 1.75 2/24 plus 257.9bp). Aegon is the fifth insurer to have sold insurance capital this year in Europe.

**NN Group issues euro-denominated hybrid transaction:** On 1 April, ING's insurance entity issued a Eu1bn 30NC10 hybrid bond. The transaction was priced at mid-swaps plus 295bp (DBR 1.75% 2024 plus 316.9bp) and a coupon of 4.625%. More than 375 investors placed orders and the books reached Eu7bn. The Dutch insurer completed a roadshow the week beforehand, testing interest for the 30NC10 bond at the mid-swaps plus 312.5bp area, later revised to the mid-swaps plus 300bp area. UK investors accounted for half of the deal (47%), followed by Germany (11%) and the Benelux (10%). Asset managers constituted the bulk of demand, with 70%.

**Coface prints EUR 10 year bullet T2:** On 19 March, the French credit insurance group issued a Eu380m 4.125% 10 year bullet Tier 2 transaction, after a series of investor meetings in Europe. Momentum was strong as the book reached Eu3.7bn of orders from more than 290 accounts. The deal was priced at mid-swaps plus 235bp (259.2bp over the DBR 1.75% 2/2024). ●

# Danske opens Nordic AT1s, sticks to size pledge

Danske Bank opened the Nordic CoCo market on 5 March, drawing some Eu13bn of demand for a much anticipated AT1 transaction of Eu750m (Dkr5.60bn) before the market took a weaker turn.

The deal was one of three CoCo transactions launched in the first week of March, with Banco Santander in the market alongside Danske, and Nationwide Building Society out in the sterling AT1 market the day before and a mandate for KBC adding to a growing euro pipeline. *(See separate news article on KBC and Santander.)*


Danske's issue was a Eu750m perpetual non-call six that would be temporarily written down if its CET1 ratio drops below 7% on a Basel III (transitional) basis, a high trigger. Leads Bank of America Merrill Lynch, BNP Paribas, Danske, Goldman Sachs, HSBC and JP Morgan priced the deal at a coupon of 5.75%, with orders worth around Eu13bn coming in from nearly 700 investors, according to one of the leads.

The Danish issuer temporarily held the record for the tightest pricing of any AT1 instrument, until KBC a week later priced its AT1 debut at 5.625%, the smallest coupon on an AT1 to date.

Peter Holm, senior vice president, group treasury, Danske Bank, said that the issuer had anticipated being able to execute a successful transaction given the strength of the market, as demonstrated by recent deals, and its strong buffer to the 7% CET trigger — but that the actual outcome of the deal surpassed expectations.

"The speed with which the order books grew and the magnitude of demand came as a very pleasant surprise," he said. "We could have sold a larger deal, but Eu750m was our goal and this is what we communicated to investors and we stood by that."

Indeed, a syndicate banker away from the leads said that limiting the deal to Eu750m was a responsible decision and "made all the difference", contrasting it with Santander and KBC deals that were priced too tightly and were too large.

Jeremy Spinney, global head of debt syndicate at Danske, said that the size of the deal helped ensure secondary market performance.

The immediate interest for the transaction was "overwhelmingly high", he said, with many investors indicating concretely how much they wanted and their desired return both before and during the roadshow and ahead of any transaction details being released.

As a result, the leads were able to do without an initial price thoughts (IPTs) process and open order books directly, added Spinney. Guidance was set at the 6% area, with the leads keeping the order books open only for the minimum one hour.

Alex Sönnerberg, Nordic FIG DCM origination at Crédit Agricole CIB, said that Danske's deal highlighted the "tremendous" appetite for AT1s and that it was encouraging for other Nordic banks looking to participate in the market once there is sufficient regulatory clarity.

"Although demand was primarily driven by UK asset managers, as expected, it was very encouraging to see Nordic investors getting fully engaged in the asset class for the first time, picking up a quarter of the book," he said. ●

**JAPAN**

## Mizuho in Japanese first

**Mizuho issues first Japanese Basel-III compliant offering:** On 20 March, Mizuho issued a $1.5bn 4.6% Reg S/144a 10 year bullet bond, the first ever Basel III-compliant offering by a Japanese bank. The deal was announced with official guidance of US Treasuries plus the 187.5bp area (plus or minus 2.5bp) and strong investor demand allowed the issuer to ultimately price the deal at Treasuries plus 185bp. Mizuho's note is subject to a full and permanent write-down if the bank is deemed to have reached the PONV, based on Japan's Deposit Insurance Law.

**Sumitomo issues US dollar-denominated T2:** On 25 March, Sumitomo Mitsui Financial Group held a series of investor calls across Asia, Europe, and the US regarding a new Reg S/144a US dollar 10 year bullet Tier 2 issue. The following day, the Japanese bank priced a $1.75bn 4.436% April 2024 Tier 2 bond at US Treasuries plus 175bp, from initial guidance of Treasuries plus 175bp-180bp. The notes bear a contractual permanent write-down mechanism. ●

# French trio in Tier 2, BPCE opts for sterling

France's BPCE priced an inaugural sterling subordinated deal on 9 April, a £750m (Eu911m) 15 year Tier 2 transaction that came in between euro issues for BNP Paribas and La Banque Postale.

BPCE's deal was also the French bank's inaugural sterling benchmark and the largest sterling Tier 2 from a French financial institution. It came after Crédit Agricole CIB had earlier in the month priced a £500m perpetual non-call 12 deal alongside a euro issue in a dual-tranche AT1, while France's Société Générale sold a euro AT1.

BPCE took advantage of strong liquidity in the sterling market and high demand for long end maturities in printing its deal, according to a syndicate official at one of the leads — HSBC, Lloyds, Natixis and RBS.

The 5.25% April 2029 Tier 2 securities were priced at 215bp over UK Treasuries, the middle of guidance of the 215bp over area that was revised from initial price thoughts of the 225bp over area, with nearly £2.5bn of orders placed, mainly by UK investors.

"Sterling investors are looking for yielding assets and duration," said a lead syndicate banker. "They warmly welcomed this rare transaction, which gave them a good opportunity to invest in a 15 year subordinated deal from an infrequent issuer."

The deal is BPCE's fourth Tier 2 benchmark since July 2013, a $1.5bn (Eu1.08bn) 5.15% 10.5 year in January having been the most recent.

Other French issuers took to the euro market for their first subordinated transactions in several years, tapping a market that a syndicate banker said has been "extremely robust relative to the rest of the capital structure" and where spreads have performed the best.

BNP Paribas priced a Eu1.5bn 2.875% 12 non-call seven on 13 March, its first Tier 2 deal since 2007, while La Banque Postale sold a Eu750m 2.75% 12 non-call seven on 11 April, two days after BPCE's transaction.


BNP Paribas' deal was priced at165bp over mid-swaps, the tight end of guidance of 165bp-170bp over, with outstanding deals from a range of issuers, such as ING Bank and Swedbank, serving as reference points for what was a relatively straightforward price discovery process, according to a banker close to the deal.

Sole lead BNP Paribas gathered around Eu5bn of orders, benefitting from demand for a rare issuer in Tier 2 format. Nearly all of the notes were taken by real money accounts across a granular spread of jurisdictions. The transaction was at the time of writing said to be bid at 141bp over.

La Banque Postale priced its Eu750m 2.75% 12 non-call seven Tier 2 notes at 152bp over, after guidance of the 155bp over area, with nearly Eu3bn of orders placed, according to a syndicate official at one of the leads — Barclays, BNP Paribas, SG and UBS.

The deal marks the issuer's return to the public subordinated market after an absence of three-and-a-half years and helps optimise the bank's capital structure under CRD IV and offset the regulatory amortisation of legacy Tier 2 instruments from November 2015, according to the banker. French investors and asset managers took the majority of the securities by geography and investor type (55% and 80%, respectively). ●

LIABILITY MANAGEMENT

## Credit Suisse, Citi buybacks

**Credit Suisse LME on Claudius Tier 1 in conjunction with regulatory call:** Credit Suisse announced on February 14 a buyback on the outstanding $1.5bn perpetual Tier 1 issued by Claudius Limited, at 103% (purchase price plus early tender premium). In conjunction with the announcement, Credit Suisse also issued a notice of the exercise of the regulatory par call on the bond, which is expected to be redeemed after the settlement of the buyback. According to the official announcement, the offer "is consistent with the Offeror's pro-active approach to capital management and commitment to simplify its capital structure". The offer expired on March 14 and attracted a 93.4% success rate (Eu1.4bn).

**Citi announces results of subs LME:** On 12 February, Citigroup communicated the results of a tender offer launched on 3 February on outstanding Eu1.25bn 4.25% 2030 and £500m 4.5% 2031 subordinated notes. The pricing was determined pursuant to a Modified Dutch Auction procedure. The bank accepted for purchase all sterling bonds tendered at the maximum purchase spread of 135bp and none of the euro notes, resulting in an aggregate US dollar equivalent nominal amount repurchased of approximately $296.9m, increasing accordingly the maximum acceptance amount. ●

# Swedbank in T2 tight, pre-empts Swedish finish

Swedbank priced a Eu750m 10 year non-call five Tier 2 transaction on 17 February, the Swedish bank's first such benchmark since November 2012, and an official at the issuer said it was launched in anticipation of final capital requirements from the Swedish FSA.

The deal was Swedbank's first transaction in the benchmark market after it announced its fourth quarter results on 28 January and came after Svenska Handelsbanken opened the bank capital market on 7 January with a Eu1.5bn 10 non-call five subordinated issue.

Gregori Karamouzis, head of investor relations at Swedbank, said that Swedbank has no imminent need for Tier 2 capital given buffers available in the form of Common Equity Tier 1 (CET1) capital, but that there are indications that the financial supervisory authority, Finansinspektionen, is close to finalising its capital requirements for Swedish banks under Basel III and that the Tier 2 deal was launched in anticipation of these.

"This was an attempt to pre-empt these requirements and pro-actively fill the Tier 2 requirements we envisage being part of the Swedish finish," he said. "The FSA has also changed its mind about Basel I transitional floors, which will remain effective until further notice, and this Tier 2 counts toward that."

Swedbank has a CET1 ratio of 18.3% under Basel III, and a total capital adequacy ratio, which includes Tier 2, of 20.6%. Although the issuer does not need more Tier 2 capital, it is cheaper to hold than CET1, and in launching the trade Swedbank was anticipating being able to use Tier 2 capital to meet regulatory requirements, according to Karamouzis.

The issuer had been monitoring the market and meeting with investors since releasing its results, and decided to proceed with a transaction after markets opened positively on the Monday morning of its deal.


Leads Bank of America Merrill Lynch, Credit Suisse, Deutsche Bank, JP Morgan and Swedbank built an order book of around Eu2bn for the trade and priced it at 140bp over mid-swaps, with a coupon of 2.375%. Initial price thoughts had been set in the high 140s over, implying a 15bp new issue premium, with Handelsbanken's Tier 2 from January seen trading in the high 120s over, according to a syndicate official at one of the leads.

At 140bp over, the spread was the tightest on a 10 non-call five Tier 2 transaction since the collapse of Lehman Brothers, noted Karamouzis. The record had been held for a short while by Handelsbanken, which priced its Tier 2 in January at 143bp over, it in turn having taken over the baton from DNB, which had priced a Eu750m 10NC5 at 177bp over in September 2013.

"We're quite happy with the outcome," said Karamouzis. "The reception was good and shows that investors perceive Swedbank as a low risk and stable bank."

The issuer chose the 10 year non-call five structure as the most "efficient" structure, reflecting the fact that once a Tier 2 capital instrument reaches a maturity below five years there is no full recognition for regulatory capital purposes.

More than 140 accounts participated in Swedbank's Tier 2. The Nordics and the UK/Ireland were each allocated 25%, Germany and Austria 16%, the Benelux 14%, France and Switzerland 13%, Italy and Iberia 4%, and others 3%.

Real money took 75% — split between 55% for asset managers and 19% for insurance companies and pension funds, official institutions 16%, banks and private banks 6%, and hedge funds 4%. ●

**RUSSIA**

## Sberbank incorporates new rules

**Sberbank $1bn 10NC5 T2:** Russian lender Sberbank issued a new $1bn 2024NC2019 Reg S/144A Tier 2 on 18 February, attracting demand of $2.2bn. The transaction was priced at 402.3bp over the benchmark, for a yield of 5.5%.

It is the first Russian Tier 2 to incorporate the amendments to Regulation 395-P with regard to the point of non-viability and activation of the capital ratio trigger, which were released by the Central Bank of Russia in autumn 2013. ●

# Regulatory updates

BANKING

## Parliament adopts SRM, BRRD and DGS

The plenary vote of the European Parliament on the Single Resolution Mechanism, Bank Resolution & Recovery Directive (BRRD) and the Deposit Guarantee Schemes (DGS) took place on April 15. The European Parliament (EP) and the Council had reached a provisional agreement on 24 March on the proposed Single Resolution Mechanism (SRM) after long negotiations. The SRM would enter into force on 1 January 2015, whereas bail-in and resolution functions would apply from 1 January 2016, as specified under the BRRD. *For more details, please see our article on pXX.*


European Banking Authority, London

**EBA launches discussion on impact of the deduction of defined benefit pension plans:** The European Banking Authority (EBA) published on 17 February a discussion paper on the impact on the volatility of own funds of the revised International Accounting Standard for employee benefits (IAS 19) and the deduction of defined benefit pension assets from own funds in accordance with the Capital Requirements Regulation (CRR). The discussion paper gives the EBA's preliminary views based on: (i) a qualitative analysis of the accounting and prudential changes and their impact on the volatility of own funds; (ii) a quantitative analysis of this impact for a sample of EU institutions; and (iii) a qualitative analysis of the factors that may impact the volatility of own funds in the future. Following the outcome of this consultation, the EBA will deliver its report to the Commission by 30 June 2014.

**EBA publishes final draft RTS on instruments used for variable remuneration:** The EBA published on 19 February its final draft Regulatory Technical Standards (RTS) on classes of instruments that can be used for the purposes of variable remuneration, which responds to the mandate contained in Article 94(2) of CRD IV. The document introduces the requirements for Additional Tier 1, Tier 2, and a sundry category defined as "Other Instruments", and specifies the write-down, write-up and conversion loss absorption mechanisms.

**EBA reports on impact of possible leverage ratio definitions:** The EBA published on 5 March a report recommending the alignment of the CRR leverage ratio definition to the Basel Committee on Banking Supervision (BCBS) January 2014 standard. Overall, the EBA assessment indicates that the revised Basel III framework leads to leverage ratios that are broadly in line with, or possibly slightly higher than, leverage ratios calculated according to the current CRR. Through its delegated act, the European Commission is empowered to amend, as per the CRR, the capital measure and total exposure measure before the start of public disclosure of leverage ratios in 2015.

**EBA consults on revised guidelines on remuneration benchmarking and data collection for high earners:** The EBA launched on 7 April consultations on its revised Guidelines on the data collection exercise for high earners and on its Guidelines on the remuneration benchmarking exercise. The updates to these two Guidelines, which had originally been published on 27 July 2012, follow on from changes in reporting requirements as laid down in CRD IV and CRR. Both public consultations will run until 7 May.

**BCBS finalises capital standard for bank exposures to central counterparties:** The Basel Committee published on 10 April a final standard for calculating regulatory capital for banks' exposures to central counterparties (CCPs), which will replace the interim capital requirements published in July 2012. The final standard will take effect on 1 January 2017, with the interim requirements applying until then.

