Nov-Dec 2014

Bank+Insurance Hybrid Capital

With CRÉDIT AGRICOLE
CORPORATE & INVESTMENT BANK

2014/2015

Asia
Momentum builds

EBA interview
AT1 monitor

Roundtable
Review and outlook

Bank+Insurance
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New Year sales?

A year ago, deeply subordinated debt markets and the nascent bank AT1 asset class were looking forward to an exciting year ahead. Twelve months later, a sense of foreboding is more appropriate.

On the supply side, forecasts are only increasing. While the AT1 market may be off its highs, hybrid issuance remains economically efficient for financial institutions seeking to optimise their capital structure. 2014 may have seen several jurisdictions opening up and many issuers debuting, but there is much more to come.

On top of this, the launch of the Financial Stability Board's Total Loss Absorbing Capital (TLAC) consultation on 10 November raised the prospect of multiple billions more of subordinated instruments hitting the market over the coming months. Already, issuers are gearing up to hit the market with Tier 2 deals in January.

They will be joining the most active issuers in the year-end market: insurers. Having avoided the worst of the volatility suffered by banks, insurance companies have taken advantage of market windows to launch deals designed to optimise capital structures ahead of and going into the implementation of Solvency II — while next year will see the first hybrids purely based on the new framework.

Meanwhile on the demand side it is clear that the investor base for AT1 is thinning. Many private bank and hedge fund accounts have either exited the market or cut down their tickets, while those remaining committed to the asset class can afford to be selective — and are taking advantage of that.

Tier 2 investors also suffered a knock in December when Erste Group announced that — as it had warned it might — it would be skipping coupons on outstanding Upper Tier 2 and Tier 1 instruments. And all that goes without mentioning the slew of postponements of senior unsecured and covered bonds in late November.

Yet the market does not appear to have priced in these ominous trends, let alone some potentially unpleasant negative macro headlines. When it begins to — as it surely must when supply resumes in January — the last thing issuers should expect is a happy New Year.

Neil Day
Managing Editor

Bank+Insurance Hybrid Capital

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Neil Day
Managing Editor
+44 20 7428 9575
nday@bihcapital.com

Tom Revell
Reporter
+44 20 7267 5354
trevell@bihcapital.com

In association with

CRÉDIT AGRICOLE CORPORATE & INVESTMENT BANK

Vincent Hoarau
MD, Head of FIG Syndicate
vincent.hoarau@ca-cib.com
+44 20 7214 6162

Christian Haller
MD, Head of DCM Financial Institutions
christian.haller@ca-cib.com
+49 69 78901680

Julian Burkhard
MD, Head of Hybrid Capital & Liability Management
julian.burkhard@ca-cib.com
+44 20 7214 5472

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Fulfilment & distribution
Celeritas Solutions

Newtype Media
Office 37
Spectrum House
32-34 Gordon House Road
London NW5 1LP
+44 20 7428 9575

Market news

Hybrids sour into year-end after brief comeback

Bankers were expecting 2015 to come to an early end for bank capital transactions after a November resurgence in activity quickly fizzled out against the backdrop of poor sentiment and market participants were again left questioning the level of support for hybrid capital going forward.

Sweden's SEB on 6 November reopened the Additional Tier 1 (AT1) market with a $1.1bn perpetual non-call 5.5 year issue that was the first AT1 since Nordea in mid-September, and the success of the transaction *(see separate article)* raised hopes that — with the ECB's Comprehensive Assessment also smoothly out of the way — the hybrid market could regain some of momentum it displayed early this year.

However, although issuers such as Deutsche Bank were able to return in mid-November, the market's pick-up proved as fleeting as that of September, when a mixed bag of euro and dollar trades showed only selective demand for AT1s.

Deutsche Bank on 18 November priced a $1.5bn PerpNC10.5 AT1 with a 7.5% coupon, its second issuance of the instrument after a Eu3.5bn equivalent deal in euros, dollars and sterling that was the first AT1 out of Germany and the biggest to date. The German national champion had previously stated that it had a Eu5bn target for AT1.

Its previous issue had attracted an aggregate order book of some Eu25bn equivalent, and the new dollar issue attracted $3.6bn of orders from over 230 accounts. In spite of the respectable order book, the deal soon traded down, as did other transactions launched around the same time.


Deutsche Bank, Frankfurt

It was no surprise that virtually none of these deals have performed

These included a $500m 10.5 year non-call 5.5 Tier 2 for Erste Group on 19 November, which was the first subordinated transaction from an Austrian bank since junior bonds of Hypo Alpe-Adria were hit by the Austrian government. An investor said that it was not surprising that demand for the new issue hardly covered the size of the deal.

"It feels very much like investors and traders have already closed their books for the year with flows being light in European financials, even by today's anaemic standards," added the investor. "CoCos drifted lower on the week.

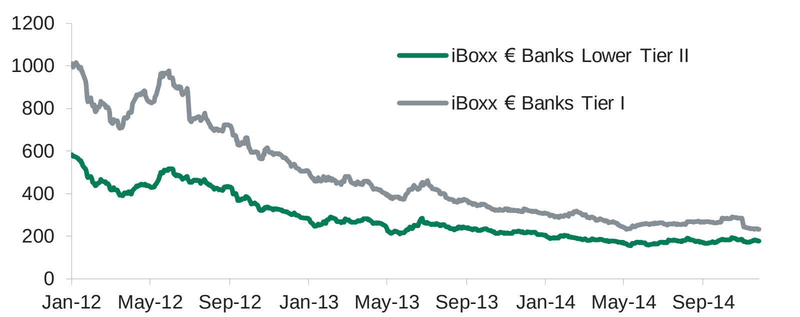
"Nevertheless bond syndicates seem determined to launch a series of new issues into an unreceptive market before the window closes for the year. Therefore, it was no surprise that virtually none of these deals have performed."

The situation turned even worse in the wider financial institutions market, as senior unsecured transactions for the likes of ASR, Nomura and Santander Consumer Bank, as well as a benchmark covered bond for AIB Mortgage Bank, were pulled.

Vincent Hoarau, head of FIG syndicate at Crédit Agricole CIB, warned that the new year could also prove difficult, particularly with recent FSB TLAC proposals having increased supply expectations further.

"The liquidity situation remains intact," he said. "But if investors anticipate oversupply they will react accordingly when it comes to positioning in primary. The first deals may go well, but if there is no secondary performance to be had, people will hold off and we could see spreads widen." ●

Secondary bank subordinated indices



Source: Markit, Crédit Agricole CIB

KBC launches Group-level Tier 2

Belgium's KBC launched one of the more successful bank Tier 2 issues of November, a Eu750m 10 year non-call five deal on 18 November that attracted a Eu2bn book in spite of deteriorating market conditions.

Leads DZ, Goldman Sachs, JP Morgan, KBC and Natixis went out with initial price thoughts of the mid-swaps plus 210bp area and on the back of Eu1.8bn of interest tightened guidance to 200bp-205bp over. The paper was ultimately re-offered at 198bp over mid-swaps with the final order book above Eu2bn.

Bankers suggested that reasonable IPTs and issue size had contributed to a solid outcome for the transaction. Dirk Van Damme, head of capital markets, bond issues, at KBC, attributed the deal's success to several factors.

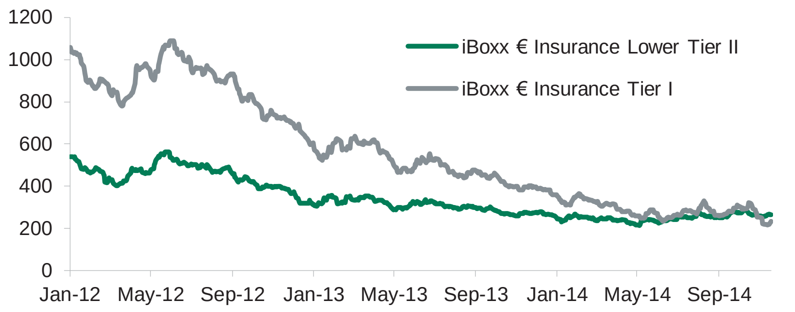
"First of all this was our first public syndicated benchmark issue in subordinated Tier 2 format at the level of KBC Group," he said. "Secondly, the credit spread and particularly the credit spread performance reflects the underlying credit quality of KBC Group.

"And then thirdly I must say that we met with tremendous demand, from large institutional investors from different areas across Europe. And thereafter some investors who missed the initial subscription period expressed interest in buying some paper."

However, an investor noted that with TLAC considerations fresh in investors' minds, issuing out of the holding company may not have been a positive factor, and that the deal traded down in the aftermarket as the market weakened.

UK and Irish accounts were allocated 25% of the transaction, France 20%, the Benelux 19%, southern Europe 13%, Germany 10%, Switzerland 9%, and others 4%. Fund managers took 75%, insurance companies 13%, banks 7%, central banks 3%, hedge funds 1%, and others 1%. ●

Secondary insurance subordinated indices



Source: Markit, Crédit Agricole CIB

NEWS IN BRIEF

Saxo AT1 debut amid Tier 2 flurry across currencies

Saxo Bank Eu42.5m 9.75% PerpNC5 AT1: Danish lender Saxo Bank issued its inaugural AT1 note on 19 November, pricing a Eu42.5m offering at mid-swaps plus 930bp for a coupon of 9.75%. The notes feature a 7% CET1 trigger with a temporary write-down mechanism.

Standard Chartered Eu500m 3.125% 10 year Tier 2: Standard Chartered issued a Eu500m 3.125% 10 year bullet Tier 2 on 14 November. IPTs were initially set at the mid-swaps plus 225bp area, with the deal eventually printing at plus 220bp.

Yorkshire £250m 4.125%10NC5: Yorkshire Building Society printed a £250m 10NC5 4.125% deal on 14 November. The deal was initially marketed at Gilts plus 300bp-310bp, which was later revised to 290bp-295bp. Final terms were eventually set at plus 290bp, with a final book size of approximately £1.2bn.

Lloyds issues dollar-denominated Tier 2 notes: Lloyds Banking Group sold a $1bn offering of Tier 2 notes on 29 October. The notes were priced at 225bp over US Treasuries and garnered an order book of $3.5bn, following a 15bp upward revision to IPTs. The transaction marks the first Yankee Tier 2 bond from Lloyds in four years.

BNP Paribas sells Tier 2 note: French lender BNP Paribas returned to the Tier 2 market on 6 October with a euro-denominated offering, opting for a 13NC8. IPTs for the notes were set at the mid-swaps plus 190bp-195bp area and received strong interest from investors, achieving a total order book of Eu2.7bn.

The strong demand allowed guidance to be tightened to 185bp, before final pricing at mid-swaps plus 183bp for a coupon of 2.625%. The issuer also launched a $1bn Tier 2 3(a)(2) offering later in the session with IPTs at Treasuries plus 220bp and a final spread of 195bp.●

SEB draws $5.3bn for $1.1bn debut AT1 reopener

Skandinaviska Enskilda Banken (SEB) reopened the AT1 market on 6 November with a debut $1.1bn (Eu883m, Skr8.17bn) perpetual non-call 5.5 issue with a coupon of 5.75% in the first European bank AT1 supply since a deal for fellow Swede Nordea on 17 September.

The deal has a temporary write-down trigger of 8% CET1 at group level, and 5.125% at bank level.

Leads Bank of America Merrill Lynch, Goldman Sachs, JP Morgan, SEB and UBS priced the deal at 385bp over mid-swaps on the back of a total order book of some $5.3bn.

"The bonds performed immediately in the secondary market to close 100.125-100.25, with continued better buying from retail and institutional demand," said a syndicate official at one of the leads.

The deal reopened the market after a bout of volatility that came after Nordea's successful AT1 debut, and the execution and a positive aftermarket performance of the inaugural SEB AT1 of was welcomed by bankers.

"This is exactly what we needed to have: confidence return to a market that had not seen any AT1 supply for almost two months," said Vincent Hoarau, head of FIG syndicate at Crédit Agricole CIB. "A strong name from the Nordic regions, with an investment grade rating and a limited size showing immediate performance in the secondary market.

