Bank+Insurance Hybrid Capital

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With CRÉDIT AGRICOLE CORPORATE & INVESTMENT BANK

Made in Germany

Hybrids revved up after Deutsche debut

Bank+Insurance HybridCapital

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How low can you go?

Correction? What correction? The Ides of March seem a long time ago now, with the underperformance of deals for the likes of KBC and Santander now looking likely to go down as a footnote in the history of the AT1 market rather than a dramatic turning point.

Witness the enthusiasm for the first AT1 transaction from Germany, a Eu3.5bn equivalent transaction for Deutsche Bank two months later, on 20 May, that was not only the largest transaction for the young asset class, but at the time the tightest yet across currencies. Can 600 investors placing 1,400 orders for Eu25bn equivalent be wrong?

Indeed, the market has only tightened since then. Credit Suisse, for example, on 11 June priced a $2.5bn 6.25% perpetual non-call 10.5 AT1 that had the lowest coupon for such a maturity structure in any currency and the tightest spread against mid-swaps for any AT1.

It did so on the back of a package of measures from the European Central Bank on 5 June that included a negative deposit rate, TLTROs and the promise of more. Whether or not this was Super Mario pulling out his big bazooka, it certainly gave credit markets renewed momentum, while across the pond Yellen's Fed has held off hitting the brakes.

Where will it all end?

Bears might point to the ECB's next act, the results of the asset quality review. More likely, this could provide an excuse for profit-taking, particularly over the quiet summer months. However, any pause in supply may only serve to provide a platform for an autumn resumption of the rally.

Cassandras might then find their patience more sternly tested than ever. Some investors have already marked out lines in the sand: 5% and no further when it comes to AT1 coupons. How realistic such a stand will be in a world where even euro high yield indices trade at a paltry 3.5% remains to be seen.

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Market news

Hopes remain high after DB, Bankia top off H1

A high pace of activity led to just over Eu31bn of euro bank capital supply hitting the market in the first half of the year, nearly 10 times that from the first six months of 2013, but plenty more is said to be in store, with Dutch and Scandinavian AT1 firsts eagerly anticipated, for example.

Euro bank capital issuance stood at Eu31.5bn at the end of June, up Eu27.9bn from comparatively measly Eu3.6bn H1 2013 volumes, as regulatory clarity and bullish markets combined to pave the way for a surge in supply this year. And this is without even taking into account deals in US dollars and sterling from European banks.


Deutsche Bank, Frankfurt

A syndicate official said that issuance volumes have already outstripped expectations, but that Tier 2 supply should increase considerably and that the AT1 market is poised to grow.

"Everyone is expecting the Scandis to come and I'm sure after Deutsche other Germans will look at the market, too, and then there are also lower tier banks that could do deals," he said. "I expect supply to continue."

Deutsche Bank opened the German market on 20 May with a three currency issue totalling some Eu3.5bn — the biggest AT1 to date. Split into Eu1.75bn perpetual non-call six, $1.25bn perpetual non-call eight and £650m perpetual non-call 12 tranches, the German national champion's landmark transaction attracted an aggregate order book of over Eu25bn equivalent, comprising over 1400 orders from more than 630 investors, leaving the issuer pleased with its multi-currency strategy.

"Given our Eu5bn AT1 target, this allowed us to take a very significant step to achieving this target with a Eu3.5bn issue while avoiding overloading any individual tranche and hence not jeopardising the secondary market performance," said Jonathan Blake, global head of debt issuance at Deutsche Bank.

Vincent Hoarau, head of FIG syndicate at Crédit Agricole CIB, noted that at the time the transaction was the tightest across currencies in spite of the record volume.

"There is always a bit of magic surrounding the Deutsche signature and the issuer made a strong statement," he said. "The outcome in terms of all-in cost was impressive and you got the feeling that people forgot about metrics.

"Other issuers will benefit from a similar situation, with strong technical supports predominating in the market."

(See Made in Germany feature for more.)

> **You got the feeling that people forgot about metrics**

The clarification of tax treatment in Germany unlocked Deutsche's AT1, and, with similar progress being made in the Netherlands, the first Dutch issue is awaited.

In Scandinavia, while Danske Bank has priced an AT1 other Nordic banks have yet to raise capital via new style contingent capital (CoCo) instruments. Swedish banks have, nevertheless, been active in the Tier 2 market this year, most recently SEB with a Eu1bn 12 year non-call seven deal at the end of May. *(See separate Market News article.)*

The syndicate official said he does not expect weaker issuers to have difficulty accessing the hybrid capital market, noting that a Banco Popular Español AT1 is trading at 6% after having come at 11.5% in October.

"The performance has been incredible," he said. "As long as you pay a decent concession you can do deals."

The potential for financial institutions away from national champions to tap into the bullish subordinated debt market was amply illustrated by Spain's Bankia in May when, one year on from having bailed in junior bondholders following its bail-out, it was able to raise Eu1bn of Tier 2 debt in the form of a 10 year non-call five issue priced at 316bp over mid-swaps.

"What happened with Bankia was quite spectacular," said a DCM banker. "They went through a rights issue where the existing shareholders were almost wiped out and then the Tier 1 and Tier 2 bondholders were bailed-in.

"But since then they have been able to return to the markets and issue this subordinated debt." *(See Q&A for more.)*

Further supply could also come from some of the more developed countries for Basel-III compliant capital instruments, according to market participants. French national champions Crédit Agricole and Société Générale have already played a leading role in AT1 issuance, but BNP Paribas is now being touted as a likely issuer in the wake of a fine of almost $9bn (Eu6.6bn) by the US authorities announced at the end of June.

"The French bank should weather the near-$9bn fine for breaching US sanctions with proscribed states — and may even be compelled to issue attractively-priced debt in response," said Filippo Alloatti, senior credit analyst, financials, at Hermes Fund Managers.

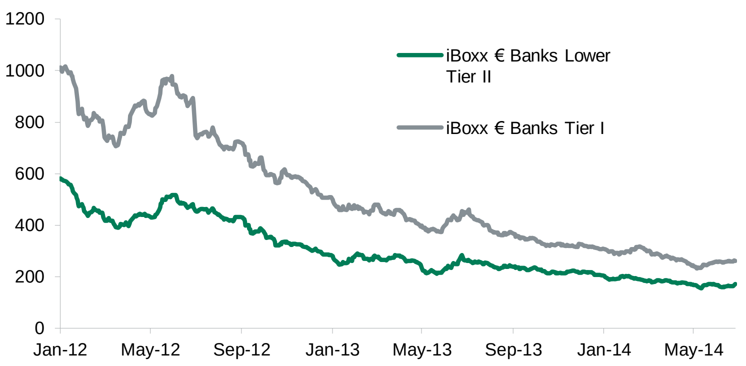
In a sign that the bank capital market is maturing, deals priced later in the first half of the year are not trading as high on a cash basis as those from the first quarter, according to the syndicate banker.

"The AT1s from the beginning of the year have rallied dramatically and apart from a couple of deals are trading above 104 or in that area," he said, identifying a Nationwide Building Society sterling and a KBC euro deal as exceptions.

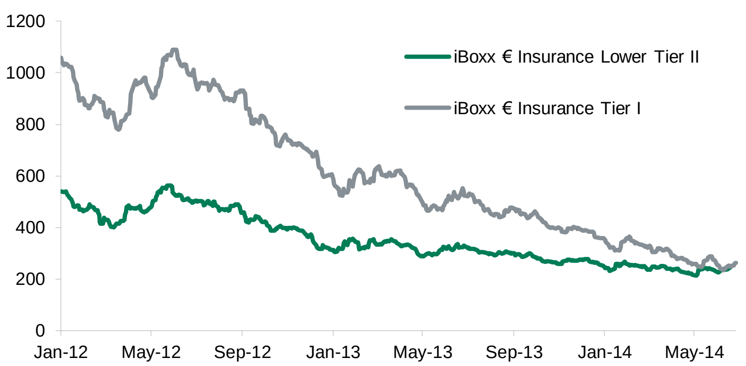
CoCos priced from around May onwards, meanwhile, are not trading as high — at around 99-101.

"A lot of the performance has already gone, but more importantly it is easier to spot where a deal should be coming," he said. "The market is slowly maturing." ●

Secondary bank subordinated indices



Secondary insurance subordinated indices



Source: Markit, Crédit Agricole CIB

STERLING

Standard Chartered goes longer in sterling Tier 2

Standard Chartered took advantage of conducive market conditions to secure duration with a £900m (Eu1.3bn, US$1.54bn) 20 year Tier 2 deal on 3 June, its first subordinated debt transaction in sterling since April 2008.

The bullet deal was launched into a "viable" market that had over the preceding weeks absorbed a £1bn 15 year Tier 2 deal for Rabobank in early May and a £750m 15 year Tier 2 issue for BPCE in early April, noted a syndicate banker at one of the leads — Barclays, Credit Suisse, Lloyds and Standard Chartered.

Standard Chartered, meanwhile, opted for a 20 year maturity, a move along the curve that did not require paying up on a credit basis, according to the syndicate official.

"They were happy to take duration," he said.

The £900m 5.125% June 2034 was priced at 195bp over Gilts, which followed initial price thoughts of 200bp-210bp over. More than £2bn of orders were placed for the deal. Rabobank's £1bn deal came at 165bp over Gilts.

The sterling transaction is Standard Chartered's second benchmark subordinated deal this year, coming after a US$2bn 5.7% 30 year in March. The sterling securities were at the end of June said to be trading at 203bp over Gilts, with credit-specific issues said to behind the widening.

UK investors took 91% of the Tier 2 bonds, other European accounts 8%, and others 1%. Asset managers were allocated 56%, insurance companies and pension funds 8%, hedge funds 7%, corporates 5%, banks 1%, and others 3%. ●

Credit Suisse, SG hit AT1 tights with Yankees

Credit Suisse, Zurich

Credit Suisse achieved the tightest spread of an Additional Tier 1 in any currency when it launched a $2.5bn (Eu1.84bn, Sfr2.24bn) perpetual non-call 10.5 issue on 11 June, taking advantage of a rallying US market to increase the size of its 144A/RegS transaction from an initially-planned $2bn.

The deal was launched in the week following a European Central Bank meeting after which ECB president Mario Draghi announced a raft of measures including a negative deposit rate and targeted longer term refinancing operations (TLTROs). The unconventional measures prompted a rally in credit markets, teeing up the Swiss bank's issue

"Draghi's announcement has had a positive impact on the whole European credit market, including the Yankee segment," said an analyst anticipating the new AT1. "Investor appetite is expected to be strong."

Indeed, when Credit Suisse went out with initial price thoughts of the 6.375% area late morning New York time the day before launch, it was able to attract $3bn of orders by the US close, according to a banker at sole lead Credit Suisse. Continued momentum through Asia and Europe meant that by the time guidance was set at 6.25% at the New York open on 11 June the books were over $12bn. The books were left open to allow some high quality accounts to participate, according to the banker, and the deal was then sized at $2.5bn and priced with a 6.25% coupon on the back of more than $16bn of orders from over 500 accounts.

According to the Credit Suisse banker, the pricing was based on a 5.9% YTC of an outstanding Credit Suisse 7.5% AT1, with an additional 10bp for the extra year of duration and 12.5bp for the lower back-end, implying a new issue premium of 12.5bp. The bonds traded up to 101.625/102.125 on the first day.

The spread of 345.5bp over mid-swaps is the tightest for an AT1 in any currency, according to the banker, and the only inside 400bp, while a syndicate official away from the leads said that the 6.25% coupon is the lowest for a perpetual non-call 10 issue in any currency. Another suggested that the issuer could have achieved an even tighter level, but instead opted for taking the larger amount out of the market.

> Draghi has had a positive impact on the whole European credit market

The perpetual non-call 10.5 structure was chosen to diversify Credit Suisse's maturity profile beyond the first call, in December 2023, of the outstanding 7.5% AT1, whilst benefiting from more attractive financing on a spread to swap basis at that part of the curve, said the lead banker. The bank dispensed with a roadshow, because it has held three in the past year as it has built up its capital issuance, and instead held a global investor call.

North America was allocated 59% of the paper, Europe 30%, Switzerland 7%, and Asia 4%. Asset managers took 60%, hedge funds 19%, private banks 13%, insurance companies and pension funds 6%, and others 2%.

Credit Suisse's AT1 is treated as progressive component capital in Switzerland, according to the bank. The securities write down 100% upon PONV breach or a 5.125% CET1 trigger.

SG goes post-FOMC

Société Générale was next into the US dollar AT1 market after Credit Suisse, on 19 June launching a $1.5bn perpetual non-call 5.5 deal in 144A/RegS format that is the bank's fourth AT1.

Like Credit Suisse, the French bank was also able to leverage off benign central bank pronouncements, in its case measured comments from Federal Reserve chair Janet Yellen.

"Despite the rather subdued market open on 18 June, there was an extremely favourable window following the FOMC," said a banker at SG.

That afternoon, the bank held a global investor call and then opened books with IPTs of the low to mid-6%, with an investor call for Asian and European accounts held the next morning.

"In the midst of a very active subordinated market, the deal received strong investor feedback late evening of the US and Asian morning, with over $8bn of indications of interest gathered before the opening of US market on 19 June," said the banker.

Books went subject in Asia and Europe after reaching $11bn, pre-reconciliation, and official guidance of 6.125% plus or minus 0.125% was released at the US open. By the time books went subject in the US, the reconciled book had reached $13.5bn, enabling pricing of 6% and a deal size of $1.5bn.

The 6% coupon is the lowest for any US dollar AT1. The pricing was equivalent to 406.7bp over mid-swaps and the banker said that no new issue premium was paid.

The US took 60% of the bonds, Europe 24%, Asia 13, and others 3%. Fund managers were allocated 59%, private banks 13%, hedge funds 11%, insurance companies and pension funds 8%, banks 4%, and others 5%.

Société Générale, Paris

Santander debuts in dollars

While Deutsche Bank accessed the US dollar market as part of the first German AT1 in May *(see separate article)*, Santander made its US dollar debut in AT1 format on 8 May with a RegS $1.5bn perpetual non-call five issue. The deal followed the Spanish bank's AT1 debut in March, a Eu1.5bn perpetual non-call five.

The deal was launched after a two day roadshow and books were officially opened after a shadow book of more than $3bn, comprising over 100 accounts, was built. Guidance was set at the 6.625% area and revised to 6.375%-6.500% after more than $9bn of orders were taken by 11am London time. Books were closed 15 minutes later with more than $10bn of orders from over 500 accounts, and the size and price set at $1.5bn and 6.375%.

The UK took the largest share of the deal with 36%, followed by Asia with 16%, Switzerland 11%, North America 7$, the Nordics 7%, Germany and Austria 6%, Italy 4%, Iberia 3%, the Benelux 3%, and others 3%.

Fund managers were allocated the biggest share by investor type with 59%, followed by hedge funds with 19%, banks and private banks 16%, insurance companies and pension funds 4%, and others 2%. ●

NEWS IN BRIEF

Coventry with CCDS conversion, Intesa, UBS T2 in dollars

Coventry Building Society issues £400m PerpNC5.5 AT1: Coventry, the UK's third largest building society, issued a £400m perpetual non-call 5.5 AT1 note, marking the deal as the second to convert into Core Capital Deferred Shares (CCDS) after Nationwide's AT1 in March 2014, although Coventry's CCDS are yet to be issued. The notes will be converted into CCDS based on a conversion price of £67. Guidance started at the 6.5% area, before the notes were finally being priced tighter, at 6.375%.

Intesa Sanpaolo targets US and Canadian markets with $2bn 10 year Tier 2: On 19 June, the Italian banking group launched a $2bn Tier 2 note targeted exclusively at the US and Canadian markets. The issue was a 10 year, fixed rate note issued under the US dollar MTN Programme of Intesa Sanpaolo. Pricing could be tightened to Treasuries plus 240bp from IPTs of 262.5bp.

BFCM issues Eu1bn Tier 2: On 14 May, Banque Fédérative du Crédit Mutuel sold its first subordinated issue since 2010, a Eu1bn 10 year Tier 2 with a 3% coupon. IPTs of mid-swaps plus 165bp were revised to 155bp-160bp as the book grew to Eu2.75bn. At closing there were Eu3.75bn of orders from over 200 accounts, allowing the issuer to tighten pricing to 150bp. French and UK accounts took 58% between them. By investor type, fund managers took the bulk, with 73%.

UBS issues Tier 2 RegS US dollar CoCo: On 8 May, UBS priced a $2.5bn 10 year Tier 2 CoCo with a write-down threshold of 5% of CET1 (rated BBB/BBB+). IPTs of the mid-swaps 250bp area were revised to 240bp-250bp as orders grew to $7bn. The book closed with orders in excess of $7.7bn and pricing was fixed at 240bp. The UK, Asia and Switzerland took the majority of allocations. Asset managers and hedge funds between them took 74% of the deal. ●

Bank of Ireland normalises via Tier 2


Bank of Ireland, Dublin

Bank of Ireland sold its first benchmark Tier 2 offering since July 2008 in early June, a Eu750m 10 year non-call five that an official at the issuer said marked the bank's full return to the market and its desire to move to a more normalised capital structure.

The deal is Bank of Ireland's first public subordinated debt deal since it sold a Eu250m 10 year bullet in December 2012, and, as a benchmark transaction, shows that Bank of Ireland is "very much fully back in the subordinated debt capital market", said Brian Kealy, head of capital management at Bank of Ireland.

"The Tier 2 in 2012 was not a benchmark but it did help us back into the capital space and was helpful when we re-marketed our Tier 2 CoCo in January 2013 and later the re-marketing of our preference shares," he added.

The Tier 2 contingent capital (CoCo) instruments were securities placed with the Irish government as part of its bailout of Bank of Ireland, with the government selling these to private investors, in a Eu1bn three year deal, in January last year. In December 2013 the bank re-marketed Eu1.3bn of state-owned preference shares.

At 4.25%, the coupon on Bank of Ireland's Eu750m 10NC5 issue in June was a far cry from that on the bank's Eu250m Tier 2 in late 2012 — 10%.

"The price reflects the progress the bank has made and is a lot less painful from a profit and loss perspective, of course," said Kealy. "We were very pleased with the pricing and the size and nature of demand, which came from a broad cross-section of investors."

BNP Paribas, Davy, Deutsche Bank, Morgan Stanley and UBS collected more than Eu5bn of orders for the bonds from some 370 accounts, with 97% being taken up by international investors.

Bank of Ireland's Tier 2 is part of a plan to make the bank's capital structure more efficient to meet its regulatory objectives, according to Kealy.

"Our capital structure has been predominantly made up of common equity and a large part of our Tier 2 at the moment is supplied by the Tier 2 CoCo that matures in July 2016 and is amortising on a daily basis now, so we felt it was important to move to a more normalised structure over time as CRD IV transitions come in," he said.

Germany and Austria were allocated 11%, Switzerland 10%, France 7%, Nordics 6%, Iberia 4%, the Benelux 3%, Ireland 3%, Asia 4%, and others 6%. Fund managers bought 60%, hedge funds 17%, insurance companies and pension funds 8%, retail investors 7%, banks 6%, and others 2%. ●

AMERICAS, ASIA

Banco do Brasil goes Basel III-compliant, KTB in Thai T2 first

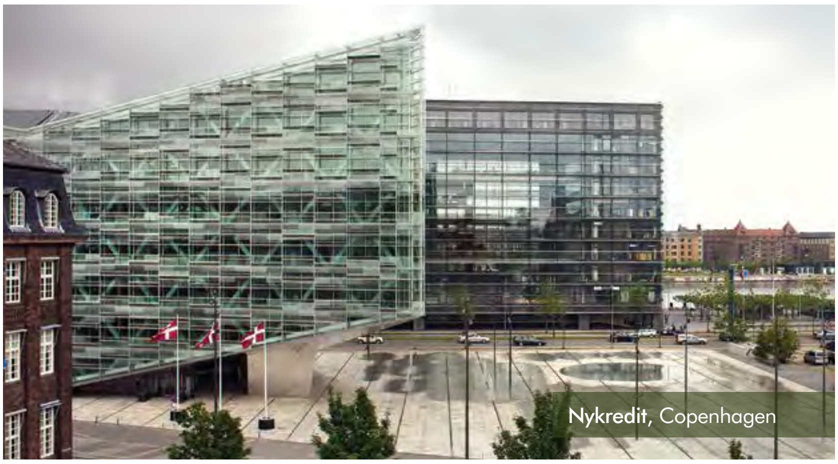
Banco do Brasil builds healthy order book for its first Basel III-compliant AT1: The $2.5bn Tier 1 deal marks the issuer's first deal under Brazilian Basel III regulation. The perpetual bond, launched on 11 June, converts to equity if Banco do Brasil's CET1 ratio falls below 5.125%. The deal attracted orders of $5.5bn, allowing initial price thoughts of 9.5% to be narrowed to final guidance of 8.875%-9.125% and the deal to be priced at 9%.

Wells Fargo $2.5bn 12 year Tier 2: On 28 May, Wells Fargo issued a $2.5bn 12 year Tier 2 subordinated bond with a 4.10% coupon, rated A3/A/A+. The issuer was able to price it at T+160bp on the back of a $5.5bn book.

Citigroup issues $1bn subordinated notes: On 29 April, Citigroup issued a $1bn 30 year subordinated note with a 5.30% coupon, pricing it at T+185bp on the back of a $3bn book.