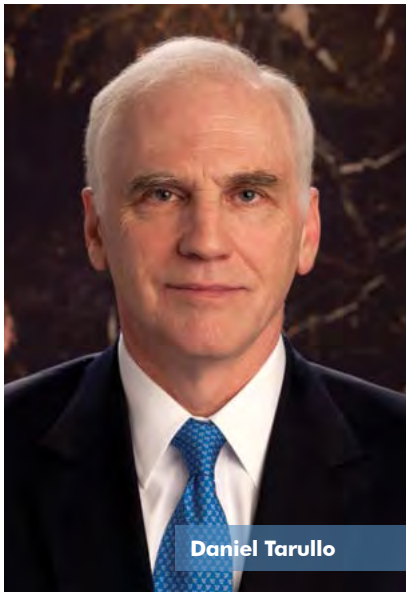
**BCBS releases new progress report on Basel implementation:** The Basel Committee published an updated version of the Progress report on implementation of the Basel regulatory framework, which provides a high level view of Basel Committee members' progress in adopting Basel III, as of end-March. The document also states that the Regulatory Consistency Assessment Programme (RCAP) assessment for the EU and the US is currently underway, and a report will be published in September 2014.

**European Central Bank publishes the manual for the "Phase 2" (on-site**

**inspections) of the Asset Quality Review (AQR) on 11 March:** This manual has been issued to the National Competent Authorities (NCAs) and details technical instructions on how to perform the Phase 2 on-site inspections of the AQR. This review will cover Eu3.7tr of assets, which represents 58% of the total Risk Weighted Assets (RWAs) of the 128 selected banks. It will focus particularly on the riskiest assets, including Level 3 exposures assets that have the higher potential for misstatement. The AQR is a key component of the Comprehensive Assessment, which aims to enhance the transparency of the balance sheets of significant banks, trigger balance sheet repair where necessary, and rebuild investor confidence prior to the ECB taking over its supervisory tasks in November 2014. Phase 2 must be completed by the end of July and the Stress Tests will follow during the summer. The results will be published in October. The AQR adjusted minimum CT1 threshold for banks is 8% for the "baseline scenario" and 5.5% for the "adverse stress test scenario".

**FSB publishes report to G20 on reform priorities:** In a document addressed to the G20, the Financial Stability Board (FSB) reviewed what remains to be completed in terms of financial reforms ahead of the Brisbane Summit in November. The priorities for international regulators include:

- The Basel Committee plan to address excessive variability in RWA calculations, to improve consistency and comparability in bank capital ratios;
- The finalisation of the proposed Net Stable Funding Ratio (NFSR), which is designed to improve the resilience of bank funding and to complement the Liquidity Coverage Ratio (LCR) that has already been agreed;
- A global standard for a minimum level of gone-concern loss-absorbing capacity that global systemically important banks should hold to be proposed by the FSB;


Daniel Tarullo

- Proposals for contractual or statutory approaches for cross-border recognition of resolution actions, including bail-in and temporary stays on the close-out of financial contracts, and cross-default rights when a firm enters resolution.

**PRA releases consultation on approach to supervising international banks:** The UK Prudential Regulation Authority (PRA) is seeking views on its proposed approach to supervising international banks (CP4/14), with a specific focus on branches from outside the European Economic Area (EEA). It will be relevant to all PRA-supervised deposit-takers and designated investment firms operating in the UK that are not UK-headquartered. The consultation ends on 27 May. The document includes the following draft new rules:

- The requirement for all deposit-taking and/or designated investment firms that operate through EEA and non-EEA branches to complete a new data collection return to be effective from 2015. The purpose is to enhance the PRA's understanding of the potential impact that branches could have on UK financial stability, consistently with Article 40 of CRD IV.
- The requirement for all non-EEA firms to have adequate provision made in resolution plans for UK branches, which should be read alongside the recently announced CP2/14. A firm that does not comply with the proposed rule would likely fail to satisfy the Threshold Condition requiring that the firm have adequate non-financial resources.

**US regulators prepare to approve rules limiting biggest banks' leverage:** The Federal Reserve, Federal Deposit Insurance Corporation and Office of the Comptroller of the Currency are set to finalise a leverage ratio proposal under which eight of the biggest US banks must retain at least 5% capital against their total assets. The limit, which would affect firms including JPMorgan Chase and Bank of America, is tougher than the 3% standard agreed by the Basel Committee. The agencies will also propose a revision to the leverage rule. The proposed rule will be open for public comment.

**Tarullo defends Foreign Banking Organization (FBO) rules:** During a speech at a Harvard Law School Symposium on 27 March, Federal Reserve Board governor Daniel Tarullo defended the Fed's new capital regulations applicable to FBOs. According to Tarullo, the US capital requirements for FBOs are structurally similar to those that apply to foreign banks in the EU, with the new US rules being somewhat more favourable to foreign institutions in that they only apply once the non-branch US assets of an FBO exceed $5bn (Eu3.61bn). The observations came as a response to a "curious" charge of "Balkanization" that has been levelled at the US.

**Germany clears tax treatment for AT1:** The German Federal Ministry of Finance released on April 10 the details of the tax regime for banks' AT1 instruments, clearing the legal uncertainty over the deductibility of the notes. The Association of German Banks welcomed the decision. *For more details, please see our article on pXX.*

## INSURANCE

**European Parliament adopts Omnibus II Directive:** The European Parliament on 11 March adopted in plenary session the Omnibus II Directive, by 560 votes to 113 against, thus avoiding the risk of a delay to the new legislation. The Omnibus II Directive completes the Solvency II Directive and finalises the new framework for insurance regulation and supervision in the EU. The Solvency II Directive should apply as of 1 January 2016. After adoption by the European Parliament, the directive will need to be formally adopted by the Council and be published in the Official Journal. It will enter into force the day after publication.


European Parliament plenary, 11 March

**The Joint Committee of the European Supervisory Authorities publishes consultation paper on Financial Conglomerates Directive:** The consultation paper is seeking to provide guidelines on the cooperation between NCAs for Financial Conglomerates. The consultation period will take place until 12 June and final guidelines will be published in the second half of the year.

**IAIS releases summary of feedback from consultation on BCR for G-SIIs:** The International Association of Insurance Supervisors (IAIS) has published the summary of the feedback received on the consultation on Basic Capital Requirements (BCR) for Global Systemically Important Insurers (G-SIIs), launched in Dec. 2013. Among the main feedback:

- **Objective of the BCR:** Concerns about a lack of clarity of the BCR's objective, with a general discomfort with focus on "going-concern" as a goal. Some believe it should focus on gone-concern only. A large number of respondents believe BCR should be a minimum (MCR);
- **Capital resources:** Many expressed the view that BCR should not have tiering of capital. Several also believe qualification of capital resources should be principles-based rather than rules-based There was some concern that supervisory discretion on transferability/fungibility of capital reduces comparability and should be minimised;
- **Interaction with other capital requirements:** Many respondents expressed concern that BCR should not increase or conflict with existing group capital requirements on insurers. Many also pointed out that the intended interaction between BCR and other standards/policy measures (HLA; ICS; ICP 17) lacked clarity;
- **Timing:** While nearly all agreed the timeframe was tight, several respondents explicitly requested IAIS reconsider the timeframe for BCR. Several suggested implementing a phase-in period for BCR to allow for further calibration. Two respondents urged IAIS to seek FSB agreement to deliver the framework by November and calibrate during 2015.

**EIOPA releases the first set of Implementing Technical Standards (ITS) for Solvency II:** On 1 April, European Insurance & Occupational Pensions Authority (EIOPA) invited stakeholders to comment on the first set of ITS. It defines the procedures for the approval processes of the Matching Adjustment, Ancillary Own Funds, Undertaking-Specific Parameters, Internal Models and Special Purpose Vehicles, as well as the joint decision process on Group Internal Models. Comments are due by 30 June. EIOPA will then submit the ITS to the European Commission by 31 October 2015 for final endorsement.

**Council approves amending rules for the insurance industry:** On 14 April, the Council approved amendments to EU rules for the insurance industry in respect of the powers of two EU-level supervisory authorities. The amendments include the provision of specific tasks for EIOPA and the European Securities & Markets Authority (ESMA). In particular, they clarify the role of EIOPA in ensuring harmonised technical approaches for the calculation of technical provisions and capital requirements.

Michael Benyaya, Jonathan Blondeau, Julian Burkhard, Cyril Chatelain, Stefano Rossetto
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# League tables

**Bookrunners all European FI hybrids (all currencies)**
**01/01/2014 to 25/04/2014**

| | Managing bank or group | No of issues | Total EUR m | Share (%) |
|---|---|---|---|---|
| 1 | HSBC | 9 | 3,940 | 11.1 |
| 2 | BAML | 9 | 2,805 | 7.9 |
| 3 | BNP Paribas | 7 | 2,698 | 7.6 |
| 4 | Société Générale | 7 | 2,421 | 6.8 |
| 5 | UBS | 9 | 2,157 | 6.1 |
| 6 | Crédit Agricole CIB | 5 | 1,747 | 4.9 |
| 7 | Goldman Sachs | 6 | 1,533 | 4.3 |
| 8 | JP Morgan | 7 | 1,528 | 4.3 |
| 9 | Deutsche Bank | 8 | 1,453 | 4.1 |
| 10 | Citi | 5 | 1,360 | 3.8 |
| 11 | Morgan Stanley | 5 | 1,324 | 3.7 |
| 12 | Credit Suisse | 5 | 1,295 | 3.7 |
| 13 | Barclays | 6 | 1,280 | 3.6 |
| 14 | UniCredit | 5 | 1,276 | 3.6 |
| 15 | RBS | 6 | 1,253 | 3.5 |
| | Total | 41 | 35,439 | |

*Source: Dealogic, Thomson Reuters, Crédit Agricole CIB*

**Bookrunners all financials (EUR)**
**01/01/2014 to 22/04/2014**

| | Managing bank or group | No of issues | Total EUR m | Share (%) |
|---|---|---|---|---|
| 1 | BNP Paribas | 37 | 9,586 | 10.5 |
| 2 | Société Générale | 24 | 6,580 | 7.2 |
| 3 | Goldman Sachs | 24 | 6,180 | 6.8 |
| 4 | Morgan Stanley | 20 | 6,156 | 6.8 |
| 5 | Deutsche Bank | 25 | 5,982 | 6.6 |
| 6 | HSBC | 21 | 5,478 | 6 |
| 7 | Crédit Agricole CIB | 13 | 4,939 | 5.4 |
| 8 | Natixis | 12 | 4,734 | 5.2 |
| 9 | Barclays | 19 | 4,581 | 5 |
| 10 | Citi | 12 | 3,038 | 3.3 |
| 11 | JP Morgan | 18 | 2,576 | 2.8 |
| 12 | Credit Suisse | 12 | 2,524 | 2.8 |
| 13 | Commerzbank | 12 | 2,408 | 2.6 |
| 14 | RBS | 13 | 2,182 | 2.4 |
| 15 | BAML | 10 | 2,123 | 2.3 |
| | Total | 155 | 88,403 | |

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

# BRRD & SRM
# Where Do We Stand?

The European Parliament's recent acceptance of key Commission proposals provides further clarity over the EU's new financial landscape. *Jonathan Blondeau*, DCM, capital structuring & liability management at Crédit Agricole CIB, reviews the current state of play and its implications for the bank capital market.

The financial crisis has generated a large number of government-funded bank bailouts from European states that were criticised by the public for using taxpayers' money and creating moral hazard.

Back in October 2011, the Financial Stability Board laid out the foundation for an effective resolution regime in its "Key Attributes of Effective Resolution Regimes for Financial Institutions" and described the objectives of an effective resolution regime in order "to make feasible the resolution of financial institutions without severe systemic disruption and without exposing taxpayers to loss, while protecting vital economic functions through mechanisms which make it possible for shareholders and unsecured and uninsured creditors to absorb losses in a manner that respects the hierarchy of claims in liquidation."

And on 15 April, a major milestone in the Banking Union was reached: the European Parliament accepted the Commission's proposals on the Bank Resolution & Recovery Directive (BRRD), the Single Resolution Mechanism (SRM), and the Deposit Guarantee Schemes (DGS) Directive.

The BRRD and SRM illustrate the intention of the European Union to take regulatory integration one step further in order to strengthen the stability of the banking system. They also clarify bondholders' capacity to absorb losses prior to requesting governmental support.


Jonathan Blondeau, CACIB

## HOW DO THE MECHANISMS WORK, AND WHAT IS THEIR PURPOSE?

Bank Resolution & Recovery Directive: Bail-in would include all liabilities with the exception of insured deposits (under Eu100,000), secured liabilities including covered bonds, liabilities arising by virtue of client assets or money, liabilities with a tenor of less than seven days, and employees and trade and tax liabilities.

The sequence of the write-down and conversion mechanism is described in Article 43 of the draft document as follows: Common Equity Tier 1 must be written down first, followed by Additional Tier 1, Tier 2, and finally "authorities can reduce to the extent required the principal amount of subordinated debt that is not Additional Tier 1 or Tier 2 in accordance with the hierarchy of claims in normal insolvency proceedings". This means that senior debt and uninsured deposits can be written down if the amount of subordinated securities does not cover up to 8% of total assets. Once the 8% threshold has been reached, a Member State could submit a request to the Commission to exempt certain creditors from bail-in. At this point the Single Resolution Fund can step in for up to 5% of total assets. A Minimum Required Eligible Liability (MREL) ratio will be set by regulators for each bank and could be above or below this 8% level.

Single Resolution Mechanism: The SRM offers centralised decision-making built around the Single Resolution Board, which involves permanent members as well as the Commission, the Council, the ECB and the national resolution authorities. In most cases, the ECB would notify the Board and the Commission, as well as the relevant national resolution authorities of a pending bank failure. The Board would then assess whether there is a systemic threat and any potential private sector solution. If this is not the case, it will adopt a resolution scheme. A resolution scheme currently needs to be approved within a weekend, from the closing of the US markets to its reopening.

The Single Resolution Fund, owned and managed by the Board, is expected to reach a minimum target level of 1% of covered deposits (around Eu55bn) over an eight year


Press conference following Parliament's vote

period, instead of over a 10 year period as initially planned. During this transitional period, the fund will start with 40% of the amount in its first year and will include national compartments for each participating Member State. The resources in those compartments should be progressively mutualised. Before the regulation enters into force, the Single Resolution Fund will be enabled to borrow, which is crucial in the first years due to its low capitalisation.

According to the European Parliament's and Commission's press releases, the agreed mechanism is described as a major step forward. But this compromise has raised some criticisms.

First, the size of the fund looks limited compared with those that were necessary during the last crisis. Unofficial estimates from economists on the necessary size of the fund vary between Eu500bn and Eu1,000bn. Even if the new prudential regulation is to prevent a new crisis and its potential damages, Eu55bn looks small. In addition to this, the Single Resolution Fund will have no possible recourse to the European Stability Mechanism, which can lend up to Eu500bn, as some states, such as Germany, wanted to avoid a mutualisation, and states will have to negotiate intergovernmental agreements in order mutualise the national contributions to the fund.

Doubts have also been raised about the decision-making process and the ability of resolution to be implemented under the restricted timeframe whilst having to involve the European Commission, the Council of Ministers, the European Central Bank, the supervisory board of the Single Supervisory Mechanism, the executive board of the SRM and the plenary council.

Agenda: A Provisional Agreement between the European Parliament and the Council on the Single Resolution Mechanism was reached on 20 March. The deal has also been approved by Parliament's political group leaders and was submitted to the vote at the second plenary session on 16 April ahead of European elections in May. The SRM should enter into force on 1 January 2015, whereas bail-in and resolution functions would apply from 1 January 2016, as specified under the BRRD.