"The $1.1bn print size completely fills the issuer's capital need and investors like that. The size element and the number of appearances of an issuer are gaining importance in this market and any type of scarcity element is valued by investors."

In its capital planning, SEB had communicated that it planned to issue an AT1 before next summer, supplementing a strong CET1 capital ratio, according to John Arne Wang, head of treasury management at SEB, with the bank having two legacy hybrid transactions that are callable in March 2015 equivalent to around Skr8bn (Eu865m, $1.08bn).


John Arne Wang, SEB

"Given our excellent ratios, we could obviously have waited longer than that, but ideally we like to take the opportunity of refinancing ahead of such calls," he said.

"So in that respect we were always looking to optimise the capital structure on that kind of a timescale, and once we had the clarity on CRD IV from the Swedish FSA we were able to move ahead."

This then left SEB with the choice of moving ahead before year-end, or issuing in the first half of 2015, depending on how market conditions played out, said Wang.

"After the rather substantial market volatility seen in the first half of October, we have had a remarkable rebound, not only in equity markets but also in credit, where volatility has steadily declined," he said. "In connection with that we have seen an increased appetite from investors and also the kind of positive backdrop we were looking for that would enable us to achieve attractive levels."

"There hadn't been any European AT1 transactions since the Nordea transaction in September and it wasn't obvious that was going to happen now, but we had several days with constructive market conditions spurred by the Japanese central bank and we felt fairly comfortable that throughout November there would be good opportunities. We also felt quite confident given the feedback from the market that investors would be open for business, with books not yet having started to close and indeed the rather dry period in the AT1 market having driven appetite higher, with significant cash to be put into action."

Wang said that the strong outcome of the trade met with SEB's expectations.

"It is always a challenge opening a market after a volatile period as you want to avoid having to pay up to get investors involved," he said, "but the total book size of $5.3bn and more than 360 accounts involved is not only a testament to SEB's high credit quality, but given the circumstances an excellent result. We decided to go with a NC5.5 year transaction, which allowed us to utilise the steepness of the dollar swap curve, hence providing a more attractive headline coupon at no extra credit spread.

"We saw particularly strong support from many of the large real money investors," he added, "of which Nordic investors made up a solid 35% share."

Wang said that the concession paid versus Nordea's outstanding transaction was low on a swapped basis.

"When you have a comparable transaction in the market the challenge is always that you will be priced versus that plus a new issue premium," he said. "We saw the premium paid versus that particular transaction's secondary levels in the mid-teens.

Wang said that SEB chose to tap the dollar market because on an after swap basis it was "considerably cheaper" than what could have been achieved in euros. ●

Aareal sells inaugural AT1 after postponement

Aareal Bank on 13 November became only the second German bank to issue an AT1, and did so at its second attempt, having postponed its transaction in September when market conditions deteriorated.

The German lender had been expected to issue Additional Tier 1 after the German finance ministry in April clarified the tax treatment of the new instruments, paving the way for Deutsche Bank to open the German sector in May. Aareal had previously said that it would seek to issue AT1 capital in conjunction with repaying Eu300m of remaining silent participation hybrid capital to SoFFin, the German government's Financial Market Stabilisation Fund.

To this end, Aareal embarked upon a roadshow for a Eu300m temporary write-down 7% CET1 trigger issue on 19 September. However, the market quickly took a turn for the worse.

"The first day of the roadshow was a good day in the market," said Tobias Engel, head of capital markets at Aareal Bank. "But from this day onwards spreads moved higher almost every day."

In light of the deteriorating conditions Aareal postponed its issue, but nevertheless repaid the SoFFin capital in October.

"From our side we had no pressure to do it," said Engel. "We repaid Soffin without issuing the AT1. So we then tried to find a good market opportunity to issue the bond."

The market then awaited and digested the Comprehensive Assessment, with Fitch — which rates Aareal's AT1 B+ — noting that the bank's CET1 ratio of 11.4% under the ECB's adverse scenario was the fifth highest of 16 rated German banks tested.

The bank waited until after it released its third quarter results on 11 November to return with its AT1 and by that time market conditions had improved.

"We took the earliest opportunity," said Engel, "talking to investors the next day, with a conference call, and printing on the 13th."

Leads BNP Paribas, Deutsche and HSBC went out with initial price thoughts of the 8% area for the perpetual non-call April 2020 issue and, with indications of interest approaching Eu1bn within two hours, released guidance of the 7.75% area. The final order book totalled Eu1.5bn, with over 180 accounts, allowing for pricing on the Eu300m issue of 7.625%, despite what a lead banker said was noticeable price sensitivity.

"It was finally a positive result," said Engel. "We issued what we planned, Eu300m, on the back of a five times oversubscribed book."

He was philosophical about the pric-

Tobias Engel, Aareal

ing that was ultimately achieved after the postponement.

"There were times when we thought it would be possible to print such a deal at a tighter level — but not in this market environment," he said.

"The deal is trading around par," he added, "and so it seemed we ended up with a fair market price for this bond."

Germany was allocated 37% of the issue, the UK 31%, the Nordics 8%, Switzerland 6%, other Europe 11%, and others 7%.

"I think this was the highest German participation in percentage points of any AT1 transaction," said Engel. "Ahead of the transaction we had not expected Germany to be so strong.

"We have the feeling that it was partly thanks to our reputation in Germany currently being quite strong that participation was higher."

He said that there were several reasons why Aareal used a high trigger structure.

"An important one is that we wanted to achieve an efficient capital structure and, being a small bank and unlikely to be a regular AT1 issuer, the bond should also meet capital requirements in the coming years," said Engel, "and there might be the risk that in the future low trigger instruments are not recognised as strongly as high trigger." ●

RUSSIA, MIDDLE EAST IN BRIEF

Alfa sells Tier 2, Burgan AT1

Alfa Bank $250m 9.5% 10.25NC5.25 Tier 2: On 13 November Russian lender Alfa Bank issued $250m of 10.25NC5.25 Tier 2 Notes at 9.5%, the lower end of price guidance of 9.50%-9.75%. As is customary for Russian Basel III instruments, the notes contain a contractual Point Of Non-Viability clause, based on which the notes will be written down if the issuer's CET1 falls below 2% or in the event of Deposit Insurance Agency Bankruptcy Prevention Measures.

Burgan prices AT1: Burgan Bank sold a $500m AT1 note on 23 September. The Kuwaiti lender released IPTs of the low to mid-7s for its PerpNC5 AT1 deal the day before. Final guidance for the Reg S-only notes was set at 7.25%-7.375%, before pricing at the tight end at 7.25% on the back of an order book of over $750m. ●

Insurers tap into demand ahead of Solvency II

Insurance companies played a leading role in the autumn hybrid market, with issuers keen to take advantage of low yields and the approach of the forthcoming implementation of Solvency II acting as a catalyst.

Companies including BNP Paribas Cardif, CNP Assurances and Crédit Agricole Assurances were among those to access the market in October and November, with further issuance expected going into year-end of both perpetual and Tier 2 issuance. Insurers including Axa and Generali meanwhile embarked upon liability management exercises *(see separate article)*.

According to Robert Chambers, FIG syndicate manager at Crédit Agricole CIB, the forthcoming changes to the regulatory environment for insurers are a factor in the brisk supply.

"Issuers want to anticipate the adoption of future Solvency II rules in 2016," he said. "The recent deals should benefit from grandfathering treatment as Tier 1 capital during the transitional period and are expected to be eligible as Tier 2 under Solvency II after the first call date."

Crédit Agricole Assurances (CAA) on 7 October launched a debut bond issue, a Eu750m perpetual non-call 11 subordinated deal. According to Gregory Erphelin, CFO of CAA, the inaugural transaction was driven by changes under Solvency II and to Standard & Poor's methodology that make it economically more efficient for the unit to see external subordinated funding rather than meet its needs internally from Crédit Agricole SA *(see Q&A for full details)*.

Lead Crédit Agricole CIB priced the deal at the tight end of guidance, at 335bp over mid-swaps, after having gone out with initial price thoughts of the mid-swaps plus 340bp area and then built a book of Eu2bn comprising 124 accounts.

CNP Assurances returned to the market after a Eu500m 31NC11 issue in May to sell a Eu500m PerpNC10 on 12 November. Leads Crédit Agricole CIB, Deutsche Bank, Natixis, Nomura, RBS and Société Générale went out with IPTs of mid-swaps plus 330bp for the Eu500m no-grow deal, and ultimately priced the issue at 310bp over on the back of a Eu6.5bn order book including over 400 investors.

"The level of demand for insurance sector paper is extremely high as net supply has been limited," said Chambers, noting that some of the other recent issuance had been part of liability management exercises. "When we announced guidance, the order book doubled in just 10 minutes as investors rushed to upsize their orders ahead of the books closing.

EIOPA, Frankfurt

"Some of the high quality real money accounts did reduce or remove their orders as we approached fair value, but the overall level of interest ensured the bonds traded well in the secondary market."

The issue was priced with a coupon of 4% and Vincent Damas, director for ALM and funding at CNP Assurances, noted that the prevailing level of interest rates was very favourable for issuers.

"We also see that credit spreads are at their lowest levels of the last five years – although they are still wider than before the 2008 banking crisis," he added.

(See CNP Assurances Q&A for full details.) ●

NEWS IN BRIEF

Perps, tenders and Tier 2 offerings

BNP Paribas Cardif Eu1bn 4.032% PerpNC11: French insurer BNP Paribas Cardif sold a benchmark Eu1bn PerpNC11 note on 18 November. Initial price thoughts (IPTs) for the notes were set at mid-swaps plus 300bp, with final guidance being set at mid-swaps plus 295bp following a mid-morning order book of Eu1.5bn. With final books in the region of Eu1.9bn, the notes were ultimately priced at mid-swaps plus 293bp for a coupon of 4.032% fixed until the first call date, with a floating interest rate at three month Euribor plus 393bp payable quarterly in arrear thereafter. Contrary to the majority of the recent undated issues, the notes do not contain optional deferral.

Society of Lloyd's announces tender offer results: The Society of Lloyd's on 30 October announced the results of an any-and-all cash tender launched in conjunction with a £500m 10 year 4.75% Tier 2 offering. Lloyd's bought back £148.696m of £153.241m of targeted 21NC11 6.875% notes for a fixed price of 105.75%. The transaction was structured in order for the issuer to "benefit from reorganisation of its own funds with the intention of complying with the requirements of Directive 2009/138/EC of the EU (as amended) on the taking-up and pursuit of the business of insurance and reinsurance (Solvency II) as implemented in the UK and applicable to Lloyd's".

Axa, Generali optimise through LM exercises

Axa and Generali completed liability management exercises taking in perpetual subordinated notes in October and November, in what is expected to be a growing theme for the insurance sector going into 2015.

Axa launched its any-and-all exchange offer on 29 October as part of active management of its refinancing programme aimed at ensuring adequate visibility and optimal terms for the renewal of its outstanding debt maturities in the coming years, according to the insurance company.

Axa repurchased an average 57% of two euro-denominated and two sterling-denominated fixed-to-floating perpetuals, and issued a new Eu984m PerpNC24 and a £723.9m PerpNC26, with the exchange made on a par for par basis and the exchange premium paid in cash. The dealers were BNP Paribas, Commerzbank, Crédit Agricole CIB, Deutsche Bank, HSBC, Natixis and Société Générale.

"The high level of participation from investors is extremely encouraging for the insurance sector," said Chambers. "For issuers the benefits are obvious: the transaction can provide economic benefits through a reduction in the cost of funding, while also maintaining or increasing regulatory capital levels.

"The market is tried and tested for exchange offers and we would expect confidence to grow around such transactions."

Generali launched its exercise the week after Axa, on 6 November, saying the tender offer and new issue was "in line with the Generali's pro-active approach of efficiently refinancing its debt by addressing notes with first call dates falling between June 2016 and February 2017, with the aim of reducing interest costs during the next years and [to] optimise its regulatory capital structure".