Krung Thai Bank offers Thailand's first dollar Basel III: Krung Thai Bank (KTB) issued Thailand's first US dollar-denominated Tier 2 note on 19 June. The notes feature a partial write-down in the event of KTB reaching the PONV. As a result of strong demand for the deal, KTB increased the size of the issue, raising the $500m offering to $700m. The order book closed at over $4bn, with pricing at 5.2%, or 353.5bp over Treasuries.●

Nykredit 5x covered in first Danish T2 CoCo


Nykredit, Copenhagen

Nykredit Realkredit launched the first Tier 2 CoCo out of Denmark on 23 May, a Eu600m (Dkr4.48bn) 22 year non-call seven transaction that was five times oversubscribed and is the issuer's first CRD IV/CRR-compliant capital instrument.

The deal comes after Danske Bank sold the first CoCo from Denmark, a Eu750m AT1 issue, at the beginning of March.

Nicolaj Legind Jensen, head of funding at Nykredit, said that the group had been planning for new capital issuance ahead of the call dates of outstanding old-style Tier 1 instruments this year and next, with a Eu500m step-up callable in September 2014 and a Eu900m non-step-up in April 2015.

"So we had been looking at this for some time, but had been waiting for regulation to fall into place," he said. "We have then been effectively working on this transaction for three or four months."

Danske Bank's transaction was only launched after certain tax issues related to the new generation of hybrid instruments in Denmark was resolved, and Jensen said that the resolution of these ahead of its peer's transaction made preparing Nykredit's Tier 2 CoCo easier. However, Jensen said that the release of a Standard & Poor's FAQ relating to Tier 2 hybrids in the midst of Nykredit's preparations necessitated some extra work.

"We did have some issues trying to adapt to S&P's revised views, but we managed to find a solution in the end," he said. "Basically it needs to be refinanced before it can be called."

An aim of the transaction was to support Nykredit Realkredit's senior ratings.

According to Jensen, investors' focus on a roadshow that preceded the deal was on the credit rather than the structure of the deal.

"Of course investors needed to get comfortable with the structure, but that was fairly quickly done given that it is a Tier 2 with must-pay coupons and therefore provides a bit more certainty than the Tier 1 varieties out there," he said. "So it was more the Nykredit story, and the capitalisation and future capitalisation of Nykredit that was uppermost in investors' minds."

The 22 year non-call seven instrument has a 7% permanent write-down trigger at solo and group level.

An aspect of the transaction that was adapted in light of investor feedback was a plan to issue two tranches rather than the single, Eu600m tranche that ultimately emerged. That plan would have meant a non-call five issue being sold alongside the non-call seven, affording Nykredit a smoother refinancing profile.

"We were also at some point considering a dual tranche issue, with two sub-benchmark deals, but we got some pushback from investors towards that, and therefore we decided to do one larger benchmark deal," said Jensen.

He added that the Eu600m size reflected the issuer's needs.

Leads Barclays, BNP Paribas, JP Morgan, Natixis, Nykredit Markets and UniCredit attracted Eu1.5bn of indications of interest the day before launch at initial price thoughts of the 300bp over mid-swaps area, which Jensen said took into account comparables and initial investor feedback. Books were then opened the following morning and after demand quickly approached Eu3bn guidance was set at the 290bp area, according to one of the leads, with the strong order book, comprising some 200 accounts, ultimately justifying a 285bp re-offer spread.

"It was an excellent outcome given that we are a new issuer and it is the first Tier 2 CoCo out of this jurisdiction," said Jensen. "We managed to get a lot of new investors on board, which is of course something that we are always quite happy about."

He noted that the deal tightened on the break to trade at around 270bp-272bp the week after launch.

Asset managers were allocated 47%, pension funds and insurance companies 20%, private banks 11%, hedge funds 10%, banks 7%, and SSAs 2%. Nordic investors took 30%, the UK and Ireland 28%, France 10%, the Benelux 7%, Germany and Austria 8%, Switzerland 7%, Italy 5%, Iberia 3%, Asia 1%, and others 1%.

Nykredit's Jensen said that an AT1 issue was not in Nykredit's thinking.

"We had no Tier 2 outstanding at all, so from a cost perspective it would seem odd if we had started filling up our Tier 1 buckets before looking at Tier 2," he said.

"We haven't made a decision yet, but we may come to market in the next year or so," he added. "But in which structure, it's still not clarified." ●

SEB fills bucket, Danske wraps up with 12NC7 T2s

SEB priced a Eu1bn (Skr9bn) 12 year non-call seven Tier 2 issue on 22 May that an official at the issuer noted was the first Swedish deal this year to feature a 12NC7 structure, while Danske Bank had on 16 May issued a Eu500m 12NC7 deal that wrapped up planned adjustments to its Tier 2 levels.

SEB's issue was launched to meet regulatory requirements for Tier 2 capital of 2% of risk-weighted assets and to cover additional Pillar 2 requirements for Tier 2 capital, said John Arne Wang, head of treasury management at SEB. Before the transaction the bank had Tier 2 capital of 1.1%.

The deal was the fourth Nordic Tier 2 transaction of the year, and the first from Sweden to feature a 12NC7 structure, with Svenska Handelsbanken and Swedbank having done 10NC5 deals. Wang said that the structure was chosen because investors showed a preference for it over 10NC5 and it was a better fit for SEB's maturity profile.

"With a 12NC7, you can offer investors additional yield from the swap curve without having to pay up much for it," he said.

Leads Deutsche, Goldman Sachs, Morgan Stanley, RBS and SEB priced the Eu1bn issue at 145bp over mid-swaps, after guidance of 145bp-147bp over and IPTs of the 150bp over area. More than Eu1.5bn of demand was registered for the issue, with Wang emphasising the quality of the order book.

"There was no inflation in the order book, and all of the demand was pure end-user interest," he said. "That is probably a function of less momentum in the market than what was experienced two to three weeks ago, when a lot of order books were inflated due to investors jumping on the bandwagon."

Dankse had tapped into that busier market with its Eu500m (Dkr3.73bn) no-grow 12NC7 Tier 2 issue. The deal marked a return to a market in which

Danske Bank had been active last year while it awaited clarity on tax issues in order to be able to sell an AT1, which it did in March.

"The investor community knew that we had plans to make some adjustments to our Tier 2, so it was then just a question of timing," said Peter Holm, senior vice president, group treasury, Danske Bank. "Our capital management will respond to new developments, of course, but for now we have completed our plans."

The deal came after the issuer on 11 April redeemed Dkr24bn of government hybrid Tier 1, a move that had been high on the bank's agenda and was behind Tier 2 issuance in 2013 and its AT1, and also followed an upgrade by Standard & Poor's on 29 April ahead of the bank reporting its first quarter results on 1 May.

Leads BNP Paribas, Danske, RBS and Société Générale began marketing the Eu500m maximum 12NC7 at the 165bp over mid-swaps area and then set guidance of 155bp-160bp after taking IOIs of Eu2bn. The deal was priced at 152bp over on the back of some Eu4.7bn of orders from 310 investors.

Holm that the new deal came at a much tighter spread than a 10NC5 Tier 2 deal in September despite having a longer maturity.

"The spread was very encouraging," he said. ●

LIABILITY MANAGEMENT

Barclays, Groupama exchanges

Barclays edges closer to its AT1 target: Barclays successfully completed an offer to exchange nine old-style Tier 1 notes for £2.27bn of CRD IV-compliant AT1 securities that closed on 12 June. This will take the bank's total of outstanding CRD IV-compliant AT1 capital to £4.24bn, more than half of its £7bn target. The new notes, with a perpetual maturity non-callable until September 2019, will convert to equity if the group's CET1 ratio falls below 7%. The new five year callable notes in dollars, euros and sterling tranches have coupons of 6.625%, 6.5% and 7%, respectively.

The exchange accelerates the transition of Barclays' capital structure, contributes to its leverage ratio target, and manages the interest cost associated with legacy non-CRD IV-compliant securities. Barclays' end-state capital structure targets a 2% AT1 bucket (which includes a Pillar 2A charge) and a leverage ratio above 4% for 2016.

Groupama completes exchange and opens issue to new money: French insurer Groupama on 22 May announced the results of a sub-for-sub exchange offer announced on 7 May. The issuer accepted Eu449.4m (91.16%) of its 2005 notes and Eu550.6m (57.24%) of 2007 notes (pro ration factor: 0.961975). The new issue, a perpetual non-call 2024 Solvency I-compliant Tier 1 issue with a 6.375% coupon, consisted of Eu1bn from the exchange and Eu100m from new money. ●

INSURANCE

Axa, UnipolSai sell perps amid flurry of sub debt issues

Legal & General issues £600m Tier 2: Legal & General announced a £600m 50NC30 Tier 2 deal, the insurance company's first debt issuance since 2009. Initial price thoughts of 225bp over Gilts were announced on 19 June before being revised to 220bp plus or minus 3bp, with the final level being set at 217bp over.

UnipolSai sells Eu750m PerpNC10 Tier 1: Italian banking and insurance company UnipolSai successfully priced a Eu750m perpetual non-call 10 year Tier 1 bond at 5.75% (mid-swaps plus 418bp) on 11 June. IPTs of the high 5% area were tested, with books opened at the 5.875% area, which attracted orders nearing Eu2.5bn from over 250 accounts. Italy took 31%, the UK and Ireland 31%, France 16%, Switzerland 9%, Germany and Austria 4%, the Benelux 3%, and others 6%. Asset managers took 63%, hedge funds 17%, banks 8%, private banks 4%, and others 8%.

Delta Lloyd sells Eu750m PerpNC10 Tier 2: Dutch insurance company Delta Lloyd NV issued a fixed-to-floating perpetual non-call 10 4.375% note on 5 June. The bond was issued out of the holding entity as opposed to the operating company, which Delta Lloyd issued its last subordinated deal out of. IPTs were mid-swaps plus 300bp-310bp, but demand of Eu5.7bn allowed the issuer to tighten guidance to 290bp-295bp and finally price the deal at 290bp over.

Zurich Insurance taps Swiss franc market: Zurich Insurance sold a Sfr200m no-grow perpetual non-call seven bond on 2 June. Guidance started at the 2.75% area and the deal was priced in line with this, which translates to mid-swaps plus 207.8bp.

Delta Lloyd, Amsterdam

Poste Vita Solvency I-compliant five year Tier 2: Italian insurer Poste Vita sold Eu750m five year Tier 2 notes at mid-swaps plus 215bp, for a 2.875% coupon. Books closed in excess of Eu3bn. The bond, structured to comply with Solvency I, should benefit from grandfathering as Tier 2 under Solvency II. Asset managers received 77% of allocations, followed by banks with 11%, insurers 10%, and others 2%. Italy bought 44%, the UK and Ireland 22%, France 16%, Germany and Austria 7%, other Europeans 8%, and non-Europeans 3%.

AXA sells Eu1bn PerpNC11 Tier 2: On 15 May, French insurance company AXA issued a Eu1bn perpetual non-call 11 Tier 2 3.875% note, following up on its £750m 5.625% 40NC20 Tier 2 note issued in January. IPTs of mid-swaps plus 240bp allowed the deal to gain traction and by the time the books were closed some Eu7bn of orders had been gathered. This allowed the issuer to price the deal 15bp inside guidance, at 225bp over. German, UK and French accounts took 58% between them, and fund managers took 70%.

The transaction's structure absorbs some of the recent developments stemming from the EIOPA Technical Specifications:

- The terms include an exchange and variation clause triggered by a Regulatory Event (provided that the modified notes will not be prejudicial to the interests of bondholders, as customary for English Law bonds). The clause itself (along with the Tax and Accounting Event calls) would lapse if uncompliant with future regulation;
- The Regulatory Event has been expanded to include the case based upon which the bond would be initially recognised as Tier 2 (even on a grandfathered basis) upon implementation of Solvency II, and then disqualified. Similarly, the regulatory call relative to the first five years will lapse after the first call date if its presence will cause the ineligibility of the bond. The clause might have been designed to hedge against a disqualification of the bond after the Solvency II grandfathering period.

Württembergische Lebensversicherung launches euro Tier 2: On 7 May, German insurer Württembergische Lebensversicherung issued a Eu250m 30 year non-call 10 Tier 2 bond. IPTs of mid-swaps plus 375bp were tightened and pricing fixed at 350bp on the back of strong demand. ●

Regulatory updates

BANKING

Resolution mechanisms and funds in focus

EC launches consultation on the contributions of credit institutions to resolution fund: On 20 June the European Commission launched a consultation on the contributions of credit institutions to resolution financing arrangements under the Bank Recovery & Resolution Directive (BRRD) and the Single Resolution Fund (SRF) for the Banking Union. In the banking union, the national resolution funds set up under the BRRD as of 1 January 2015 will be replaced by the Single Resolution Fund as of 1 January 2016 and those funds will be pooled together gradually. The amount that individual credit institutions will have to pay will depend on the bank's size and risk profile. The risk adjustment of individual contributions in proportion to the risk profile of institutions is based on criteria set out in the Bank Recovery & Resolution Directive but these criteria have to be specified in greater detail by the Commission in a delegated act. The consultation covers (1) calculation of contributions, (2) application of the principle of proportionality, (3) weight of the flat contribution versus risk adjusted contribution and (4) Individual risk indicators. The answers to the public consultation will contribute to the Commission's proposals.

BCBS publishes consultation on supervisory guidelines for dealing with weak banks: On 18 June the Basel Committee on Banking Supervision published for comment a consultative document on the supervisory guidelines for identifying and dealing with weak banks. The revised guidelines aim to provide a toolkit for authorities to identify weak banks early and deal with them in an effective manner. Key changes include: (1) emphasising the need for early intervention and the use of recovery and resolution tools, and updating supervisory communication policies for distressed banks; (2) providing further guidance for improving supervisory processes, such as incorporating macroprudential assessments, stress testing and business model analysis, and reinforcing the importance of sound corporate governance at banks; (3) highlighting the issues of liquidity shortfalls, excessive concentrations, misaligned compensation and inadequate risk management; and (4) expanding guidelines for information-sharing and cooperation among relevant authorities. The consultation closes on 19 September.

Sabine Lautenschläger, ECB

Eurogroup reaches political agreement on the direct bank recapitalisation instrument: The president of the Eurogroup on 10 June announced that euro area member states had reached a political agreement regarding the operational framework of the European Stability Mechanism (ESM) direct recapitalisation instrument. Following the relevant national procedures and the formal adoption by the ESM board of governors, it is expected that the instrument will be added to the toolkit of the ESM by the start of the Single Supervisory Mechanism (SSM) supervision in November. This new tool may be activated in case a bank is unable to attract sufficient capital from private sources and if the ESM member concerned is unable to recapitalise it. In a transitional period, which will be in place until 31 December 2015, a bail-in of 8% of all liabilities will be a precondition for using the instrument, along with use of the resources available in the ESM member's national resolution fund. Starting from 1 January 2016, bail-in in line with the rules of the Bank Recovery & Resolution Directive will be required. With a Eu60bn maximum recapitalisation capacity, this new instrument will serve as another important pillar of the Banking Union.

SSM to use Pillar 2 to enforce the results of the comprehensive assessment: On 23 May Sabine Lautenschläger, member of the executive board of the ECB, gave a speech in Madrid on the comprehensive assessment in which she said that the SSM will likely incorporate the outcome of the assessment into the yearly Pillar 2 decision, which will enable the common regulator to use the related range of instruments. These include quantitative measures, including restrictions on the distribution of dividends, limitation or even prohibition of bonus payments, prohibition of credit lending and limitations on opening up new business areas, and a number of qualitative measures (addressing management and reporting issues, for example), internal controls and risk management practices.

Member states sign SRF Intergovernmental Agreement: On 21 May 26 member states (all EU member states except Sweden and the UK) signed the Intergovernmental Agreement (IGA) on the transfer and mutualisation of contributions to the SRF, an essential part of the Single Resolution Mechanism (SRM) and a part of the overall compromise reached by the member states and the European Parliament on the Banking Union. In order to become law, the Council must formally adopt the SRM regulation.

- Content: Under the IGA, the SRF will be built up over eight years, reaching a target level of at least 1% of the amount of covered deposits of all credit institutions authorised in all the participating member states. It is estimated that this will amount to about Eu55bn. Contributions by banks raised at national level will be transferred to the SRF, which will initially consist of compartments corresponding to each contracting party. These will be gradually merged over the eight year transitional phase. This mutualisation of paid-in funds will be front-loaded, starting with 40% in the first year and a further 20% in the second year, and continuously increasing by equal amounts over the subsequent six years until the SRF is fully mutualised. The individual contribution of each bank will be calculated pro rata to the amount of its liabilities (excluding own funds and covered deposits) with respect to the aggregate liabilities (excluding own funds and covered deposits) of all the institutions authorised in the participating member states. Contributions will be adjusted in proportion to the risk profile of each institution;
- Next steps: The SRM will enter into force on 1 January 2015 once published in the Official Journal, whereas the transfers of banks' contribution to the SRF will start from 1 January 2016. The European Commission will adopt in the coming months a proposal for a Council implementing act on the banks' contributions to the SRF, which will specify the calculation methodology of the contributions. The act will have to be discussed and adopted by the Council.

Vítor Constâncio, ECB

EC presents a first comprehensive review of the EU's reform agenda: The European Commission published on 15 May a first comprehensive review of the financial regulation agenda as a whole. The package includes "A reformed financial sector for Europe", a Commission Communication, accompanied by a detailed economic review explaining how the reforms reshape the financial sector and the resulting benefits. The communication recalls the objectives that guided the Commission, presents an overview of the reforms it proposed, and takes stock of the key effects that can already be observed today.

Giegold responds to Constâncio over bail-in rules application: A speech by European Central Bank (ECB) vice-president Vítor Constâncio at an OeNB Economics Conference in Vienna on 12 May included the following: "It is worth mentioning that the BRRD rules about bail-in enter into force only in January 2016. They will therefore not apply to the recapitalisations in the context of the Comprehensive Assessment that the ECB is conducting and to be implemented this year and the next. The bail-in rules that will then be in place stem only from the European Commission's communication on "State Aid rules to support measures in favour of banks in the context of the financial crisis" of July 2013, which establishes that any public support to banks considered as State Aid should be preceded by bail-in of bank shares, capital hybrids and subordinated debt. The text contemplates that exceptions 'can be made where implementing such measures would endanger financial stability or lead to disproportionate results'. For specific cases at the end of the Comprehensive Assessment, it may be adequate to invoke such principles." The speech generated controversy at European levels. MEP Sven Giegold said to *Bloomberg* that "what the ECB is asking for is a new wave of banking recapitalisations by the state, which is from my perspective scandalous".

Council officially adopts BRRD: On 6 May the Council adopted a directive harmonising national rules on bank recovery and resolution. Member states have until 31 December to transpose it into national law.

European Commission adopts 2 RTS, 3 ITS and releases state of play: The European Commission on 4 June adopted two new sets of Regulatory Technical Standards (RTS) (Geographical location of a relevant credit exposure and Passporting notifications) and three new sets of Implementing Technical Standards (ITS) (Information Exchange, Supervisory practices relating to the securitisation retention rules, and Supervisory disclosure). In addition, a state of play document has been released for both types of standards submitted to the Commission for endorsement.

ECB

SSM Framework Regulation: The ECB published the SSM Framework Regulation for the SSM on 25 April. The document lays the basis for the work of the SSM when it takes over as supervisor of euro area banks in November 2014. The identification of significant banks, which will be subject to ECB direct supervision, will take place according to criteria set out in the SSM Council Regulation and further developed in the SSM Framework Regulation, with the result announced in September.

Eligible instruments to cover capital shortfalls: The European Banking Authority (EBA) released on 29 April the methodology and macroeconomic scenarios for the EU-wide stress test, which include the key features of the common methodology and the design of the adverse scenario. Following the EBA announcement, the ECB has communicated on how capital shortfalls must be addressed by banks following the comprehensive assessment. According to the Note on the comprehensive assessment, if a bank's capital ratio falls short of the relevant thresholds (8% transitional Common Equity Tier 1 (CET1) for the Asset Quality Review (AQR) and the baseline scenario, 5.5% transitional CET1 for the adverse scenario), it will be requested to take remedial actions within six months for the shortfalls identified in the AQR or the baseline stress test scenario, and within nine months for those identified in the adverse scenario, starting from the release of the results (in October). Capital plans will have to detail how the shortfalls will be covered, with the only eligible instruments being the following:

- AQR and Baseline scenario: CET1 instruments;
- Adverse scenario: CET1 and/or Additional Tier 1 (AT1) instruments

The use of AT1s is limited to the following (as a percentage of overall Risk-Weighted Assets (RWAs)):

- instruments with a trigger below 5.5% CET1: 0%
- instruments with a trigger at or above 5.5% CET1 and below 6% CET1: up to 0.25%;
- instruments with a trigger at or above 5.5% CET1 and below 7% CET1: up to 0.5%;
- instruments with a trigger at or above 7% CET1: up to 1%

Tier 2s with a high trigger (>5.5% CET1) seem to have been excluded from the eligible instruments. However, the EBA has also updated the FAQ on the stress test, and changed the section on capital definition to add a new paragraph, which hints at a degree of discretion from national regulators:

> "While CET1 is the only eligible capital for covering stress test losses, banks are also required to report Additional Tier 1 (AT1) and Tier 2 (T2) instruments that convert (or are written down) if CET1 ratio after the stress falls below the trigger level of these instruments. Since the supervisory reactions rest in the hands of national competent authorities, CAs [competent authorities] will decide how to consider this in their reaction functions".