## MARKET AND RATING IMPLICATIONS

Is a new bail-in-able subordinated category of securities about to emerge? Some major issuers have already started to publish their Minimal Required Eligible Liability ratios thereby addressing questions from a growing number of investors. Issuers may issue Tier 2 in excess of the 2% requirement in order to protect their senior spreads. Some issuers may consider not calling existing capital securities that may be disqualified as own funds but keep their subordinated status and reset at very favourable levels given the current low interest rate environment.

Another yet to be fully explored possibility may consist in issuing an additional layer of subordinated debt between Tier 2 and senior debt. This could be an option if a significant repricing were to occur – to date senior debt funding levels have remained at historical lows and contagion from the latest bank crisis has remained very limited.

Impact on ratings: These regulatory evolutions have already moved the rating agencies' positions regarding both sovereign support to banks as well as capital securities rating methodologies.

In order to take into consideration the tougher bail-in stance from regulators, Standard & Poor's issued a Request for Comment on 8 February that may trigger further downgrades of hybrid capital instruments, mainly legacy ones, after the publication of the updated criteria. On 4 March, S&P announced a review of government support in European bank ratings as a consequence of the recovery and resolution legislation nearing finalisation. The focus of the latter is that senior unsecured creditors of European banks that S&P considers to be systematically important may now be subject to bail-in. This review should be completed by the end of April and mainly result in changes to outlooks, prior to potential downgrades. By way of background, over 77% of the top 100 banks globally rated by S&P benefit from an upgrade for government support of at least one notch.

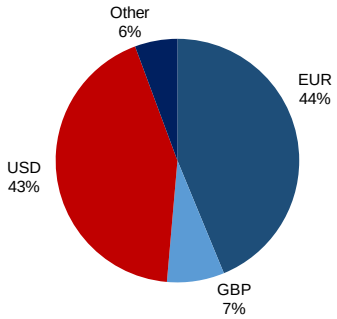
On 26 March Fitch published a press release warning that downward revisions were likely within the next two years for most banks due to weakening support from sovereigns.

In Moody's view, the agreement on the BRRD reached in December is sending a negative signal to unsecured bondholders. In this respect, it is widely expected that Moody's will review its methodology in the course of the second half of 2014.

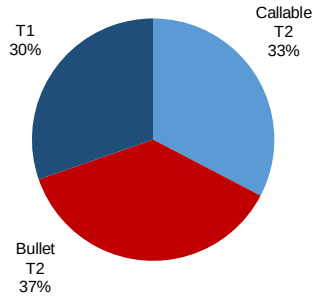
Conclusion: Tier 2 and AT1s are now available to issuers thanks to highly supportive market conditions, and loss absorption at the right price no longer seems to be a limit for investors. In spite of the threat of bail-in for senior bondholders, subordinated layers of capital now protect them better. These new regulations provide the market with clearer rules, even if their efficacy remains unproven as long as it is untested. ●

# Hybrid data: currencies, structures and spreads

## Bank hybrid issuance by currency (2013-2014 ytd)

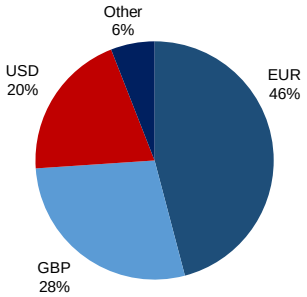



## Bank issuance by instrument/structure (2013-2014 ytd)

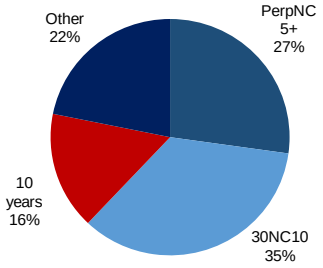



*Source: Crédit Agricole CIB*

## Insurance hybrid issuance by currency (2013-2014 ytd)

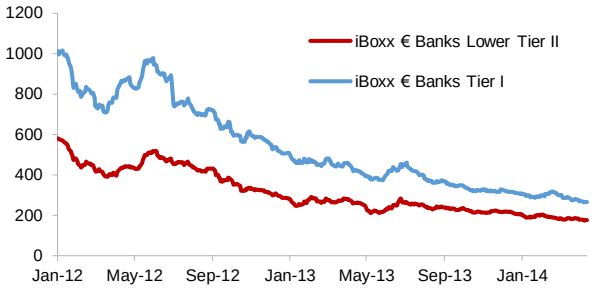



## Insurance issuance by instrument/structure (2013-2014 ytd)



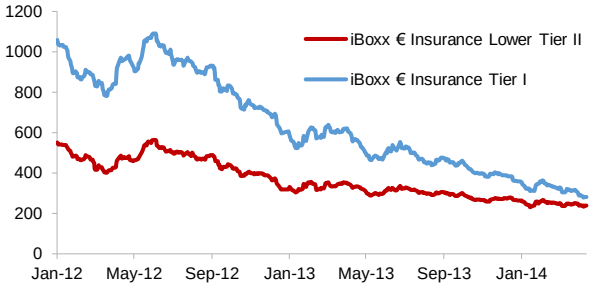

*Source: Crédit Agricole CIB*

## Secondary bank subordinated indices




*Source: Markit, Crédit Agricole CIB*

## Secondary insurance subordinated indices




*Source: Markit, Crédit Agricole CIB*

## Recent bank and insurance issuance

**BANK**

| Date | Security | Structure | Currency | Amt (m) |
|---|---|---|---|---|
| 04-Mar-14 | Nationwide Building Society | AT1 | GBP | 1,100 |
| 05-Mar-14 | Danske Bank A/S | AT1 | EUR | 750 |
| 05-Mar-14 | Banco Santander SA | AT1 | EUR | 1,500 |
| 05-Mar-14 | HSBC Holdings plc | Bullet T2 | USD | 1,987 |
| 05-Mar-14 | HSBC Holdings plc | Bullet T2 | USD | 1,487 |
| 11-Mar-14 | Aareal Bank | Callable T2 | EUR | 300 |
| 12-Mar-14 | KBC Group NV | AT1 | EUR | 1,400 |
| 13-Mar-14 | BNP Paribas | Callable T2 | EUR | 1,500 |
| 20-Mar-14 | RBS Group plc | Bullet T2 | EUR | 996 |
| 20-Mar-14 | Lloyds | AT1 | EUR | 750 |
| 20-Mar-14 | Lloyds | AT1 | GBP | 1,481 |
| 20-Mar-14 | Lloyds | AT1 | GBP | 1,494 |
| 20-Mar-14 | Lloyds | AT1 | GBP | 750 |
| 21-Mar-14 | Standard Chartered plc | Bullet T2 | USD | 2,000 |
| 27-Mar-14 | UniCredit SpA | AT1 | USD | 1,250 |
| 28-Mar-14 | Societe Generale | AT1 | EUR | 1,000 |
| 01-Apr-14 | Credit Agricole SA | AT1 | EUR | 1,000 |
| 01-Apr-14 | Credit Agricole SA | AT1 | GBP | 500 |
| 02-Apr-14 | BBVA | Callable T2 | EUR | 1,500 |
| 03-Apr-14 | NordLB | Bullet T2 | USD | 500 |
| 09-Apr-14 | BPCE | Bullet T2 | EUR | 750 |
| 11-Apr-14 | La Banque Postale | Callable T2 | EUR | 750 |

**INSURANCE**

| Date | Issuer | Structure | Currency | Amt (m) |
|---|---|---|---|---|
| 19-Mar-14 | COFACE | 10 year | EUR | 380 |
| 01-Apr-14 | NN Group | 30NC10 | EUR | 1,000 |
| 17-Apr-14 | Aegon | 30NC10 | EUR | 700 |
| 23-Apr-14 | Generali | 12 year | EUR | 1,000 |

# Hybrid data: deals, performance and investors

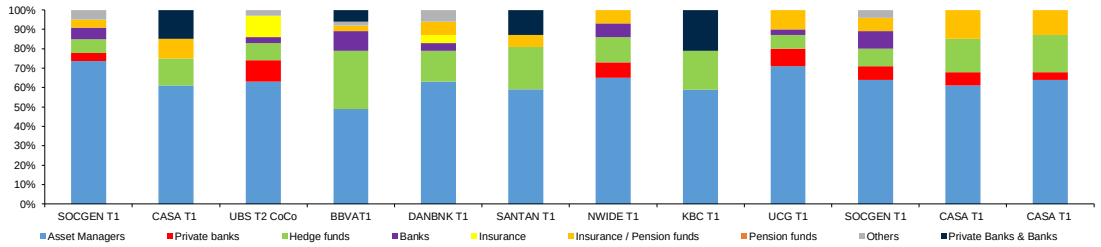
## AT1 performance monitoring (as at 14/4/14)

| Issuer | ISIN | Amount | Coupon | Call | Trigger | Loss absorption | YTC % | Price | ASW | CDS sub |
|---|---|---|---|---|---|---|---|---|---|---|
| BBVA | XS0926832907 | USD1.5bn | 9.00% | PerpNC5 | CET1 transit 5.125% | EC | 6.40 | 109.3 | 484 | 142 |
| BBVA | XS1033661866 | EUR1.5bn | 7.00% | PerpNC5 | CET1 transit 5.125% | EC | 6.04 | 104.0 | 517 | 142 |
| SG | XS0867614595 | USD1.25bn | 8.25% | PerpNC5 | CET1 5.125% | Temp w/d | 6.26 | 107.9 | 478 | 132 |
| SG | USF8586CRW49 | USD1.75bn | 7.875% | PerpNC10 | CET1 5.125% | Temp w/d | 7.26 | 104.2 | 455 | 132 |
| SG | XS0867620725 | EUR 1bn | 6.75% | PerpNC7 | CET1 transit 5.125% | Temp w/d | 6.09 | 103.7 | 481 | 132 |
| CSG | XS0989394589 | USD2.25bn | 7.50% | PerpNC10 | CET1+higher trigger CoCos 5.125% | Temp w/d | 6.24 | 109.0 | 364 | 96 |
| BPE | XS0979444402 | EUR0.5bn | 11.50% | PerpNC5 | CET1 5.125% | EC | 7.13 | 116.6 | 679 | 224 |
| BACR | US06738EAA38 | USD2bn | 8.25% | PerpNC5 | CET1 7% | EC | 6.62 | 106.5 | 516 | 116 |
| BACR | XS1002801758 | EUR1bn | 8.00% | PerpNC7 | CET1 7% | EC | 6.63 | 107.3 | 555 | 116 |
| ACAFP | USF22797RT78 | USD1.75bn | 7.875% | PerpNC10 | transit CET 5.125% (SA)/7% (Grp) | Temp w/d | 6.91 | 106.8 | 429 | 120 |
| ACAFP | XS1055037177 | EUR1bn | 6.50% | PerpNC7 | transit CET 5.125% (SA)/7% (Grp) | Temp w/d | 5.93 | 103.3 | 461 | 120 |
| ACAFP | XS1055037920 | GBP0.5bn | 7.50% | PerpNC12 | transit CET 5.125% (SA)/7% (Grp) | Temp w/d | 7.20 | 102.4 | 439 | 120 |
| DANBNK | XS1044578273 | EUR750m | 5.75% | PerpNC6 | CET1 7% | Temp w/d | 5.68 | 100.9 | 440 | 206 |
| SANTAN | XS1043535092 | EUR1.5bn | 6.25% | PerpNC5 | CET1 transit 5.125% | Temp w/d | 6.10 | 100.6 | 513 | 138 |
| NWIDE | XS1002801758 | GBP1bn | 6.875% | PerpNC5 | CET1 7% | EC | 6.37 | 102.2 | 445 | 95 |
| KBC | BE0002463389 | EUR1.4bn | 5.63% | PerpNC5 | CET1 transit 5.125% | Temp w/d | 5.75 | 99.5 | 474 | - |
| Lloyds | XS1043545059 | EUR750m | 6.38% | PerpNC6 | CET1 7% | EC | 5.74 | 103.3 | 460 | 111 |
| Lloyds | XS1043550307 | GBP1481m | 7.00% | PerpNC5 | CET1 7% | EC | 6.56 | 101.9 | 455 | 111 |
| Lloyds | XS1043552188 | GBP1494m | 7.63% | PerpNC9 | CET1 7% | EC | 7.03 | 104.0 | 453 | 111 |
| Lloyds | XS1043552261 | GBP750m | 7.88% | PerpNC15 | CET1 7% | EC | 7.22 | 106.0 | 436 | 111 |
| Lloyds | US539439AG42 | USD1.675bn | 7.50% | PerpNC10 | CET1 7% | EC | 6.87 | 104.6 | 412 | 111 |
| UCG | XS1046224884 | USD1.25bn | 8.00% | PerpNC10 | CET1 transit 5.125% | Temp w/d | 7.68 | 102.2 | 484 | 155 |

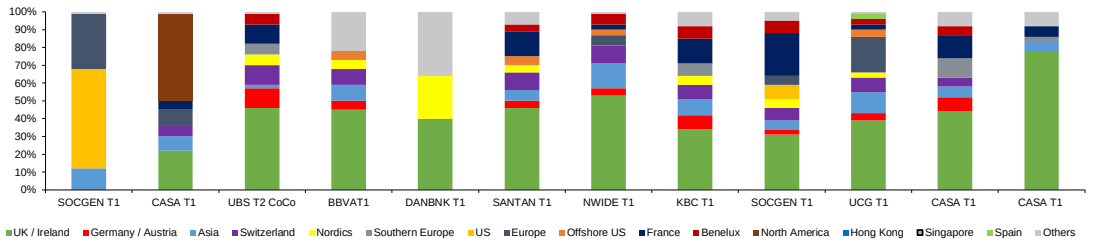
## T2 CoCo performance monitoring (as at 14/4/14)

| Issuer | ISIN | Amount | Coupon | Call/Maturity | Trigger | Loss absorption | YTC % | Price | ASW | CDS sub |
|---|---|---|---|---|---|---|---|---|---|---|
| BACR | US06740L8C27 | USD3bn | 7.625% | 2022 | CET1 ratio below 7% | Perm w/d | 5.95 | 111 | 346 | 137 |
| BACR | US06739FHK03 | USD1bn | 7.75% | 23NC18 | CET1 ratio below 7% | Perm w/d | 4.62 | 112 | 350 | 137 |
| ACAFP | US225313AC92 | USD1bn | 8.125% | 33NC18 | CET1 ratio below 7% | Perm w/d | 4.12 | 116 | 280 | 136 |
| CSG | CH0181115681 | CHF750m | 7.125% | 22NC17 | CET1 ratio below 7% | EC | 3.35 | 111 | 332 | 103 |
| CSG | XS0957135212 | USD2.5bn | 6.5% | 2023 | CT1 ratio below 5% | Perm w/d | 5.02 | 111 | 236 | 103 |
| CSG | XS0972523947 | EUR1.25bn | 5.75% | 25NC20 | CT1 ratio below 5% | Perm w/d | 4.02 | 110 | 281 | 103 |
| KBC | BE6248510610 | USD1bn | 8% | 23NC18 | CET1 ratio below 7% | Perm w/d | 4.14 | 114 | 314 | 261 |
| UBS | XS0747231362 | USD2bn | 7.25% | 22NC17 | CT1 ratio below 5% | Perm w/d | 3.29 | 111 | 258 | 97 |
| UBS | US90261AAB89 | USD2bn | 7.625% | 2022 | CT1 ratio below 5% | Perm w/d | 4.85 | 119 | 249 | 97 |
| UBS | CH0214139930 | USD1.5bn | 4.750% | 23NC18 | CT1 ratio below 5% | Perm w/d | 3.96 | 103 | 263 | 97 |
| UBS | CH0236733827 | EUR2bn | 5% | 26NC21 | CT1 ratio below 5% | Perm w/d | 4 | 103 | 276 | 97 |

## Distribution by investor type (up to 14/4/14)




## Distribution by geography (up to 14/4/14)




*Source: Crédit Agricole CIB*


**Woori Bank, Seoul**
*Photo: Farrukh/Flickr*

# Woori takes Korea into Basel III era

On 23 April Woori Bank launched the first Basel III-compliant capital instrument from South Korea, a $1bn 10 year bullet with write-down loss absorption. *Neil Day* asked Chang Yeon Kim, general manager, treasury department, Woori Bank, about the challenges of bringing such a deal, and Frits-Jan Algera, head of syndicate for Asia ex-Japan, at Crédit Agricole CIB, about the execution.