The insurer tendered for three undated subordinated notes and priced a new Eu1.5bn PerpNC11 issue. Eu2.01bn equivalent was tendered in the offer, representing around 59% of Eu3.42bn equivalent of targeted notes, and the issuer accepted Eu1.36bn equivalent, 40% of the targeted outstandings. The new notes were priced on 14 November at 350p over mid-swaps, the middle of IPTs. ●

NEWS IN BRIEF (*CONTINUED*)

Helvetia S/V taps Tier 2 notes: Swiss insurance firm Helvetia S/V tapped newly-issued Tier 2 notes on 8 October, less than a week after their initial launch. The tap was launched on both tranches, with Sfr75m added to 3.5% PerpNC5.5 notes and Sfr25m to 4% 30NC10 notes taking the total new issue sizes to Sfr400m and Sfr225m, respectively. The notes were issued to partly finance the acquisition by Helvetica S/V of the Nationale Suisse Group.

RSA prices 31NC11 Tier 2 note: UK-based insurance company RSA Insurance Group priced a £400m 31NC11 Tier 2 note on 2 October. IPTs for the deal were initially released at Gilts plus 280bp-290bp. With an order book of over £700m, final pricing was set at Gilts plus 280bp for a coupon of 5.125%, the tight end of IPTs.

ASR Nederland completes tender offer, new issue: ASR Nederland announced on 26 September the results of a cash tender offer on its outstanding Eu386.3m 10% step-up PerpNC2019 and Eu37.7m 7.25% non-step-up PerpNC2019, with Eu192.3m and Eu20.7m, respectively, accepted. The issuer priced a Eu500m fixed-to-fixed PerpNC10 note at mid-swaps plus 395bp, the wide end of initial guidance. ASR had held a European roadshow before pricing the deal.

MACIF in sub-for-sub exchange offer: MACIF announced on 23 September an any-and-all exchange offer on its outstanding Eu150m 4.625% fixed-to-floating PerpNC2015 subordinated notes, with a 101.50% exchange price. Bondholders were offered the opportunity to switch into new PerpNC2024 subordinated notes and the insurer on 1 October priced a Eu124.4m issue at 280bp over mid-swaps.

SCOR prices Tier 2 note: French reinsurer SCOR sold a euro-denominated PerpNC11 note on 25 September. Books were opened at the mid-swaps plus 287.5bp area for the Eu250m no-grow offering. The deal attracted over Eu1.5bn orders, allowing the notes to be priced at mid-swaps plus 270bp, the tight end of the guidance. The note was the insurer's first issue in the euro market for over eight years and it held a roadshow for the deal the week before launch. ●

Bank of China opens AT1, BoCom takes Asians to euros

Bank of China sells China's first Basel III-compliant AT1 preference shares: Bank of China sold its debut offering of AT1 preference shares on 15 October. The US dollar-settled CNY39.94bn PerpNC5 offering marks the world's largest single issue of AT1 capital, and China's first Basel III-compliant AT1 instrument. The issue targeted no more than 200 qualified investors. Following a strong order book of $21.8bn, it was priced at 6.75%, tighter than the initial thoughts of 6.875%-7.000% area.

The main structuring elements are outlined below:

- The offering (structured as Offshore Preference Shares) is a direct issue out of Bank of China Limited. Each Offshore Preference Share has a par value of RMB100, a minimum subscription amount of 20,000 and integral multiples of 100 Offshore Preference Shares in excess thereof. However, all the amounts due under, and all claims arising out of or pursuant to, the Offshore Preference Shares from or against the bank shall be payable and settled in US dollars only, with a fixed exchange rate;
- Payments of dividends are subject to restrictions linked to Distributable Profits and the issuer's discretion (which requires a shareholders resolution). Nevertheless, the instrument contains a parity and junior dividend stopper;
- The Offshore Preference Shareholders will irrevocably and compulsorily convert into H Shares (Hong Kong-listed shares with a nominal value of RMB1.00 each in the ordinary share capital of the Bank, and traded in Hong Kong dollars) upon an "Additional Tier 1 Capital Instrument Trigger Event" (CET1 trigger of 5.125%) or a "Tier 2 Capital Instrument Trigger Event" (i.e. a point of non-viability). The conversion price is fixed, subject to the usual adjustments;
- The Offshore Preference Shares and the rights attached to them are governed by the law of the People's Republic of China;
- The instrument is rated Ba2 by Moody's and BB- by S&P.


CCB, Xinhui

Bank of China CNY32bn 6.000% AT1 preferred shares: Bank of China priced a CNY32bn ($5.23bn-equivalent) onshore offering of AT1 preferred shares via a private placement on 18 November. The transaction follows the issuer's $6.5bn offshore Basel III-compliant AT1 issue. The transaction was well received by investors, with insurance funds and wealth management arms of onshore banks being a significant proportion of the demand.

Bank of China $3bn 10 year bullet Tier 2: Bank of China sold its debut Basel III-compliant $3bn 10 year bullet Tier 2 on 5 November. The offering was opened at 300bp over Treasuries, before tightening to 270bp-280bp on the back of strong orders. It finally gained an order book of over $18bn from 580 accounts, allowing the deal to price at 270bp over Treasuries for a coupon of 5%, 30bp tighter than initial price talk. The deal followed a series of investor meetings in both Asia and the US.

The notes will be fully and permanently written down upon a contractual point of non-viability, defined as the earlier occurrence of (1) the regulator decides that a write-off is necessary, without which the issuer would become non-viable, or (2) any relevant authority decides that a public sector injection of capital or equivalent support is necessary, without which the issuer would become non-viable.

CCB CNY2bn 10NC5 Tier 2: China Construction Bank (CCB) sold a Reg S Basel III-compliant 10NC5 Tier 2 Note on 5 November. The CNY2bn offering priced at 4.9% from initial guidance of the 5.25% area following CNY13.7bn of orders from over 140 accounts.

Bank of Communications sells Basel III-compliant Tier 2 notes: Chinese lender Bank of Communications (BoCom) sold a $1.2bn Tier 2 note on 24 September. The notes were priced 5bp tighter than initial guidance on the back of a $1.8bn order book. The following day BoCom priced a Eu500m 3.625% 12NC7 note at mid-swaps plus 300bp, down from IPTs of the low 300 area.

The trade marks BoCom as the first Asian Bank to issue Basel III-compliant notes in euros.

The notes will be written off in full if the China Banking Regulatory Commission declares the bank to be no longer viable without a write-down, or if any other relevant authority decides state support is necessary to avoid the issuer becoming non-viable. ●

ECB stress test results: keep calm and carry on

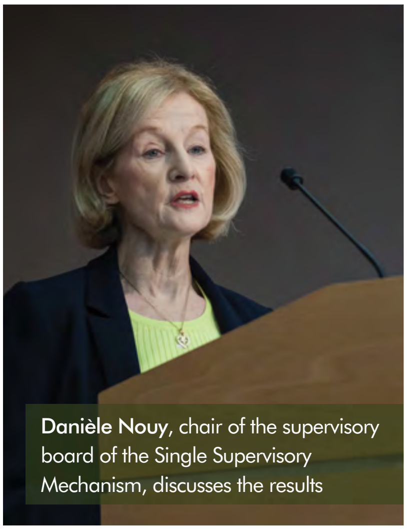
The European Central Bank announced the results of its Comprehensive Assessment of 123 banks' capital on 2 November and the market was relieved that the results contained no major negative surprises.

The joint exercise with the European Banking Authority comprised an Asset Quality Review (AQR) and Stress Test, with the latter conducted under baseline and adverse scenarios. The results were based on figures as at the end of 2013.

Twenty-five banks failed the stress test under the adverse scenario, meaning that their CET1 ratio would fall below 5.5%, but of these 11 had already taken measures in 2014 to improve their capital ratios. This left 14 banks still failing and their combined shortfall was Eu24.6bn, according to Crédit Agricole CIB analysts.

The biggest shortfall was at Monte dei Paschi di Siena, which had a Eu2.11bn capital shortfall. Like other institutions that failed, it has since taken actions to address the shortfall and in MPS's case this includes a sale of the bank.

Although some questions were raised about the methodology used — for example, deflation risk being untested and litigation issues not being taken into account — the results were generally well received by the markets.



Danièle Nouy, chair of the supervisory board of the Single Supervisory Mechanism, discusses the results

"The review seems harsh enough to be convincing but still manageable for banks," said the Crédit Agricole CIB analysts. "This should improve confidence, and we see this outcome as positive for the whole sector, notably on the subordinated segment."

Indeed, after the results were announced on the Sunday, SEB reopened the AT1 market on Thursday, 6 November *(see separate article)*, while other institutions saw the way open to access the market.

"Doing a subordinated capital deal fairly closely ahead of the announcement of the stress test results would have been rather inappropriate," said a funding official at one bank that went on to issue in the aftermath. "I think that's why several banks waited to take a decision on going ahead with such deals."

An investor meanwhile said that the outcome of the exercise should help the asset class.

"It is very positive for AT1," he said, "because what you can basically see is that if that stress test played out, no AT1 would have been triggered.

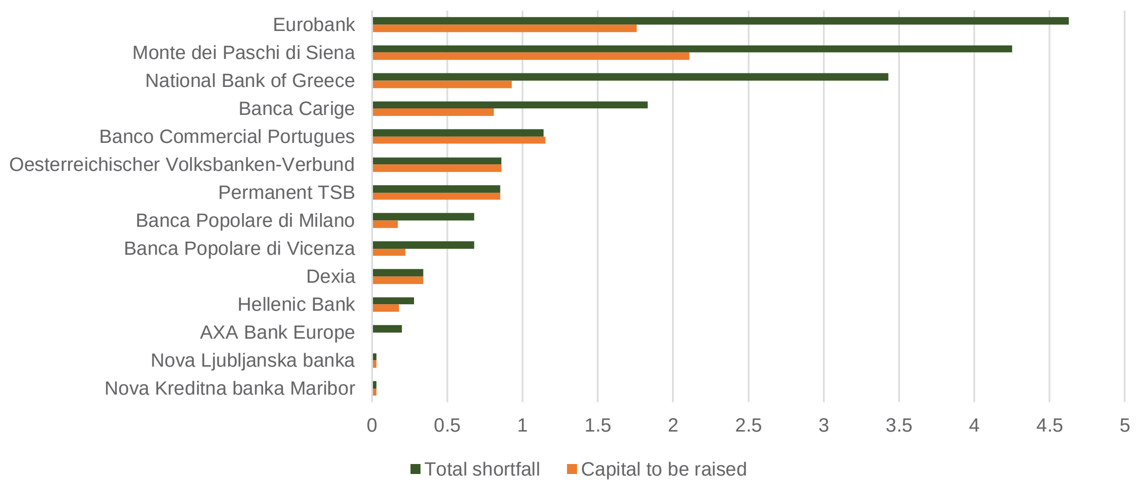
"But at the same time," he added, "if you really had these losses, it's very likely that most of the coupons would also have been deferred by 2016."

He said that the results were in line with his expectations.

"I think they perhaps should have been a bit more stringent with the definition of capital," he added. "Some of the larger banks looked a bit better than they should have because they used phased-in rather than fully-loaded numbers, and what was missing was the litigation and operational risk. And the ECB said itself that DTAs were treated too generously.