The ECB note also clarified the treatment for the following securities:

(1) Existing convertible instruments that are subject to unconditional predefined conversion into CET1 within the stress test horizon are recognised without limitation for the coverage of shortfalls, as long as (i) a certain and mandatory conversion will take place at a fixed date, (ii) these instruments cannot be redeemed before the conversion date and (iii) there is no uncertainty regarding the conversion into CET1; and
(2) State aid instruments used by member states (Cyprus, Greece, Ireland and Portugal) in the context of financial assistance programmes are recognised without limitations for the coverage of capital shortfalls in adverse stress test scenarios. For other SSM member states, the grandfathering of state aid instruments provided by the Capital Requirements Regulation (CRR) applies.

EBA CLARIFICATIONS

Reiterates Q&A 2013_15 principle: The EBA added two new relevant answers to the Single Rulebook Q&A on 20 June:

- **Tier 2 instruments** [2013_314]: The impact of a buyback on the calculation of the regulatory amortisation amount for a Tier 2 instrument was clarified. According to the authority, should a portion of the nominal amount of the original instrument be reimbursed, the remaining amount becomes the revised nominal amount of what should be considered as a new instrument, and thus the base for calculating the amortisation;
- **Q&A 2013_15 principle** [2013_50]: Due to the existence of an incentive to redeem, Tier 1 instruments for which the institution was able to exercise a call with an incentive to redeem only prior to or on 31 December 2011, where no call was exercised and when the instrument is not eligible under Article 52 of CRR, would not meet the eligibility criteria for inclusion in fully eligible Tier 2 capital. The answer confirms the principle reported under 2013_15: the fact that the instrument is not called does not mean

NETHERLANDS

Dutch progress in AT1 tax campaign

The Dutch Ministry of Finance on 11 June published a proposal for new legislation in Article 29a of the Dutch corporate income tax act to open the market to AT1 bonds from banks.

Under the proposed legislation, interest payments on AT1 instruments will be deductible and not subject to withholding tax. If approved, the legislation will have retroactive effect to 1 January 2014.

The proposal must be voted on by the Dutch Parliament, something that is unlikely to occur before the Senate goes on a two month break starting in mid-July.

Photo: Ryan Pierse/Getty

Robin Van Persie

that the instrument may be reclassified as an instrument without an incentive to redeem.

Three new questions related to own funds were added to the (also recently revised) Single Rulebook Q&A by the EBA in early June:

- **Own funds: Buffers** [2013_173]: The EBA clarified that the rules in Art 131 (16 and 17) of CRD (Capital Requirements Directive) IV emphasise that buffers imposed on the group should not be taken as a reason for reducing buffers imposed individually on the group's subsidiaries and sub-groups, and do not mean that the decision of the home regulator as regards the combined buffer requirement (CBR) of the group could effectively introduce a floor for subsidiaries.
- **Own funds: Grandfathering** [2013_220]: The exchange of a Tier 1 instrument for bonds that have similar provisions but a different issuer would be considered by the EBA as a new issuance. Moreover, if the new instrument is issued after 31 December 2011, even if the exchange offer has been launched prior to 31 December 2011, grandfathering provisions laid down in Article 484 of the CRR would not be applicable.
- **Own funds: Grandfathering** [2014_1071]: The EBA confirmed that answer 2013_16 ("a material change in the terms and conditions of a pre-existing instrument shall be considered in the same way as the issuance of a new instrument") still applies, and can include cases where these changes have been imposed by an external party (e.g. court ruling following a litigation). In order for the amended instrument to be reported as fully compliant within a lower own funds category, it would need to meet all CRR eligibility criteria for that category (in particular the absence of incentives to redeem).

Legacy CET1 instruments under the CRR

- 2013_408: A contract with the 100% mother company of an institution according to which distributable profits of the subsidiary need to be fully distributed to the mother company at the end of each year and losses of the subsidiary are to be compensated in full by the mother company would breach Article 28(1)(h) of CRR. The latter specifically prohibits CET1 instruments from including any obligation for the institution to make distributions, to ensure that the issuer has full discretion over the payment of dividends so that the institution can retain capital as necessary to be regarded as an obligation hindering eligibility of the instrument as CET1.
- 2013_541: A profit and loss transfer arrangement between the majority shareholder and the credit institution, which results in a contractual obligation of the majority shareholder of the credit institution to pay a fixed compensation to the minority shareholder of the credit institution, does not meet the requirement of Art. 28(1)(i) of CRR. The latter states that CET1 instruments must absorb the first

and proportionately greatest share of losses as they occur, and each instrument absorbs losses to the same degree as all other CET1 instruments. Such a profit and loss transfer arrangement could also result in an obligation on the credit institution to pay distributions if this is required to maintain the fixed compensation payment to the minority shareholder, which would be non-compliant with Article 28(1)(h) of the CRR.

Implications of the supervisory permission to reduce own funds: Questioned over the use of retained earnings as capital replacement, the EBA responded that retained earnings or other CET1, Additional Tier 1 or Tier 2 items that are documented within the own funds planning of the institution are not sufficient to meet the requirement of Article 78 (1)(a) of the CRR, but it would be required by the institution to issue a new own funds instrument to investors. However, the answer did not change the interpretation of provision of Article 78(1)(b) of the CRR.

Grandfathering clarification, but uncertainty remains over pari passu legacy issues: The EBA clarified a number of open issues with regard to the grandfathering of legacy Tier 1 instruments in response to question 2013_542 on 28 May:

- First, the EBA confirmed that grandfathered instruments may include terms according to which the distribution would be cancelled if the institution does not make a distribution on another capital instrument, without that being regarded as interfering with the flexibility of payments required for fully eligible instruments. The same would apply to instruments with or without step-ups. This is due to the fact that grandfathered instruments are not subject to the requirements that apply to capital instruments that are fully eligible in their own right;
- However, when questioned whether an Additional Tier 1 included in the list of pari passu bonds under the terms of legacy Tier 1 would not be eligible due to the presence of pusher provisions, the EBA did not confirm the view, the reasoning being the same as above. However, this does not explain whether the same is true for legacy Tier 1 reclassified as fully-compliant Tier 2 at the end of the transitional period.


European Commission, Brussels

Consultation on technical standards on assessment methodologies for the use of advanced measurement approaches for operational risk: On 12 June the EBA published a consultation on draft RTS assessing the criteria that competent authorities need to consider before granting institutions permission to use advanced measurement approaches (AMA) for calculating their capital requirements for operational risk. These RTS will form part of the Single Rulebook aimed at enhancing regulatory harmonisation in the banking sector in the EU. The draft RTS detail the assessment methodology to be used by competent authorities for operational risk AMA models and also clarify the scope of operational risk and operational loss. These RTS form part of the overall review of internal models undertaken by the EBA and show progress in the harmonisation of practices for the approval of internal models. This consultation runs until 12 September.

Comparability of RWA for residential mortgages: The report, published on 11 June and the second on the topic, is part of a wider ongoing EBA work on comparability of RWAs. The analysis confirmed the existence of a positive correlation between the value of the different variables — such as loan to value at origination, indexed loan to value, debt to service at origination, and loan to income at origination — and the risk weights at an aggregated level. The analysis also highlighted the potential impact of market differences, banks' specific credit policies, as well as modelling choices. While the EBA is currently engaging with competent authorities on the topic, final conclusions at bank level can only be drawn by national competent authorities (NCAs).

Final draft RTS on G-SII methodology and ITS on disclosure for the leverage ratio: The EBA on 5 June published the final draft RTS on the methodology for identifying Global Systemically Important Institutions (G-SIIs). The RTS will have to be formally adopted by the European Commission and published in the Official Journal of the EU.

On the same day, the EBA also published its final draft ITS on disclosure for the leverage ratio, which are still subject to future changes depending on the decisions made in the Commission delegated act.

List of CET1 instruments might still be affected by RTS on own funds part IV: The EBA on 28 May published a list of capital instruments across the EU that national supervisory authorities have classified as Common Equity Tier 1-compliant. This list, which was compiled in accordance with Article 26 of the CRR, is based on information received from the 28 national competent authorities across the EU. However, it does not take into account the provisions on multiple dividends and preferential distributions laid down in EBA final draft RTS on own funds (part IV), as these have not yet been adopted by the European Commission. According to the EBA, the final adoption of these RTS may affect the ultimate eligibility of some of the instruments as CET1.

Treatment of non-grandfathered portion of step-up Tier 1s: On 23 May the EBA published a new set of answers on the Q&A Tool, which included a response to question 2013_696 regarding the recognition as Tier 2 of the amount of a step-up Tier 1 in excess of the Tier 1 grandfathering limit, prior to the first call date. The EBA confirmed that the excess over the Tier 1 grandfathering limit could still be eligible as grandfathered Tier 2, subject to the applicable limit but only until the date of effective maturity of the instrument (i.e. the step-up date). The question originated from controversial response 2013_47, in which the EBA set the criteria for reclassification of legacy Tier 1 instruments.

Restrictions on sale of bail-in-able debt to retail clients: According to sources reported by the *Financial Times* on 20 May, the EBA could consider higher disclosure requirements or quantitative limits to the sale of bail-in-able instruments to a bank's own retail customers. The move would be aimed at the protection of investors from the consequences of a potential loss absorption.

Template for the data collection exercise on CVA: The EBA, following the launch of the data collection exercise on Credit Valuation Adjustment (CVA), released on 16 May an updated version of the template that participating banks will be requested to fill in as well as a set of relevant instructions. The exercise was launched on 30 April and will be carried out on a voluntary basis. Participating banks are expected to submit the template of the data collection exercise to their respective national supervisory authority by 31 July.

Consultation on RTS on the treatment of equity exposures under IRB approach: The EBA on 7 May launched a consultation on draft RTS to specify the treatment of equity exposures under the internal ratings-based (IRB) approach. The consultation runs until 7 July. These RTS propose that competent authorities grant institutions a temporary exemption from IRB treatment of certain equity exposures if such exemption was being applied on the last day of application of the CRD I (31 December 2007).

NATIONAL REGULATORS

FDIC adopts the Basel III interim final rule as a final rule: The US Federal Deposit Insurance Corporation (FDIC) has adopted the Basel III interim final rule as a final rule with only technical revisions designed to ensure that it conforms with the final rules issued by the Board of Governors of the Federal Reserve System and the Office of the Comptroller of the Currency (OCC). The final rule was effective 1 January 2014, with mandatory compliance beginning 1 January 2014, for FDIC-supervised institutions that are subject to the advanced internal ratings-based approaches (advanced approaches). Mandatory compliance is scheduled to begin 1 January 2015 for all other FDIC-supervised institutions.

BoE publishes summary of feedback received on the stress testing Discussion Paper: In October 2013 the Bank of England published a Discussion Paper that set out the main features of the proposed stress testing framework over the medium term. The aim of the Discussion Paper was to elicit feedback from interested parties to help inform Financial Policy Committee (FPC) and Prudential Regulation Authority (PRA) Board decisions over the ultimate design of the UK stress testing framework. The regulator provided a summary of the feedback received in May. A number of respondents asked for greater clarity around the framework for assessing capital adequacy in the stress test, the usability of capital buffers, the role of AT1 instruments, and the role of the leverage ratio. However, the document is not intended to be the Bank's response to that feedback, as further material on how it intends to develop the stress testing framework going forward will follow the completion of the 2014 exercise.

On 29 April, the Bank of England set out further details of the scenario for the stress tests that the eight major UK banks and building societies will be undertaking this year. A key threshold for the UK variant test will be set at 4.5% of RWAs, to be met with Common Equity Tier 1 capital in the stress — using a CRD IV end-point definition of CET1 in line with the UK implementation of CRD IV. If a firm's capital ratio is projected to fall below the 4.5% CET1 ratio in the stress, there is a strong presumption that the PRA will require the firm to take action to strengthen its capital position. However, depending on the outcomes for specific firms, the PRA may still require action to strengthen capital positions even if the threshold is met.

In addition to the stress scenario focussed on the UK, the Bank of England will also assess the impact of an EU-wide baseline macroeconomic scenario exercise co-ordinated by the EBA. Under this baseline scenario, the PRA expects firms to have a CET1 ratio of 7% of RWAs and a 3% leverage ratio using a Tier 1 definition of capital.

PRA completes proposals for implementing capital buffers: On 30 April the PRA set out the proposals for implementing the CRD IV provisions on capital buffers (CP 5/13) in the UK, which include the capital conservation and countercyclical capital buffer frameworks. The rules were not included in its original statement — Strengthening capital standards: implementing CRD IV, feedback and final rules (PS 7/13) — as HM Treasury first needed to designate the authorities responsible for the buffers. The PRA intends to consult on and set out its policy for identifying Other Systemically Important Institutions (O-SIIs) in 2015.

Swedish FSA releases capital buffer legislation: Sweden's Finansinspektionen (FI) on 8 May released a memorandum on the capital requirements for the nation's banks, which builds on the power granted by a government bill issued on 3 April, and reflects the agreement with the Riksbank and the Swedish Ministry of Finance. The memorandum is divided into seven main sections, including an impact study.

- The Pillar 2 capital charge is divided between Pillar 2 basic requirements — which represents an assessment of additional capital needs to cover risks not included under Pillar 1 — and a so-called capital planning buffer. The rules apply to all companies subject to the capital adequacy regulations, regardless of size. The capital planning buffer is supposed to be covered in its entirety by CET1, while Pillar 2 basic requirements shall in principle be covered by the same capital allocation as Pillar 1, including the static buffer requirements (capital conservation buffer, systemic risk buffer, and buffers for other and globally systemically important institutions).
- The capital adequacy level at which the maximum distributable amount (MDA) restrictions take effect will not be affected by the special funds requirement as long as these requirements are not formally decided. If a formal decision on special capital requirements for the company has not been taken, the computation of the maximum distributable amount can be made without Pillar 2 basic requirements and capital planning buffer included. FI will not normally make any formal decisions on particular funds requirements. Instead, FI is to inform each company of FI's overall capital assessment of the company. A formal decision will only be taken in cases where it is deemed necessary. A departure from the general rule of Pillar 2 basic requirements can be made for specific types of risk.


Bank of England, London

Dutch Central Bank publishes study on national lenders' capital needs: De Nederlandsche Bank on 23 April published a study on the capital needs of Dutch banks until 2019. This amounts to nearly Eu26.7bn in total, serving to meet the requirements of Basel III, contributions to the deposit guarantee and resolution fund, and the 4% leverage ratio.

RATING AGENCIES

Moody's releases proposed approach to rate high trigger CoCos: On 1 May Moody's presented its new proposed approach for rating bank high trigger contingent capital securities. The agency's framework employs a model-based approach that incorporates the view of the issuing bank's current financial strength as represented by its assigned Baseline Credit Assessment (BCA), its current capital level, the capital level associated with the point of non-viability, and the capital level associated with the trigger in the security being rated that determines the distance to trigger breach. Instead of a traditional notching-based approach, Moody's model will construct a specific curve for each bank, assuming that the distribution of a bank's future CET1 ratios follows a normal distribution, and using a volatility-computed starting from the BCA. As part of the new proposal, Moody's is also seeking market feedback on potentially establishing a cap of Ba1 for the ratings of high trigger securities. Lastly, the agency is also proposing to remove the additional notch on non-viability securities classified as Additional Tier 1 relative to the ratings for traditional Tier 1 and Tier 2 securities, and describes circumstances under which it might consider removing the notch from Tier 2 securities. *(See Q&A with Moody's Barbara Havlicek for more.)*

S&P clarifies the treatment of insurance subsidiaries in the RAC-F: On 23 May S&P released answers to FAQs relating to the treatment of insurance subsidiaries in the bank RAC framework (RAC-F). In this model, S&P applies a 1,250% risk weighting factor to investments in insurance subsidiaries. The scope of "investments" was not always consistent across jurisdictions, in the sense that often only core equity was captured. In this report, S&P clarifies that the 1,250% factor applies to all forms of capital, including Tier 1 and Tier 2 issued by the insurance company and held by the parent bank.

Moody's revises approach to Variation or Substitution Provisions: Moody's on 22 April published a new cross-sector rating methodology that updates and replaces its May 2013 publication "Rating Obligations with Variable Promises" by revising a section on Securities with Variation or Substitution Provisions. When rating securities with these provisions, the agency will consider (1) the likelihood that the contingent event allowing for substitution/amendment will occur, (2) the likelihood that the issuer will exercise its right, taking into account the investor protections, and (3) how the security could be changed in the future, or some combination of these considerations. If the likelihood is low and/or the difference in risk between the original security and the new or amended one is minimal, Moody's would rate the original security. However, if the likelihood is high or increasing that the original security will be replaced or amended, the agency will look through to the new security and rate on that basis. Moody's intends to maintain and monitor the ratings assigned under the previous methodology. ●

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INSURANCE

PRA releases consultation paper on the use of subordinated guarantees: On 30 May, the UK Prudential Regulation Authority (PRA) set out a new consultation paper (CP9/14) on subordinated guarantees and the quality of capital for insurers. The consultation seeks views on the PRA's expectations in relation to: (1) the use of subordinated guarantees in connection with capital instruments, whereby the payment of coupons and repayment of principal are guaranteed by a different entity (guarantor); (2) how subordinated guarantees should not undermine the quality of capital held by firms to meet capital requirements; and (3) how the guarantor's regulatory capital position should be reported if the liability created by the guarantee serves to undermine the guarantor's quality of capital. In summary, the PRA expects the subordinated guarantees to not override the capital instruments' loss-absorbing features or prevent investors from bearing losses when appropriate. Any subordinated guarantee arrangement will be assessed by the PRA to ascertain whether it is consistent with one of the following two acceptable situations:

1. From the perspective of the guarantor, if a subordinated guarantee is called upon, the guarantee should effectively extinguish or replace an existing subordinated liability. The subordinated guarantee should possess the same, or better, features regarding quality of capital as the subordinated liability it is replacing;
2. Alternatively, the guarantor should acknowledge the existence of the guarantee by disqualifying the guaranteed amount from the guarantor's Tier 1 capital (the amount may still count towards a lower tier of capital if the terms of the subordinated guarantee meet all of the relevant criteria).

The consultation will close on 11 July and the final supervisory statement should be released during the third quarter. The PRA expects firms to have resolved all issues by December 2015.

PRA publishes SS5/14 on calculation of technical provisions and use of internal models: On 25 April the PRA issued a new supervisory statement (SS5/14) setting out the PRA's expectations of general insurers in relation to the calculation of technical provisions and the use of internal models. As part of the PRA's preparations for the Solvency II regime, this statement seeks to ensure that firms set an adequate level of technical provisions and hold sufficient capital, and it is intended to apply to all general insurers within the scope of Solvency II. ●

INSURANCE

Structuring developments in Solvency II capital

Following the recent publication of the Technical Specifications in conjunction with the Stress Tests and the Implementing Technical Standards/Guidelines by EIOPA, we consolidate here the most recent developments in relation to own funds under the Solvency II framework.

EIOPA, Frankfurt

Solvency II process and next steps

- The Omnibus II Directive, which updates the Solvency II Directive of 2009 (Level 1), was adopted in March by the European Parliament and subsequently approved by the Council of the EU in April. The Directive was published in the EU Official Journal on 22 May.
- The Commission's Delegated Acts (Level 2) containing the implementing measures are not public but were reflected in the Solvency II Technical Specifications for the preparatory phase issued in conjunction with the Stress Tests 2014. The latest draft Level 2 text was released to the industry's stakeholders in March. The European Commission is expected to formally present and publish the text in September. The European Parliament will then have up to six months to adopt or reject the text.
- Implementing Technical Standards and Guidelines (Level 3):
  - The first set of Implementing Technical Standards (ITS) was released on 1 April. Comments are due by 30 June 2014. EIOPA will submit the final version of the first set of ITS by 31 October 2014 to the Commission. It will have three months to adopt, amend or reject the ITS. If they are rejected, EIOPA will have six months to submit a new version. Once adopted, ITS will be published in the EU Official Journal and enter into force 20 days after.
  - The first set of Level 3 Guidelines was released on 2 June. Comments are due by 29 August 2014. Of note, the Guidelines relating to Pillar 1 contain a section on Own Funds that provides for a convergent application of the features for determining the classification of capital instrument set out in the draft implementing measures. Those guidelines can fall under the statutory framework and left outside of the terms of the bond.
  - A second set of ITS and Guidelines will be issued between December 2014 and March 2015.

Supervisory approval for the use of ancillary own fund items

- The ITS stipulate that an insurance or reinsurance undertaking shall submit a written application for approval of each ancillary own fund item specifying a monetary amount and compliance with own funds' criteria. The supervisory authority shall decide on an application within three months (or six months under exceptional circumstances).