**Through its Tier 2 issue, Woori has been a pioneer in a nascent segment, the Basel III-compliant Tier 2 space, in Asia ex-Japan, and more particularly in Korea. What were the main obstacles that Woori had to overcome before launching this deal, which I understand you had been planning for quite some time? How did you manage the process with the regulator? Did you face any particular challenges?**

**Chang Yeon Kim, Woori Bank:** There were many obstacles we had to overcome, especially because the deal was the very first of its kind out of Korea and moreover, from the Korean banking sector. Especially given that Basel III implementation in Korea had begun only a short while ago. Everything had to be produced from scratch — the relevant communication with the regulators Financial Services Commission (FSC), Financial Supervisory Service (FSS) and Ministry of Strategy & Finance (MOSF), and the documentation process, among others. Even the regulators' approval processes had to be newly established, as they, too, had to deal with this type of transaction for the first time.

Furthermore, three separate channels of communication had to be managed concurrently. With the FSC, we had to discuss the amendment of the Banking Act, while with the FSS we had to address the financial strength and prudence of the bank in relation to raising capital under Basel III. The MOSF was focused on making sure we chose the right issuance window.

**What were the key elements of the structure?**

**Frits-Jan Algera, Crédit Agricole CIB:** The Basel III regimes in Japan and Korea allow for pre-emptive capital injections before a bank reaches the point of non-viability (PONV) and a write-down of subordinated debt is triggered. A Korean bank is deemed to have reached the point of non-viability if it receives a management improvement order, which could result from situations including a bank failure or its Tier 1 capital adequacy ratio breaching 1.5%, or CET1 ratio below 1.2%, or Total Capital ratio below 2%.

At year-end 2013, the Basel III Total Capital ratio of Woori stood at 15.52%, the Tier 1 ratio at 12.68%, and the CET1 at 11.05%, far above the PONV Trigger Event levels.

**Woori executed a global roadshow prior to the transaction. How would you describe the experience from this critical marketing exercise? Was it in line with your expectations?**

**Kim, Woori:** In our view the roadshow was highly effective and beneficial. The lion's share of the investors we met on the road placed firm orders. Moreover, we received a lot of follow-up questions through which we could confirm that the investor interest was quite high.

**How did the pricing and order book develop?**

**Chang Yeon Kim:**
"The deal is history in the making"

**Algera, CACIB:** After a one week roadshow in Europe and Asia and several investors calls with US accounts in the week of April 14, we announced the transaction on Tuesday, April 22, just after the Easter break, and communicated the broad structural terms of the potential transaction. On the back of positive feedback on the structure and some large indications of interest received on Tuesday, we were comfortable to open books on Wednesday.

We started the bookbuilding process with an initial pricing guidance of Treasuries plus the 237.5bp area during Asian hours. Within 90 minutes the books grew to over $1bn, with high quality accounts and good granularity. The book enjoyed a second round of momentum when Europe opened. Asia books went subject at 1600 Hong Kong time, while the European ones closed at 0930 UK time.

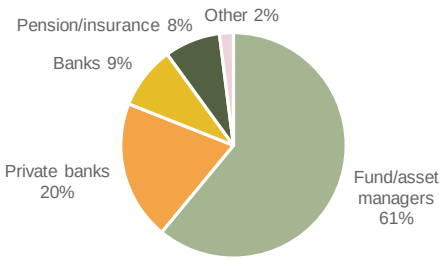
The syndicate decided to accelerate the process and to close books in Asia and Europe before announcing the final guidance. The rationale behind this was to avoid excessive inflation. The order book settled at $4.5bn by the end of the Asian trading day and ahead of the US open. Given the overall reception of the trade and the level of interest out of Europe and Asia, the syndicate tightened final guidance to the 212.5bp over Treasuries area (plus or minus 5bp). The books closed well in excess of $5bn, with over 230 accounts participating. The $1bn RegS/144A transaction was priced at 207.5bp over Treasuries, the tight end of the final guidance, with a 4.75% coupon to yield 4.756%.

### What factors influenced the approach to pricing? What are the main reference points you and your syndicate banks looked at to determine the appropriate pricing level?

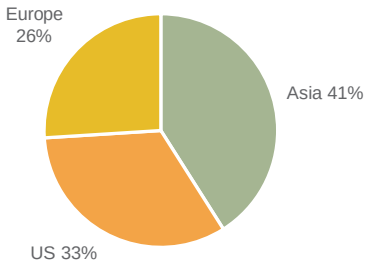
**Kim, Woori:** The most difficult part of determining the pricing was the selection of comparables. Thanks to the similar transactions completed by Japanese banks (Mizuho and SMBC), we were able to first pick a starting point.

**Algera, CACIB:** Indeed. In terms of pricing rationale, we took two approaches. We looked at the trade in relative terms versus peers Mizuho and Sumitomo in Basel III format. Mizuho's recently priced 4.6% 2024 subordinated notes traded in the context of 170bp over Treasuries, while Sumitomo comparable 4.436% 2024 bonds were indicated just below the 160bp mark. In senior, Mizuho and Sumitomo are trading around 35bp and 45bp inside Woori, respectively. This implied fair value in Basel III subordinated format at around 205bp over Treasuries. But we also looked at applying a Basel III premium to Woori's legacy Tier 2 bonds. The premium is around 20bp in Japan, while Korea's Basel III rules are not as investor-friendly as Japan's. Applied to Woori's existing 5.875% 2021 legacy Tier 2 bonds, after adjusting for the curve to 2024, we were back in the low 200bp over Treasuries.

**Distribution by investor type**




**Distribution by geography**




*Source: Crédit Agricole CIB*

**Kim, Woori:** The other concern was how receptive the investors would be to usage of a single rating of Baa3 from Moody's. Although this is an investment grade rating, we were concerned that some investors might be reluctant to participate in the deal for lack of a second rating.

### Why was a 10 year bullet structure chosen?

**Algera, CACIB:** Woori's bond was the first 10 year bullet Tier 2 from an Asian (ex-Japan) issuer. Despite not physically going to the US for a roadshow, Woori still opted for the more US investor-accepted 10 year bullet structure. The marginally lower participation from the US was also explained by the fact that US investors are more familiar with the Japanese banks given that Korean ones haven't been very active. The Asian participation rate was not a surprise as investors showed a very keen response during the roadshow and bookbuilding process for the Korean credit story. This was also a result of the recent outperformance of Korean credits versus bonds from other Asian jurisdictions.

In the end Asia took 41% of the transaction, while the US made up for 33% and Europe 26%. Fund and asset managers bought 61%, private banks 20%, banks 9%, pensions and insurers 8%, and other investors came in for the rest.

### What are the key takeaways from this transaction? And are you happy with the distribution and granularity of the book?

**Kim, Woori:** There were a number of key takeways.
In completing this transaction Woori Bank strengthens its capital base, which would help with price negotiation in terms of the privatisation process.

The deal is history in the making as it is the first ever transaction of this kind out of Korea. Effectively, the transaction was also an assessment of the success of Basel III implementation in Korea.

The size, structure, tenor, book size and finally the ultimate pricing all contributed to the success of the inaugural transaction.

### How did the deal perform in the aftermarket?

**Algera, CACIB:** The transaction was FTT at 1230 EST in New York. At the break, the bonds traded as tight as 203bp on the bid side. The bonds subsequently widened during the first day of Asian trading to re-offer in the Asian hours as the market backdrop worsened on the increased geopolitical tensions in the Ukraine and the heavily anticipated pipeline from Asia for the following week. The bonds closed the week out at 218bp/216bp, however, on very limited flow.

### The AT1 market is booming in Europe. Is it an instrument that Woori could consider in the future?

> The transaction was also an assessment of the success of Basel III implementation in Korea

**Kim, Woori:** If further capital raising becomes necessary AT1 issuance might be considered, but there are no plans at this time.

### And what are your impressions about sentiment towards the Korean banking sector in general?

**Kim, Woori:** The perception of the Korean banking sector seemed quite positive from the investors. They seemed very comfortable with not only our credit story but also with the Korean bank sector. We did feel that Korean bond spreads have been tightening a bit too aggressively in the eyes of the investors. Perhaps that is why our Tier 2 was able to achieve the success it did. ●

**Issuer:** Woori Bank
**Issuer ratings:** A1 (Moody's)/A- (S&P)/A- (Fitch)
**Expected issue ratings:** Baa3 (Moody's)
**Security description:** Basel III-Compliant Tier 2 Subordinated Bonds
**Format:** 144a/Reg S
**Issue size:** US$1bn
**Tenor:** 10 year Bullet
**Settlement:** 30 April 2014 (T+5 days)
**Maturity:** 30 April 2024
**Re-offer spread:** CT10 + 207.5bps
**Coupon:** 4.75% SA (30/360 unadj); first pay 30 Oct 2014
**Re-offer yield:** 4.756%
**Re-offer price:** 99.953%
**Benchmark:** T 2.75% 02/15/24//100-19//2.681%
**HR:** 0.92
**Non-viability loss absorption:** Write-down (see offering circular for details)
**Use of proceeds:** General corporate purposes
**Bookrunners:** Barclays, BNP Paribas, BAML, Crédit Agricole CIB, HSBC, JP Morgan, Nomura
**Manager:** Woori Global Markets Asia Limited
**Terms:** SGX Listing, $200k/$1k denoms, English Law (Notes) and Korean Law (Subordination)

**Earth,** as photographed from Apollo 4
*Photo: NASA/Wikimedia Commons*

# AT1 GOES GLOBAL

Only a few months ago serious questions were being asked about the likely demand for CoCos. Explosive growth this year across currencies has put paid to any such doubts. But the market has not been without its problems. *Neil Day* asked leading players for their views on the drivers of this burgeoning asset class and its potential pitfalls.

**Roundtable participants:**

**Filippo Alloatti**, Senior Credit Analyst, Financials, Hermes Fund Managers

**Santiago Armada**, Head of Funding, Banco Popular Español

**Vincent Hoarau**, Head of FIG Syndicate, Crédit Agricole CIB

**Peter Holm**, Senior Vice President, Group Treasury, Danske Bank

**Chris Huggins**, Senior Portfolio Manager, GLG Partners

**Raphael Robelin**, Co-Chief Investment Officer, BlueBay Asset Management

**Elisabeth Van Sante**, Vice President and Credit Research Analyst, Pioneer Investments Management

**Neil Day**, Managing Editor, Bank+Insurance Hybrid Capital, and moderator

**In the space of a month Danske, Santander and UniCredit printed inaugural AT1 transactions while a non-bank UK institution, Nationwide Building Society, and a non UK financial institution Crédit Agricole opened the sterling sector. What explains the rapid and successful globalisation of AT1 after its opening in the US dollar market?**

Peter Holm, Danske: I'm positively surprised at the speed the market has taken off at, particularly against the background of all the views you previously heard that there would be a limited investor clientele for these products. To start with it was in US dollars, but now you are also able to issue in euros, and we also saw Nationwide and then Crédit Agricole in sterling, so now we have basically seen three major currencies available. And there is a much broader number of investors, not only one particular group.

That it took off to the extent that it has done is very satisfactory — we had hoped that this would be the outcome. I think the yields available on these instruments in this low interest rate environment paved the way for this broadening of the investor base and has been very, very helpful in bringing about this situation.

Chris Huggins, GLG: The development doesn't really surprise us because issuers need to build out a curve in these instruments, in both maturities and currencies. We envisage issuers funding in all the G3 currencies, and with a curve of call dates on AT1s.

While it doesn't particularly surprise us, it's a welcome development for investors to have a choice of currency and structures to look at. And the pipeline is clear: as the various jurisdictions in Europe get sign-off for the tax treatment for the coupons on CoCos, that is catalysing issuance in those jurisdictions. The UK and Switzerland were first to give sign-off, then France and Spain got done, and more recently we've seen Italy and finally Germany getting approval.

I wouldn't say that there's one particular jurisdiction that we are more or less excited about. It's more at an issuer level than a country level that we look at these things.

**Elisabeth Van Sante, Pioneer:** The new regulatory regime is without doubt the main reason for the number of recent issues in the market; not only are the great majority of old-style subordinated instruments losing all regulatory eligibility after their first call date, banks also face higher capital buffer requirements where the equity-like and loss-absorbing CoCos have a preferred position. The Swiss issuers are even likely to issue only CoCo-style subordinated instruments going forward. The stock of old-style Tier 1s being redeemed over the next few years means we should expect close to $50bn (Eu36.2bn) of issuance per year, in a format that meets the new Basel III rules, and the fact that tax-deductibility on coupons is being agreed across jurisdictions will support issuance levels. Also, the upcoming ECB stress test is encouraging many European issuers to pre-emptively reinforce their capital buffers. For many banks, issuing AT1 is one of the most efficient ways to do so.

From an investor perspective, we believe demand is likely to remain quite solid in the short term given that the yields/spreads that these instruments offer can be interesting vis-à-vis the rest of an issuer's capital structure.

> The periods of frenzy we can observe are mainly driven by the still-exceptional liquidity

**Vincent Hoarau, Crédit Agricole CIB:** The globalisation of the AT1 market is a natural step. The new regulatory regime and the requirements to expand the capital base are obvious reasons for supply to increase. Some major technical obstacles have also been overcome: most of the products are index-eligible, people are getting more and more comfortable with subordination to equity, and we also found a common basis to compare instruments and work on relative value.

But I think that the periods of frenzy we observed were mainly driven by the still-exceptional liquidity situation in the context of the low interest rate environment. As an investor, you can't miss out on such juicy coupons and to some extent you are forced to buy. Those deals are priced a couple of hundred basis points wide of pre-crisis levels. You can hardly pass them up, even if you are not a big fan of loss-absorbing features.

Meanwhile, euro and sterling denominated bonds are offering investors very interesting opportunities for diversification while the deeply subordinated market was historically in US dollar format.

**Raphael Robelin, BlueBay:** I think that the evolution of the AT1 market is a consequence of the clarification of the Basel III rules and which structures will obtain regulatory capital treatment going forward. This is something that was only clarified last year and so a lot of the issuers we had met were waiting for this visibility before coming to market. On top of this there has also been affirmation from tax authorities in many jurisdictions confirming that these instruments' coupons will be tax-deductible, which again I think is an input that potential issuers needed to be clear on before deciding on how much they wanted to issue, in which currency, as well as which structure was most appropriate.

We have known for some time now that by 1 January 2019 banks, from a capital standpoint, need to be Basel III-compliant, and so they are going to need a lot more capital. If you look at a bank's capital stack they have the choice between having 2% of their risk weighted assets (RWA) in Tier 2 and 1.5% in Tier 1, or all equity instead. So if you think about it, for a bank with a cost of equity of 10%, and an average tax rate of 20%, it means that as long as you can issue sub debt with a coupon of less than 12.5%, it is economic for you to do so. We also know that legacy hybrid capital, in particular in the Tier 1 space, will typically cease to count as capital after the first call date if the bonds contain step-up language.