"So they have to tighten things up a bit going forward, but otherwise, the rest was good." ●

Capital shortfalls of banks that failed

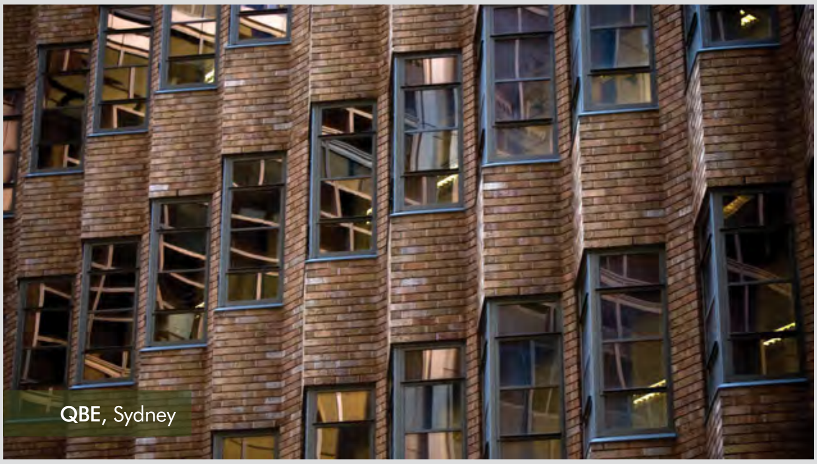


Source: EBA, Crédit Agricole CIB

ASIA-PACIFIC (EX-CHINA), LATIN AMERICA

Aussies, Koreans busy, plus Japan, India and Peru, too

QBE Insurance Group $700m 6.75% 30NC10 Tier 2: Australian Insurance group QBE Insurance priced a $700m Tier 2 note on 24 November. The notes were initially marketed with guidance of the 7% area, which was revised to the 6.875% area plus or minus 12.5bp on the back of books in the region of $2bn. The deal was finally priced at 6.75%, the tighter end of guidance. Contrary to European structures, the notes contain contractual principal loss-absorption.


QBE, Sydney

NAB Eu750m 10NC5 Tier 2: National Australia Bank (NAB) sold the first euro-denominated Basel III-compliant Tier 2 note from an Australian issuer on 5 November. Books for the 10NC5 deal were opened with initial price thoughts (IPTs) of the 175bp over mid-swaps area. Guidance was later revised to 170bp plus or minus 5bp, following an order book of Eu1.75bn. The Eu750m offering finally priced at 165bp over mid-swaps for a coupon of 2%, the tight end of guidance.

CBA sells AUD-denominated Basel III-compliant Tier 2 Notes: Commonwealth Bank of Australia (CBA) completed a Basel III-compliant issuance of Tier 2 capital following a series of institutional investor meetings that took place in Sydney and Melbourne at the end of October. The A$1bn offering was priced in the middle of formal guidance, at 195bp over three month BBSW.

Dai-ichi Life Insurance sells Perp NC10 subordinated notes: Dai-ichi Life Insurance sold $1bn of 144A/Reg S PerpNC10 subordinated notes on 23 October. The notes feature a floating rate reset at 368bp over three month US dollar Libor on the first call date. Initial guidance for the notes was set at the 5.375%-5.5% area, before final pricing considerably tighter at 5.1% on the back of an order book of over $10bn.

Korean Re sells Korea's first insurance hybrid notes: Korean Reinsurance Company sold a 30NC5 offering of subordinated notes on 14 October. The Reg S notes were capped at $200m, an amount targeted in order to improve the insurer's ratings. Following IPTs at 4.875%, the offering gained an order book of $1.2bn, allowing pricing to be tightened to 317bp over US Treasuries for a coupon of 4.5%. The notes have a first call date in 2019 and a reset from 2024 onwards every five years to the prevailing five year US Treasury rate plus the initial spread and a 100bps step-up.

IDBI sells Basel III-compliant AT1 notes: Industrial Development Bank of India (IDBI) sold a Rs25bn domestic offering of Basel III-compliant AT1 notes on 15 October. The issue marks the first AT1 issuance in India following modifications made to the Basel III guidelines by the Reserve Bank of India on 1 September. The PerpNC10 offering was priced at 10.75%.

KEB sells inaugural Tier 2 notes: Korea Exchange Bank sold its first offering of Basel III-compliant Tier 2 notes on 7 October. Initial guidance on the 10 year bullet was announced at around 210bp over 10 year US Treasuries, with the issue size for the offering capped at $300m. The order book for the transaction reached over $3bn, allowing the notes to be priced at 185bp over Treasuries, 25bp tighter than initial guidance.

Hana Bank sells Basel III-compliant Tier 2 notes: Hana Bank completed the sale of its first Basel III-compliant Tier 2 notes on 25 September. IPTs for the $300m 10 year bullet offering were launched at the Treasuries plus 225bp area, before pricing at plus 195bp, the tighter end of guidance, on the back of a $2bn order book from 150 accounts.

BBVA Continental sells Tier 2 note: BBVA Continental, the Peruvian arm of Spanish lender BBVA, sold a 15NC10 Tier 2 Note on 15 September. IPTs were launched at the 300bp over Treasuries area for the notes, which feature a coupon reset to the prevailing five year Treasury plus the initial credit spread after 10 years. It was indicated from the outset that the deal would be a $300m no-grow. The deal achieved an order book of $2.4bn, allowing the notes to be priced at Treasuries plus 275bp. ●

Regulatory updates

TLAC: FSB releases proposals

The Financial Stability Board (FSB) on 10 November issued for public consultation policy proposals consisting of a set of principles and a detailed term sheet on the adequacy of loss-absorbing and recapitalisation capacity of global systemically important banks (G-SIBs). The proposals respond to the call by G20 leaders at the 2013 St Petersburg summit.

The deadline for responses is 2 February 2015. The FSB will revise the principles and term sheet in light of the public consultation and findings from a quantitative impact study (QIS), currently scheduled for early 2015, and market survey (to gauge the depth of markets for eligible Total Loss Absorbing Capital (TLAC) instruments). They will then submit a final version to the G-20 by the 2015 summit. The conformance period for the TLAC requirement will be informed by the QIS, but will not be before 1 January 2019.

Minimum TLAC and relationship with Basel III capital requirements and CBR — risk of MDA restrictions

The FSB is proposing that a single specific minimum Pillar 1 TLAC requirement be set (1) within the range of 16%-20% of RWAs, and (2) at least twice the Basel III Tier 1 leverage ratio requirement. The final calibration of the common Pillar 1 minimum TLAC requirement will take into account the results of this consultation and the QIS and market survey. Additional Pillar 2 TLAC requirements could also be added. However, the overall requirement does not seem to be proportioned to the size of the G-SIB buffer.

Minimum TLAC is defined as an additional, rather than parallel, capital requirement to the Basel III framework. It will sit below the Combined Buffer Requirement (CBR), and only CET1 in excess of the Basel III minimum regulatory capital requirements and minimum TLAC may count towards the CBR.

According to the document, a breach of the minimum TLAC requirement could trigger the same restrictions set out in the Basel III framework for the duration of the breach, i.e. the MDA. However, this would technically be the consequence of the indirect breach of the CBR, rather than the TLAC per se, due to the principle of no-double-counting set out above. For example, if a TLAC-qualifying Tier 2 instrument matures and is not replaced, the amount will have to be filled by CET1, which will not be able to be counted for the CBR, with the associated possibility of a breach.

Eligible instruments and role of (debt) hybrid and senior unsecured instruments — minimum 33% on TLAC

All regulatory capital instruments issued by the resolution entity or resolution entities of a firm and held by third parties will be eligible to satisfy minimum TLAC requirements. In addition, there is an expectation that the sum of a G-SIB's resolution entity or entities' (i) Tier 1 and Tier 2 capital instruments in the form of debt plus (ii) other eligible TLAC that is not regulatory capital, should be equal to or greater than 33% of their minimum TLAC requirements, so that there will be sufficient resources available in resolution. It is not clear what the reference to debt-form should precisely refer to.

Below is a table summarizing the total TLAC and the quota for additional senior and hybrid instruments (assuming no CCyB, Systemic Risk Buffer or Pillar 2 buffer(s), where included in the CBR, and a 2.5% limit on the use of senior unsecured instruments — *see below*).

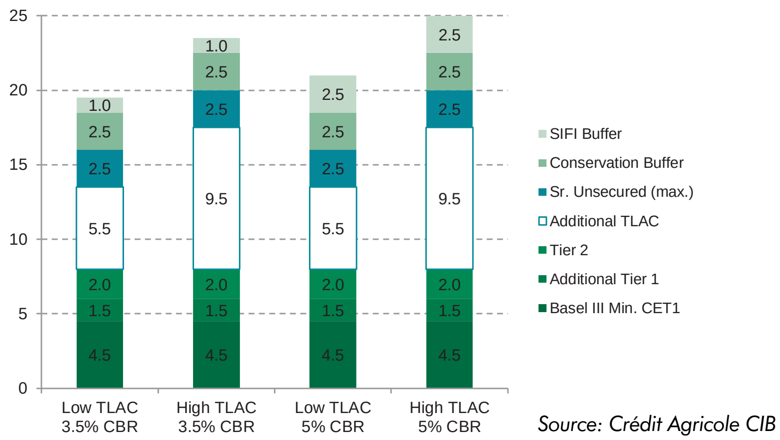
Other requirements include redemption restrictions (prohibition from redeeming eligible external TLAC without supervisory approval), governing law, and a minimum remaining maturity of at least one year. Authorities will also have to ensure that the entire TLAC maturity profile would be adequate to sustain periods of impaired market access.

The document also adds the possibility for "credible ex-ante commitments" from resolution authorities to be counted towards the TLAC, subject to a cap of 2.5% of RWA and other conditions. However, there must be "no particular limit specified in law in respect of the amount which may be contributed", which might disqualify the European SRF.

Eligibility of senior unsecured Instruments — conflicts with the BRRD framework

Based on the priority requirements for eligible external TLAC, there are three base alternatives for the inclusion of Senior Unsecured instruments:

Total TLAC and quotas for additional senior and hybrid instruments (% RWA)



Source: Crédit Agricole CIB

- Contractual subordination: contractually subordinated to all excluded liabilities on the balance sheet of the resolution entity; or
- Statutory subordination: junior in the statutory creditor hierarchy to all excluded liabilities on the balance sheet of the resolution entity; or
- Structural subordination: issued by a resolution entity that does not have excluded liabilities on its balance sheet (for example, a holding company or a special purpose vehicle) and the proceeds down-streamed from the resolution to subsidiaries in a form that subordinates the eligible liabilities to the excluded liabilities of subsidiaries. Therefore there is no need for the TLAC issued from the resolution entity itself to be contractually or statutorily subordinated.

Senior unsecured bonds issued from banks subject to the BRRD framework, and governed by EU laws, might be able to qualify for TLAC under the second alternative above (statutory subordination). Nevertheless, the presence of derivatives within the TLAC-excluded list could create a problem for European issuers, as equally-ranking senior bonds might fall short of the requirement above.

In the absence of an HoldCo/OpCo group structure that could make the structural subordination option feasible, the document confirmed the waiver introduced in a 21 September version, i.e. the possibility to include senior unsecured instruments up to a maximum usage of 2.5% on RWAs (or more if the final calibration of the common Pillar 1 minimum TLAC requirement exceeds 16% RWA).

Location of TLAC within group structures — resolution entities and material subsidiaries

Under the proposal, a minimum TLAC requirement will apply to each resolution entity within each G-SIB and will be set in relation to the consolidated balance sheet of each resolution group.

Moreover, each material subsidiary (as defined in the document) of a G-SIB that is not a resolution entity should meet an internal TLAC requirement by maintaining a minimum amount of eligible internal TLAC of 75%-90% (the range will be reviewed in the QIS and the actual figure within that range would be determined by the relevant host authority in consultation with the home authority of the external Pillar 1 minimum TLAC requirement that would apply to the material subsidiary if it were a resolution entity).

Tier 1 and Tier 2 regulatory capital instruments issued externally by a material subsidiary may count toward that material subsidiary's internal TLAC requirement, but only to the extent that: (a) the relevant host authority can expose them to loss, or convert them to equity at the point of non-viability, without applying resolution tools to the subsidiary; (b) they are recognised as Tier 1 or Tier 2 capital instruments for the purpose of consolidated capital requirements applicable at the level of the resolution entity, under the rules set out in paragraphs 62 to 64 of the Basel III framework; and (c) home and host authorities agree that the quantum of externally issued regulatory capital does not pose a "change of control" risk in resolution that would be inconsistent with the agreed resolution strategy.