Common features of own fund items

- Guideline 13 clarifies that early redemption calls (e.g tax/regulatory/rating agency) are not allowed prior to five years from the date of issuance. However, substitution and variation language will be allowed (Guideline 5 1.29 mirrored by 1.42 and 1.50)
- The exchange or conversion (repayment or redemption) of an own fund item into (out of the proceeds of) another own fund item of at least the same quality shall not be deemed to be a repayment or redemption, subject to the approval of the supervisory authority.
- Dividend stoppers are not allowed in any own fund item.
- Incentives to redeem that are not limited and hence not compliant include:
  - Principal stock settlement/mandatory conversion/increase in the principal amount combined with a call option.
  - A change in the distribution structure from a fixed to a floating rate combined with a call option. This will probably be a major point of contention between EIOPA and issuers as the majority of transactions targeting direct Tier 2 Solvency II eligibility have used that coupon structure.
  - Other provisions that can reasonably be regarded as providing an eco-

nomic basis for the likely redemption of the item (catch-all language).

- A moderate step-up is defined for Tier 2 and 3 as 100bp or 50% of the initial credit spread, less the swap spread between the initial index basis and the stepped-up index basis. The same wording can be found in the Basel II banking regulation. However, an example provided in the FSA Handbook (GENPRU 2.2.150) seems to indicate that this would not affect transactions priced versus mid-swaps and reset on a Euribor basis.
- Guideline 14 (exceptional waiver of suspension of redemption in the event there is non-compliance with the SCR, subject to compliance with the MCR) clarifies that the issuer should demonstrate how the exchange/conversion (in an item of at least the same quality) contributes to the restoration of the SCR and should not issue a new instrument to repay existing holders.
- Guideline 16 (exceptional waiver of cancellation or deferral of distributions) clarifies both the procedure for an exceptional waiver in respect of ACSM settlement (though the issue of new shares) and a (somewhat more blurred) application for an exceptional waiver of cancellation or deferral of distributions.
- Guideline 18 clarifies that an undertaking would have to submit the request for supervisory approval three months prior to the earlier of the proposed repayment or redemption date (or required contractual notice). Moreover, it would have to provide (1) the current and short-to-medium term impact on the undertaking's overall solvency position and how the action is consistent with the undertaking's medium-term capital management plan and its ORSA, and (2) the capacity to raise additional own funds if needed. Regulatory equity credit will be lost from the date of notice to holders or the date of supervisory approval if no notice is required.
- In the case of a request to redeem a capital instrument in years 5-10, Guideline 15 expands Art. 59 COF2 of the


Michael Benyaya, CACIB

draft Level 2 rules and defines what the supervisory authority would assess to determine whether the margin over the SCR would be appropriate, notably based on the issuers' current and projected solvency position, Own Risk & Solvency Assessment (ORSA), volatility of the SCR and access to capital markets.

Restricted Tier 1 items

- Undated, first call date not allowed to occur before five years. No incentive to redeem. Dividend pushers/stoppers not allowed.
- Suspension of repayment and cancellation of distributions in case of non-compliance with the SCR*. Distributions are paid out distributable items that are determined on the basis of individual accounts.
- Loss absorption in case of significant non-compliance with the SCR (possibility to insert additional triggers) defined as SCR<75% or non-compliance with MCR. The trigger point needs to be clearly defined in the T&C. The loss absorption mechanism is effective without delay.
  - In case of a conversion into equity, the T&C will have to specify either (1) the rate of conversion and the limit on the permitted amount or (2) a range within which the instrument will convert. Issuers should ensure that authorisations are in place.
  - In case of principal write-down structure, a write-up will be permitted only after the undertaking has achieved compliance with the SCR provided that (i) it is not activated by reference to own fund items issued or increased in order to restore compliance with the SCR and (ii) it occurs on the basis of profits which contribute to distributable items made subsequent to the restoration of compliance with the SCR.

Tier 2 items

- Minimum maturity of 10 years. First call date not allowed to occur before five years. A moderate step-up cannot occur before 10 years. Suspension of repayment and deferral of distribution in case of non-compliance with the SCR*.

Tier 3 items

- Minimum maturity of five years. Suspension of repayment in case of non-compliance with the SCR* and deferral of distribution in case of non-compliance with the MCR*.

**Subject to waiver*

Grandfathering and eligibility of own funds instruments in the capital structure

- Grandfathering over 10 years. Cut-off date for the grandfathering of Solvency I format probably early 2015 (date of the adoption of the delegated acts). Non Solvency II-compliant perpetual bonds expected to be grandfathered in Tier 1.
- Compliance with the SCR: at least 50% of Tier 1 (of which max 20% of restricted Tier 1). Excess Tier 1 can be treated as Tier 2. Tier 2 and Tier 3 items < 50 % of the SCR (with Tier 3<15%).
- Compliance with the MCR: min. 80% Tier 1 (of which max 20% of restricted Tier 1). Max 20% Tier 2.

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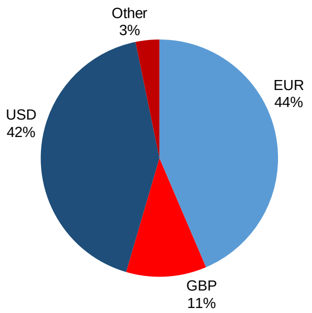
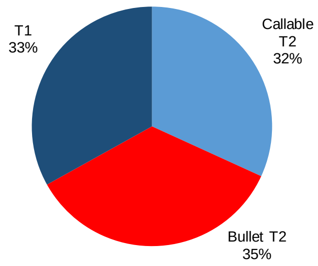
Currencies, structures and distribution

Bank hybrid issuance by currency (2013-2014 ytd)

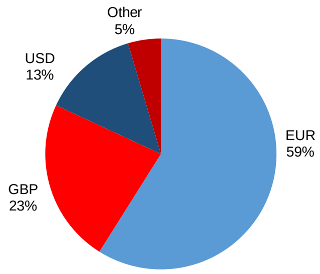


Bank issuance by instrument/structure (2013-2014 ytd)

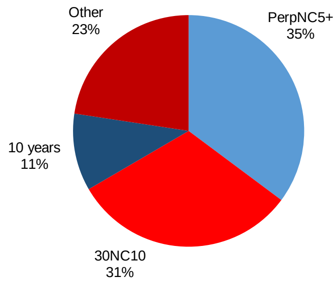


Source: Crédit Agricole CIB

Insurance hybrid issuance by currency (2013-2014 ytd)

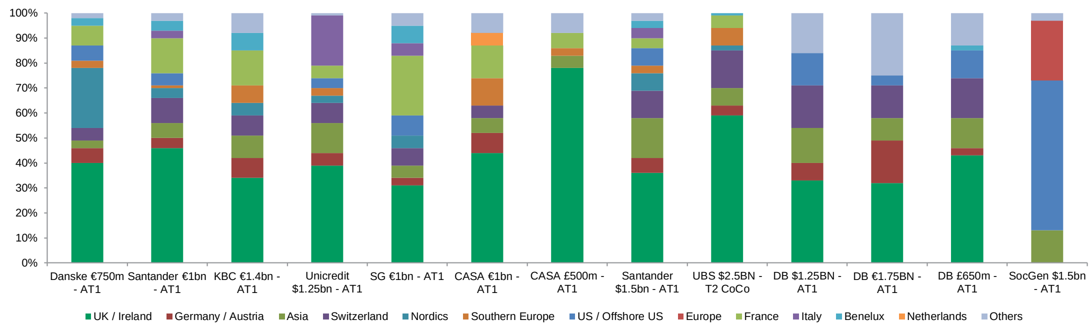


Insurance issuance by instrument/structure (2013-2014 ytd)

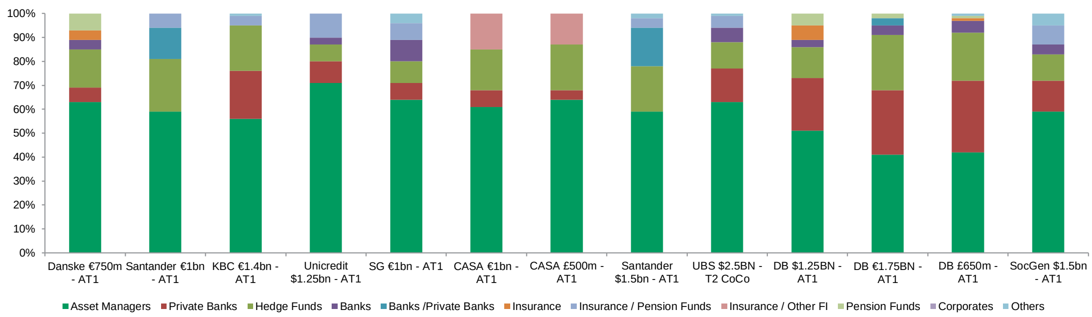


Source: Crédit Agricole CIB

Distribution by investor type



Distribution by geography



Source: Crédit Agricole CIB

AT1, Tier 2 CoCos

AT1 performance monitoring (as at 27/6/14)

Launch	Issuer	Issue ratings	Currency	Amount (m)	Coupon	Maturity date	First call date	Principal loss absorption	Trigger	Price	I-Spread	Yield to call
13/06/2014	BACR	-/B+/BB+	EUR	1,077	6.500%	PERP	15/09/2019	CE	7.000%	101.75	555	6.10
20/05/2014	DB	Ba3/BB/BB+	EUR	1,750	6.000%	PERP	30/04/2022	TWD	5.125%	101.25	467	5.80
01/04/2014	ACAFP	-/BB+/BB+	EUR	1,000	6.500%	PERP	23/06/2021	TWD	7%/5.125%	107.00	441	5.29
28/03/2014	SOCGEN	-/-/BB	EUR	1,000	6.750%	PERP	07/04/2021	TWD	5.125%	106.88	464	5.52
20/03/2014	LLOYDS	-/BB-/BB	EUR	750	6.375%	PERP	27/06/2020	CE	7.000%	107.25	424	4.97
12/03/2014	KBCBB	-/BB/BB	EUR	1,400	5.625%	PERP	19/03/2019	TWD	5.125%	101.38	478	5.29
05/03/2014	SANTAN	Ba2/-/-	EUR	1,500	6.250%	PERP	12/03/2019	CE	5.125%	103.75	484	5.34
05/03/2014	DANBNK	-/BBB-/BB+	EUR	750	5.750%	PERP	06/04/2020	TWD	7.000%	104.50	412	4.84
11/02/2014	BBVASM	-/-/BB	EUR	1,500	7.000%	PERP	19/02/2019	CE	5.125%	106.50	491	5.40
03/12/2013	BACR	-/B+/BB+	EUR	1,000	8.000%	PERP	15/12/2020	CE	7.000%	110.20	532	6.08
01/10/2013	POPSM	-/-/-	EUR	500	11.500%	PERP	10/10/2018	CE	5.125%	121.24	543	5.85
19/06/2014	COVBS	-/-/BB+	GBP	400	6.375%	PERP	01/11/2019	CE (*)	7.000%	100.38	410	6.29
13/06/2014	BACR	-/B+/BB+	GBP	698	7.000%	PERP	15/09/2019	CE	7.000%	99.00	512	7.23
20/05/2014	DB	Ba3e/BB/BB+	GBP	650	7.125%	PERP	30/04/2026	TWD	5.125%	100.75	405	7.03
01/04/2014	ACAFP	-/-/BB+	GBP	500	7.500%	PERP	23/06/2026	TWD	7%/5.125%	104.63	412	6.93
20/03/2014	LLOYDS	-/BB-/BB	GBP	1,481	7.000%	PERP	27/06/2019	CE	7.000%	102.88	423	6.32
20/03/2014	LLOYDS	-/BB-/BB	GBP	1,494	7.625%	PERP	27/06/2023	CE	7.000%	107.00	399	6.59
20/03/2014	LLOYDS	-/BB-/BB	GBP	750	7.875%	PERP	27/06/2029	CE	7.000%	110.00	385	6.81
04/03/2014	NWIDE	-/BB+/BB+	GBP	1,000	6.875%	PERP	20/06/2019	CE (*)	7.000%	103.00	403	6.16
19/06/2014	SOCGEN	Ba3/-/BB	USD	1,500	6.000%	PERP	27/01/2020	TWD	5.125%	99.13	433	6.19
13/06/2014	BACR	-/B+/BB+	USD	1,211	6.625%	PERP	15/09/2019	CE	7.000%	99.38	506	6.77
10/06/2014	CS	-/BB/BB+	USD	2,500	6.250%	PERP	18/12/2024	PWD	5.125%	100.75	348	6.15
20/05/2014	DB	Ba3e/BB/BB+	USD	1,250	6.250%	PERP	30/04/2020	TWD	5.125%	101.00	403	6.04
08/05/2014	SANTAN	Ba2/-/-	USD	1,500	6.375%	PERP	19/05/2019	CE	5.125%	101.13	448	6.11
07/04/2014	LLOYDS	-/BB-/BB	USD	1,675	7.500%	PERP	27/06/2024	CE	7.000%	106.50	404	6.61
27/03/2014	UCGIM	-/-/BB-	USD	1,250	8.000%	PERP	03/06/2024	TWD	5.125%	107.50	433	6.94
15/01/2014	ACAFP	-/BB+/BB+	USD	1,750	7.875%	PERP	23/01/2024	TWD	7%/5.125%	109.88	397	6.48
11/12/2013	SOCGEN	Ba3/BB+/BB	USD	1,750	7.875%	PERP	18/12/2023	TWD	5.125%	107.63	421	6.77
04/12/2013	CS	-/BB/BB+	USD	2,250	7.500%	PERP	11/12/2023	PWD	5.125%	111.38	336	5.91
13/11/2013	BACR	-/B+/BB+	USD	2,000	8.250%	PERP	15/12/2018	CE	7.000%	107.25	488	6.37
29/08/2013	SOCGEN	Ba3/BB+/BB	USD	1,250	8.250%	PERP	29/11/2018	TWD	5.125%	109.25	431	5.84
26/04/2013	BBVASM	-/-/BB	USD	1,500	9.000%	PERP	09/05/2018	CE	5.125%	112.50	408	5.38

Principal loss absorption: CE = conversion into equity; TWD = temporary write-down; PWD = permanent write-down; *Converts into Core Capital Deferred Shares (CCDS)

T2 CoCo performance monitoring (as at 27/6/14)

Launch	Issuer	Issue ratings	Currency	Amount (m)	Coupon	Maturity date	First call date	Principal loss absorption	Trigger	Price	I-Spread	Yield to call
23/05/2014	NYKRE	-/-/BBB	EUR	600	4.000%	03/06/2036	03/06/2021	PWD	7.000%	100.51	293	3.91
06/02/2014	UBS	-/BBB/BBB+	EUR	2,000	4.750%	12/02/2026	12/02/2021	PWD	5.000%	107.25	257	3.50
11/09/2013	CS	-/BBB/BBB+	EUR	1,250	5.750%	18/09/2025	18/09/2020	PWD	5.000%	111.75	274	3.60
29/07/2011	BKIR	-/-/-	EUR	1,000	10.000%	30/07/2016	-	CE	8.000%	111.19	393	-
08/05/2014	UBS	-/BBB/BBB+	USD	2,500	5.125%	15/05/2024	-	PWD	5.000%	100.38	241	-
12/09/2013	ACAFP	-/BBB-/BBB-	USD	1,000	8.125%	19/09/2033	19/09/2018	PWD	7.000%	114.88	277	4.23
01/08/2013	CS	-/BBB/BBB+	USD	2,500	6.500%	08/08/2023	-	PWD	5.000%	111.25	244	-
15/05/2013	UBS	-/BBB/BBB+	USD	1,500	4.750%	22/05/2023	22/05/2018	PWD	5.000%	102.13	275	4.14
03/04/2013	BACR	-/BB+/BBB-	USD	1,000	7.750%	10/04/2023	10/04/2018	PWD	7.000%	111.75	303	4.34
17/01/2013	KBC	-/BBB-/-	USD	1,000	8.000%	25/01/2023	25/01/2018	PWD	7.000%	114.50	239	3.63
14/11/2012	BACR	-/BB+/BBB-	USD	3,000	7.625%	21/11/2022	-	PWD	7.000%	114.50	304	-
10/08/2012	UBS	-/BBB/BBB+	USD	2,000	7.625%	17/08/2022	-	PWD	5.000%	120.13	225	-
15/02/2012	UBS	-/BBB/BBB+	USD	2,000	7.250%	22/02/2022	22/02/2017	PWD	5.000%	109.50	252	3.41
17/02/2011	CS	-/-/BBB-	USD	2,000	7.875%	24/02/2041	24/08/2016	CE	7.000%	108.13	324	3.89

Principal loss absorption: CE = conversion into equity; TWD = temporary write-down; PWD = permanent write-down

Source: Crédit Agricole CIB

Latest bank Tier 2, insurance hybrids

Latest Tier 2 performance monitoring (as at 27/6/14)

Launch	Issuer	Issue ratings	Currency	Amount (m)	Coupon	Maturity date	First call date	I-Spread	Yield to call
26/06/2014	BPCEGP	Baa3e/-/A-e	EUR	1,000	2.750%	08/07/2026	08/07/2021	188	2.89
19/06/2014	ISPIM	Ba1/BBB-/BBBe	USD	2,000	5.017%	26/06/2024	-	221	-
04/06/2014	BKIR	-/B/-	EUR	750	4.250%	11/06/2024	11/06/2019	368	4.33
03/06/2014	STANLN	A3/A-/A+	GBP	900	5.125%	06/06/2034	-	208	-
22/05/2014	SEB	Baa2/BBB+/A	EUR	1,000	2.500%	28/05/2026	28/05/2021	147	2.45
21/05/2014	RBS	Ba3/BB+/BBB-	USD	2,250	5.125%	28/05/2024	-	229	-
20/05/2014	LBBW	Baa2/-/-	EUR	500	2.875%	27/05/2026	27/05/2021	184	2.82
14/05/2014	BFCM	Baa1/BBB+/A	EUR	1,000	3.000%	21/05/2024	-	143	-
14/05/2014	RABOBK	A2/A/A+	EUR	2,000	2.500%	26/05/2026	26/05/2021	163	2.61
14/05/2014	RABOBK	A2/A/A+	GBP	1,000	4.625%	23/05/2029	-	164	-
13/05/2014	BKIASM	-/B-/B+	EUR	1,000	4.000%	22/05/2024	22/05/2019	344	4.08
12/05/2014	DANBNK	-/BBB/A-	EUR	500	2.750%	19/05/2026	19/05/2021	167	2.65
02/04/2014	FRLBP	-/BBB/-	EUR	750	2.750%	23/04/2026	23/04/2021	164	2.60
08/04/2014	BPCEGP	Baa3/BBB+/A-	GBP	750	5.250%	16/04/2029	-	208	-
26/03/2014	NDB	Ba1/-/-	USD	500	6.250%	10/04/2024	-	369	-
02/04/2014	BBVASM	Baa3/BBB-/BBB+	EUR	1,500	3.500%	11/04/2024	11/04/2019	211	2.74
21/03/2014	STANLN	A3/A-/A+	USD	2,000	5.700%	26/03/2044	-	204	-
20/03/2014	RBS	Ba3/BB+/BBB-	EUR	1,000	3.625%	25/03/2024	25/03/2019	247	3.09
13/03/2014	BNP	Baa2/A- /*-/A	EUR	1,500	2.875%	20/03/2026	20/03/2021	164	2.59
11/03/2014	AARB	-/-/BBB-	EUR	300	4.250%	18/03/2026	18/03/2021	237	3.32
05/03/2014	HSBC	A3/A-/A+	USD	2,000	4.250%	14/03/2024	-	129	-
05/03/2014	HSBC	A3/A-/A+	USD	1,500	5.250%	14/03/2044	-	144	-
18/02/2014	INTNED	Baa2/BBB+/A-	EUR	1,500	3.625%	25/02/2026	25/02/2021	208	3.02
17/02/2014	SWEDA	Baa2/A-/A	EUR	750	2.375%	26/02/2024	26/02/2019	143	2.04
12/02/2014	RBIAV	Baa3/BBB /*-/-	EUR	500	4.500%	21/02/2025	21/02/2020	329	4.06
14/01/2014	SOCGEN	Baa3/BBB+/BBB+	USD	1,000	5.000%	17/01/2024	-	185	-
13/01/2014	BPCEGP	Baa3/BBB+/A-	USD	1,500	5.150%	21/07/2024	-	176	-
07/01/2014	SHBASS	Baa1/A/A+	EUR	1,500	2.656%	15/01/2024	15/01/2019	137	1.96

Insurance performance monitoring (as at 27/6/14)