So if you put all these elements together: the need to have 1.5% of RWA for Tier 1, 2% for Tier 2, in hybrid capital, the visibility on the type of structures that will qualify as hybrid capital under Basel III and the visibility of the tax treatment, there's going to be a large amount of supply so it comes as no surprise to us that banks are keen to be the first ones to establish a curve, and therefore we are starting to see a lot of issuance. We would expect this to be a continuing theme between now and 1 January 2019, when the Basel III capital rules will be fully implemented.

### But is the opening of different investor bases surprising?

**Robelin, BlueBay:** It's very symptomatic of where we are in today's market. This is an environment where yield levels are extremely low and where attractive investments are more and more scarce. The average yield in the European high yield index is 3.75%, and the average yield in the euro corporate investment grade index is 1.75%. When the average yield on offer is so low it's extremely difficult for investors to ignore an asset class giving coupons of between 5% and 10%.

So to me this is the one part of the equation where medium term I'm still a little bit sceptical. At the start of the year, certainly from a demand standpoint, all the stars were aligned: there was low volatility in the market, risk appetite was very high, and the low rate environment meant investors were desperate for incremental yield. I still feel, though, that there is a lack of dedicated natural demand for these new-type hybrid securities and in particular AT1. So far it has primarily been a combination of private banking investors, hedge funds, and asset managers going off piste that has led to the success of these deals. It is not obvious to me that all these investors see these instruments as core holdings, and so I suspect that we will have air pockets at some stage in this market. One of the great difficulties with this market is precisely the lack of a core stable

investor base. Hedge fund managers and asset managers buying these as an off-index bet, or even private banking clients, may not have the appetite for the volatility in the asset class if bond prices go down five or 10 points, which in my experience can happen much more easily than people anticipate.

We at BlueBay tried to work with the regulators between 2008 and 2012 to make sure that the voice of fixed income investors was heard. We tried to make it clear that if regulators wanted fixed income investors to have a natural demand for new hybrid capital securities then they had to make sure that the deal features were broadly acceptable to this investor base. Unfortunately our advice was not heeded, so a number of features — such as the ability to be fully written down or converted into equity when the underlying bank is still a going concern entity, as well as the ability to pay a dividend and not pay a coupon — really mean that the capital structure waterfall is not being fully respected. As a result of this I think it is questionable whether these new type of securities have a natural home in classic fixed income portfolios.

**Banco Popular opened up the euro segment in October 2013? How was the situation back then? What were the major differences compared with today's environment?**

**Santiago Armada, Banco Popular Español:** Yes, exactly, Banco Popular placed the first AT1 denominated in euros and it came as the third issue in Europe. At that time the market was underdeveloped, as you can clearly see from the number of investors involved and with the geographical distribution, which was concentrated in UK. The instrument was not widely understood, so the meetings needed to be much longer and deeper, and many investors still didn't believe in the product and looked at it as a short term opportunity.

However, quite a few first tier investors saw the value proposition of the bank and went on buying bonds in the secondary. Thanks to them, Banco Popular's AT1 has had so far an extraordinary performance, being quoted 14% higher in just five months.

**What were the main obstacles that Danske had to overcome before launching the deal, which I understand you had been planning for quite some time?**

**Holm, Danske:** We of course needed to have full clarity on the regulatory rules through consultation with the Danish supervisory authorities. But on top of that it became clear that we also had to deal with two tax issues, which held up the process a little bit further and meant that we had to leave the project on the shelf last autumn.

One of the tax issues came up last summer, if I remember correctly. The guidelines were unclear about the issue of if you should ever have a temporary or permanent write-down, and by doing this write-down create taxable income, whether you should make a deduction upfront for that potential tax liability. For some time that issue was with the European Banking

**Raphael Robelin, BlueBay:**
"Unfortunately our advice was not heeded"

Authority, and then late last year it was passed back to the domestic regulators to deal with. That eased the situation for us because we could discuss it quickly with someone who had an insight into our group, so we very quickly arrived at a solution to that — which is that there is no tax to be drawn upfront, so no haircut, so to speak.

The other issue was on the tax deductibility of coupon payments. We did the first hybrid issue in Denmark, in 2004, and at that point in time we had a change in tax legislation giving us a deduction on the coupon payments. Then you had the change in regulations requiring fully discretionary coupon payments, and that created a new question over tax deductibility, and we had to have it confirmed again. That was confirmed in legislation passed by parliament in March.

As part of our capital plan we wanted to complete our AT1 by 11 April in light of the repayment of the government hybrid Tier 1 that we took in 2009 for Dkr24bn, with that date being the first call. We had been planning for that for a long period, doing equity issues, and then adding some Tier 2 issues, which you referred to before — in euros, the Trekroner issues, and a little Swiss francs — and we wanted to complete that chain of transactions with an AT1 to be fully prepared for the repayment of the government hybrid.

**Why did Crédit Agricole SA opt for sterling on top of euros for its second appearance of the year, which was not something that had been done before?**

**Hoarau, CACIB:** A large number of UK investors expressed an interest in buying sterling exposure to CASA when we were roadshowing the inaugural US dollar AT1 in early January. The same accounts also gave unsolicited indications of interest at an

**Santiago Armada, Banco Popular Español:**
"Many investors still didn't believe in the product"

early stage of the marketing process for the second issue. That interest, plus the size of the demand attracted by Nationwide for its inaugural AT1 in sterling, made the sterling tranche an easy decision.

The dual currency format was validated when we received evidence from investors that there was no risk of cannibalisation between the two offerings. The sterling market is as nascent as the euro market, while supply in absolute terms is really limited, at least for the time being. So we did not see any downside to doing a dual tranche issue while we knew from the outset that the size of both offerings would remain relatively limited.

And yes, we certainly broke new ground. It was the first multi-currency AT1 benchmark, as well as the first time a non-UK financial has sold benchmark sterling AT1. Overall, the transaction was very well received and the three points of performance in the secondary market should satisfy everyone involved.

**If you hadn't seen the euro market evolve so much so quickly, would Danske possibly have gone ahead in dollars?**

**Holm, Danske:** For us, the fact that the euro market developed in such a way that we could take advantage of it was a very positive development. We prefer to issue these instruments in a currency that is closer to our home currency, Danish kroner, which gives us a much more stable capital element, so to speak.

**You did a "Trekroner" Tier 2 issue last year in the Danish, Norwegian and Swedish markets — is Danish kroner a currency in which you could envisage doing an AT1 in, or are any of the other Nordic currencies?**

**Holm, Danske:** I don't think one should exclude that as a possibility one day when the need appears. Definitely we should not exclude that. And in that respect it was very, very positive for us to see that when you look at the investor clientele behind our deal 24% was allocated to Nordic investors.

**We suddenly have plenty of reference points in the secondary market, in US dollars, euros and now in sterling. Are the relative value schema of these instruments fully consistent across the different currencies? What about the cross-currency element and the possibility of arbitrage across markets?**

**Huggins, GLG:** I would hesitate to suggest that there are arbitrage opportunities, because I would imagine that bid/offer spreads, transaction costs and borrow costs probably eat up any meaningful arbitrage that exists. However, we think there are opportunities to switch between structures or currencies from the same issuer to ensure that investors have exposure to their favoured part of the curve, if you like. And different investors will have a different idea about what represents value there.

If you take the Lloyds exchanges, for example, there are now three deals in sterling with three call dates. There was quite a lot of flow in the ECNs that were going to become the AT1s, and you could see how interest shifted amongst them. While the deal was initially priced by Lloyds based on how it thought investors would see value in the curve, the market priced it slightly differently. I think more generally there's a preference for longer dated calls.

**Van Sante, Pioneer:** The investible universe is certainly growing as this market expands rapidly across a number of jurisdictions. The fact that the structures differ, that spread levels vary across markets, and that the technicals are also different creates opportunities across currencies for investors. Our impression is that the market is not differentiating much between certain structural features — either within or across currencies. This also creates opportunities before the market matures and pricing efficiency increases.

**Robelin, BlueBay:** I think that there are great arbitrage opportunities in the market. Clearly the more issuance we see, the more diversity we will have — be it the different currencies in which we have instruments outstanding, the different structures in terms of high and low triggers, conversion into equity and write-down, the different levels of coupon resets and so on. There are many inputs and in a young asset class the market will tend to be quite inefficient in pricing them. I also think that there is still a bit of a question mark for investors as to whether they should value the instrument on spread or in yield.

**Filippo Alloatti, Hermes:** Yes, between currencies there are from time to time some opportunities. But the way we would approach the question of valuations is that there are many different angles. We look for example at all old Tier 1s, we look

at the bank's cost of equity, we look at trades banks may do in the reg cap space, and then we take, if you like, a holistic view on valuations. But the fact that we can invest in the three main currencies, and eventually could consider other currencies, also allows us to express some views in different currencies.

**Hoarau, CACIB:** The number of reference points in the secondary market increased significantly at the end of the quarter, with Danske, Santander, KBC, Société Générale, CASA and UniCredit surfacing within 15 days in euro, dollars or sterling. But there is still a lot of discrepancy in the valuation schemas. Structures differ across jurisdictions and issuers, while the handful of instruments available is quite inhomogeneous.

I also think that there is not enough credit differentiation in the asset class. We meanwhile have to bear in mind that the quality of the placement in the primary market and the sizing of the tranches also play an instrumental role in the level of performance in the secondary market as well as volatility. So, it's not an easy call when discussing consistency of valuations. There are always different ways to look at a trade.

When UniCredit's inaugural US dollar AT1 surfaced at 8%, you had investors valuing the trade three-quarters of a full point higher! The 8% yield was certainly eye catching and high enough to ensure a good trade, but if you looked at it in spread it was quite tight, in particular versus BBVA AT1 perpetual non-call five, to which the UniCredit perpetual non-call 10 came flat. Nevertheless, versus a UCGIM 9⅜ 07/29/49 "soft CoCo" trading at 6% back then, the new deal looked cheap.

There was also a lot of price discovery around the recently launched CASA perpetual non-call 12 AT1 tranche in sterling. We received indications ranging between 7.25% and 8%! Some investors worked on relative value terms versus Lloyds. Others simply reflected the euro-sterling yield curve differential to come up with a valuation in sterling. In addition to that, whether or not you crystalise the inversion of most subordinated sterling curves was debated. And ultimately I have to admit that there is also a gut feeling element that interferes with this objective valuation process, plus the envisaged deal size and market tone consideration at the time of the launch.

### When you see a new issue where there is more than one currency, for example CASA in euros and sterling, how do you position yourself?

**Robelin, BlueBay:** There are many different inputs involved in our investment process. Usually for a multi-tranche deal you would expect the structure to be identical but the initial spread will be quite different. Clearly that means that there is more risk of one bond not being called than the other, so that obviously is one differentiating factor between the different tranches: you've potentially got far more extension risk for one deal than for another.

Then there is the specific analysis of supply and demand for the different currencies based on the issuer and how much outstanding debt the issuer has in the respective currencies. Where is the domestic market? How much supply have we had over the last few months in the respective market, and how much supply do we expect in these different markets going forward?

All else being equal, we think that there is a natural bias for European accounts to buy the debt of European banks, so we are not surprised to see a strong demand for euro-denominated deals, for example. And so it really is an analysis of all these factors. Clearly for the dollar bonds you have to assess whether there is demand out of the US but also what Asian demand there is. Asia tends to buy far more dollar-denominated debt than euro-denominated debt. These are examples of the types of inputs we take into account before deciding which tranche to invest in.

### What can we say about the spread differential between Tier 2-hosted CoCos and AT1? What about the value of the deferral element?

**Van Sante, Pioneer:** At the moment, the key differentiating feature between T2 and AT1 CoCos is centred upon the risk of coupon deferral, which therefore commands the bulk of the discount over Tier 2 structures (currently in the range of 130bp-150bp). This is valid in our view when considering that coupons on AT1 instruments may be suspended well before the capital ratios fall to the official trigger point. In theory, coupons may be suspended from the moment capital ratios fall into the capital conservation buffer; although when precisely this happens may differ between national regulators. For example, the UK PRA and Swiss regulator appear to have a more rigid view on the point of non-viability. As national regulators' views on PONV become clearer, this is something which may require a more nuanced pricing approach. Going forward, the market may focus more on other features such as extension risk, which may mean that AT1 trade at a greater discount.

> The market is not differentiating much between certain structural features

**Hoarau, CACIB:** I fully agree with the risk differential implied by the two instruments, but I think that in terms of valuation, the differential should be a bit higher. And this is what the market is telling us: there are roughly 200bp of spread differential between Barclays US dollar 8¼ 12/29/49 AT1 (PERPNC5) and Barclays US dollar 7¾ 04/10/23 (T2 10NC5). In the euro market, CASA 8⅛ 09/19/33 T2 (20NC5) is trading in the context of 4.35% or around 275bp over five year swap rates. This implies 205bp of differential between Tier 2 hosted CoCo and AT1.

I expect the differential to widen further, because AT1s are much riskier instruments with regards to the risk of coupon deferral, and I think that this risk is undervalued and will be reassessed.

Elsewhere, the scarcity element regarding Tier 2-hosted CoCos will likely push spreads tighter and lead to some squeeze situations, while — in the meantime — AT1 supply might weigh on valuations.

### Does issue size play as important a role as the credit itself or the distance to trigger? What are your priorities when evaluating these instruments?

**Van Sante, Pioneer:** We would usually require a minimum size of 500m to invest in these instruments, and above that figure we would not really differentiate between 750m and 1bn. But once the deal size is above our minimum threshold, the size would not play a huge part in our decision-making process.

Our priority when assessing those instruments is rather the quality of the issuer and the structure of the instrument, including the trigger point, the capital cushion above the buffer, the write-down mechanism, duration and structure (AT1 or T2 host). Our preference remains for structures with a recovery mechanism (be that a temporary write-down mechanism or equity conversion versus permanent write-down).

**Hoarau, CACIB:** Triggers as a percentage and distance to trigger are key parameters. Even more important is to look at them in absolute terms with the balance sheet in front of you. You can better assess the risk of burning through the buffer and triggering a write-down. But yes, the issue size is also critical to the liquidity of the bond, and more importantly the size of the deal has an impact on the performance of the instrument in the secondary market. So it should also be taken into account when modelling the valuation of the instrument. The market recovered from the wobble experienced mid-March after some hybrid capital new issues performed poorly after pricing. And that was the result of the size of the print versus the coupon offered. Too big and too tight, perhaps!

> In the end these people can have a big impact

When we brought the CASA euro/sterling AT1 transaction to the market, one of the objectives imposed by the funding management team was to protect the performance of the transaction in the secondary market. The sizing strategy was therefore designed around that and I think sticking to £500m and Eu1bn was key for the overall performance of the trade even if we could have easily printed a much bigger trade.

### What structural features do you prefer or consider key? And are there any you think are underappreciated?

**Alloatti, Hermes:** The so-called Maximum Distributable Amount (MDA) is very important, and if you look at some transactions then you may get the feeling that this aspect is underappreciated by the market.

And I would add in respect of that two aspects that are very important and should also be borne in mind: first, the attitude of management vis-à-vis the bondholder and vis-à-vis the equity holder; and second, the attitude and the track record of the regulator, because in some tough situations the regulator could actually swing the pendulum towards one side quite easily.