Timing

As mentioned above, the final timing for the enforcement of the requirements is still undecided, but the document confirmed that it will not be earlier than 1 January 2019. Nevertheless, firms' TLAC positions will have to be disclosed and monitored "at an earlier date". G-SIBs that are headquartered in emerging markets will not, initially, be subject to the requirement.

EBA launches MREL RTS consultation

The European Banking Authority (EBA) on 28 November launched a public consultation on draft Regulatory Technical Standards (RTS) further specifying the criteria to set the Minimum Requirement for Own Funds and Eligible Liabilities (MREL) laid down in the Bank Recovery & Resolution Directive (BRRD).

The BRRD does not establish a common minimum MREL, but actual levels should be adapted to reflect the resolvability, risk profile, systemic importance and other characteristics of each institution. These RTS aim to further specify these minimum criteria in order to achieve an appropriate degree of convergence in how they are applied and interpreted across Member States, and ensure that similar levels of MREL can be set for similar institutions.

Below is a summary of the draft RTS. The deadline for the submission of comments is 27 February 2015. A public hearing will take place at the EBA premises on 19 January.

Basic MREL, i.e. CRR/CRD IV Pillar 1 and 2 requirements + the amount needed to recapitalise the resolved firm (equivalent minimum CRR/CRD IV requirements + market confidence add-on)

The MREL will be first calibrated so as to ensure that there are enough own funds and eligible liabilities available to (1) absorb losses and (2) contribute to recapitalisation, which lead to two main additive metrics:

1. Loss absorption (Art. 2) (equal to the CRR/CRD IV requirements including Pillar 2 and leverage ratio, if any)

The CRR/CRD IV regulatory capital requirements (both Pillar 1 and 2) and buffers already reflect a judgement of the supervisor and regulatory community about the level of unexpected losses an institution should be able to absorb. It is therefore proposed that as a baseline the resolution authority should seek to ensure that losses equal to capital requirements (including buffers) can be absorbed.

2. Recapitalisation (Art. 3) (set at "0" for those banks that can be liquidated)

The resolution authority will determine the amount of recapitalisation that would be required to implement the preferred resolution strategy identified in the resolution planning process. This recapitalisation amount is only necessary for those institutions for whom liquidation under normal insolvency processes is assessed not to be feasible and credible. Hence, for those banks that can be liquidated, the recapitalisation amount may be zero. This evaluation consists of two parts.

- The first creates a link between MREL and the capital ratio (including any leverage ratio requirement that has been applied) necessary to comply with conditions for authorisation for the institution after resolution. Based on the CRR/CRD IV framework an institution would have to comply, immediately after resolution, at a minimum, with the 8% total capital ratio requirement and any Pillar 2 capital requirement that the authorities have set (and potentially any leverage ratio requirement).
- The second part of the recapitalisation criterion is to ensure sufficient market confidence in the institution. The draft RTS proposes that this should be assessed by considering how much is needed to restore the capital buffers established by CRD IV, and, for Globally Systemically Important Institutions (G-SIIs), to reach similar capital levels to the firm's peer group.

See table for an example provided by the EBA of the application of the capital and resolvability criteria.

Further adjustments for exclusions, deposit guarantee scheme contributions and systemic risks

EBA example of application of capital and resolvability criteria

Type of Bank	A/ Small bank	B/ Medium-sized bank	C/ G-SII
Total capital requirements (1)	10.50%	10.50%	15%
RWA density (2)	35%	35%	35%
Loss absorption amount (3) = (1)*(2)	3.70%	3.70%	5.40%
Resolution strategy	Liquidation	Assets/Liabilities (critical functions, equiv. to 50% of RWA) transfer to a bridge bank	Bail-in
Recapitalisation amount (4)	0%	1.80%	5.40%
MREL (=3+4)	3.70%	5.50%	10.80%

Source: Crédit Agricole CIB

1. Adjustment for deposit guarantee scheme contributions (Art. 4)

Article 109 permits the use of deposit guarantee funds in resolution, but limits their contribution to the lesser of a) the amount of losses covered depositors would have borne in insolvency, or b) 50% (or a higher percentage set by the member state) of the target level of the deposit guarantee fund. The RTS proposes that resolution authorities should be required to set MREL to ensure that these limits would be respected if losses equal to the amount determined for purposes of the first criteria were incurred.

2. Adjustment for bail-in-able liabilities (Art. 5)

Bail-in-able liabilities (i.e. those which meet the conditions for inclusion in the amount of own funds or eligible liabilities) may be excluded from loss in this way and so not be able to contribute to the absorption of losses or recapitalisation. If this contingency is envisaged in the resolution plan, the MREL needs to be increased to account for their exclusion. Additionally, exclusion of liabilities from loss increases the amount of loss or recapitalisation that must be borne by other liabilities. If a sufficiently large amount of excluded liabilities rank equal to or junior to in insolvency any liabilities that are bailed in, this could result in holders of bailed-in liabilities receiving worse treatment than in insolvency, and so being eligible for compensation.

3. Size and systemic risk (Art. 7)

For G-SIIs and Other Systemically Important Institutions (O-SIIs), resolution authorities are therefore required to assess whether the level of MREL is sufficient to ensure that the conditions for use of the resolution fund described in Article 44 of the BRRD could be met. That article requires that a contribution to loss absorption and recapitalisation of not less than 8% of the total liabilities including own funds of the institution (or, under certain conditions, 20% of risk-weighted assets) has been made by the holders of relevant capital instruments and other eligible liabilities.

Timing: 2016 application, but potential 4 year (max) phase-in

By way of derogation from Article 8, resolution authorities may determine a lower level of MREL to enable an appropriate transitional period (not longer than 48 months).

Structuring takeaways

On the back of the consultation, we have updated our review of the available structuring options for MREL and TLAC-compliant instruments aimed at bolstering an institution's loss absorption capacity.

- In our view, the safest option to build loss-absorbing capacity, aside from regulatory capital instruments, remains the use of "other subordinated instruments", i.e. non-regulatory capital subordinated notes, without the need for a contractual point of non-viability (PONV) clause. These securities would be TLAC, MREL and (likely) Additional Loss Absorbing Capital (ALAC)-compliant. However, as previously stated, their likely cost advantage could be limited to the shorter duration (one to five years), as they would share the same insolvency ranking as outstanding Tier 2 instruments

- OpCo senior unsecured instruments are technically MREL-eligible. However, the extent of their actual computation within the MREL numerator could be limited due to their reduced loss absorbency capacity. If an institution's resolution plan envisages the exclusion of certain bail-in-able liabilities, this will increase the amount of loss or recapitalisation that must be borne by other liabilities. If a sufficiently large amount of excluded liabilities rank in insolvency equal to or junior to any liabilities that are bailed in, this could result in holders of bailed-in liabilities receiving worse treatment than in insolvency, and so being eligible for compensation. In addition, their ALAC computability, based on S&P's recent RFC *(see below)*, also remains unclear
- OpCo senior unsecured instruments with a PONV clause could avoid such a risk of compensation arising. This would be in line with Article 45(13) of the BRRD, which allows contractual bail-in instruments. The RTS leaves the resolution authority to determine whether this is viable. However, the requirements of Article 45(14)(b), which expands Article 45(13), also imposes a change in the insolvency ranking of the security, which might not always be practicable. Without the latter, the PONV clause might not be enough to override the statutory application of the no-creditors-worse-off principle
- Where applicable, HoldCo senior unsecured instruments remains a viable solution under all three frameworks. However, the legal entity must not only be free from TLAC-excluded liabilities, but also from liabilities which could be exceptionally excluded from under the institution's resolution plan, resulting in litigation risk

Interactions with TLAC

The bulk of the TLAC framework should be able to be indirectly included by the envisaged MREL provisions. According to the EBA, the FSB TLAC standards (16%-20% of RWA, 2x leverage ratio), along with the differences in the denominator of the metrics, should be absorbed with setting a single MREL requirement. Other aspects are more challenging, including:

- 33% debt requirement: It is unclear if this refers to a legal or accounting definition. Its application would also be outside the scope of the draft RTS
- MDA implications: The MDA framework is disciplined under the CRD IV, therefore, secondary legislation would not be the correct way to address this. However, the MDA restrictions stemming from a breach of TLAC might fall under Art. 104(i) of the CRD IV, which already gives regulators the power to cancel AT1 distributions
- Prudential treatment of holdings of TLAC instruments: The full deduction of other institutions TLAC holdings might require an amendment of the CRR. ■

Standard & Poor's RFC

S&P on 25 November released a Request For Comment on the proposal to add a new component in the banks ratings criteria termed as Additional Loss Absorbing Capacity (ALAC). This will address how a bank issuer credit rating (ICR) may be higher than the bank's stand-alone credit profile (SACP), depending on the ALAC the bank maintains. The RFC aims to define the instruments eligible in ALAC as well as providing explicit ALAC ranges (in terms of a % of S&P RWA) to benefit from a rating uplift above the SACP. ALAC will only benefit the ICR in jurisdictions where an effective resolution regime is in place (e.g. BRRD).

ALAC-eligible instruments:

- Hybrids with at least minimal equity content (e.g. plain vanilla Tier 2) and Non-Operating HoldCo financial obligations will be eligible in ALAC..
- An ALAC instrument must have a mandatory contingent capital clause or the relevant resolution framework creates the equivalent of such a clause (e.g. BRRD)
- Minimum 12 months remaining life, redemption earlier than the maturity date subject to the regulator's approval.
- Exclusion of the amount in excess of 0.5% S&P RWA of instruments maturing within 12-24 months.

ALAC calibration: One notch uplift when ALAC is within 5%-6% of S&P RWA and two notches if it is within 8%-10%. At first sight, it probably implies a massive amount as S&P RWA are much higher than regulatory RWA.

ALAC and RAC interactions: Risk-Adjusted Capital (RAC) will remain the key measure of a bank's solvency position. ALAC will come on top of RAC. As such, it will not affect the SACP.

Expected ratings impact: According to S&P, the impact on ratings will be limited in the short term because the resolution frameworks are still in the phase of implementation. Longer term, ALAC may compensate for the loss of government support currently embedded in long term ratings.

Timing: Comments may be submitted until 16 January 2015. We expect that the final criteria will be implemented in Q2 2015.

BANKING

UK leverage ratio plan out

On 11 July the Financial Policy Committee (FPC) of the Bank of England published a consultation paper setting out its analysis of the policy choices that would determine the role of a leverage ratio in the capital framework in the UK. Twenty-six responses were received. The Committee met on 15 October to agree its final proposals for the design of the leverage ratio framework and to discuss its view on calibration, and the resulting document was published on 31 October.

Main recommendation

The FPC recommends that HM Treasury exercise its statutory power to enable the FPC to direct the Prudential Regulation Authority (PRA) to set leverage ratio requirements and buffers for PRA-regulated banks, building societies and investment firms, including:

- a minimum leverage ratio requirement;
- a supplementary leverage ratio buffer that will apply to G-SIBs and other major domestic UK banks and building societies, including ring-fenced banks; and
- a countercyclical leverage ratio buffer

As opposed to the original proposal, the committee judged that having a leverage conservation buffer would introduce unnecessary complexity. For the same reasons, the committee agreed that the leverage ratio framework should not reflect Pillar 2 risks.

Quantitative requirements

The minimum leverage ratio requirement will be set at 3%.

Supplementary leverage ratio buffers would be set at 35% of the corresponding risk-weighted systemic risk buffer rates. This 35% conversion factor should preserve the relationship between the 3% minimum leverage requirement and the 8.5% Tier 1 risk-weighted capital requirement (including the CCB).