T1/T2	Launch	Issuer	Issue ratings	Currency	Amount (m)	Coupon	Maturity Date	First Call Date	New issue spread (over mid-swaps)	I-spread
T2	26/06/2014	AVLN	//	EUR	700	3.875%	03/07/2044	03/07/2024	248	251
T2	19/06/2014	LGEN	Baa1/BBB+/BBB	GBP	600	5.500%	27/06/2064	27/06/2044	-	240
T2	06/06/2014	USIMIT	Ba2/BB+/-	EUR	750	5.750%	PERP	18/06/2024	418	429
T2	06/06/2014	DLNA	-/BBB-/-	EUR	750	4.375%	PERP	13/06/2024	290	312
T2	27/05/2014	CNPFP	-/BBB+/-	EUR	500	4.250%	05/06/2045	05/06/2025	260	250
T1	22/05/2014	CCAMA	-/-/BB	EUR	1,100	6.375%	PERP	28/05/2024	477	454
T2	21/05/2014	POSIM	-/-/BBB	EUR	750	2.875%	30/05/2019	-	215	182
T2	14/05/2014	AXASA	A3/BBB/BBB	EUR	1,000	3.875%	PERP	08/10/2025	225	243
T2	07/05/2014	WUWGR	-/BBB/-	EUR	250	5.250%	15/07/2044	15/07/2024	350	290
T2	23/04/2014	ASSGEN	Baa3/BBB+/BBB	EUR	1,000	4.125%	04/05/2026	-	225	219
T2	17/04/2014	AEGON	Baa1/BBB/BBB	EUR	700	4.000%	25/04/2044	25/04/2024	235	248
T2	01/04/2014	NNGRNV	Baa3/BBB-/BBB-	EUR	1,000	4.625%	08/04/2044	08/04/2024	295	271
T2	19/03/2014	COFCHD	Baa1/-/A-	EUR	380	4.125%	27/03/2024	-	235	199
T2	08/01/2014	AXASA	A3/BBB/BBB	GBP	750	5.625%	16/01/2054	16/01/2034	-	227
T2	04/12/2013	PRUFIN	A3/A-/BBB+	GBP	700	5.700%	19/12/2063	19/12/2043	-	225
T2	22/11/2013	RLMI	Baa1/BBB+/-	GBP	400	6.125%	30/11/2043	30/11/2023	-	274
T2	17/10/2013	ALVGR	A2/A+/A	EUR	1,500	4.750%	PERP	24/10/2023	260	231
T2	01/10/2013	VIGAV	-/A-/-	EUR	500	5.500%	09/10/2043	09/10/2023	-	284
T2	10/09/2013	ISPVIT	-/-/BBB	EUR	500	5.350%	18/09/2018	-	385	197
T2	23/07/2013	UQA	-/BBB/-	EUR	350	6.875%	31/07/2043	31/07/2023	499	336
T2	16/07/2013	ZURNVX	A2/A/-	EUR	211	4.250%	02/10/2043	02/10/2023	245	187
T2	12/07/2013	CNPFP	-/BBB+/-	USD	500	6.875%	PERP	18/07/2019	-	304
T2	02/07/2013	AVLN	Baa1/BBB/-	EUR	650	6.125%	05/07/2043	05/07/2023	413	245
T2	26/06/2013	MACIFS	Baa1/-/-	EUR	400	5.500%	08/03/2023	-	374	241

Source: Crédit Agricole CIB

League tables

Bookrunners all European FI hybrids (euros and US dollars)
01/01/2014 to 02/06/2014

	Managing bank or group	No of issues	Total EUR m	Share (%)
1	Deutsche Bank	16	6,108	11.7
2	UBS	12	4,569	8.7
3	HSBC	11	4,290	8.2
4	BAML	14	4,165	8.0
5	BNP Paribas	11	3,340	6.4
6	Société Générale	10	2,796	5.3
7	Crédit Agricole CIB	9	2,347	4.5
8	Goldman Sachs	10	2,335	4.5
9	Morgan Stanley	9	2,074	4.0
10	RBS	9	1,989	3.8
11	Citi	7	1,937	3.7
12	UniCredit	8	1,643	3.1
13	JP Morgan	8	1,628	3.1
14	Barclays	8	1,580	3.0
15	ING	6	1,401	2.7
	Total	58	52,312	

Source: Dealogic, Thomson Reuters, Crédit Agricole CIB

Bookrunners all financials (euros)
01/01/2014 to 02/06/2014

	Managing bank or group	No of issues	Total EUR m	Share (%)
1	BNP Paribas	49	10,990	8.7
2	Deutsche Bank	40	10,381	8.2
3	Morgan Stanley	31	8,625	6.8
4	Société Générale	34	7,981	6.3
5	Goldman Sachs	31	7,804	6.2
6	Natixis	20	7,500	5.9
7	Crédit Agricole CIB	19	7,265	5.8
8	Barclays	33	7,061	5.6
9	HSBC	32	7,037	5.6
10	Citi	23	5,151	4.1
11	JP Morgan	27	5,017	4.0
12	UBS	15	3,120	2.5
13	BAML	14	3,020	2.4
14	RBS	18	2,933	2.3
15	Rabobank	6	2,856	2.3
	Total	225	126,104	

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

Bankia, Madrid
Photo: Maciej Janiec/Flickr

Bankia
Capital comeback

Bankia made a spectacular return to the Tier 2 market on 13 May just a year after junior bondholders were bailed in following its bail-out in 2012. Here, Fernando Cuesta, head of funding at Bankia, and Vincent Hoarau, head of FIG syndicate at Crédit Agricole CIB, discuss the preprations for and execution of the Spanish bank's comeback trade.

This is a major subordinated benchmark transaction after the crisis and restructuring of BFA/Bankia Group. What are the main takeaways of this landmark trade for the issuer?

Fernando Cuesta, Bankia: Following the Eu1bn five year senior unsecured bond executed in January, we decided to take advantage of the strong market appetite for southern European credits in order to start building up our Tier 2 capital buffer — prior to the deal Bankia had no outstanding subordinated debt after the restructuring process conducted in the previous months.

The transaction is the third Tier 2 bond from a Spanish issuer in the last two years, following CaixaBank (Eu750m in October 2013) and BBVA (Eu1.5bn this April), both in 10NC5 format.

This transaction represents a big success for Bankia, further restoring investor confidence by continuing to rebuild its presence in the capital markets.

What was the rationale for the issue?

Cuesta, Bankia: The transaction represents a further step in the normalisation of the bank, and it allows Bankia to build up the new capital requirements set under Basel III. Up to now Bankia's capital structure was mainly made up of equity, which is not the most efficient structure considering the new bank capital regulation.

This transaction improves the bank's capital position: Bankia's Basel III total capital ratio increases by 103bp, moving from 11.29% at the end of March to 12.32%.

You did not execute a global roadshow prior to the transaction. Why was this?

Cuesta, Bankia: We decided to go for a smooth two day execution instead of a global roadshow in line with recent Tier 2 deals, leveraging off good market conditions and the recent credit update roadshow completed after our 1Q14 results. A global investor call was organised for Monday, 12 May, with the Group CFO hosting it and over 70 investors participating. The investor call attendance was supportive enough to open books on Tuesday, 13 May.

Vincent Hoarau, Crédit Agricole CIB: The level of participation of international investors is clear evidence that the absence of a global roadshow did not harm the transaction at all. The issuer was very well prepared and the global investor call was sufficient. Some 85% of the total was distributed outside the Iberian peninsula and the level of granularity in the order-book was exceptional.

Why was a 10NC5 structure chosen?

Cuesta, Bankia: The structure is very well known on the investor community side, and from a regulatory point of view it is more efficient, as the issuer can avoid disqualification of 20% per year in the last five years.

Many investors expressed their preference for a standard maturity, in order to easily compare value versus other credits.

Hoarau, CACIB: Yields and coupon levels have dropped significantly, but over time there is room for spread improvement and further convergence, I think. The situation in Spain is improving; peripheral names are en vogue. The imbalance in the demand/supply/redemption dynamic predominates. So I would understand the risk implied by locking in a spread at the current level for a longer than necessary period from a regulatory standpoint. And as Fernando rightly said, the 10NC5 structure is very well established.

How did the pricing and order book develop?

Cuesta, Bankia: After announcing the mandate and holding the global investor call on 12 May, feedback was collected with indications of interest of around Eu800m. We then decided to launch the transaction with initial price thoughts of the low 4s on Tuesday, 13 May at 8.20am London time.

The book grew quickly and exceeded Eu2bn in roughly an hour. At 11.05am, with demand already exceeding Eu3.5bn, guidance was revised to 4%-4.125%. The book closed with total demand above Eu4bn — very well balanced between hedge funds and real money accounts — and more than 260 investors participating, enabling Bankia to price at a yield of 4.0%.

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

Cuesta, Bankia: Our main reference points were other Spanish euro Tier 2 secondaries. Starting from there we calculated Bankia differentials to our peers in senior, and then added it to the aforementioned Tier 2 levels. This implied at the time a fair value of around mid-swaps plus 300bp. We considered a new issue premium of 15bp was fair enough, leading to the final price of mid-swaps plus 316.6bp.

Hoarau, CACIB: Indeed. At the time of the launch, CaixaBank senior unsecured outstanding May 2018s were trading in the context of mid-swaps plus 75bp, while Bankia January 2019s were around 160bp. This implied roughly 80bp of credit spread differential between the two signatures. In the Tier 2 segment, CaixaBank 5% November 2023s were trading around the 215bp mark. Adding a few basis points for the curve extension led to a fair value of around 300bp.

For what it is worth, we also looked at the CDS market and the credit spread differential there was tighter, with BBVA around 125 and Bankia around 195. But we were not convinced about the meaningfulness of having CDS levels as reference points.

In hindsight, would you have done anything differently?

Cuesta, Bankia: We were extremely happy with the result of the transaction. Timing was key, as market conditions became more volatile shortly after we priced the transaction. Having a Eu4bn book to cover a Eu1bn transaction is never easy, and made the allocation process complicated. Some investors could not be satisfied in their final takes. We always try to learn from every execution in order to be as fair as possible with them during this process.

Hoarau, CACIB: Within syndicate, we considered the marketing of the deal on a mid-swap spread basis. But given where the five year swap rate was ahead of the bookbuilding phase we thought marketing on a yield basis was much more appropriate and looked more appealing. As outlined before by Fernando, we started bookbuilding at the low 4s IPTs and priced the deal at a coupon of 4% versus a re-offer price of 100%. I think this was decisive in the marketing process. It also offered additional room to tighten the spread versus swaps given the nature of the demand. ●

Issuer: Bankia SA

Issue ratings: B- (S&P)/B+ (Fitch)

Security description: Dated subordinated, Tier 2

Format: RegS

Issue size: Eu1bn

Tenor: 10 year non-call five

Settlement: 22 May 2014

Maturity: 22 May 2024

First call date: 22 May 2019

Re-offer spread: 316bp over mid-swaps

Coupon: 4%

Re-offer yield: 4%

Re-offer price: 100%

Bookrunners: BAML, Bankia, Barclays, Crédit Agricole CIB, Goldman Sachs

Distribution:

UK & Ireland 46%, Iberia 14%, US offshore 12%, France 10%, Germany & Austria 7%, Switzerland 4%, Italy 2%, Benelux 2%, Asia 2%, others 1%

Investment funds 58%, hedge funds 23%, banks 12%, insurance companies and pension funds 3%

Moody's AT1 o'clock

Moody's methodology for rating hybrid securities has evolved with the development of post-crisis, Basel III-compliant instruments, most recently with the publication of a Request for Comment on "high trigger" CoCos in May. *Barbara Havlicek, senior vice president, team leader, hybrid capital group, at Moody's,* explains the rating agency's thinking.

Moody's has recently proposed an update to its bank hybrid rating methodology. What is the scope of this proposal?

Our proposed methodology will allow us to rate the whole universe of contingent capital securities where equity conversion/principal write-down is triggered by regulatory discretion and/or the breach of regulatory capital triggers.

The proposal specifically outlines our approach to the following:

- A framework for rating "high trigger" contingent capital securities that includes a conversion/write-down trigger designed to trip well in advance of a bank's point of non-viability or failure.

- Revisions to our existing framework for rating non-viability contingent capital securities, where conversion/write-down is triggered at or close to the point of non-viability or failure.

How has Moody's thinking evolved over the past years regarding the rating of bank capital securities?

The universe of bank contingent capital securities currently consists of non-viability securities (where losses are imposed at or close to the point of non-viability) and "high trigger" securities (where losses are imposed well in advance of the point of non-viability). In February 2010, when the market was in its infancy, we established a moratorium on rating contingent capital securities that have conversion/write-down triggered by regulatory discretion and/or the breach of regulatory capital triggers.


Barbara Havlicek, Moody's

Our decision reflected the difficulty of predicting when an impairment event would be triggered given the limited performance history of such securities, the rapid innovation of structures, associated lack of a developed market, and the evolving regulatory and political environments. These factors all influenced when contingent capital securities could possibly absorb losses as a bank's financial condition deteriorates.

Since that time, regulatory and political willingness to impose losses on bank creditors — particularly junior creditors, in advance of, and as a means to limit public sector support — has become more firmly entrenched, both in practice and in our bank rating considerations. These market developments have helped us gain comfort that an impairment event for a non-viability contingent capital security would be triggered at a point close to when junior bank securities that we currently rate are taking losses. Consequently, we are more comfortable using the analytical tool we already have in place — our Baseline Credit Assessment (BCA), which measures the bank's standalone financial strength and is a proxy for the point of non-viability, as the starting point for rating non-viability securities.

As a result, in May 2013, we introduced a framework to rate non-viability securities in an update to our Global Bank Rating Methodology. However, we continued our moratorium on rating "high trigger" securities because they required analytical tools beyond the scope of our BCA to capture the additional risk of a trigger breach.

Since May 2013, we have continued working to develop the needed set of analytical tools to capture the additional risk of impairment resulting from a trigger breach for "high trigger" securities, beyond determining the probability of a bank-wide failure and coupon suspension. This is the proposal that we outlined in our Request for Comment that was published in early May.

What are the key challenges in rating "high trigger" bank capital securities?

The key challenge in rating "high trig-

One Canada Square, home of Moody's London offices
Photo: Simon Wicks/Flickr

ger" securities is that they could behave in ways that are difficult to predict. While our model provides an analytical tool to capture the probability of a bank-wide failure and a trigger breach ahead of a bank-wide failure — both significant risks in rating these securities — there is the possibility that a regulator could intervene earlier than anticipated or that bank capital ratios fail to adequately capture the true financial health of the bank. As a result, similar to the way that we assign bank ratings generally, rating committees may use judgment to position ratings reflecting their assessment of the expected loss of the security.

Can you take us through the main steps when assigning ratings to bank capital securities?

As mentioned previously, the contingent capital universe consists of non-viability securities (where equity conversion or principal write-down is triggered at or close to the point of non-viability) and "high trigger" securities (where equity conversion or principal write-down is triggered well in advance of the point of non-viability).

For rating non-viability securities — where we use our BCA as a proxy for the point of non-viability or bank-wide failure — we use a notching framework that is anchored from the Adjusted BCA (BCA plus parental and/or cooperative support, if any). For rating non-viability Tier 2 securities, our default position would remain Adjusted BCA less two notches to reflect the subordination of the instrument and the uncertain timing to the triggering of conversion/write-down. For Additional Tier 1 (AT1) securities, we are proposing to position the ratings three notches — rather than four notches as is our current practice — from the Adjusted BCA to reflect the higher probability of impairment associated with non-cumulative coupon suspension and to avoid double counting this risk with the probability of a bank-wide failure.

For rating "high trigger" securities, our framework uses a model-based approach that incorporates our view of the bank's current financial strength as captured through its BCA and its last-reported Common Equity Tier 1 (CET1) capital ratio, potentially adjusted for our forward-looking view, to determine the probability of a trigger breach as well as the probability of a bank-wide failure.

The model measures the distance from the bank's CET current capital ratio to the capital level set as the "trigger" for imposing losses on the security. It takes the probability of a bank-wide failure and adds to it the probability of trigger breach ahead of a bank-wide failure, which is then mapped to Moody's four year idealised default tables. After factoring in loss severity, the model generates a rating that is the starting point for the rating discussion.

We will cap the "high trigger" security rating at the level of the non-viability security rating if the model-based rating outcome points to a "high trigger" security rating that is above the bank's non-viability security rating. That is because a "high trigger" security rating is comprised of the credit risk of its non-viability component and that associated with the distance to trigger breach, which means the "high trigger" rating could never be above the non-viability security rating. The non-viability security rating also captures the risk of coupon suspension, if such a feature exists. Effectively, we are rating to the greatest risk among a trigger breach, non-viability, and impairment associated with coupon suspension.

Final positioning of the rating involves rating committee input to evaluate specific features that may prompt certain bank behaviours (for example, if a "high trigger" security has a full principal write-down, a bank may not have any qualms about allowing the trigger breach to occur because there is no associated equity dilution). Beyond the features of the specific security, we may also factor in other circumstances of a particular bank such as its ability to issue new equity or take other remedial actions such as deleveraging or selling off business units to avoid a trigger breach. We may also consider how close a bank is to breaching its capital buffers, which would result in coupon suspension as a first step once a bank starts to weaken financially.

Why does Moody's believe that a model-based approach is needed to rate "high trigger" securities? What are the main assumptions factored into your model?

Simply stated, the absolute risk of a "high trigger" security is the distance to trigger breach, which is best captured through a model rather than through a simple notching-based approach. However, this distance only captures one aspect of these securities' risks, the second being the risk of the security relative to the fundamental strength of the bank.

As a result, we tie our determination of the probability that the trigger will be breached to the bank's BCA and cap the "high trigger" security rating at the non-viability security rating, which also captures the risk of coupon suspension, in our proposed rating approach. The end result is an analytical framework that incorporates the incremental credit risk of a trigger breach in a manner consistent with the overall credit assessment of the bank.

In our model, we assume that the distribution of a bank's forward capital ratios follows a normal distribution. To create the distribution, the bank's expected capital ratio is assumed to be the mean of the distribution of forward capital ratios. Our model inputs include the capital ratio trigger in the security itself, the bank's expected capital ratios (which we may adjust based on our forward view of the bank's capital), and its BCA.

How is your proposal reflecting the development of resolution frameworks (e.g. BRRD)? How can it affect the rating of bank capital instruments?

Our proposal captures the risk of contractual non-viability and "high trigger" securities, which may be subject to losses as a means to avoid a bank-wide resolution.

If implemented as currently proposed, what is the expected rating impact for outstanding bank capital securities i.e. AT1, legacy Tier 1 and Tier 2?

If the proposed changes are implemented, approximately 20, mostly Additional Tier 1 non-viability security ratings could be upgraded by one notch.

Does Moody's differentiate among the various loss absorption mechanisms (temporary and full principal write-down, equity conversion)?

For the ratings of both Tier 2 and Additional Tier 1 non-viability securities, we do not distinguish the risk of a full principal write-down versus equity conversion or a partial/temporary principal write-down. That is because by the time a bank reaches the point of non-viability, the difference between these types of loss mechanisms would not likely warrant an additional notch. However, for the ratings of "high trigger" securities, we will add an additional notch for a full principal write-down to reflect the potential for greater loss severity relative to equity conversion or a partial/temporary principal write-down, unless the rating is already subject to the non-viability security rating cap.

What is the equity credit granted to Additional Tier 1 instruments? Is there any difference between high and low trigger instruments?

For Additional Tier 1 securities, we typically assign equity credit based on the features of the host security, whether there are high or low (non-viability) triggers. Generally speaking, these securities are assigned 75% equity credit.

Would the same criteria be applied to contingent capital securities issued by non-bank institutions, e.g. insurance companies?

Contingent capital issued by non-banks would be rated using the same analytical thought process proposed for banks. Specifically for insurers, we would determine the non-viability point based on each jurisdiction's regulatory framework as well as factor in the probability of a trigger breach. ●

Moody's positioning of capital securities

			EXISTING	PROPOSED
Host type	Regulatory treatment	Traditional securities (without contractual loss absorption)(1)	Non-viability securities (with contractual loss absorption)	Non-viability securities (with contractual loss absorption)
		Anchor point is Adjusted BCA (2)		
Subordinated debt	Tier 2	-1 to -2	-2 to -3	-1 to -2
Non-cumulative preferred securities	Additional Tier 1	-3	-4	-3

(1) May be subject to a bail-in regime depending on jurisdiction

(2) Our starting point for rating hybrid securities and subordinated debt, in a number of jurisdictions, is the BCA to which we add parental support to arrive at our Adjusted BCA. Whether or not parental support is incorporated in this anchor point can vary by security type and jurisdiction.

Source: Moody's Request for Comment (closed), 1 May 2014

CNP Assurances, Paris
Photo: Philippe Eranian for CNP Assurances

CNP Assurances
Achieving new standards

France's CNP Assurances on 27 May sold a Eu500m 31NC11 subordinated bond that addressed Solvency I, rating agency and the latest Solvency II requirements, while achieving the third-lowest coupon on a euro-denominated Solvency II Tier 2-eligible issue. Vincent Damas, director for ALM and funding, and Stéphane Trarieux, funding and rating agencies department, of CNP Assurances discuss the rationale for the deal and share their views on Solvency II developments, while Crédit Agricole CIB's Michael Benyaya explains the context of the latest EIOPA pronouncements.

Why did CNP Assurances come to the market with a subordinated bond at this time?

Vincent Damas, CNP Assurances: Market conditions are very favourable to issuers, with low interest rates and credit spreads having compressed over the past 18 months. In today's markets, windows of issuance are remaining open while new issue premiums are falling. This situation contrasts sharply with the 2008-2012 period, when spreads were volatile and tending to head northward.

So we considered it was time to take advantage of this market backdrop and to progress in our regular funding programme.

Insurance sector spreads and yields are at historically low levels. Was this a factor in choosing to come to the market now?

Stéphane Trarieux, CNP Assurances: Subordinated debt is a high beta instrument, which exacerbates widening and tightening spread moves more than any senior unsecured debt. In today's historically low yield environment, appetite for such investment opportunities out of the insurance sector is growing. The headline coupon of our subordinated 31 non-call 11 structure reached 4.25%, which is the lowest level ever achieved by CNP Assurances since its first subordinated issue in 1999.