You really have to look at the management's track record in terms of putting the shareholder or the bondholder first, or the other way around, in recent decisions. And also look at the track record of the regulator because in the end these people can have a big impact. I'm thinking of the FSA in Denmark increasing the RWA requirement for Danske Bank to the tune of 100bp, or the UK PRA taking a selective approach to the implementation of the Leverage Ratio, or the Swiss imposing additional RWAs for operational risks at UBS. And I don't expect those to be the last examples of this type of regulatory intervention.

Also — to complement the answer — the distance to trigger is important. Some people are suggesting the distance to trigger is so far away that these instruments basically are non-CoCo, i.e. straightforward bonds with a tail risk attached in the form of massive systemic loss and a triggering of the bonds. But we don't feel this is an academic debate.

**Huggins, GLG:** We greatly prefer equity conversion triggers to write-down structures because we think it aligns the interests of issuers and shareholders with those of bondholders. There are a number of scenarios one can construct where a write-down structure perverts the normal hierarchy of capital, i.e. if a bank is close to a trigger on a write-down structure, then management might want the situation to deteriorate in order to bail in junior bondholders, or CoCo holders, without equity shareholders being diluted.

**Alloatti, Hermes:** I think it is a question of taking them on a case by case basis, because, for example, the Société Générale write-down, write-up is to some extent different from the Crédit Agricole write-down, write-up. Philosophically and speaking generally, perhaps equity conversion is better because you have a little bit of upside.

But then also it depends on what the floor on the share price is, if there is some type of pre-emption right for the current shareholders, and if it is converted 100% equity or if there is a combination of cash plus equity. There are a lot of elements that need to be considered.

### Were both equity conversion and write-down open to you? And if so, why did you choose what you did?

**Holm, Danske:** I would say that, in respect of regulation, all the options were available to us. But the bank has been very clear in this respect, that we would like to deal with this as a

debt-like instrument and to separate the elements of this from the shares of the bank.

**Regarding bookbuilding and order inflation, is a $25bn order book and 1,000 investors involved a healthy development?**

**Huggins, GLG:** You can't read a huge amount into it. There will always be an inflated order book for a bond where there is anticipated to be new issue premium — there's never a shortage of investors who want free money!

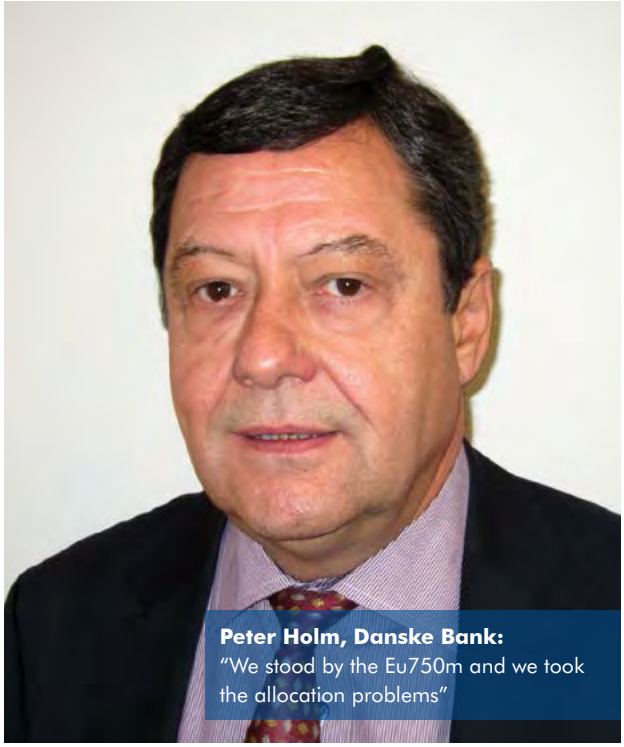
Our concern on inflated order books is that obviously it persuades issuers to push the terms to a point where there is no longer value, so investors just have to be disciplined about not following the crowd too much and ensuring that they know when to stay in and when to come out of an inflated order book. In some of the more recent deals that have subsequently struggled in secondary, perhaps the size of the deal was influenced by the size of the order book, and that weighed on its secondary performance.

**Van Sante, Pioneer:** While overhang was not a major issue for us in the first deals that were issued in the market, we are obviously becoming more concerned at the size of the books and inflated orders. Part of it is a welcome increase of real money investors in the investor base, but the somewhat disappointing performance of the most recent deals — which were many times oversubscribed — shows there is still a very high proportion of inflation and some faster money in the books.

**Hoarau, CACIB:** If you are referring to Crédit Agricole's inaugural AT1 and its record order-book of $24.5bn, the answer is yes, it is manageable, but it is not healthy at all. The total book size is completely misleading and it is a real challenge to appreciate the level of inflation and the level of real demand for the security. As Elisabeth said, there are lot of fast money investors on board. On the one hand you want to zero them all to best protect the secondary market performance, but you can't discriminate too much. So in the end it is just a question of how you make everyone equally unhappy while favouring smart and real money accounts. But more annoying is when an issuer decides to upsize a deal because the book looks many times covered. And in that respect I like very much Chris's comments on investor discipline!

**Alloatti, Hermes:** I can understand why some books get oversubscribed so fast, given that there is in general in the market a hunt for yield and we have basically no issuance out of the old-style securities, the old Tier 1s, for obvious reasons. But at the same time when you see the books on some recent deals being more than 10 times covered then of course you start asking yourself some questions. There is a little bit of froth in the market, to put it politely.

**Holm, Danske:** I don't think we have ever had a roadshow



**Peter Holm, Danske Bank:**
"We stood by the Eu750m and we took the allocation problems"

where we have seen interest to the extent that we saw for our AT1 roadshow. And when we opened the book we knew that even if we were out there simultaneously with Santander, there was great interest in this. I think we stood at Eu17bn at one point in our bookbuilding before we reduced the coupon to 5.75%, and then some investors left the book, and we ended up at some Eu13bn with some 700 accounts.

Was this a problem? I don't think it is a problem that you see investors showing such an interest in the credit of your bank, in the instruments you are offering. But of course it leaves the syndicate and at the end of the day also the issuer with an allocation issue to deal with.

**Is it hard to judge the right size in light of the demand? And what guidance did you give on size, if any?**

**Holm, Danske:** We will normally guide investors as to what we intend to do, and in this case we indicated that we would do a benchmark issue, which in our terminology is at least Eu500m. But we also gave guidance that investors should not expect us to do a jumbo. So I think investors who saw us on the roadshow had a fairly good idea that this was going to be an issue in the amount of Eu750m. There might have been some investors believing that we would drive that to Eu1bn, but Eu750m was what we had internally been aiming at, and that was what we stood by when we did the deal — even if it would obviously have eased the allocation process a little if we had done a bigger issue. So we stood by the Eu750m and we took the allocation problems. And I think the fact that we stood by Eu750m, and we had a quality book, can be seen in the aftermarket of the issue, which was relatively good compared with some of the competing supply.

**Vincent Hoarau, CACIB:**
"Investors are soberer, more selective and price sensitive"

### Spanish national champions now trade very close to UK names in AT1 — are you surprised at this?

**Armada, Banco Popular:** It is no surprise. It is only the speed of the economic upturn that is surprising. We're at the point when recovery is translating into figures at a pace much higher than expected. As an example, revised Bank of Spain projections for 2014 are 1.2% for GDP and 1.1% for private consumption, while just a few months ago we were expecting a quite weak recovery. This will also bring closer the end of the Spanish banking restructuring, from which we will come out strong and maintaining our recurrent profitability.

In this context, the appetite for Spanish assets that started to pick up around November 2013 is also accelerating. We are seeing inflows basically in all asset classes, and I think the AT1 category is a very attractive recovery play.

### Do you feel investors are being too indiscriminate resulting in too flat pricing across credits?

**Huggins, GLG:** Our concern on inflated order books is that obviously it persuades issuers to push the terms to a point where there is no longer value, so investors just have to be disciplined about not following the crowd too much and ensuring that they know when to stay in and when to come out of an inflated order book. In some of the more recent deals that have subsequently struggled in secondary, perhaps the size of the deal was influenced by the size of the order book, and that weighed on its secondary performance.

### Some exceptions apart, most of the trades so far have shown a tremendous performance in the secondary market. Is the current liquidity situation the main theme in the spread tightening across asset classes?

**Van Sante, Pioneer:** Without doubt, high cash balances and a search for yield resulted in significant spread tightening for most of the AT1/CoCo deals launched last year. However, the performance of recent deals has been quite mixed given tighter valuations and greater supply. A heavy supply pipeline is likely to lead to a far more selective approach amongst investors over the coming months, notably as MDA considerations become mainstream. The difference between banks that have front-loaded that risk and others is not yet reflected properly in valuations so we would expect more differentiation going forward.

**Hoarau, CACIB:** Credit investors are sitting on mountains of cash and are eager to increase credit, spread and duration risk because they are all convinced that the normalisation of credit markets and the convergence across assets classes will continue. So the expectation of further spread compression is pushing everyone to get involved in the AT1 market. As said before, in a very low interest rate environment when you are a portfolio manager you can hardly afford to miss out on the juicy coupons being offered by top tier European financial institutions. And when you get disappointed in allocation in primary you complete your investment in the secondary market. So, it is not a surprise to see most AT1 deals performing well off the break.

### What explains the poor performance of some of the deals?

**Robelin, BlueBay:** As always, when a market has just rallied 10 points, you end up with a dynamic of investors chasing the market, and perhaps those who did not participate at the start of the rally suddenly feel that they need to start getting involved. This usually means they end up buying deal structures that are ever more aggressive and less favourable for investors, buying at valuations that are ever more stretched.

And remember initial valuations are important for two reasons in AT1: they are important because this is the headline coupon you are being paid; it's also important because the reset of the coupon is based on the initial spread, and so if a bond was allowed to come at the top end of the range in price, low end of the range in coupon, and then you move back to the middle of the range, it makes it far more likely that this bond will not be called at the first call date. In other words, the call option that you have sold to the issuer as an investor — i.e. the option to call the bond typically every five years after the first call date — is far more valuable because the coupon reset is that much tighter.

So from that standpoint you have to be particularly careful to not buy new issues at the top of the market, and maybe the deals you are referring to performed poorly specifically because of that dynamic. On the back of a 10 point straight line rally

in this space, more and more investors who are not natural investors were getting involved. That is typically a sign that the market is due for a little bit of a correction and when there is a correction it's always the most recent deals that came at the most challenging valuations that will tend to perform the worst, having been allocated to new entrants who are less naturally biased to buy the asset class, and being the deals with the least favourable structures.

### Do fundamentals justify the performance of AT1? Should we expect a correction at some point, such as AQR?

**Van Sante, Pioneer:** The European banking sector is undoubtedly on an improving path and the pressure to de-risk and rebuild capital will persist until the results of the AQR/BSA (Balance Sheet Assessment) are released. In this context, some of the spread tightening we have witnessed has been justified by improving fundamentals.

However, we believe that some AT1/CoCos are now looking a little rich, and given the compressed nature of the market we are moving up in quality. We try to consider valuations in the context of the broader IG/HY market as well as an issuer's full capital structure.

**Hoarau, CACIB:** We already observed a correction move in mid-March after some issuers pushed it too far in primary and deals underperformed off the break. But markets recovered quickly. Nevertheless, since then investors are soberer, more selective and price sensitive. Inflated orders in order books have not disappeared, but things are getting more reasonable. Valuations in the AT1 segment will remain very volatile, anyway, because at current levels you see more and more buy-side accounts that dislike AT1. But I have to admit that most of the time those same investors end up buying because they are forced to do so.

In the end, fundamentals do not justify the level of performance. Current valuations reflect the fact that market participants are trading the levels of liquidity in the market and the negative net supply across asset classes. And this is one of the main drivers and supportive factors out there in my opinion — together with the yield offered by the asset class, relative to others, of course.

The main question is where do you put the floor in AT1? A way to approach the question could be to look at the high yield index, because in the AT1 segment we have investment grade issuers issuing non-investment grade instruments. And, as Raphael suggested before, you will see that there is still much room for performance. But we will continue to have some periods of indigestion and congestion on the back of oversupply.

In the end, I think the real correction might happen in the second half of the year when people will start focussing on the AQR and stress tests. A failure could theoretically lead to the write-down of an AT1 instrument and if investors were to anticipate that, you could see the appetite for the product becoming much more volatile and investors getting very selective.

**Huggins, GLG:** Probably the more macro volatility there is, then the more investors will congregate around the stronger structures and the better credits, and that will probably drive dispersion.

In terms of events on the horizon to worry about, yes, I think the AQR is definitely one, but more generally Europe is very vulnerable to a deflationary shock right now, and some of those economies are more vulnerable than others. We think that's something that all investors should bear in mind when they are underwriting a deeply subordinated, high trust instrument from a levered issuer with a mid-single digit yield.

**Robelin, BlueBay:** AQR will definitely have some impact because clearly for European banks it's one of the key game-changers for this year. I suspect that there is as much possibility that it will have a positive impact as a negative impact, because I don't see many banks who are particularly at risk of failing the stress tests having AT1 bonds outstanding. The single biggest risk to AT1 instruments in our opinion is the non-payment of a coupon and the rules around stopping distributions by banks will only go live on 1 January 2016.

**Alloatti, Hermes:** The AQR does play into our strategy in the sense that we may expect some issuance of AT1 hosted CoCos because some banks may have to resort to the public markets in order to increase their capital, even before the results of the ECB Balance Sheet Assessment are published — some banks said to us that they have been told to raise additional capital by their own regulators. And as long as raising capital through CoCos is tax efficient in terms of coupon deductibility, and non-EPS penalising, it is quite attractive from a corporate finance point of view to have 1.5% of RWAs in AT1 and the finance directors of these banks may see an opportunity to tap the bond market as opposed to asking shareholders for more money. So that's how it could impact the supply.

> Given the compressed nature of the market we are moving up in quality

For the investor, or course, the question we ask ourselves — and which is very difficult to answer — is how much supply there will be and whether it is digestible. Recently, for example, we had the Lloyds exchange, which resulted in an additional £5bn of AT1s on the sterling market. So we are constantly monitoring the situation to see if there is too much coming into the market too quickly.

But more generally I think there is an important point to be made, which is that in the context of similar securities, be they financial or corporate, with a similar volatility, it is not obvious to us that these CoCos have outperformed. If you compare the performance of CoCos against the share prices of their issuers, then you can find some unexpected answers. So for us the

question, do fundamentals justify the performance, actually we think this should be the other way around.

And regarding whether we expect a correction at some point in time, for us the relevant question is how the space will perform when we eventually have the first case of a security having the coupon switched off.

These securities have been spread so broadly across the market — you have hedge funds involved, real money investors, private bank investors, and you even have individual retail invested — and an important point is that the buy-side's response in a coupon switch-off event will be very difficult to predict.

We can take some examples from the past: we had some German issuers in the so-called old-style securities that were Basel II-compliant — with the dividend stoppers and pushers that are prohibited under CRD IV — and French insurance company Groupama switched one coupon off on its Tier 1. The market reaction was quite severe and the bonds went down by some 10 points in a trading session — that was because the market was discounting a situation where coupons were switched off for many years, which turned out not to be the case.

### To what extent are rating constraints a factor in AT1?

**Alloatti, Hermes:** Ratings are market relevant, and we take them into consideration, but they are not the principal driver that governs our investment decision.

**Van Sante, Pioneer:** Ratings — whether the bond is non-rated or high yield — can be an issue for some specific funds, but we have quite a lot of flexibility across most of our funds to take off-index positions. Also, we rely more on internal ratings rather than those of the agencies. We put a lot more emphasis on the investment case, the structure of the CoCo or the distance to trigger and relative value. Linked to this, the inclusion of such instruments in broad credit indices could help those instruments become mainstream.