- For UK systemically important firms, the G-SIB buffers would currently range when implemented from 1% to 2.5%. Using a 35% scaling factor would result in a systemic leverage buffer of between 0.35pp and 0.875pp, with a requirement, before any CCLB, of between 3.35% to 3.875% for G-SIBs
- The risk-weighted supplementary capital buffer for large domestic UK banks and building societies, including ring-fenced banks, had not been set yet but would be in the range of 0% to 3%. Using a 35% scaling factor would imply a systemic leverage ratio buffer of up to 1.05pp for these firms – and so a leverage ratio requirement, before any CCLB, of between 3% and 4.05%
- For the CCLB, using the Basel buffer guide range for the CCB of 0% to 2.5% would result in a CCLB of 0% to 0.9% (rounded to the nearest 10 basis point increment) – though the buffer guide would be only one input to its decisions on the appropriate CCB rate and so the CCB rate could be higher

Putting all of this together would lead to estimated ranges of leverage ratios of:

- Non-systemically important firms: 3%-3.9%
- G-SIBs: 3.35%-4.775%
- Other major domestic UK banks and building societies including ring-fenced banks: 3%-4.95%

In addition, the FPC would consider the overall calibration of UK bank capital requirements, including risk-weighted capital buffers for systemically important firms such as ring-fenced banks, following progress on relevant international agendas and taking into account its discussions on ending "too big to fail" (i.e. TLAC).

Role of AT1 Instruments

The committee agreed that the share of AT1 instruments eligible to meet the

Component	Population of firms	Timing	Proposed calibration
Minimum leverage ratio requirement	G-SIBs and other major domestic UK banks and building societies	Immediately	3%
	All PRA-regulated banks, building societies and investment firms	From 2018, subject to a 2017 review	3%
Supplementary leverage ratio buffer	G-SIBs and other major domestic UK banks and building societies	In parallel with corresponding risk-weighted buffer, hence phased from 2016 for G-SIBs and introduced in 2019 for other major domestic UK banks and building societies	35% of the corresponding risk-weighted systemic buffer rates
Countercyclical leverage ratio buffer (CCLB)	G-SIBs and other major domestic UK banks and building societies	Immediately	35% of the risk-weighted countercyclical capital buffer rate
	All PRA-regulated banks, building societies and investment firms	From 2018, subject to a 2017 review	35% of the risk-weighted countercyclical capital buffer rate

Source: Crédit Agricole CIB

minimum leverage ratio should be limited to 25% and that all leverage buffers should be met with CET1 only. This arrangement would mirror the rules in the risk-weighted framework. Further, it was agreed that only high trigger contingent convertible instruments (i.e. those that triggered at a ratio of at least 7% CET1) should be allowed to count in the AT1 portion.

Impact on MDA restrictions

Turning to actions that could be taken in the event that firms did fall below their leverage ratio requirements, the committee emphasised the importance of the PRA acting promptly and appropriately in that case. The supervisory actions to take in response should be similar to those in place if firms fell below their risk-weighted requirements. The committee agreed, however, that it would not, as part of this review, specify automatic supervisory actions following breaches of these leverage requirements and buffers.

Stress tests

Having not set an explicit minimum leverage ratio threshold with respect to firms' stressed capital positions in the 2014 stress test exercise, the committee agreed that for future stress tests it would expect regulatory responses to be based both on risk-weighted and leverage requirements.

Timing

- Minimum leverage ratio of 3%: as soon as practicable for the UK G-SIBs and other major UK banks and building societies at the level of the consolidated group
- A supplementary leverage ratio buffer relating to G-SIBs: parallel with the corresponding risk-weighted systemic risk buffers (2016)
- A supplementary leverage ratio buffer relating to other major domestic UK banks and building societies: in parallel with the corresponding risk-weighted systemic risk buffers (set by the FPC following a consultation in 2015, and would be implemented from 2019)
- Changes to CCLB rates: at the same time as changes to CCB rates, and applied to firms at the point they become subject to the minimum leverage requirement. The committee also proposed that the period by which firms must comply with increases in the countercyclical leverage ratio buffer could be up to 24 months rather than 12 months

The FPC agreed to set out its planned approach to using leverage powers in a draft Policy Statement early in 2015, in order to inform any parliamentary debate.

In 2017, the FPC expects to review its proposed leverage ratio framework and particularly the application to individual entities and non-systemic groups in light of progress towards international and EU leverage ratio frameworks. ●

Other regulatory developments

ECB

ECB speaks on supervision and next steps after Comprehensive Assessment: In a speech on 18 November, Sabine Lautenschläger, member of the Executive Board of the ECB, summarised the key findings of the Comprehensive Assessment and explained how the results of the assessment will support the ongoing supervisory work that now begins for the ECB. In the speech, it was made clear that the ECB expects banks to create provisions for the non-performing exposures identified in the AQR and to make improvements to their data systems and internal models. The ECB's supervisory work will be driven by the objective of creating a level playing field for banks within the euro area and will therefore take into consideration the options and discretions exercised by Member States when implementing the CRR and inconsistencies of banks' internal models.

ESRB appears before ECON: On 17 November, Mario Draghi, in his role as chairman of the European Systemic Risk Board (ESRB), made an introductory statement at a hearing before the Economic & Monetary Affairs Committee (ECON) at the European Parliament regarding the role of the ESRB and its supervisory activities. He announced that the ESRB plans to devise (together with the European Banking Authority) a methodology for banks to calculate potential misconduct costs under stress in order to ensure a robust and comparable assessment across banks and help ensure appropriate contingency planning across jurisdictions. In addition, he reviewed the macroprudential measures that Member States have adopted so far, including countercyclical buffers and higher capital requirements on too-big-to-fail banks. Looking ahead, he considered the effect on liquidity of reduced market-makers' inventories and announced further enquiry by ESRB into the systemic risks posed by this development. In addition, he announced the ESRB's intention of publishing a report early next year on the regulatory treatment of sovereign exposures and the systemic vulnerabilities arising from these exposures.

ECB assumes responsibility for euro area banking supervision: The European Central Bank (ECB) on 4 November assumed responsibility for the supervision of euro area banks, directly supervising 120 significant banking groups, which represent 82% (by assets) of the euro area banking sector. For all other 3,500 banks, the ECB will also set and monitor the supervisory standards and work closely with the national competent authorities in the supervision of these banks.

Koenig calls for focus on quality of capital: Elke Koenig, president of Ger-


New ECB premises, Frankfurt

many's banking regulator, BaFin, and member of the new ECB Supervisory Board, said in Milan in September that the Single Supervisory Mechanism (SSM) will focus on the issue of the quality of capital, in addition to the nominal levels. A lack of harmonisation across EU Member States in spite of the Single Rulebook was recently questioned. It had been reported that Greece would allow banks to treat certain deferred tax assets as tax credits, following similar initiatives from Italy, Spain and, to some extent, Portugal.

EBA

EBA consults on guidelines on the use of the bail-in power: The European Banking Authority (EBA) on 11 November launched two public consultations, on: (i) Guidelines on the treatment of shareholders when applying the bail-in tool or the write-down or conversion of capital instruments; and (ii) Guidelines on when and how different conversion rates from debt to equity should be set for different types of liability. The first set of Guidelines clarifies the circumstances that should guide the choice between cancellation and severe dilution of existing shares (or other instruments of ownership) when applying the bail-in tool or the write-down or conversion of capital instruments power provided for in the BRRD. The second set of Guidelines clarifies when and how different conversion rates from debt to equity should be set for different types of liability.

EBA consults on assessment methodology for IRB approach: On 12 November EBA launched a consultation on its draft Regulatory Technical Standards (RTS) on assessment methodology for the internal ratings-based (IRB) approach. These draft RTS set out standards for the competent authorities to help them assess an institution's compliance with minimum IRB requirements when it (i) initially applies to use the IRB approach, (ii) applies to use the IRB approach for certain types of exposures in accordance with the sequential implementation plan, (iii) applies for implementation of material changes to the IRB approach, and (iv) applies to resume less sophisticated approaches. Competent authorities will also use these draft RTS to assess whether an institution meets minimum IRB requirements on an ongoing basis following their regular review of the IRB approach as well as of the changes that require notifications from the institution. The deadline for submission of comments is 12 March 2015.

EBA consults on contractual recognition of bail-in: The EBA launched on 5 November a consultation on its draft RTS on the contractual recognition of write-down and conversion powers under Article 55(3) of the Bank Recovery & Resolution Directive (BRRD). Pursuant to the latter, Member States shall require institutions to include a contractual term by which the creditor or the party to the agreement creating a relevant liability recognises that liability may be subject to the write-down and conversion powers and agrees to be bound by any reduction of the principal or outstanding amount due, conversion or cancellation that is effected by the exercise of those powers by a resolution authority, if the liabilities are governed by the law of a third country. The draft RTS include two main sections:

- The definition of the cases in which the requirement to include the contractual term does not apply. In particular, the requirement to include a contractual term is displaced where a statutory regime in the third country concerned or an international agreement exists that provides for an administrative or judicial procedure to secure recognition of the application of the write-down and conversion powers by a Member State resolution authority.
- The specification of the contents of the contractual term required to be included in relevant liabilities where no alternative, i.e. statutory, mechanism exists to secure recognition. The objective was to find a balance between the need for harmonisation and flexibility. Therefore, the mandatory contents are set out in the RTS but there are no limits on the ability of institutions and relevant entities to supplement the contents if necessary to take account of issues arising in relation to a particular type of liability or specific third country law.

These updates are split into bank and insurance, and after the initial updates listed according to the relevant body, with the most recent first.

EBA consults on valuation in recovery and resolution: The EBA on 7 November launched a consultation on its draft RTS on valuation in recovery and resolution. These draft RTS aim to provide a common structure to decisions made by resolution authorities and independent valuers and to promote a consistent application of methodologies for such valuations across the EU. The consultation runs until 6 February 2015. Prior to resolution, valuations are required to (i) assess whether the conditions for resolution or the write-down or conversion of capital instruments are met and (ii) inform the choice on the resolution action to be adopted, the extent of any eventual write-down or conversion of capital instruments, and other decisions on the implementation of resolution tools. After the resolution, a valuation is required to determine whether an entity's shareholders and/or creditors would have received better treatment if the entity had entered into normal insolvency proceedings. These draft RTS do not seek to provide detailed valuation rules for particular types of asset or liability, but to specify the principles on the basis of which independent valuers must apply their own information and expertise in particular cases.

EBA consults on methods for calculating contributions to DGSs: The EBA on 10 November launched a public consultation on its draft Guidelines on methods for calculating contributions to Deposit Guarantee Schemes (DGSs). The proposed Guidelines put forward methods for calculating ex-ante contributions to DGSs, and particularly the methods for adjusting contributions to banks' risk profiles in order to incentivise sound risk behaviours. The deadline for the submission of comments is 11 February 2015. A public hearing will take place at the EBA premises on 8 January 2015.

The Guidelines specify five categories of risk indicators in order to ensure that a sufficiently wide range of key aspects of institutions' operations are reflected in the risk classification. The selection of risk categories reflects the minimum elements specified in Article 13 of the DGS Directive, such as capital adequacy, asset quality and liquidity, but also the business model and management, and a need to take into account the potential loss to the DGS. In order to strike the right balance between the need for flexibility inherent in the diversity of institutions on the one hand, and the need for harmonisation on the other, the Guidelines specify core risk indicators and provide guidance for assigning weights to the risk categories and indicators. Within each risk category, a set of core risk indicators should be used in order to promote comparable treatment of institutions. However, competent authorities may exclude, with regard to any institution, a core risk indicator upon justification. In addition, they may also introduce additional risk indicators if they consider that the core indicators do not sufficiently take into account the characteristics of the member institutions.


EBA offices, London

EBA advises on the application of prudential requirements: The EBA on 29 October published an Opinion addressed to the European Commission on the appropriateness of the rules governing the levels of application of prudential requirements for credit and investment institutions (Pillar 1 and 2), in particular the exemption regime. This Opinion follows a call for advice by the European Commission asking the EBA to look into whether the waivers under Pillar 1 and Pillar 2 are prudentially justified and whether they should be modified. To respond to this call, the EBA engaged directly with National Competent Authorities (NCAs) through a questionnaire and issued its Opinion based on 22 responses, covering over 6,000 supervised institutions. Overall, the EBA is of the opinion that the use of waivers should be reviewed in the future to allow for better alignment and also to take into account how and where they interact with each bank's recovery and resolution strategies, as well as the new intragroup financial support regime introduced by the BRRD. This Opinion will inform the Commission's review and final report, which will be transmitted to the European Parliament and Council by end-December 2014.