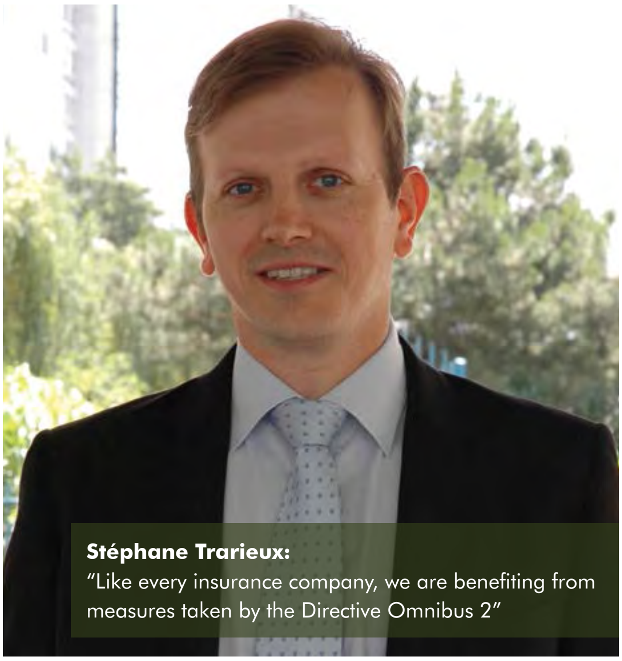
Were you satisfied with the execution of the deal in terms of size and demand?

Damas: CNP Assurances decided to cap the size of the issue at Eu500m from the outset. We enjoyed an order book almost 10 times as large as the transaction size. On the back of this strong response, initial guidance was tightened by 15bp from initial price thoughts of mid-swaps plus 275bp to mid-swaps plus 260bp. This level implies zero new issue premium.

Why did you not hold a roadshow? Was there any marketing ahead of execution?

Trarieux: CNP Assurances' signature is well known by investors and very well established across the board. We have a long track record in the primary market, with several benchmark issues in various markets and currencies — euros, US dollars and sterling — and with a greater frequency of issuance since 2010.

Nevertheless, permanent investor dialogue is key and essential. This is why we conducted a pan-European credit update in April to present our 2013 annual results.



Stéphane Trarieux:
"Like every insurance company, we are benefiting from measures taken by the Directive Omnibus 2"

Why did you choose the 31 non-call 11 structure?

Damas: The 31 non-call 11 structure is the right instrument to lengthen the average duration of our debt. It also leaves us the possibility of tapping that particular bond during one year if we need to.

We opted for the traditional insurer-style Tier 2 structure, as it is well known and accepted by investors. This structure is eligible under Solvency I, Solvency II and offers equity credit from the rating agency standpoint.

More generally, how is the transition to Solvency II affecting your capital planning and needs?

Trarieux: CNP Assurances was one of the first European insurers to launch a Solvency II-compliant Tier 2 transaction as early as September 2010. Since then, this format has become a standard in the industry although Solvency II had not even come into force. At that point in time the final rules had not even been officially published.

Like every insurance company, we are benefiting from measures taken by the Directive Omnibus 2, which establishes the grandfathering until 2026 of debt issued before 2016. This transition period is long enough. It offers a great degree of comfort with regards to the eligibility of our debt. It also allows a smooth replacement of our maturing debt.

Michael Benyaya, DCM Solutions, Crédit Agricole CIB: There are no identified capital needs stemming from the implementation of Solvency II for the largest insurance companies. This is notably highlighted by the absence of large capital increases in the insurance sector launched to comply with the new standards. Insurance companies remain active on the subordinated debt market, but this is primarily for refinancing purposes.

The flexibility of the grandfathering provisions provides insurers with a high degree of visibility in terms of capital planning. These grandfathering arrangements have led to the resurgence of the Solvency I format and a couple of issuers have even issued perpetual Solvency I bonds to benefit from a grandfathering of Tier 1 in the Solvency II capital structure.

That said, the vast majority of issuers, like CNP Assurances, continue to demonstrate a strong willingness to adhere to the Solvency II standards despite the remaining uncertainties, notably introduced by the recent EIOPA texts and in particular the publication of the Technical Specifications in conjunction with the Stress Tests.

(See box, right, for further details.)

To what extent are differences between rating agency and Solvency requirements a challenge in your capital planning and also bond issuance?

Damas: So far the insurance sector has benefited from relative stability of rating methodologies for hybrid instruments

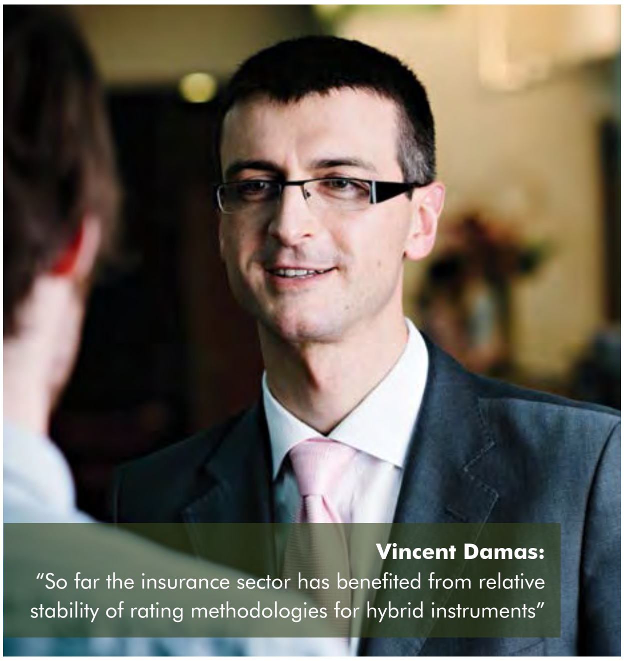
Issuer: CNP Assurances
Issue ratings: BBB+ (S&P)
Description: Tier 2 capital under Solvency II
Issue size: Eu500m
Tenor: 31 non-call 11
Settlement: 5 June 2014
Maturity: 5 June 2045
First call: 5 June 2025
Re-offer spread: 260bp over mid-swaps; 295.8bp over the 1.75% January 2024 Bund
Coupon: 4.25%
Re-offer yield: 4.3%
Issue/re-offer price: 99.569%
Bookrunners: BAML, Crédit Agricole CIB, Deutsche Bank, Morgan Stanley, Natixis, Société Générale CIB
ISIN: FR0011949403

Distribution:
UK & Ireland 33%, France 21%, Germany & Austria 12%, Switzerland 9%, Benelux 7%, Italy 5%, rest of Europe 9%, others (including Asia) 4%
Asset managers 64%, insurance companies & pension funds 15%, banks & private banks 11%, hedge funds 7%, others 3%

as well as from their treatment in the economic capital. We think that the rating agency methodologies will evolve and could gradually converge with the prudential rules of the European Union. In the mid to long run this should offer greater visibility with regards to the eligibility criteria of the outstanding debt in the market. To the best of our knowledge, we have not seen any rating agency-driven early calls of insurance hybrid debt. And we are not aware of any projects to modify insurance hybrid debt criteria.

Is the perpetual structure that was used by Allianz in late 2013 of interest to CNP Assurances? Are similar issues in your plans?

Trarieux: We are closely looking at any such structures, and already in 2012 we issued perpetual transactions denominated in US dollars on the back of the strong appetite of Asian private banks. We don't rule out coming back in perpetual format in euros, depending on our capital planning needs and subject to market conditions. ●



Vincent Damas:
"So far the insurance sector has benefited from relative stability of rating methodologies for hybrid instruments"

How EIOPA standards affect structuring

What are the key structuring developments introduced by the recent EIOPA texts?

Michael Benyaya, DCM Solutions, Crédit Agricole CIB: EIOPA has specified the form of incentives to redeem that are not limited and hence not compliant with the Solvency II framework. This includes a change in the distribution structure from a fixed to a floating rate combined with a call. This will probably be a major point of contention between EIOPA and issuers as the majority of transactions targeting direct Tier 2 Solvency II eligibility have used a fixed-to-floating mechanism. In addition, EIOPA texts also clarify that early redemption calls — e.g. tax/regulatory/rating agency — are not allowed prior to five years from the date of issuance. However, substitution and variation language will be allowed.

In this context, what were the key elements of the structure utilised by CNP Assurances?

Benyaya: The 31NC11 bond targets direct Tier 2 eligibility under Solvency II and qualifies under Solvency I in the dated category up to 25% of capital requirements. The structure effectively absorbs some of the recent developments in relation to Solvency II own funds released by EIOPA. The coupon structure thus has a five year interest reset period after the first call date, in lieu of a fixed-to-floating mechanism, which seems to be considered as an incentive to redeem that is not limited and not compliant. EIOPA's clarification on early redemption calls is addressed by a provision in CNP Assurances's 31NC11 bond whereby the early calls at par upon tax, regulatory or rating methodology events and the exchange and variation clause upon a regulatory or a rating methodology event will automatically lapse if, at any time following the implementation of Solvency II but before the first reset date, they would prevent the notes from being treated as at least Tier 2 under Solvency II including for the purpose of compliance with any grandfathering provisions.

What are the key drivers for issuing a dated subordinated bond while some issuers have used a perpetual format to potentially benefit from a grandfathering in Tier 1 under Solvency II?

Benyaya: In contrast to banks, there is no specific focus at this stage on Tier 1 in the insurance sector and there is no identified need for Tier 1 capital under Solvency II for the largest issuers. CNP Assurances will also benefit from the full eligibility of the expected profits in future premiums in unrestricted Tier 1 as well as the probable grandfathering in restricted Tier 1 of the legacy perpetual hybrid.

Another important driver is that there is no additional equity credit benefit for the perpetual format in the S&P methodology as it can qualify in the intermediate content category like the dated format. CNP Assurances is currently only rated by S&P and hence does not specifically target the higher basket recognition with a perpetual format afforded by the Moody's criteria. Finally, a dated format carries obviously a lower coupon hence protecting the fixed charge coverage ratio which is closely monitored by insurance companies in the current environment.

Hybrids Made in Germany

German banks had been notable by their absence from the AT1 market until May, when Deutsche Bank launched the largest such issue yet. The asset class is now primed for further growth, with subordinated debt also coming in more familiar guises. Here, leading German issuers and investors share their views on the market's prospects.

Jonathan Blake, Global Head of Debt Issuance, Deutsche Bank

Norbert Dörr, Head of Capital Management & Funding, Commerzbank

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Bodo Winkler, Head of Investor Relations, Berlin Hyp

The tax treatment of hybrid capital in Germany was under discussions for months and consequently this delayed the launch of the first German Additional Tier 1 (AT1) transaction. Why was this?

Florian Lechner, Linklaters: In order to have implemented something in a straightforward way it would have been beneficial to change the tax law, simply to ensure that the treatment of AT1 instruments is in line with what the market expects — which is also what the tax authorities have now confirmed. The reason why there were delays is that under the current law it is not entirely clear how to qualify these instruments and I can understand that there were some headaches for the tax authorities. They have now come to the conclusion that the desired result is in line with the existing law — but there it was not 100% black or white, it's a grey area, and so I have some sympathy for the tax authorities. They had some issues and needed to analyse this thoroughly. The fault in my view is with the legislators — they should basically have passed specific rules for the treatment of AT1 instruments.

Norbert Dörr, Commerzbank: We were included in the discussions from the beginning — even more so when the market for AT1 really opened up and we were already seeing a lot of issuance activity outside Germany. We simply wanted to have the option for German banks to do AT1, too — it is a question of having a level playing field internationally. While outside Germany the issue is not resolved everywhere yet, I believe we are getting there.

If the tax law had needed to be changed to support the tax treatment that has now been agreed, that would have taken longer. So the approach from day one was to find appropriate arguments that the decision could be made within the current legal framework, and that is what ultimately happened.

The other difficulty at the very beginning was that the CRR wasn't finalised and approved by the European Parliament, but was still in draft form. When you talk to the tax authorities you need to be clear about the legal form and terms and conditions of the instruments under discussion. The tax authorities nevertheless expect the regulator to confirm that the statements made with respect to potential tax treatment are consistent with the regulatory requirements from a CRR perspective for such an instrument.

So it was a big and necessary step following the finalisation of the CRR for the industry to reach the point where we are now, having agreed a sample term sheet for these instruments with the regulator confirming that it qualifies for AT1 according to CRR.

Deutsche Bank announced its AT1 plans at the end of

Porsche Panamera S E-Hybrid
Photo: Abdullah AlBargan/Flickr

April and issued only three weeks later. What was the process in between? How did the capital increase affect the process?

Jonathan Blake, Deutsche Bank: DB announced its intention to issue Eu5bn AT1 by end-2015 in October 2013, so we had been working on the transaction for many months prior to the announcement on 28 April. In the release, we announced our plans to conduct a roadshow to explain the transaction structure and credit story to investors. The roadshow concluded on 9 May, with very strong feedback. However, we decided to delay execution by one week to ensure that investors had full transparency regarding our capital plans before proceeding. When the news broke on 11-12 May, investors reconfirmed interest and we proceeded with execution over two days.

Why did Deutsche opt for sterling and US dollars on top of euros for this first appearance in AT1 format?

Blake, Deutsche: A euro tranche is a natural choice for DB. However, many investors are currency-agnostic and the markets in US dollars and, to a lesser extent, sterling are also deep. Given our Eu5bn AT1 target, this allowed us to take a very significant step to achieving this target with a Eu3.5bn issue while avoiding overloading any individual tranche and hence not jeopardising the secondary market performance.

How did you manage the size and price elements in this multi-tranche offering? Did you face a risk of cannibalisation across tranches?

Blake, Deutsche: This did pose an execution challenge as many investors had interest across a number of tranches. However, by staggering the relevant non-call periods and ensuring pricing consistency across currencies and tenors versus peer transactions, we were able to ensure that all three tranches saw similar levels of interest. The euro and US dollar tranches had total order volumes just in excess of 10bn in their respective currencies and the sterling tranche had roughly £6.5bn in orders. This left us in the comfortable position of having a number of options on how to size the three different tranches to achieve the best result.

What were the key factors behind the transaction's success?

Blake, Deutsche: The AT1 market is still, despite a number of transactions so far, a nascent one and the requirements of CRR are such that all AT1 instruments feature considerable issuer discretion. As such, investors have a number of valid questions regarding structure, credit and management intent. We undertook a week-long roadshow, including a broad investor call to cover anyone we couldn't physically meet. According to the feedback we received, this transparency was well received by the investor base. Combining this with the DB credit story, rarity value and good market timing resulted in the strong outcome we saw.

Were you happy to see Deutsche getting its deal done and the German AT1 market open after the delays with the tax issue?

Dörr, Commerzbank: Absolutely. To be honest, we had actually hoped that they would get it done earlier, because in the end the structure they did — meaning the 5.125% trigger and temporary write-down — would highly likely also be the target structure for us. In addition, we would have proof that the instrument has been cleared with regulators and tax authorities. From a structural perspective, the important element, really, is not necessarily the tax deductibility of the coupons; it's the treatment of withholding tax, because the ultimate decision allows direct issuance of AT1, and that is very important.

So we had been awaiting it as a proof of concept. And, to be honest, it also serves as another data point for pricing purposes.

> The difference between senior and subordinated paper won't shrink to zero

The Ministry of Finance confirmed the treatment of an AT1 instrument based on model terms proposed by the Association of German Banks — does that possibly restrict the potential development of different structures?

Lechner, Linklaters: It is limiting, at least with regards to timing.

If there had been a change in law, there would have been much greater certainty. But given that we don't have specific rules, what the tax authorities have provided is probably as good as they could have. Obviously they can't rule on all kinds of instruments because they need to analyse certain characteristics, and they have done so with the model brought by the banking association. The problem is that if you deviate from these model terms, the only way you can get certainty is to apply for a binding ruling, and there are two issues with that.

Firstly, it is time consuming, it normally takes six to eight weeks to obtain one. And given that these financial instruments are complex, it also depends on which tax office is responsible — if you go to Frankfurt they are probably more familiar with these types of instruments than if you go to a smaller tax office elsewhere in Germany.

And the other thing is that binding rulings can be quite expensive: they are subject to fees and can cost up to a little over Eu100,000.

Dörr, Commerzbank: Of course, if you were to have a legal statement saying that anything that is AT1-compliant according to CRR is tax-deductible, that would give much more certainty. But I believe that is not necessarily what was desired given the urgency of the matter. The tax authorities really wanted to embed it in the tax treatment of instruments according to their legal form independent of the actual issuer or purpose of the instrument.

And yes, if you deviate a little bit from the terms of the sample term sheet you have to convince your tax authority that you have not done so in a way that substantially changes the tax treatment — but I can't anticipate any such cases. Where would you deviate from the model terms for an AT1? The only thing I can think of is the trigger level, and that is irrelevant for tax purposes.

Were there any significant challenges that LBBW had to overcome to ensure a successful debut in benchmark Tier 2 format?

Jörg Huber, LBBW: Actually there were no obstacles. Of course, we wanted to have the appropriate documentation in place once we decided to proceed. But as we had just updated our EMTN programme and all the new necessary language for sub debt was included, we just needed to look for the right timing.

If you hadn't seen such a spread tightening in the first quarter, would you have gone ahead with the benchmark Tier 2 project?

Huber, LBBW: As we have quite a comfortable CET1 ratio of 12.9% and a Total Capital Ratio of 18.5%, we were in no hurry to launch a Tier 2 transaction. We rather prefer to tap the market when conditions are very favourable.

Spreads had rallied quite dramatically in the previous months, and we saw that we had reached levels that are close to those we had before the financial crisis. It therefore seemed that there was not much room to go further. At some point it gets just too much — the difference between senior and subordinated paper won't shrink to zero. Therefore, with this kind of demand out there and with the levels that are achievable in the market, we saw this as quite an attractive situation for us. Rather than wait for a time when we might need to issue and then just have to take the market conditions at that time, we decided to go ahead now.

What are the main takeaways of your respective inaugural transactions?

Blake, Deutsche: We took the time required to iron out all the regulatory and tax issues involved and also to prepare the investor base appropriately. This, together with a strong market backdrop, resulted in a successful transaction.

Huber, LBBW: As LBBW had not issued Tier 2 debt in public format for quite some time, we were aware that an investor update about our story was necessary. We were quite successful and the investors we spoke to were positively surprised. But as we did not tour through all of Europe, we see the need to visit our European investors more frequently.

Commerzbank tapped the 144A dollar market with a Tier 2 transaction in September — what was behind the decision to do that, the timing, and the choice of dollars?

Dörr, Commerzbank: Several factors played into our decision at that time. Firstly, we had done our equity capital increase a few months earlier, so it wasn't that much effort to update our 144A programme. It was therefore a very lean process. Secondly, the US market is very deep and offered quite a spread advantage compared with euros or the dollar RegS market, as we saw at that time and as we still see — for example, with the Intesa Tier 2 trade just recently.

At the same time, we wanted to establish a new liquid instrument in the market, particularly in the context of the overall supportive environment for our Tier 2 levels. And it did pretty well, if you look at what happened to Tier 2 spreads after that.

Do you already have further plans for AT1 in 2014 or any intention to build up your Tier 2 curves further?

Blake, Deutsche: We plan to raise Eu5bn AT1 by the end of 2015 so have a further Eu1.5bn to raise over the next 18 months. You can expect to see us return to the market over this time period, but we haven't decided exactly when or in which market at this point.

Huber, LBBW: We do not plan any other new issuance activities in the sub sector for the time being.

Bodo Winkler, Berlin Hyp: Berlin Hyp already covered its Tier 2 needs for 2014 in the first quarter. In total we issued Eu150m, exclusively via private placements and at favourable conditions.

Of course Berlin Hyp occupies itself with the subject of AT1, but there won't be any new issue from our bank in the near future.

Why could AT1 be interesting for Berlin Hyp?

Winkler, Berlin Hyp: As a member of the savings banks' institutional protection scheme, we see AT1 not so much as a security buffer for our unsecured investors. In its last full rating report Fitch described Berlin Hyp's bail-in risk as low due to its ownership structure, as the mutual support scheme would come into force before unsecured creditors would be bailed in. Anyway, we feel that there are quite a few senior unsecured investors in the market that simply want to see a certain Total Capital Ratio and certain MREL (minimum requirements for own funds and eligible liabilities) even for a

Jonathan Blake, Deutsche Bank:
"You can expect to see us return to the market"

bank that is embedded in an institutional protection scheme like ours. Furthermore, AT1 would help us with respect to the leverage ratio.

What impression have you got about how much interest there is in doing AT1?

Lechner, Linklaters: There is much more activity in the market than a couple of months ago. That is something we see quite clearly. A couple of other players are now trying to launch their instruments.

Dörr, Commerzbank: I think it is fair to say that we are looking closely at AT1 as an option. We want to have that option available — ideally you would have a term sheet on the shelf.

The question for Commerzbank is, do we really need it at this time? We have done substantial deleveraging, with the rundown of our non-core assets portfolio, where we are ahead of the game-plan. Then it is just a question of, do we do it now while the market is in really good shape as it is now and pay the running costs, or do we do it at a later stage? This is the balance we need to strike.

The focus of Commerzbank is still on improving the CET1 fully phased-in ratio given the externally communicated target of reaching 10% by the end of 2016. However, if there is a need to do AT1 at some stage, we have the option of doing something.