> The buy-side's response in a coupon switch-off event will be very difficult to predict

**Robelin, BlueBay:** The one investor base where the rating constraint is real is the investment grade fixed income space. To me, it is questionable whether this is a natural asset class for an investment grade bond fund, because again, as I mentioned earlier, banks have the option to turn off the coupon at any moment. The regulator also has the option to turn off the coupon at any moment. The coupon is non-cumulative so this income is lost forever. Banks also have the option to make these instruments perpetual, and while some transactions have been designed more favourably — i.e. if they are not called after the first call date then the coupon is reset for five years, and only callable again five years later, other transactions have been issued to the market where after the first call date there is a mismatch between a coupon that is reset for five years but then from the first call date the instrument is callable every three months, which I think will be a nightmare for bond funds because then you don't know the interest rate duration of the instruments. That will make it quite difficult for institutions to own this type of paper.

The vast majority of the universe is rated high yield so if you are ratings sensitive it doesn't really make sense to get involved. But also, to me one of the single biggest risks is that there will be from time to time one or two bonds where there is a suspension of coupon payments because the bank needs to raise capital and then the bank does raise capital and then coupon payments are resumed in due course. The problem is, with the methodology that ratings agencies employ, whether you just miss a coupon payment, even though it is in the docs that you have the right to skip coupons, or you default, it's the same outcome. The issuer would be downgraded to single-D. So if you are ratings sensitive, between the risk of changes of methodology that we currently see with S&P and the risk of a straight downgrade to single-D as soon as one coupon is missed, to me you would have to be extremely brave to be very active in this space. I think it only makes sense to be active in this space if you are not ratings sensitive and if you have full flexibility to invest across the ratings spectrum.

The other aspect is to what extent these bonds will eventually make it into the fixed income indices. Right now most of these are high yield rated, so I think that therefore there is pressure from high yield investors to buy them, less so for investment grade investors. In due course, as banks improve their profile and as the asset class becomes mature, will there be pressure for rating agencies to move a lot of these bonds to an investment grade rating, and will they be eligible for index inclusion? This is very much what we saw with the old-style Tier 1 bonds that started to come to the market in the late 1990s, entered the indices in the early 2000s, and became very much a mainstream asset class for investment grade investors over the following few years after index inclusion.

### German investors have proven reluctant to buy any type of loss-absorbing fixed income instrument, while German issuers have been absent from the AT1 market. Is this frustrating?

**Van Sante, Pioneer:** Clearly it would be better to have German investors participating in this market, but liquidity seems to be improving given that the investor base is growing significantly in many other jurisdictions. However, now that tax-deductibility on coupons has been agreed for German AT1s, it is only a matter of time before Deutsche Bank hits the AT1 market and likely brings with it German investors to this market.

**Hoarau, CACIB:** It is a bit frustrating. But Germany lagged

behind in putting in place the tax framework and deductibility for this new generation of loss absorbing contingent capital trades while, so far, the bulk of the supply has come in US dollar-denominated format. And as euros becomes established and the German authorities have sorted out the legal and tax issues we will see the first German AT1 transaction. This will force most of the reluctant German investors to get involved. It is mainly a matter of time. But I also believe it is a matter of education.

**Robelin, BlueBay:** I do think that a Deutsche Bank AT1, for example, could be potentially interesting to German retail. But again, it will depend a lot on how the deal is structured and marketed including details like the minimum lot size for example. Having access to Deutsche Bank at a high single-digit coupon could be appealing to German investors.

On the institutional side, I still think that the level of demand is questionable. First of all, as you know, the capital treatment for that type of investment is becoming quite penal, so for other banks or for insurance companies AT1s are very expensive to hold in terms of capital usage. So this is why again I think so far it has been primarily hedge funds, private banks, and to some degree asset managers who have been buying them. So it is not necessarily obvious to me that the level of institutional demand for a Deutsche deal would be a game-changer. I think it really depends whether they want to tap the German retail market or not.

### Do you already have further plans in AT1 for 2014, or any intention to diversify in currency and build up your curve?

**Armada, Banco Popular:** As one of the first players in this market, we probably maintain a high profile for most of the investor base, so a follow-up transaction would benefit from Banco Popular's inaugural AT1 success. We would like to build our T1 buffer well in advance, but we cannot anticipate if it would take place in 2014.

We could go for longer tenors and other currencies, but we are currently keener on sticking to euros. The final decision should be taken in line with Banco Popular's strategy and targeted capital structure.

**Holm, Danske:** I would say that if we'd had any actual plans for doing AT1 in the immediate future, we should probably have availed ourselves of not only Eu750m, but perhaps done Eu1bn, which investors probably would have liked to have seen. So we presently have nothing on the agenda in AT1. But as for what the future will bring? Well, we will probably be back at some point in time.

### How do you anticipate your activity for the rest of 2014 in the CoCo space?

**Van Sante, Pioneer:** We will be active but highly selective in this market — we will maintain a quality bias — focusing on high quality investment cases and good quality structures.

**Filippo Alloatti, Hermes:**
"It is not obvious to us that these CoCos have outperformed"

**Robelin, BlueBay:** We at BlueBay are in the process of launching a dedicated CoCo fund to take advantage of the opportunities in this space, because we think that banks are one of the improving sectors. They had a terrible time during the 2008 crisis, but it is our experience that the sector that has the worst crisis the previous time around very often has a much better crisis the next time around — telecoms, being the sector under pressure in 2002 and then subsequently faring far better in 2008, is a typical example of that dynamic. With banks, I suspect this will be amplified by the fact that not only did management teams have a shocking crisis and would typically learn from that, or get replaced, but so did the regulator, so the regulatory environment is changing dramatically. The pendulum is going from one extreme to the other in terms of oversight. So banks are going to become far more utility-like in our opinion, the volatility in quarterly earnings is going to be a fraction of what it used to be. For a creditor, this is good news.

And so I think that this is clearly one of the key selling points for this new family of hybrid instruments, which are giving you attractive coupons when the underlying credit risk will improve over time. So the extent to which we see a growing investor base, as asset managers come to this same conclusion, and further dedicated funds are launched, will be key to the success of the asset class. This is the only dedicated money that I can see right now that when the market goes down will have a bias to buy more instead of thinking: "Ouch! This is not my core universe, my benchmark doesn't have these bonds, I don't have a bias to own them. I'm a hedge fund, or I'm managing against the investment grade index. I want out." ●

# Germany
# Ministry clears tax treatment of AT1 capital

Germany has been notable by its absence in the burgeoning market for Additional Tier 1. But a key obstacle has been removed thanks to a letter from the Federal Ministry of Finance.

*By Florian Lechner, partner, tax, Linklaters LLP*

On 10 April the German Federal Ministry of Finance issued a circular letter clarifying the tax treatment of Basel III-compliant hybrid regulatory capital, so-called Additional Tier 1 (AT1) instruments. The position taken by the Ministry is mostly favourable for banks, in particular as it treats the AT1 instruments as debt, which allows for the tax deductibility of coupons.

The Ministry's release was keenly awaited in the market. Many German banks have waited to issue AT1 instruments until tax treatment became clear, putting them at a disadvantage to, for example, banks in the UK, where the legislator had earlier passed specific rules to ensure favourable tax treatment.

Germany does not have specific legal provisions dealing with the tax treatment of regulatory capital. Under the old CRD II rules, AT1 instruments could be structured as debt for tax purposes, which allowed for favourable tax treatment. The requirements for Basel III-compliant instruments are, however, much stricter, which led to the question whether the new instruments could still be seen to be closer to debt than equity for tax purposes. Under the new rules, AT1 instruments must, for example, be truly perpetual, interest can only be paid out of "distributable items", and losses of the issuer must be absorbed either through a write-down of the principal ("Write-down Instruments") or a contingent conversion of the instrument into shares of the issuer ("CoCo Instruments").

Based on model terms released by the Association of German Banks (Bundesverband deutscher Banken) for both Write-down and CoCo Instruments, the Ministry has now taken the following positions:

## Recognition as debt item in the issuer's tax balance sheet

Most importantly, the Ministry confirms that AT1 instruments are — despite their perpetual nature and

"We welcome today's release by the Federal Ministry of Finance of the long-awaited administrative rules governing the tax treatment of banks' so-called Additional Tier 1 capital instruments. Now, as in other countries, there is a tax framework in place for banks in Germany, too.

"This gives German banks the legal certainty they need to protect themselves against crises by raising Additional Tier 1 capital in the form of bonds that can be converted into shares or contain write-down mechanisms."

**Michael Kemmer**, general manager of the Association of German Banks, responding to the Ministry's letter, 10 April

*Photo: Marc Darchinger/ Bankenverband*

their participation in losses of the issuer — to be recognised as debt items in the issuer's tax balance sheet. This is irrespective of potential equity treatment of the instruments for commercial accounting purposes. A de-recognition would have led to fully taxable cancellation of debt income in the amount of the instrument's principal and hence have been prohibitive for the use of such types of capital.

### Tax deductibility of coupons

The coupon on AT1 instruments is tax deductible as regular interest expense. There were concerns that the combination of perpetuality and the requirement to pay interest only out of distributable items could lead to the non-deductibility of coupon payments. The Ministry has now confirmed that the favourable treatment of CRD II-compliant instruments will not change for instruments issued under the new rules.

### Withholding tax on coupons

As is the case for every debt instrument issued by German banks, coupon payments are generally subject to German withholding tax, which can be fully credited by German tax resident investors. For both types of AT1 instruments held by foreign investors the Ministry confirms that no such withholding obligations apply. This is most important for tax exempt foreign investors like pension funds for whom the German withholding tax would otherwise have resulted in a definitive tax leakage.

### Taxation of write-down and conversion

The views taken by the Ministry as regards the taxation of the loss compensation through a write-down (in case of Write-down Instruments) or a mandatory conversion into shares of the issuer (in case of a CoCo Instrument) are less favourable.

In case of a write-down, that Ministry holds that the write-down amount leads to a fully taxable gain at the level of the issuer. Correspondingly, if the terms of the instrument provide for a write-up in case of a future recovery of the issuer, this leads to deductible expenses.

As regards the conversion of CoCo Instruments, this shall only be tax neutral for the issuer to the extent that the AT1 instrument is not distressed. If a bank has, for example, issued a CoCo Instrument with a nominal value of 1,000, the


Florian Lechner, Linklaters, Frankfurt

fair market value of which has decreased to 600, a conversion of the instrument would lead to taxable profit in the amount of the difference between 1,000 and 600, i.e. 400.

Although in this respect the German tax treatment is less beneficial than, for example, instruments issued in the UK, where both the write-down and the conversion are tax neutral, this will in practice often not lead to an actual cash tax burden of the issuer, as in a loss absorption scenario it will likely have ongoing tax losses against which the taxable profits can be offset. It is, however, important to note that tax loss carry forwards from previous years can only be offset against up to 60% of current profits, so that pure tax losses from the past are not sufficient to fully shelter against profits from write-downs or conversions.

### Application only to banking association's model terms

The Ministry's circular letter explicitly only applies to AT1 instruments in line with the model terms released by the Association of German Banks. The circular letter is not binding for instruments with deviating terms. Certainty regarding the tax treatment of such instruments can only be reached through an advance tax ruling by the competent tax authorities, which is time consuming and subject to significant administrative fees. ●

# Southern European champions make their mark

After a debut AT1 for UniCredit in late March at least one top tier issuer from each of Italy, Portugal and Spain has tapped the burgeoning Basel III-era market for hybrid bank capital. But with regulatory questions remaining and the ECB's AQR in focus, further supply from the countries may emerge only gradually. *Susanna Rust reports.*

Issuers from Europe's southern periphery have played a leading role in the AT1 craze sweeping through debt capital markets this year, with national champions Banco Santander and UniCredit each making their Additional Tier 1 debuts in March — albeit catching the market in contrasting moods.

Santander's deal captured the frenzy in the market well. Nearly a year after Banco Bilbao Vizcaya Argentaria (BBVA) became the first European bank to sell a Basel III-compliant AT1 issue, Santander was one of three banks that helped turn the first week of March into the busiest week yet for European hybrid issuance.

It priced a Eu1.5bn perpetual non-call five issue on 5 March alongside an inaugural AT1 for Danske — making it the first time that more than one issue has hit the market on the same day, and doing so after Nationwide Building Society had a day earlier opened the sterling AT1 market.

As such, Santander's deal was one of a medley of transactions that, in the words of one observer, "blew away any doubts about the momentum in the nascent Additional Tier 1 market", meeting with strong demand despite the variety of formats and loss triggers.

In Santander's case, an upgrade by Moody's, from Baa2 to Baa1, was a welcome development the day before the transaction ended up being launched, as was a recovery in market sentiment after the flaring up of the Ukraine crisis in the Crimea.

Providing for loss absorption via trigger-based equity conversion — the same format used by BBVA and Banco Popular Español — the CoCo drew orders totalling Eu15.1bn, with more than 640 accounts involved.

The deal — which converts to equity if CET1 falls below 5.125% — was priced at 6.25%, the tight end of guidance of 6.25%-6.50% and initial price thoughts of mid to high 6%.

Santander's transaction completed a round of AT1 capital raising by Spain's national champions, with BBVA having already priced two deals — its April 2013 landmark, in US dollars, and a euro issue in February this year — and Banco Popular in October having shown the market to also be open to representatives of the country's second tier of banks.

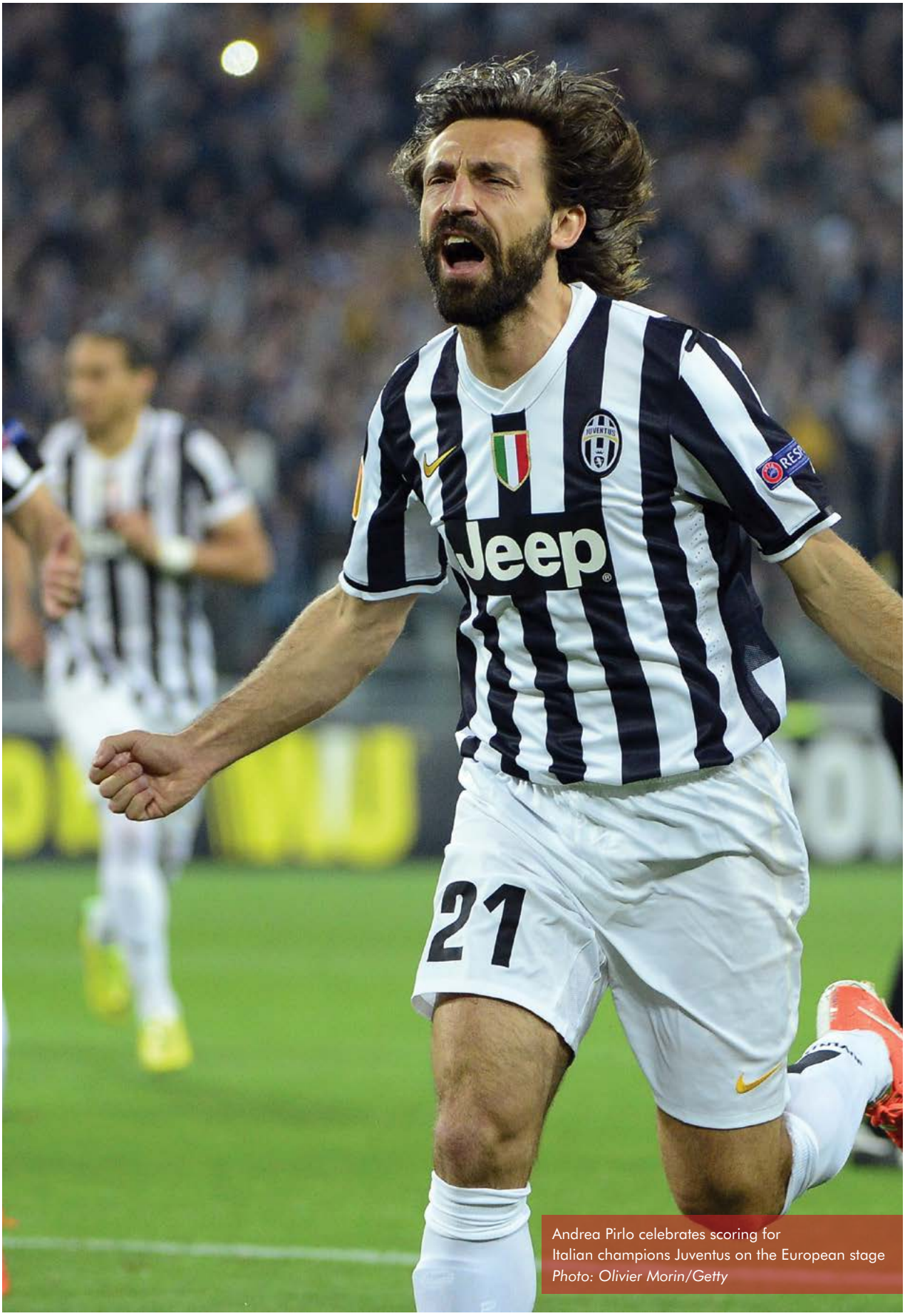
Further Spanish supply this year is expected to more likely consist of Tier 2 transactions than CoCos, as uncertainty about the full regulatory recognition of AT1 with a write-down format remains unresolved.