EBA releases work plans for 2015: The EBA on 13 October published its work programme for 2015, describing its main objectives and deliverables in the forthcoming year. The development of the Single Rulebook in banking will remain the main focus of the EBA in the regulatory policy area. In particular, in 2015 the EBA will play a central role in the area of recovery and resolution, with several mandates stemming from the BRRD. Also, the EBA will continue its work on mandates under the Capital Requirements Directive (CRD). The EBA will also continue ongoing oversight of the EU banking sector aimed at identifying, analysing and addressing key risks. Following the 2014 EU-wide stress test, the EBA will continue to monitor capital levels of EU banks, and work with competent authorities to promote the ongoing process of balance sheet repair and the restoration of sustainable funding structures.

EBA issues draft Guidelines on the Interrelationship between BRRD and

CRR loss absorption: The EBA on 1 October launched a consultation on draft Guidelines clarifying the interrelationship between the sequence in which liabilities should be written down or converted when the bail-in power introduced by the BRRD is used, and the hierarchy of capital instruments in the Capital Requirements Regulation (CRR). The consultation runs until 3 January 2015. The main takeaways are:

- **Legacy hybrid Tier 1 (including phase-out portion) grandfathered as AT1 will be treated equally to CRR-compliant AT1s:** In case of application of the bail-in tool or the write down or conversion power at PONV, CRR-compliant AT1 items and grandfathered instruments including any amount that is progressively excluded from the own funds because of the limits set out in the CRR (in particular Art. 486) should be subject to the same treatment;
- **Amortised amount of Tier 2 to be included under bail-in:** For Tier 2 instruments with less than five years of residual maturity, the amount that can be included in own funds reduces to zero on a straight-line basis. For the avoidance of doubt, the Guidelines clarify that the amortised amount of such instruments should be treated in the same way as the amount included in own funds. This is necessary to ensure the equitable treatment of creditors in accordance with the insolvency hierarchy;
- **No recognition of contractual differences in AT1s' loss absorption:** According to the Guiding Rule 1, the resolution authority should treat all AT1 instruments that rank equally in insolvency in the same way for the purposes of write-down and conversion (unless otherwise specified in BRRD) "without considering other differences between the loss absorbing capacity of these AT1 instruments resulting from their contractual clauses".

As expected, this indirectly confirms that AT1s structured with a permanent loss absorption mechanism might be subject to a conversion into shares under bail-in, or vice versa. Similarly, Tier 2-hosted CoCos, whose trigger was not activated before or at resolution, would be subject to the same loss absorption treatment of pari passu "vanilla" Tier 2 instruments.

EBA consults on group financial support: The EBA on 3 October launched a consultation on draft RTS and Guidelines specifying the various conditions for the provision of group financial support, and on draft Implementing Technical Standards (ITS) on the disclosure of group financial support agreements. The consultation runs until 4 January 2015. Group financial support refers to one entity of a banking group providing support to another entity of the same group on the basis of a financial support agreement, provided the latter entity encounters financial difficulties and meets the conditions the BRRD requires for early intervention measures by the competent authority.

- The purpose of the proposed RTS and Guidelines is to establish a clear harmonised legal framework to facilitate group support and to enhance legal certainty by overcoming existing legal obstacles. They ensure that competent authorities of the providing entity grant the authorisation to the support on the basis of a number of conditions: the interest of the group as a whole and the risks that would materialise for the providing entity if the support was not provided; the expected success of the support; the terms of the support (and various prudential requirements applying to the providing entity); the possible impact on financial stability; and the resolvability of the providing entity.
- Moreover, the draft RTS and Guidelines require authorities and institutions to consider the possible reasons for the financial distress of the institution concerned, including their business model, the current market situation and potential further adverse developments. Whether the above conditions are fulfilled must be assessed based on a description and a projection of the capital and liquidity situation, as well as the needs of the receiving entity, also on the basis of the information provided by the competent authority of the latter. In the ITS on the form and content of the disclosure of public support agreements the EBA ensures a high standard of transparency with regard to support agreements.

EBA launches sets of final and draft guidelines on BRRD issues: The European Banking Authority (EBA) in late September published new sets of final and draft documents developed in accordance to the Bank Recovery & Resolution Directive (BRRD).

- **Final Guidelines on types of tests, reviews or exercises that may lead to support measures:** Extraordinary public financial support taking the form of an injection of own funds or purchase of capital instruments to a solvent institution in order to address capital shortfalls resulting from stress tests, asset quality reviews or equivalent exercises may not be considered as a trigger for resolution when it is provided to remedy a serious disturbance in the economy of a Member State and to preserve financial stability with respect to all the conditions laid down in Article 32(4)(iii) of the BRRD. These Guidelines specify the main features of the types of tests, reviews or exercises that may lead to support measures.
- **Implementation of resolution tools:** A first set of documents includes the Guidelines on the implementation of the sale of business and asset separa-

tion tools against constraints stemming from the EU competition and transparency rules in relation to state aid. A second public consultation covers the Guidelines on necessary services, which define a minimum list of necessary "critical" services that the resolution authority may require from the institution under resolution (i.e. the purchaser after a sale of business, a bridge bank or the transferee after a transfer of assets). The consultation runs until 22 December 2014.

Eligibility of institutions for simplified obligations for recovery and resolution planning: The draft Guidelines and ITS define how EU authorities should assess whether an institution is eligible for simplified obligations with regard to, among others, the contents and details of recovery and resolution plans. The Guidelines also clarify that G-SIFIs and O-SIFIs should not be subject to simplified obligations, since it is assumed that their failure would always be likely to have a significant negative effect.

Qualitative and quantitative recovery plan indicators: The draft Guidelines identify the minimum qualitative and quantitative indicators that banks should include in their recovery plans, namely in relation to capital, liquidity, profitability and asset quality. The consultation runs until 2 January 2014.

EBA consults on triggers for early intervention and resolution: The European Banking Authority (EBA) launched on 22 September a consultation on two draft Guidelines, on (i) the triggers for using early intervention measures (triggers for early intervention) and on (ii) the circumstances under which an institution shall be considered as "failing or likely to fail" (triggers for resolution). Both Guidelines use an approach based on a combination of qualitative and quantitative factors, which also includes the overall SREP score of the institution. More specifically, the objective elements that should be taken into account by the authorities in determining that the institution is failing or likely to fail cover the following areas and elements: (1) capital position; (2) liquidity position; and (3) other requirements for continuing authorisation (including governance arrangements and operational capacity). However, the determination that the institution is failing or likely to fail will remain an expert judgement and should not be automatically derived from the list of objective elements. Deadline for the submission of comments is 22 December.

EBA Q&A

2013_290: The European Banking Authority Q&A tool addressed the use of liability management exercises to repurchase (and cancel) Tier 2 notes before five years after the date of issuance or raising. According to the EBA response, instruments grandfathered under Article 484 of the CRR can be called, redeemed, repurchased or repaid/reduced before five years after the date of issuance without the constraints imposed by the CRR. On the contrary, fully eligible instruments may only be exchanged for fully eligible instruments of a higher quality, in exceptional circumstances, and subject to the approval of the competent authority in accordance with Article 77 (conditions for reducing own funds).

2013_487: A pronouncement on how other comprehensive income has to be treated in case of calculation of the minority interests. According to the EBA, as minority interests do not comprise other comprehensive income according to Article 81(1) of CRR, these CET1 items of a subsidiary can never be included at a higher level of consolidation. Article 84 CRR sets out the method for calculating the amount of minority interests to be included in CET1 at consolidated level. The calculation method refers to CET1 capital, as defined in Article 50 CRR. Therefore, other comprehensive income and funds for general banking risk form part of this calculation, without being included in CET1 at consolidated level.

2014_1352: As per CRR, in the case of a repurchase of CET1, AT1, or Tier 2 instruments for market-making purposes, competent authorities may give their permission in advance to reducing own funds for a certain predetermined amount. According to the EBA response, the predetermined amount for which the competent authority has given its permission under Article 29(3) of Regulation (EU) 241/2014 should be deducted from the moment the authorisation is granted, pursuant to Article 28(2) of that Regulation, as sufficient certainty about the repurchase is deemed to exist from that moment.

2013_620: The question related to the recognition in the consolidated own funds of Additional Tier 1 and Tier 2 instruments issued by third-country undertakings of third countries outside Europe and subject to local requirements. According to the EBA response, these instruments should not be included, as Article 82(a)(ii) of the CRR only includes undertakings that are subject by virtue of applicable national law to the requirements of CRR and CRD IV, and not undertakings that are only subject to equivalent provisions (there is also no equivalence assessment process in place foreseen by CRR for this purpose).

2013_385: Application of Article 52 of CRR at consolidated level: The EBA confirmed what was also mentioned in the EBA report on the monitoring of AT1 instruments. Instruments issued by subsidiaries in third countries shall comply with all CRR requirements in order to be eligible at group level. In particular, for the purposes of the definition of the trigger event, the CET1 capital shall be calculated in accordance with the provisions of the CRR. However, even if an in-

European Commission, Brussels

strument issued by a subsidiary includes a group trigger, it will not be included in full in the consolidated Tier 1 as it will not be able to absorb losses at group level. For that purpose, the provisions of Article 82 and 85 of the CRR would apply.

2014_1253: Grandfathering of legacy instruments: The EBA clarified that where an institution buys back increasing parts of a legacy Tier 1 instrument that does not meet the requirements of Article 52 of CRR, but which is eligible for grandfathering, the purchase will not affect the capital computability if no changes to the terms and conditions have occurred. The remaining outstanding amount would be subject to all relevant provisions set out in the CRR, including the provisions set out in Articles 77 and 78, and the applicable percentages referred to in Article 486(5), which shall apply to the nominal amount of the instrument among other eligible items, due to the fact that the nominal amount is unchanged by the buy-back.

EUROPEAN COMMISSION

Commission adopts detailed rules on contributions of banks to resolution funds: The European Commission on 21 October adopted a Delegated Act and a draft proposal for a Council Implementing Act to calculate the contributions of banks to the national resolution funds and to the Single Resolution Fund, respectively. The Delegated Act is subject to a right of objection by Council and Parliament within three months, extendable by a further three months. The act will have to be discussed and adopted by the Council by the end of the year:

> **The Delegated Act supplementing the BRRD:** This Delegated Act will determine how much individual credit institutions will have to pay each year to their respective resolution funds according to the bank's size and risk profile by setting out in detail: (i) the fixed part of the contribution, which is based on the institution's liabilities (excluding own funds and guaranteed deposits), as the starting point for determining the contribution — so the larger the bank, the higher the fixed part of the contribution; (ii) how the basic contribution is adjusted in accordance with the risk posed by each institution. The proposal includes a number of risk indicators against which the risk level of each institution will be assessed. Finally, the Delegated Regulation applies the principle of proportionality by providing for a special lump-sum regime for small banks. This reflects the fact that, in most cases, small institutions have a lower risk profile and are less likely to use resolution funds. Banks representing 1% of the total assets would pay 0.3% of the total contributions (in the euro area).

> **Draft proposal for a Council Implementing Act:** For the financial institutions in the Banking Union, the Commission has drafted a proposal for a Council Implementing Act to specify the methodology for the calculation of contributions on the basis of the same risk indicators used in the Delegated Act. This draft text adapts the methodology to the specificities of a unified system of contributions pooled in the Fund on the basis of a European target level. In this respect, the Single Resolution Fund will be built up by bank contributions over an eight year transitional period during which it will be composed of national compartments.

EC Publishes Delegated Act on the Leverage Ratio: The European Commission published on 10 October the Delegated Act on the leverage ratio that amends Art. 429 of CRR and implements the Basel Committee on Banking Supervision revised rules text as agreed by the GHOS (governors of central banks and heads of supervision of Basel Committee member jurisdictions). The document establishes a common definition of the leverage ratio for EU banks that will be the basis for publishing the metric from the beginning of 2015 onwards. It does not introduce a binding leverage ratio. A decision on whether or not to introduce a binding leverage ratio will only be made in 2016.