Do you have a view on a management buffer to commit to on top of future CBR (combined buffer requirements) levels?

Jörg Huber, LBBW:
"We just needed to look for the right timing"

Dörr, Commerzbank: We want to be comfortably around the communicated target of 10% CET1 fully phased-in that I mentioned. The question for me is also whether down the road 10% is seen as the ultimate level by various stakeholders in the discussion — taking into account that several regulatory parts are still moving. To what extent you need an additional buffer should be seen in the then prevailing regulatory and market context.

I believe for a bank with a business model like Commerzbank and given the current information about regulatory requirements, 10% is a good number. Deutsche, for instance, as a G-SIFI with a stronger push in investment banking, as they recently announced, will obviously have to go higher in my opinion.

> We are of the very strong opinion that the capital structure should be kept simple

Do you foresee using all of the three main types of loss absorption mechanism for AT1 instruments in your ultimate capital structure?

Dörr, Commerzbank: That's an interesting one. After Commerzbank acquired Dresdner we had a myriad of different legacy instruments, and we had to deal with all the issues such a situation might create in a crisis scenario following Lehman.

We are of the very strong opinion that the capital structure should be kept simple. That's why I said earlier that direct issuance is important (and if you think about things like bail-in mechanisms, it's more or less necessary). Would I deviate in loss absorption mechanisms? Why should I, unless someone tells me I have to, which I can't think of a reason for. And could I anticipate having different instruments with different trigger levels? Not at that this time, because the simplicity argument is still for me the more important argument. It is also helpful for investors — they should see exactly where they are in the hierarchy.

Your CRD IV Leverage Ratio is already above 4% under phase-in. What is your target going forward and do you expect a shift from European authorities on the minimum requirement ahead of its Pillar 1 imposition?

Dörr, Commerzbank: It's difficult to say, because there are two types of changes that might come.

Firstly, changes to the way relevant leverage exposures are calculated. I think that in regards to derivatives and securitised financing transactions, the latest moves are going in the right direction — it is not as conservative as before and legal netting is allowed.

Then there is the question, should we have a higher leverage ratio? I think what people have to consider is the composition and interdependence of the various regulatory requirements. We have discussion about CET1 ratios, but also concepts like MREL, or the latest GLAC (gone-concern loss absorbing capacity). They all have some similarities in concept to the leverage ratio. In addition, we have other initiatives like EMIR and Liikanen, which also address certain risk aspects that leverage has in focus. So all these things have to hang together, and have to also be seen in the context of all the supervisory mechanisms that there are. So I think people should implement the leverage ratio as it is now and not think about additional isolated adjustments increasing the requirements.

Given where we are with the leverage ratio above 4% under phase-in and the further run-down of our NCA portfolio, I also believe that going forward that it is a level where we want to be. In my opinion, the leverage ratio also should not be our constraining factor. Our focus will be on CET1 and if we fulfil our targets there we want our leverage ratio to be fine.

What has been your involvement in the AT1 space so far this year? Do you have dedicated CoCo funds?

Michael Liller, DeAW: We have been active in the AT1 space this year in dedicated funds that are able to invest in these new structures. These funds are either able to hold a high yield bucket or are dedicated hybrid funds that are structured to invest in these issues and able to hold high yield.

Stefan Sauerschell, Union Investment: Union Investment has been active in the CoCo market since 2011. In some of our funds we are allowed to invest in CoCo bonds alongside other subordinated bonds.

Our clients are interested in gaining exposure to this high yielding asset class but without having to build up individual positions themselves, so we plan to launch a new diversified CoCo fund for institutional investors in the coming months, subject to approval by the regulators.

The AT1 market is lacking a core investor base in Germany. Why is this and what could change the situation?

Rainer Gehler, DekaBank: We should see more participation proportionately in terms of general appetite for financial sub debt versus other jurisdictions. It has possibly been subdued thus far because of a lack of local name issues, which will be a logical starting point

Liller, DeAW: The German fixed income market is mainly driven by insurance and pension funds, which are very rating sensitive.

Currently AT1 structures are mostly prohibited by investment guidelines and/or other restrictions. Also, the fact that most AT1 structures are high yield-rated limits the investor base, as does the fact that they are not included in most benchmarks.

Sauerschell, Union: The first CoCos from the UK were launched a few years ago and UK investors have therefore had a lot of experience with this asset class. However, we have not seen a similar development in Germany. Deutsche's deal could therefore be very important as it was a high profile transaction in Germany.

More importantly, we expect a greater number of investors to consider this type of instrument because of the tight spreads and low yield environment in Europe.

Winkler, Berlin Hyp: The experiences of German investors with subordinated instruments during the crisis were not too positive. Some of them lost quite a lot of money. This experience seem to be one of the main reasons why our domestic investor base now acts cautiously concerning AT1 instruments. In addition, Germany was quite late when it came to clarifying the full terms of AT1 issuance, with Deutsche only coming in May with the first Basel III-compliant AT1. A domestic issuer is always a special incentive for investors to engage in a new sort of assets.

Furthermore, AT1 is not an easy-to-understand asset class. Each instrument is structured individually. What they have in common is the complexity of the structures, which implies a lot of analytical and credit work in advance of buying. And, as AT1 is no pure debt instrument, it is also a question concerning the mandate to buy these assets.

But we understand that large asset managers have now set up funds and begin to invest. The low overall interest and yield level should contribute to increased buying by German investors. Another supportive factor would be an increasing number of AT1 issues by German banks.

Vincent Hoarau, Crédit Agricole CIB: Germany lagged in putting in place the AT1 tax framework for the reasons covered earlier. The euro segment developed recently, while German investors on the whole are not the biggest fans of this new generation of loss-absorbing instruments. So it is not a surprise to see some resistance.

But with Deutsche Bank opening the German segment as an issuer, things are changing. Apparently, German investors bought nearly 20% of Deutsche's euro tranche. This was by far the highest participation of German investors in an AT1 transaction. But this was not a surprise. With the help of some investor work, the domestic base should continue to grow unless an incident occurs and demonstrates they were right to be cautious. Elsewhere, the more German investors hear about buy-side accounts across Europe being in the process of launching CoCo dedicated funds, the more they will consider the asset class. I also think that the launch of AT1 dedicated indices will encourage everyone to get more heavily involved.

Amreetpal Summan, Crédit Agricole CIB: Initial supply was dollar-focused and had equity conversion, which ruled out large domestic buyers, along with the lack of domestic issuance. We expect issuance to pick up in Germany following the long-awaited approval for tax deductibility of AT1 securities and the recent issuance from Deutsche. We expect Landesbanks to take advantage of the favourable spread environment to refinance existing non-Basel III-compliant Tier 1 instruments, which we believe will be well received domestically.

> **The emergence of CoCo indices as a benchmark for us is important**

Huber, LBBW: In our discussions with investors about our Tier 2 transaction we didn't discuss Tier 1 transactions because this is not something that we are able to offer at the moment and also not for the foreseeable future. But out of other discussions I have had with investors I know that some are already investing, and others are looking more into it. Of course there are a lot of investors who are smaller investors and who would need to build up the know-how for these kinds of transactions. They used to invest in the old-style Tier 1 transactions and they got burned in the financial crisis, and now the new instruments look in a way much more dangerous than the old ones. So for these investors it will certainly take some time to adapt.

But then at some point in time they will reach a level where they say, well, on the one hand these instruments are not as secure as the old ones were, because when it comes to AT1 they have to be perpetual, but on the other hand they are issued from institutions that have to have a much higher capital base than they had in the past. So in a way you invest in a more risky

Michael Liller, DeAW:
"Vanilla Tier 2 of European banks are more eligible"

instrument, but the borrowers have become much more secure, and I guess there's a big pay-off for that. And therefore because all these investors — insurance companies, pension funds, etc — need to have some yield pick-up at some point in time they will get more and more comfortable with it.

The equity conversion provides upside optionality in the worst case scenario

Dörr, Commerzbank: Something you have to bear in mind is how certain investors who previously invested in those instruments have to treat these assets as part of their own regulatory perspective. That will make a difference for certain investor types. Also, these instruments with the fully discretionary coupon and these write-down mechanisms are slightly different to legacy hybrid Tier 1, so they might not fit into investment guidelines.

Nevertheless, the more issuance you see from a domestic market, the more investors from that domestic market you will see. And I am sure that you will see that in Germany, too, if a few more instruments are issued. When Deutsche did its deal you had quite a good portion of domestic investors, even if it was also highly anticipated by the international market, and we have seen this phenomenon in other countries if you look at domestic participation in French AT1s or UniCredit in Italy, for example.

And obviously the other important driver for investors right now is, where can you achieve a decent yield for your risk appetite in the current low interest rate environment?

How do you anticipate your activity for the rest of the year in the subordinated space, and how do you treat vanilla Tier 2 exposure compared with AT1?

Gehler, DekaBank: In the current low yield and spread environment, we anticipate our activity being the same as in the first half of this year.

We treat Tier 2 as Point Of Non-Viability instruments with minimal bail-in risk for strong banks versus AT1s, which can have coupon deferrals.

Liller, DeAW: We continue to be active in the subordinated space. New issues will be evaluated on the basis of our current investment process. If the issuer meets our investment standards and based on our relative value assessment we will invest in new subordinated structures.

Vanilla Tier 2 of European banks are more eligible for institutional fixed income funds, since they are mainly investment grade rated and do not have any equity conversion features. Given our book of business in the investment grade space, our demand will be higher than for AT1 structures. Dedicated funds will invest in the capital structure based on our view of risk/return and our relative value assessment.

What structural AT1 features do you prefer? Can you handle equity conversion as well as write-up/write-down?

Gehler, DekaBank: We prefer write-down/write-up. We also prefer language with static regulatory requirements with the option to convert or a liability management exercise on regulatory changes.

Summan, CACIB: From an investor's perspective, the equity conversion provides upside optionality in the worst case scenario and therefore should be preferred over full write-down structures. However, until fund mandates are amended to allow them to buy securities with equity optionality, we expect banks to prefer issuing write-down structures. The technicals are better for write-down/write-up AT1s.

Liller, DeAW: Since AT1 structures with equity conversion are considered as a convertible bond, most institutional funds are not able to invest in these structures. In dedicated funds there are no restrictions on structural features. From an investor's point of view, the write-up structures seem to be a good marketing instrument for issuers, since the write-up is on a discretionary basis on behalf of the issuer and linked to distributable income. Currently we view these structures as write-down structures.

Sauerschell, Union: We can handle equity conversion as well. It is very difficult for some bond funds, particularly in Germany, to handle equity conversion because it is prohibited in their prospectuses. We therefore prefer the write-down, write-up structure, because there is a broader investor base for the structure and hence more demand.

Some observers have suggested that with equity conversion there is more of an alignment of the interests of equity and bondholders, and have discussed the hierarchy of instruments in the capital structure. Do you have any views on this?

Sauerschell, Union: Yes, with equity conversion there is a higher alignment. In a stress scenario this could be an important consideration for investors, but actually the market does not differentiate between equity conversion, permanent or temporary write-down structures. CoCos with permanent write-down loss absorption triggers are structurally subordinated to equity, and we prefer write-down/write-up structures where you may recoup some losses. This also better aligns shareholders' and bondholders' interests.

Hoarau, CACIB: The difference between equity conversion and temporary write-down is difficult to quantify. Some investors prefer equity structures, arguing that they are left with something in the case of a trigger event. Other can't handle equity in their mandate. So, between the two we don't see any impact in terms of valuation. The permanent write-down bail-in feature is used mostly in Tier 2-hosted CoCos and I am not sure that current valuations properly reflect the risks associated with this structure. I fully agree with Stefan. In a stress scenario such anomalies will be corrected.

How do you handle rating constraints? Can you consider unrated AT1?

Gehler, DekaBank: We can't take up unrated issues, but we can invest in sub-investment grade debt.

Liller, DeAW: Currently we would not consider unrated AT1.

Based on our proprietary research, we are able to assign own ratings for these structures. The ratings of rating agencies are not a sole reliable source for assessing the risk attached to these structures, also when you take into account that some issues are structured in a certain way to receive a certain rating.

Sauerschell, Union: In principle we can invest in bonds that are unrated, and we then assign our own Union rating for the issuer or for these bonds. But when AT1s are unrated you have to question why they do not have a rating, and we believe it is because any rating would be below B-. We do not take new positions in bonds below B-, so we don't buy unrated AT1s.

Is the investment grade/sub-investment grade threshold significant?

Sauerschell, Union: Yes, it is very important. Many funds have constraints regarding high yield and having an investment grade rating is a technically supportive factor. This is evident in the spreads of Tier 2 CoCos from Credit Suisse and UBS, which have investment grade ratings.

Bodo Winkler, Berlin Hyp:
"AT1 is not an easy-to-understand asset class"

Spreads have compressed a lot since the beginning of the year. Do you think there is enough credit differentiation in the subordinated space in general and in AT1 in particular?

Gehler, DekaBank: No, a lot of the risk has been papered over because of the rate environment and yields. We need to see greater differentiation between names to reflect underlying credit fundamentals and the risk of coupon deferral.

Liller, DeAW: We have seen quite an impressive spread tightening this year in the AT1 space. From our point of view the main reason is the hunt for yield by most investors. We think that most investors involved in this paper do not take into account all the risks related to these structures. There are a lot of new features structured into these bonds, e.g. coupon deferral if distributable income is not sufficient. Also, we are concerned that data availability on balance sheet, income statements and capital are currently not sufficient to fully value triggers and other structural features of AT1.

Hoarau, CACIB: In the CoCo space, it has been almost one way only since the beginning of the year. And the recent ECB rate cuts combined with a series of targeted longer term refinancing operations (TLTROs) just added another round of momentum to the already phenomenal credit rally. Peripheral Tier 2 and AT1 capital benefited the most from the excess liquidity and the central bank liquidity easing measures taken over the last couple of years.

If we look at the situation in Spain, for instance, the speed of the recovery has been impressive and this has translated into better than expected financial results and much stronger capital

Vincent Hoarau, CACIB:
"Convergence has gone too far, too fast"

ratios in the Spanish banking sector. So appetite in good Spanish names has picked up massively from non-domestic investors. If we look at Banco Popular Español, for instance, it placed the first euro denominated AT1 in euros at 11.5% in October 2013. The perpetual non-call October 2018 is yielding inside 6% now, less than 150bp wide of Deutsche Bank's AT1 on a curve adjusted basis. I think convergence has gone too far, too fast, even if we know that everything out there is driven by the liquidity situation at the investor end rather than by fully rational elements.

Investing in new AT1 issues with coupons at or below 5% does not make sense

Another example is that the credit spread differential between Deutsche Bank and Santander in euro AT1 is not wider than 50bp if we adjust the curves. In US dollars, Santander is trading very close to SG AT1.

But in the "plain vanilla" Tier 2 space, credit differentiation is much more evident. We priced LBBW's 12NC7 50bp inside peer Aareal in the same format, although half of it was placed with international investors. Part of that has to do with the way you approach the pricing. In the "vanilla" Tier 2 segment, investors are focusing on spread rather than coupon, while in the AT1 market total outright yield is the focal point. This partially explains the flatness of most AT1 curves and the lack of credit differentiation across names and jurisdictions. In spread versus swaps, Barclays' euro AT1 curve is inverted, for instance.

I think that investors' attitude towards pricing will evolve, and spread focus will predominate at some point. And so anomalies or mispricing will disappear.

Sauerschell, Union: A year ago we saw new AT1 issues with coupons of 8% or 9%. Now we are at around 6%. In my opinion investing in new AT1 issues with coupons at or below 5% does not make sense.

It's a very young market, it's also supply and demand driven, and it is not very efficient. If you look at Credit Suisse in Swiss francs and US dollars, for example, they trade much tighter in Swiss francs, and this is simply because of the much lower supply in that currency. However, the market should become more efficient if there is more issuance.

Also, there is little differentiation in the market based on the time to call. When we modelled the impact of different factors on bond prices — such as the distance to trigger, five year CDS — we found that this maturity feature was not significant.

The market seems to care more about the prevalence of excess liquidity rather than structures, rationales and metrics. Are you differentiating much between structural features, buffer and distance to trigger?

Gehler, DekaBank: Yes, buffers and distance to trigger are key, although they are secondary to underlying credit fundamentals.

Liller, DeAW: Yes, we consider these features in our investment process and will value each AT1 structure on a standalone basis to derive our investment rationale.

Summan, CACIB: We believe the discretionary coupon element within the AT1 structure is not being priced correctly. Whilst the coupon is subject to restrictions subject to the MDA (Maximum Distributable Amount), other factors such as earnings volatility, dividend policy and the stance of the local regulator are not fully factored into spreads.

Hoarau, CACIB: Credit spread differentials between names are limited and this has been outlined many times already. It is even worse when it comes to differentiation among structures. A lot of investors continue to ignore metrics and when they do care their views can diverge a lot. MDA is a key figure, for instance, and I am not sure that it is considered properly.

Given the costs of repo operations on these instruments, running long/short strategies and arbitrages between signatures and structures is a great challenge. So it is difficult to try to correct or take advantage of market anomalies. This will not change unless oversupply appears and volatility comes back.

It is remarkable that more and more hedge funds have started hedging AT1 instruments that have equity conversion bail-in features by using equity puts. However, mainstream fixed income portfolio managers are not mandated to engage in such equity derivative instruments.

AQR is ahead of us. To what extent could this affect the market? Is there the risk of a severe correction?

Gehler, DekaBank: Any correction due to AQR is likely to be more idiosyncratic than market-wide.

Winkler, Berlin Hyp: We don't believe that the AQR will affect the market. The stress test should be much more important. In the case that many of the monitored banks should feel the need to strengthen their capital base after the results are published this should not leave the market unaffected. For banks with poor stress test results, market access will be more difficult. Anyway, the ongoing low interest rate environment combined with the continued risk appetite of investors should support the market, we believe.

Summan, CACIB: We do not expect the AQR to have a substantial impact. The banks have had over a year to prepare for the AQR. We have seen banks aggressively deleveraging their balance sheets as well as raising equity through rights issues and selling non-core assets.

Hoarau, CACIB: AT1 valuations are excessively expensive. The massive spread compression across asset classes has been triggered by cash rich investors forced to buy higher yielding assets deeper in the capital structure, and across jurisdictions. But I can't imagine that this is sustainable in the long run. The current demand-supply mismatch and the huge amounts of redemptions in FIG added to the recent ECB's liquidity easing measures are certainly sensible motivations.

But again, we often get the feeling that some investors are ignoring relative value schemes and metrics because of that. Looking at current valuations and the lack of credit differentiation, I think that a correction is overdue. It would be more than healthy. It can't be one way only for such a long time and in such proportion. Core AT1 yields are currently similar to 10 year covered bond yields in 2009 while AT1 can serve as equity! Is that justified by the development of the economic situation across Europe and the shape of the banking sector? I am not convinced, even if things have significantly improved over the last 18 months and outright yields have dropped massively since the crisis erupted.

The central bank will release the result of the health check AQR in one big announcement in October. But within banks, any capital holes will be known very soon and the results of the assessment could leak out chaotically. At the moment, only good news is priced in. So any disappointments, surprises or rumours based on the AQR stress test could easily lead investors to take profits. Since the AT1 segment is lacking a dedicated investor base, with dedicated real money investors and dedicated funds, any reversal could be severe.

To what extent do you expect the application of subordinated bail-in upon any failure of the EBA stress test baseline scenario?

Gehler, DekaBank: De minimis for now given the risk appetite and hence potential for mitigating actions via asset sales or equity raising.

Do you expect issuers to cover any stress test shortfall with higher-trigger AT1 instruments, as prescribed by the ECB?

Gehler, DekaBank: Yes, that would be a logical course of action. It could also be high trigger Tier 2.

To what extent do you value the presence of subordinated debt as a defence against senior unsecured bail-in? Do you differentiate between banks based on the level of bail-in-able subordinated buffer?

Liller, DeAW: We take this into account for our investment rationale on senior bonds.

Sauerschell, Union: The issuance of AT1 is positive for senior unsecured bonds in that it helps reduce the possibility and magnitude of a bail-in, as it increases the CET1 ratio. However, we consider the quality of banks' business models and management to be more important factors, and also invest in banks with lower subordinated debt buffers.

Sometimes we pull our order when the spread moves too far

Are you satisfied with the level of liquidity in the secondary market?

Sauerschell, Union: Liquidity is much lower than for other asset classes, such as industrial hybrids. The liquidity of new AT1 issues has also been lower than we would have expected in the secondary market given that the order books have been as much as 10 times oversubscribed. We are therefore aware that there is hype around some of these new issues and sometimes we pull our order when the spread moves too far between initial price thoughts and the re-offer.

As a liquidity provider, what are the main challenges you are facing?

Summan, CACIB: Liquidity and in turn volatility is improving with every new issue. With more real money mandates in the space we have seen deeper pockets of liquidity. Bond allocations have slowly changed hands from private banks and fast money to real money long-only funds who provide stability. Indexation of the CoCo market could help improve liquidity. We need the large German asset managers and other regional managers to sign on to the product. Dealer inventory still remains light and being able to manage volatility is a still a concern. ●

Olivier Giroud celebrates scoring for France against Switzerland at the World Cup 2014
Photo: Dimitar Dilkoff/Getty

France
Droit au but

Crédit Agricole and Société Générale played a key part in the development of the European deeply subordinated and hybrid capital market as it took off this year. Cheaper alternatives may deter AT1 supply from some quarters of the country's banking sector, but otherwise the stage is set for the French market to fill out. *Susanna Rust reports.*

The announcement of a fourth AT1 issue in less than a year for Société Générale at the time of writing underscores the point: although the French issuer has only been accompanied by Crédit Agricole so far, French issuers have definitely made their mark on the new hybrid capital market.