This is particularly relevant for unlisted issuers, for whom equity conversion is not an option, according to Avelino Abellás, executive director, DCM at Crédit Agricole CIB.

"Be it on an official or private basis, everyone is waiting for the Bank of Spain to clarify its position on write-down structures," he says.

Being held up by uncertainty about the tax treatment of a debt write-down is an experience that banks in several other European countries have faced. There are also some jurisdictions where the tax treatment of AT1 instruments of any type is still being clarified, with Germany the latest where tax-deductibility of coupon payments for AT1 instruments has been announced.

While further AT1 supply out of Spain could be stymied




Andrea Pirlo celebrates scoring for Italian champions Juventus on the European stage
*Photo: Olivier Morin/Getty*


**Banco Popular Español:** Its AT1 traded up 16%-17%

by the lack of regulatory clarity, no such impediment exists for Tier 2 issuance and deals of this kind are to be expected, according to Abellás.

"There are no such doubts about Tier 2 and the market is definitely there," he says, adding that some issuers are also mindful that issuing Tier 2 instruments before making their AT1 debuts could make pricing the latter easier.

BBVA priced the first Spanish Tier 2 of the year, on 2 April, a Eu1.5bn 10 year non-call five transaction that was priced at 255bp over mid-swaps with a 3.5% coupon on the back of more than Eu7bn of orders from over 400 accounts.

Crédit Agricole CIB bank analyst Gwenaëlle Lereste says that Spanish banks will gradually increase their AT1 and Tier 2 issuance to meet regulatory requirements by 2016, and that in the case of Santander this should amount to Eu12bn-Eu15bn.

Abellás says that most Spanish issuers are well capitalised, but also that market conditions are very attractive, which has pushed some issuers to tap the market earlier than one would have expected.

"Most issuance has been opportunistic as the market is pretty receptive at the moment," he says.

Indeed, those issuers that tapped the AT1 market more recently have benefitted from the expansion of demand for the asset class, fuelled by a hunt for yield. Banco Popular's AT1, for example, was trading at 16%-17% higher at the time of writing, while BBVA recently priced its euro AT1 in February at a coupon of 7% following its inaugural, 9% dollar AT1 in April last year.

And Erik Schotkamp, director, capital and funding management at BBVA, said that expectations of further improvements partly explained the bank choosing a five rather than 10 year call in its euro AT1.

"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," he said, "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."

Abellás says that individual banks' issuance plans could be affected by the ongoing Asset Quality Review (AQR) being conducted by the European Central Bank, although in general Spanish banks should be in a comfortable position as they already went through Oliver Wyman stress tests last year.

"That being said, the AQR conditions are only being revealed bit by bit and it is still a pressing matter," he says.

## Portuguese await AT1 decision

In Portugal no issuer has followed up on a Eu750m 10 year non-call five Tier 2 issue from Banco Espírito Santo in November last year, and investor appetite for CoCos from the country's banks remains untested. BES's deal was the first sale of subordinated debt capital from a Portuguese bank in some four years.

Filomena Oliveira, investor relations, at state-owned Caixa Geral de Depósitos, says that there is lot of uncertainty about how the AT1 instrument will be treated by the authorities, including the tax treatment of write-downs, with the central bank yet to make clear its position.

"We know that this is a topic being discussed, but I believe Caixa Geral de Depósitos by a bank to issue the instrument," she says.

Another source of uncertainty for Portuguese banks is how deferred tax assets (DTAs) will be classified, according to Cyril Chatelain, DCM, capital structuring and liability management at Crédit Agricole CIB.

> Most issuance has been opportunistic as the market is pretty receptive

DTAs are excluded from capital under Basel III, but in Italy and Spain banks received a boost when they were reclassified as claims on the government. Chatelain notes that under the Capital Requirements Regulation (CRR), DTAs are deducted from core capital.

"Phasing-in of deductions may somewhat alleviate the impact on reported solvency ratios," he says, "but investors' focus is on fully-loaded ratios and Portuguese banks' solvency may pale when compared with some of their European peers ahead of the AQR stress tests and as the country's economy remains weak."

Chatelain notes that Portuguese bank equity prices fell sharply in January after Portuguese news agency Lusa reported that the Portuguese finance ministry had decided not to allow DTAs to count as government tax credits.

**Caixa Geral de Depósitos** does not expect to be adversely affected by the stress tests

The ministry subsequently said it was still discussing the matter, with an analyst viewing the negative share price reaction as suggesting that "there will be something rather than nothing" for the country's banks.

Oliveira hopes that a decision will be forthcoming soon, noting it will have an important impact as Portuguese banks hold a considerable amount of DTAs.

Caixa Geral, for one, does not anticipate needing to raise capital, straight or hybrid, this year, according to Oliveira. She notes that the bank has a Common Equity Tier 1 ratio of 7.4% on a fully-loaded Basel III basis, thereby exceeding the 7% minimum requirement, and that this will be boosted by 1.8 percentage points once the proceeds from a sale of its insurance business are booked.

Notwithstanding uncertainty about the outcome of the ECB's AQR, Caixa Geral considers itself to be in a comfortable capital situation and does not expect to be adversely affected by the stress tests, says Oliveira.

Fitch in December said that asset quality deterioration, the largest risk for Portuguese banks, is likely to lessen this year, pointing out that the Portuguese authorities have been reviewing the banks' loan books since 2011.

Improved capitalisation should also help the banks with the ECB assessments, according to the rating agency.

"Their core capital ratios were well above the 10% minimum required by the Bank of Portugal at end-Q3 2013, providing a buffer against credit deterioration," it said.

More recently, the International Monetary Fund in February said that the largest Portuguese banks have robust capital buffers that put them in a favourable starting position for the ECB's comprehensive assessment.

Caixa Geral had been anticipating potentially needing to issue Tier 2 subordinated capital this year to replace legacy bonds, but following an EBA announcement of a transitional period for banks in countries that are under bail-out programmes it may not do so, according to Oliveira.

As for AT1 issuance, this is not in Caixa Geral's plans at the moment, according to Oliveira, mainly because of the aforementioned uncertainty over how the central bank will treat such instruments.

Another variable in the supply outlook for hybrid capital from Portuguese banks, according to Chatelain, is how nationalised banks will repay money they borrowed from the government in the form of CoCos that convert into state-owned equity if a predefined trigger is hit.

## There will be something rather than nothing

Banco Comercial Português borrowed Eu3bn from the government on this basis, which is reimbursable by mid-2017. Banco BPI raised Eu200m in capital during 2012 and issued Eu1.5bn in CoCos to the Portuguese government, according to Chatelain.

"Both BPI and BCP have to pay back the CoCos by 2017, with BPI having already paid Eu1.1bn and being left with Eu400m that we expect should be paid back within the next 18 months," he says, "while BCP is expected to start repaying the CoCos this year."

Regarding DTAs, Banco BPI in late January identified these as holding the key to an increase of nearly Eu250m in the bank's capacity to repay state CoCos — on the assumption

**Simone Tufo, UBI:** "We see full regulatory clarity"

of a similar treatment to Spain — saying this was the largest of several "opportunities for improving core tier 1".

## 'Paradigm shift' precedes UniCredit

UniCredit opened the Basel III-era hybrid capital market for Italian issuers at the end of March with the first AT1 from an Italian bank, a US$1.25bn (Eu905m) perpetual non-call 10 featuring temporary write-down as the loss absorbency mechanism.

The Reg S deal came with an 8% coupon, having been marketed in the low 8% range in Asia and then at the 8.25% area, with bookrunners Citi, HSBC, Société Générale, UBS and UniCredit gathering some $8bn of orders for the deal.

> The market has changed and the deals after ours also had smaller books

That was a far cry from the order books built for the contingent capital transactions that preceded UniCredit's, when record levels of demand had poured in, but Waleed El Amir, head of strategic funding and portfolio at UniCredit, is happy with the response to the bank's offering given its Reg S, undated non-call 10 format and a market comedown from heady heights reached earlier in the year.

"I thought our AT1 was absolutely critical because it was the first deal to hit the market after what I see as a big paradigm shift in the market," he says. "It became clear that order books were inflated, some deals were pushed too hard and didn't trade well, and then more supply was being anticipated.

"We were very careful in the allocation of our AT1 and it traded up nicely after to demonstrate that it is about quality rather than quantity, so we are very pleased with the result."

As has been the case for many banks, UniCredit had to wait for clarity on the tax treatment of coupons and write-down as the loss absorbing mechanism before proceeding with its plans for an AT1. This was provided when legislation was passed in December 2013, leaving market dynamics and the issuer's 2013 full year financial results as the main variables in the CoCo new issue project.

"We could have issued in January but decided not to because we had a view that spreads and yields would come down as the asset class became more commoditised, and then we also had to wait until our results were out," says El Amir.

These were announced on 11 March, with the group reporting a Eu14bn loss for 2013, a result that El Amir says necessitated waiting for reactions from the rating agencies.

"We waited for the rating agencies to affirm us and then because we felt the market was in decent shape we went out," he says. "The market had sold off a bit, but we felt that there was going to be more supply and in the end I think we hit the market at a good time."

One of the hallmarks of the year in bank capital so far has been the development of the euro market, after US dollars having been in focus in 2013. UniCredit, however, opted for a dollar denominated issue, in Reg S format, to get a more challenging transaction out of the way first, according to El Amir.

"Because UniCredit is a complex banking group getting 144A documentation in place is difficult," he says. "Reg S in dollars is in our view the most difficult trade to do, and because we felt the market was there it made more sense for us to do the dollar transaction first and then in the future a deal in our home currency, euros, which will be easier to do."

He notes that the Reg S format of UniCredit's inaugural AT1 meant US accounts couldn't participate, eliminating some $5bn-$10bn of orders, and that the undated, non-call 10 structure is an investment hurdle for private banks, and that these factors need to be borne in mind when assessing the size of the order book for UniCredit's CoCo.

"The market has changed and the deals after ours also had smaller books," he adds. "The market has matured and there is a better understanding of who to give bonds to and who not to give bonds to."

## AQR prep in focus

Fitch believes other banks in Italy, most likely UniCredit's larger peers, will follow its lead and tap the AT1 market in the medium term.

"Improved investor sentiment towards Italian banks and the search for yield are positive at a time when many Italian lenders are taking actions to strengthen capital," the rating agency said in early April. "This may open up the Basel III-compliant capital securities market for some Italian banks, to

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help them meet the markets' requirement for higher loss-absorbing capital and combat capital shortfalls that might arise from the ECB's comprehensive assessment this year."

It noted that Italian lenders are behind other banks in large European countries in issuing Basel III-compliant capital instruments, but that international investor interest appears to have returned for Italian banks more broadly, with Banca Monte dei Paschi di Siena, for example, in late March having been able to price a Eu1bn five year senior unsecured issue.

Improving market confidence could help Italian banks rebalance funding profiles and strengthen capital, said Fitch, and is likely to benefit those banks looking to access equity markets.

Stefano Rossetto, hybrid capital and liability management at Crédit Agricole CIB, says that for small to medium-sized Italian banks the priority is shoring up equity levels, and that hybrid capital issuance, at least in the public market, will likely come in small sizes or at a later stage.

"The urgency is on the Common Equity Tier 1 side, and the economics are still challenging for hybrids," he says. "Some of these banks have only recently resurfaced on the FIG flow side, so moving to hybrid instruments is more difficult for them."

The outcome of the ECB's AQR will be key for this category of smaller banks, he adds, who could be more affected than the top tier of UniCredit, Intesa Sanpaolo and UBI Banca.

According to Moody's, eight of the 15 Italian banks participating in the ECB's comprehensive assessment (which the AQR is part of) recently announced plans for capital increases totalling almost Eu8bn. The rating agency said the capital increases are credit positive but that some of the banks may need to further increase provisions as a result of the AQR.

> Some of these banks have only recently resurfaced on the FIG flow side

For top tier Italian banks, meanwhile, hybrid issuance would mostly be driven by a desire to optimise capital structures, says Rossetto, with temporary write-down most likely being the standard loss-absorbing mechanism.

"UniCredit, Intesa and also UBI Banca are well positioned on a European level in terms of Common Equity Tier 1 capital and in terms of the leverage ratio," he says. "For them it is mostly about trying to use their hybrid buckets to the fullest extent."

Anticipation of asset growth, if any, and the phasing out of legacy capital instruments could encourage the stronger banks to issue hybrid capital, he adds, with better funding levels a potential additional lure.

Simone Tufo, head of capital management at UBI Banca, says that as Italy's best capitalised bank — as at December 2013 — UBI is not planning any hybrid issuance at the moment.

**Waleed El Amir, UniCredit:**
"It is about quality rather than quantity"

"We will use our current CET1, which already includes a buffer for a capital shortfall charge, to absorb AQR and Stress Test exercises," he says. "AT1 or Tier 2 issuance will be more related to the lending growth in the next five years, and will depend on internal capital ratio projections under Basel III, the pricing available and whether a balance can be struck between investor and issuer needs with respect to the structure."

He notes that following implementation of CRD IV/CRR in January and recent regulatory clarifications "we see full regulatory clarity on the types of hybrid capital instruments available", although a final decision from the central bank on the combined buffer requirement is still awaited.

In contrast to authorities in the Nordic countries and the UK, the Bank of Italy has not yet introduced public Pillar 2 requirements in the form of additional capital buffers, says Rossetto, making the national regulatory regime closer to the standard CRD IV framework.

Despite UBI not having plans for any hybrid issuance at the moment, Tufo is positive about the overall development of the market.

"Investors' interest in this new type of debt instruments is driven both by the new regulations, which define a market for this kind of instrument, and by the higher yield offered, which they of course appreciate," he says. "This will possibly drive more accurate analysis by credit analysts and more accurate pricing of risk, and consequently to an even better awareness of investments.

"I believe that the efforts by the European banking sector during the last seven years to rebuild capital buffers has helped make the growth of this market possible." ●

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