Société Générale led the way for the country's banks when it became only the second European bank to sell new-style, Basel III-compliant loss-absorbing securities when it tapped the US market with a $1.25bn (Eu918m) perpetual non-call five deal in August 2013. Crédit Agricole SA has since then priced a landmark multi-currency transaction, after also making its AT1 debut in dollars and before pricing a rare Tier 2-hosted contingent capital (CoCo) transaction. And, while no other French issuer has been active in the public AT1 market, La Banque Postale structured an internal CoCo in December and has alongside others raised Tier 2 capital.

"French banks have been among the most resilient financial institutions during the crisis, so it was a natural move for them to be at the forefront of the reopening of the hybrid capital market," says Laurent Adoult, FIG DCM at Crédit Agricole CIB. "They also benefited from the reactivity of the French regulator, which quickly approved the AT1 term-sheet.

"It is fair to expect French banks to continue to issue both AT1 and T2 for the simple reason that they need to refinance old-style Tier 1 and Tier 2 that are gradually phasing out," he adds, "although the magnitude of supply will probably depend on the evolution of the discussions on the leverage ratio and bail-in requirements, and on market conditions."

Alain Branchey, senior director at Fitch Ratings, says that French banks are well positioned in terms of their capital levels, tracing this back in part to their experience of the euro-zone sovereign debt crisis.

"In 2011 there was a bit of a crisis facing French banks and the big four put in deleveraging and restructuring plans to improve their capital and liquidity position," he says. "Their capital ratios are well above the minimum requirements, including the add-ons for their G-SIFI status."

He notes a convergence of reasons for French issuers — like banks in other countries, to be selling AT1 securities — but highlights that only two of the country's largest banks have tapped the new-style hybrid instrument while many more French issuers have been raising Tier 2 capital.

"That obviously doesn't strengthen Tier 1 capital levels, but it fulfils a lot of goals, like replacing old securities that are being phased out and building buffers for senior debtholders that will be subject to bail-in," says Branchey.

BPCE, for example, in April sold its fourth subordinated debt benchmark since July 2013, a £750m (Eu938m) 15 year Tier 2 that was priced at 215bp over Gilts and followed a $1.5bn 10.5 year in January, while others took to the euro market for their first subordinated transactions in years.

BPCE has been aiming to further boost its total capital ratio in pursuit of a target ratio in excess of 15% in 2017 at the latest, and hopefully sooner, according to Roland Charbonnel, director, group funding and investor relations at BPCE. He said that guidance was announced to the market in November last year when the new strategic plan of Groupe BPCE for 2014-2017 was presented.

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

The issuer is targeting CET1 in excess of 12% by 2017. Raising loss-absorbing capital in the form of AT1 capital is not a top priority for BPCE at the moment since the issuer already exceeds the required level of 3%, said Charbonnel.

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

A Eu1.5bn 2.875% 12 non-call seven issue for BNP Paribas on 13 March was its first Tier 2 deal since 2007, for example. It

Sophie Renaudie, La Banque Postale: "We have identified strong demand for hybrid issues and could consider an AT1"

drew some Eu5bn of orders and was priced at 165bp over mid-swaps. La Banque Postale, meanwhile, on 11 April sold its first public subordinated debt transaction in three-and-a-half years, a Eu750m 2.75% 12 non-call seven Tier 2 that was priced at 152bp over mid-swaps on the back of nearly Eu3bn of orders.

Dominique Heckel, head of long term funding at La Banque Postale, says that the new issue was launched to replace a legacy Tier 2 instrument that begins to amortise in 2015, with the issuer keen to take advantage of favourable market conditions and a strong hunt for yield.

"Investors were quite comfortable with La Banque Postale's credit and we felt it was a good time to optimise our total capital base," he says.

In contrast to considerations in play at some other issuers, however, building bail-in buffers to protect senior unsecured creditors was not a driver of the deal.

"Customer deposits are our main source of funding plus, to a smaller extent, covered bonds, so bail-in considerations about the potential increased cost of senior unsecured funding are not as important a factor for us as it is for some other banks," says Sophie Renaudie, head of capital management at La Banque Postale. "However, we are obviously monitoring regulatory developments about minimum bail-inable debt requirements and will address any issue that arises."

Banque Postale open to public AT1

The bank is considering further Tier 2 issuance, but an inaugural public AT1 transaction could also be on the cards in the near term, according to officials at the issuer.

"We will look at the market and take advantage of opportunities in the hybrid market because we have identified strong demand for hybrid issues and could consider an AT1 deal in 2015-2016, and maybe this year," says Heckel.

Renaudie notes that La Banque Postale received very positive feedback on the topic of potential AT1 issuance when it went on a roadshow before its Tier 2 transaction, and says that such a move would be aimed at boosting its leverage ratio and Tier 1 capital base.

The bank has not made any decisions about such a move, but Renaudie says any AT1 from La Banque Postale would probably come with a low trigger, write-down mechanism.

That would contrast with a Eu800m perpetual non-call six AT1 that the issuer structured in December, which features an equity conversion mechanism linked to a high trigger and was entirely subscribed by La Banque Postale's shareholder, La Poste. That, in combination with a Eu228m capital increase via contributions in kind, helped La Banque Postale increase its prudential equity capital by over 15% in 2013, according to the issuer.

Stéphane Magnan, head of financial markets and ALM, says that the issuer had always intended to work with its parent on the December CoCo, but that this does not prevent it from in the future issuing an AT1 in the public market, and that it is encouraged by how the latter has developed since then.

"It's a very strong and impressive market," he says. "If you look at the Crédit Agricole AT1, the structure is quite complicated, but it worked well, so there do not seem to be any questions about French banks being able to issue AT1 instruments.

"At the moment we are looking at all our options but we hope the market will remain the same in the second half of the year."

Crédit Agricole priced two AT1 transactions this year, a \$1.75bn perpetual non-call 10 in January that was its debut in the asset class, and a Eu1.61bn equivalent euro and sterling dual tranche issue in April. The structure was the same for each deal, featuring two triggers — loss absorbency via a temporary write-down upon either a low bank-level or high group-level CET1 trigger being tripped.

A question of priorities

Away from Crédit Agricole, Société Générale and perhaps La Banque Postale, what are the prospects of CoCo supply coming from other corners of the French banking sector?

BNP Paribas has returned to the Tier 2 market, but has yet to make its debut in AT1. One market participant noted that it was one of the first banks to have a fully-loaded Basel III CET1 ratio in excess of 10%, and that this raises questions about its capital needs. As at the end of March the fully-loaded CET1 ratio stood at 10.6%, well above its minimum 9% requirement, and the Tier 1 leverage ratio above 3.7%, well above the 3% 2018 CRD IV threshold, according to the bank.

However, the market participant noted that BNP Paribas is in negotiations with US authorities about a fine for alleged sanction breaches, and that it remains to be seen how this pans out and what the capital implications may be.

Fitch in early May said that BNP Paribas's capital "remains solid" and that it believes the bank would be able to absorb significant non-recurring items, such as litigation costs, but that any large litigation or regulatory expense would considerably alter the bank's capital ratios, as is the case for certain peers.

"BNPP has said that the penalties the US authorities could impose on the bank for US dollar payments involving parties subject to US sanctions could far exceed the provision amount booked in 4Q13," said Fitch.

According to the rating agency, BNP Paribas booked Eu800m relating to the case in the fourth quarter, bringing total litigation reserves to Eu2.7bn.

French co-operative banks, meanwhile, have at their disposal a cheaper way of boosting Tier 1 capital levels than issuing AT1 in the public market, notes Fitch's Branchey.

"Co-operative shares are often linked to long term debt rates and are a cheap alternative," he says.

The point is also made by Jean-Pierre Gulessian, head of capital markets at Crédit Mutuel Arkéa, who says that the issuer has no plans at present for AT1 or Tier 2 issuance. This is in part because it has a strong capital base, with a Core Tier 1 ratio of 14.3% as at the end of 2013 and a leverage ratio above 3%, and sees its senior unsecured creditors adequately protected from a bail-in.

"So for the time being we are not in the mood to issue," he says. "Also, we are a co-operative group so we can raise Core Tier 1 capital by issuing member shares and do so at more favourable conditions than by going to the hybrid bond market."

When the going is good…

Contrast that with the level of activity from Crédit Agricole and Société Générale. At the time of writing Société Générale had just announced the mandate for a US dollar perpetual NC 5.5 (January 2020 call) AT1, its fourth CoCo in less than a year, and had sold four Tier 2 transactions since 2013.

After a $1bn 10 year Tier 2 issue in January, Vincent Robillard, head of group funding at Société Générale, said that the bank is aiming for a total capital ratio of 14%-15% by the end of 2015 under Basel III rules. He said that Société Générale will continue for the time being to be focused on "classic" Tier 2 and AT1 markets.

Meanwhile, in the space of four months this year Crédit Agricole had already raised Eu2.9bn of a Eu4bn minimum it has disclosed as its AT1 target for 2014-2016, with no need to raise fresh Tier 2 capital.

"The figure we disclosed to the market to reach the targeted capital structure is Eu4bn, but we also indicated that it would be *at least* this much," says Olivier Bélorgey, head of the financial management department at Crédit Agricole SA. "Due to the fall in spreads it can be more efficient to accelerate the replacement of old Tier 1 instruments and we don't want to miss an opportunity to do so if market conditions are good and it is economic for us.

"Given how much we have already raised, the market can clearly anticipate that due to the current market conditions there is a high probability that we will issue more than Eu4bn, and that this will decline if market conditions deteriorate."

The bank has deliberately not set a target leverage ratio, he adds, instead focusing on target CET1 (14%) and total capital ratios (16.5%) that are driven by an overarching desire to protect its ratings and to access to wholesale funding markets at attractive spreads.

The near term outlook is for the hybrid market to remain a seller's market, a reversal of the situation in 2013, Bélorgey believes.

"There is a lot of liquidity," he says. "The Fed is trying to cut back on quantitative easing but is only reducing flows, the ECB is stepping up its actions, and in Japan there is a lot of quantitative easing, so there will remain an excess of demand for 2014 and maybe 2015. After that, I don't know."

Alain Branchey, Fitch: "In 2011 there was a bit of a crisis facing French banks and the big four put in deleveraging and restructuring plans"

Vincent Hoarau, head of FIG syndicate at Crédit Agricole CIB, says that although the French hybrid capital market is still nascent — as is the case generally — the outlook is constructive, in particular as domestic investors open up to the asset class.

"It is getting more mature every day, particularly since the first euro transaction from a French issuer was printed, and more and more French investors are considering opening funds dedicated to this new generation of hybrid instruments," he says. "This is instrumental for the growth of the market, which needs its own investor base.

> "For the time being we are not in the mood to issue"

"For issuers in France — as in other jurisdictions — the buying power of the UK investor base continues to be decisive because of their huge capacity to buy dollars as well as euros in size."

For now, he adds, technical factors driving a bull market in hybrid capital are bringing about anomalous situations, such as Banco Santander and BBVA trading very close to Société Générale on a curve-adjusted basis, although the credit spread differential within the French market, i.e. between Crédit Agricole and Société Générale AT1s, makes sense.

After an "extraordinary" spread tightening, consolidation is needed, he suggests.

"A correction would be healthy and natural before compression can resume," says Hoarau. "The question is when will it happen, what will be the trigger, and — for absolute yields — where the floor will be in the long run." ●

Tier 1
A question of generation

From the death of legacy instruments to the hot spot of AT1, the subordinated debt asset class offers attractive opportunities even after the recent rally, according to *Julien de Saussure, fund manager at Edmond de Rothschild Asset Management (France)*. Here, he explains his strategy towards the varied instruments and highlights the key opportunities and risks to be considered.

Subordinated bonds of banks and insurance companies have strongly performed since the beginning of 2012 and are likely to continue to do so in this low yield, low inflation environment.

From a fundamental standpoint, banks and insurance companies have put a strong emphasis on strengthening their solvency positions. Banks is also one of the few sectors where issuers will continue focusing on deleveraging, which is positive from a creditor standpoint.

We also believe banks will benefit from the recently announced unconventional measures by the European Central Bank.

The real area of concern for European banks experiencing subdued profitability at the same time as elevated NPLs is largely going to find an answer in the asset quality review (AQR) and stress tests run by the ECB and European Banking Authority this year. Not only will the transparency and consistency of data be greatly improved, but the amounts of capital raised and increased provisions, either before or after the comprehensive assessment, will dramatically strengthen the overall solvency of the sector.

There remains the question whether a bank needs to fail in the process for the sake of credibility. Let's just say we hope to have been selective and thorough enough to avoid trouble in that eventuality. In any case, we do not expect any failure to be disruptive.

Finally, in the medium term, the EU Banking Union is also a very positive development for the sector and its creditors.

Our subordinated debt investment strategy

At Edmond de Rothschild Asset Management (France) we manage approximately Eu1bn of financial debt in various portfolios, with a strong focus on subordinated instruments, which make up more than 50% of these.

These funds include long-only open funds where subordinated bonds are used both to express specific convictions or to increase the beta versus benchmarks. We also manage Solvency Capital Ratio (SCR)-optimised mandates dedicated to institutional clients with a focus on Tier 2 non-CoCo bullet vanilla subordinated debt. Lastly, we manage Edmond de Rothschild Signatures Financial Bonds, our flagship funds of approximately Eu500m dedicated to financial subordinated bonds. The investment universe is the entire capital structure (except equity) of banks and insurance companies, with a strong emphasis on legacy structures issued under the guidelines of Basel II and Solvency I and that are unlikely to survive as we move to Basel III and Solvency II. The anticipated "death" of this segment of the asset class is a very powerful performance driver as it creates a technical scarcity premium, with no supply under the old guidelines (hence limited repricing risk due to primary activity), while demand remains strong for a segment with decent spread and limited interest rate sensitivity in a low yield environment. The exact way these bonds will disappear (early call vs. late call vs. tender offer) also creates compelling investment cases. In the end, even after the recent rally, we still see legacy Tier 1 bonds as the sweet spot in the capital structure with the best risk return profile. We like insurance bonds with a mix of good valuations, better fundamentals than banks, and Solvency II's starting point likely two years after that of Basel III/CRD IV helping smooth the natural attrition of the legacy segment.

Our investment universe is almost exclusively in Europe, where we see both value and sufficient diversification. Europe is also unique in undergoing regulatory changes in both the banking and the insurance sectors. And of course we pay a lot of attention and allocate gradually more and more (currently 25%) of our funds to next-generation structures, mainly 30NC10 Tier 2 for insurance and CoCos with either Tier 2 or Tier 1 hosts for banks.

Primary markets

Primary markets have been extremely active since the beginning of the year. Whereas deleveraging has been a key focus for banks in the last five years and investors in bank bonds have benefited from net negative issuance, 2014 is likely to be the year when new supply outweighs natural redemption in the subordinated segment. While most deals have performed strongly, we remain convinced of the absolute need to be selective and to review thoroughly prospectuses while new issuers and new structures come to this very technical market.

New structures

Investors are now familiar with the well-identified structures. As far as we are concerned, we differentiate six different types of structures:

- For insurance: Solvency I dated bonds; Solvency I undated bonds; and Solvency II Tier 2 bonds
- For banks: Vanilla Tier 2 bonds; CoCos with Tier 2 hosts; and CoCos with Tier 1 hosts.

Insurance

We generally like recently issued insurance bonds with Solvency I features (e.g. Groupama, Delta Lloyd or UnipolSai undated bonds) where the prospectuses' language is generally more bondholder-friendly. And it allows us to continue to invest in "legacy" instruments even in the primary market, which could seem counter-intuitive. There is a short window of opportunity before a likely cut-off date at the end of this year when issuers can issue bonds that are likely to benefit from a full grandfathering. As investors, we like

Julien de Saussure, Edmond de Rothschild Asset Management (France)

the fact that the extension risk on these bond is very limited as they will not comply with solvency rules after they lose their grandfathering treatment. But we should also be aware that this is something of a regulatory arbitrage by issuers and any change in the current grandfathering assumptions may jeopardise these investments — hence the need to review carefully variation clauses or regulatory par call clauses in the various documentation.

A lot of Solvency I dated bonds (Macif, Coface, Poste Vita, Generali, Intesa Vita)

> **We remain convinced of the absolute need to be selective**

came in bullet format, which can be compelling for our institutional dedicated mandates where a callable feature triggers different accounting treatment for French insurance companies.

We are yet to see the new Tier I termsheet under Solvency II guidelines. And the biggest part of the primary market in insurance comes in the 30NC10 format with regulatory lock-in and mandatory coupon deferral in case of SCR breach — there are obviously some differences between countries and rating agencies. We like these structures, which offer higher credit spread duration and exposure on new issuers.

The only element of doubt in these structures is the recent debate opened after the release of the latest EIOPA guidelines, which would tend to prohibit fixed/floating coupon structures. This is obviously a source of concern that we are carefully monitoring given that: (i) most 30NC10s in the market have such fixed/floating structures; (ii) most 30NC10s have regulatory par call options should they lose their regulatory treatment (with very varied legal wording in the docs, however); and (iii) most 30NC10s trade way above par. Most issuers have actually issued these structures with a view to calling them after year 10. As a result, as long as these bonds at least qualify under grandfathering provisions, we consider it should not be a major source of worry. That might, however, justify reducing exposures to very asymmetrical high cash prices.

CNP recently issued a 31NC11 Tier 2 avoiding the fixed/floating structure, which emphasises that issuers are very well aware that the EIOPA guidelines will matter.

On insurance, another market theme we have looked at is insurance subsidiaries of bancassurance groups that are replacing internal subordinated loans by external subordinated bonds, either pre-IPO (e.g. Coface, NN Group) or as substitute/risk mitigation versus the Danish compromise (e.g. Intesa Vita). They generally offer value and diversification benefits.

Banks

Vanilla Tier 2 with no CoCo features are interesting bonds for relative value trades and for risk diversification. Again, the structure is very well understood (though the interaction with the Bank Recovery & Resolution Directive and in particular the minimum requirements for own funds and eligible liabilities (MREL) might change). We have taken the opportunity to return to good names from peripheral countries that had been absent from the subordinated primary markets since the crisis. This is a way of benefitting from the periphery-core compression trade on simple structures with decent spread pick-up. The recent Bankia Tier 2 is a good illustration of this.

We have also taken advantage of vanilla Tier 2 issuance in jurisdictions that had been less prominent in this field. The recent LBBW callable Tier 2 is a good example. Firstly, the German banking industry is very heterogeneous in terms of issuers' strengths and issuer type. Secondly, lots of the legacy subordinated bonds issued by German banks (notably Landesbanks) had come in the form of Stille Beteiligungen or Genussscheine, which are not only very specific to Germany but also include legal clauses such as profitability tests calculated under German GAAP. As a result, a simple structure on a solid Landesbank such as the aforementioned LBBW is an attractive diversification trade.

We see good value in most CoCos with Tier 2 hosts for two reasons. Firstly, we believe that the trigger risk in most Tier 2s is rather remote, in particular for short calls, given that banks must continue to increase their capital ratios in most jurisdictions. Secondly, apart from Switzerland, where they have a specific role in the capital structure, most Tier 2 CoCos appear rather opportunistic or justified by very particular situations. We are not convinced Tier 2 CoCos will play a great role in the target capital structure of European banks. This again mitigates extension risks on these bonds, should their opportunistic goal disappear.

Obviously, Additional Tier 1 (AT1) — though currently close to just 10% of our portfolio — is an area where we spend a disproportionate amount of our research effort. Among the various risks and new risks embedded in these structures, we pay a lot of attention to technical risks and mandatory suspension risks.

Technical risks include the likelihood that an issuer comes back to the market to fill either its 1.5% AT1 buffer or a capital shortfall under a leverage ratio. An issuer like Lloyds that has mostly filled its AT1 buffer as a result of its Enhanced Capital Notes (ECN) exchange is appealing. But technical risks also include the assumed high correlation within the asset class, should there be a failure of one single issue. And technical risks also include the feeling that a lot of investors in the asset class are only chasing yields rather than having a long term view on it. This could partly explain why spread curves have seemed too flat in the asset class. We tend to prefer shorter calls as a consequence.

On mandatory suspension risks, many aspects are at play, notably: the kick-off of the Maximum Distributable Amount (MDA) constraint in 2016; the inflation of litigation costs; the public disclosure or not of Pillar 2 buffers going forward and whether they are part of the combined buffer; and in the recent Deutsche Bank AT1, the additional constraint before 2016 on available distributable items — to name but a few. All in all, there is a great deal of value being offered in these bonds, but this is partially offset by the feeling there are some risks pending that are objectively very difficult to assess properly.

As a word of conclusion, we still see a lot of opportunities in the subordinated bond market, in both legacy and new bonds. On the new AT1s, which has been a hot spot of the market since last year, we invest selectively on bonds where we feel we can fairly assess most of the risks embedded in the prospectuses and we believe we get a decent spread for these risks. ●

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