FSB/GSIB

FSB Chair's letter to G20 leaders for the Brisbane Summit: The Financial Stability Board (FSB) on 14 November published a letter from the FSB Chair to the G20 leaders titled "Financial Reforms: Completing the Job and Looking Ahead". The document reports on progress in financial reforms and highlights the major issues for the attention of the leaders, with an attached dashboard summarising the status of implementation by FSB member jurisdictions on priority reform areas. In his letter, the FSB Chair stated that the endorsement by the leaders of proposals to end too-big-to-fail in the banking sector will be "a watershed". The FSB also published: (i) a report detailing the additional progress made by the FSB and its members in global policy development and implementation of agreed reforms since the G20 St Petersburg Summit in September 2013; along with (ii) a progress report setting out the FSB's approach to transforming shadow banking into resilient market-based financing to date, and a roadmap for further work in 2015 that has been presented to the G20 for endorsement.

FSB publishes report on global structural banking reforms: The FSB on 27 October published a report on cross-border consistencies and global financial stability implications of structural banking reforms. The report responds to a call from the G20 for the FSB, in collaboration with the IMF and the OECD, to assess cross-border consistencies and global financial stability implications of structural banking reforms, taking into account country-specific circumstances, and to report to the 2014 Leaders' Summit. As implementation of structural banking reforms progresses, the FSB, in collaboration with the IMF and OECD, will provide an update of this assessment, expanding the analysis with data where available, to G20 finance ministers and central bank governors in 2016, as part of the FSB's ongoing work to monitor the implementation and impact of post-crisis reforms.

EC publishes Delegated Act on G-SII methodology: The European Commission on 8 October published the Delegated Act on the methodology for identifying Global Systemically Important Institutions (G-SIIs), which

FSB chair Mark Carney

adopts the EBA final draft Regulatory Technical Standards (RTS) released in June. The text has since been published in the EU Journal.

FSB releases proposals on cross-border recognition of resolution actions: The FSB on 24 September launched a public consultation on a set of proposals to achieve the cross-border recognition of resolution actions and remove impediments to cross-border resolution. The consultative document proposes a set of policy measures and guidance consisting of:

- elements that jurisdictions should consider including in their statutory cross-border recognition frameworks to facilitate effective cross-border resolution as required by the FSB Key Attributes of Effective Resolution Regimes for Financial Institutions; and
- contractual approaches to cross-border recognition that focus on two particular cases where achieving cross-border recognition is a critical prerequisite for orderly resolution: temporary restrictions or stays on early termination and cross-default rights in financial contracts; and the "bail-in" of debt instruments that are governed by the laws of a jurisdiction other than that of the issuing entity.

FSB welcomes progress on new ISDA protocol: The FSB has also welcomed the progress being made by the International Swaps & Derivatives Association (ISDA) in the development of a protocol that will address the enforceability of stays in relation to the majority of OTC bilateral derivatives contracts. FSB members have given their commitment to support this process and will seek to provide for the necessary regulatory or supervisory action so that derivatives and similar financial contracts entered into by G-SIBs and, where appropriate, other firms with significant derivatives exposures include contractual language that gives effect to stays in resolution on a cross-border basis by the end of 2015. According to the FSB, the finalisation of the protocol and its broad adoption will be an important step towards addressing the risk that resolution triggers a cascade of termination events in derivatives contracts that lead to disruption in the wider market.

EBA publishes indicators from G-SIIs: The EBA on 29 September published the indicators from G-SIIs as provided for in the ITS and Guidelines on disclosure rules applicable to large institutions. The identification as G-SII will take place in January 2015, and the G-SIFI buffer will apply about one year after the publication by competent authorities in each Member State of banks' scoring results.

Fed to increase BCBS GSIB risk-based capital surcharges: In testimony before the US Senate Committee on Banking on 9 September, Fed Board member Daniel Tarullo said that the G-SIB risk-based capital surcharge framework will strengthen the Basel Committee on Banking Supervision framework in two important respects. First, the surcharge will be higher than the levels required by the BCBS. Second, the formula will directly take into account each US G-SIB's reliance on short term wholesale funding.

BASEL COMMITTEE

Basel Committee to start working on leverage ratio requirement from 2015: According to Secretary General William Coen, the Basel Committee will start working from 2015 on the calibration of the leverage ratio, with the objective of finalising the requirement well ahead of its potential application as a Pillar 1 measure.

Net Stable Funding Ratio finalised by the Basel Committee: The Basel Committee on Banking Supervision (BCBS) issued on 31 October the final standard for the Net Stable Funding Ratio (NSFR), as endorsed by the Committee's governing body, the group of central bank governors and heads of supervision (GHOS). The final NSFR retains the structure of the January 2014 consultative proposal. The key changes introduced in the final standard published cover: (1) the required stable funding for: short term exposures to banks and other financial institutions; (2) derivatives exposures; and (3) assets posted as initial margin for derivative contracts. In addition, the final standard recognises that, under strict conditions, certain asset and liability items are interdependent and can therefore be viewed as neutral in terms of the NSFR.

INSURANCE

PRA, EIOPA on Solvency II, plus G-SII moves

PRA consults on Solvency II implementation and quality of capital instruments: The Prudential Regulation Authority (PRA) on 21 November published a consultation paper on further measures for the implementation of Solvency II (CP24/14). The release follows CP16/14, which made proposals for the transposition of the Solvency II Directive into the PRA Rulebook. The consultation closes on 30 January 2015.

The PRA also launched, on 15 October, a consultation paper on the Solvency II approvals (CP23/14). The paper seeks views on a draft supervisory statement that sets out the PRA's expectations of firms, and provides further clarity in relation to applying for certain Solvency II approvals. The consultation closes on 9 January 2015.

EIOPA speaks on strategic priorities going forward: Gabriel Bernardino, the chairman of EIOPA, spoke regarding its future strategic priorities at the 4th Annual EIOPA conference in Frankfurt on 19 November. The speech touched upon three key strategic priorities of EIOPA going forward and the key challenges faced in dealing with them:

- Solvency II implementation and the development of an EU supervisory culture. In particular, he stressed the need to ensure EIOPA's operational independence and an adequate level of funding to enable it to effectively oversee the uniform implementation of the new regulatory regime across the EU;
- The strategy needed to deliver adequate, safe and sustainable pensions to all EU citizens regardless of broader market conditions. He highlighted the need to develop an EU-wide regulatory framework for pensions to provide enhanced sustainability, strong governance and regain trust of citizens through full transparency within the industry; and
- The drive towards risk-based regulation and sufficient supervision of the conduct of business of pensions providers. He identified robust product oversight and governance arrangements, the key information documents (KIDs) for those producing or selling packaged retail investment and insurance-based investment products (PRIIPs), and the development of a set of key risk indicators as especially important tasks for the future.

EIOPA consults on the calculation process for the Solvency II relevant risk free interest rate: On 2 November, EIOPA launched a consultation on a Technical Document describing the methodology, assumptions and identification of the data for the calculation of the relevant risk free interest rate term structures, which in turn are used for the calculation of technical provisions. The period for providing comments ended on 21 November.

EIOPA submits the Set 1 of ITS to the Commission: On 31 October, EIOPA delivered the Implementing Technical Standards (ITS) on supervisory approval processes. The six ITS cover the following areas: Ancillary Own funds, Matching Adjustment, Undertaking-Specific Parameters, Internal Models, Special Purpose Vehicles, and the Joint Decision Process for Group Internal Models. The ITS need to be endorsed by the Commission, which can be expected within three months.

IAIS announces the development of BCR for G-SII: On 23 October, the International Association of Insurance Supervisors (IAIS) announced that it concluded the development of the Basic Capital Requirements (BCR) for Globally Systemically Important Insurers (G-SII). The BCR reflects the content of a consultation paper issued in July and it will be reported by G-SIIs on a confidential basis to groupwide supervisors beginning in 2015. The Higher Loss Absorbency (HLA, which will expand on the BCR) requirements to apply to G-SIIs is due to be completed by the end of 2015. From 2019, G-SIIs will be required to hold capital no lower than the BCR plus HLA. The BCR ratio is calculated by dividing Total Qualifying Capital Resources by Required Capital, which are defined as follows:

- Total Qualifying Capital Resources: classified as either core or additional capital. Qualifying Additional Capital

Svein Andresen, FSB secretary general

cannot exceed 50% of Required Capital (This limit will be re-examined once HLA is developed). Core capital is defined as an instrument that can absorb losses on a going concern basis (Equity and Perpetual non-cumulative instruments). Additional capital is comprised of financial subordinated instruments with a minimum five year maturity with a principal lock-in or 20% p.a. amortisation in the final five years. Non-paid-up capital items are limited to an amount not greater than 10% of BCR.

- Required Capital: calculated on a consolidated group-wide basis and determined using a factor-based approach (15 factors applying to defined segments).

FSB consults on the identification of critical functions of G-SII: On 16 October, the FSB launched a public consultation on guidance for the identification of the critical functions and critical shared services for G-SIIs. The guidance should assist national authorities in implementing the recovery and resolution planning requirements set out in the Key Attributes of Effective Resolution Regimes for Financial Institutions (KAs) and in the policy measures of the IAIS for G-SIIs, and support their resolution planning. The document provides a framework for the identification of the functions and services that would need to be maintained in resolution consistent with the objectives of systemic stability and policyholder protection.

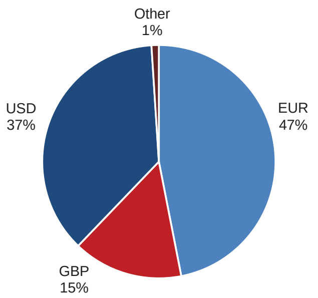
FSB updates KAs to include Annex on resolution of insurers: The Financial Stability Board (FSB) published on 15 October an updated version of the Key Attributes of Effective Resolution Regimes for Financial Institutions. The FSB adopted additional guidance that elaborates on specific KAs relating to information sharing for resolution purposes and sector-specific guidance that sets out how they should be applied for insurers, financial market infrastructures (FMIs), and the protection of client assets in resolution. All the newly adopted guidance documents have been incorporated as annexes into the 2014 version. No changes were made to the text of the 12 Key Attributes of October 2011.

IAIS releases principles for development of HLA requirements for G-SIIs: On 22 September, the IAIS published a list of HLA principles for G-SIIs, which follows the Insurance Capital Standard (ICS) ones, released on 12 September. The list includes a specific mention of the going concern nature of the HLA (Principle 5) and the need for highest quality capital (Principle 6).

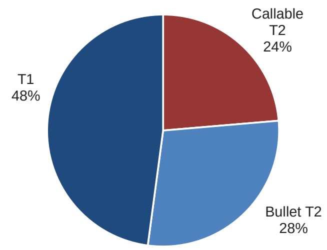
Michael Benyaya, Jonathan Blondeau, Julian Burkhard, Cyril Chatelain, Stefano Rossetto
DCM Solutions
Crédit Agricole CIB
Capital.Structuring@ca-cib.com

Currencies, structures and distribution

Bank hybrid issuance by currency (2013-2014 ytd)

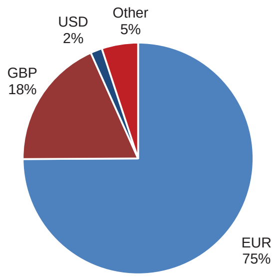


Bank issuance by instrument/structure (2013-2014 ytd)

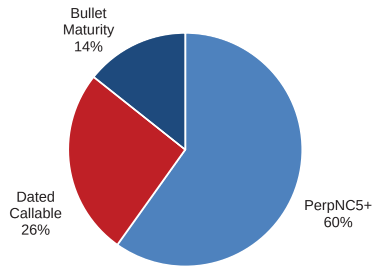


Source: Crédit Agricole CIB

Insurance hybrid issuance by currency (2013-2014 ytd)

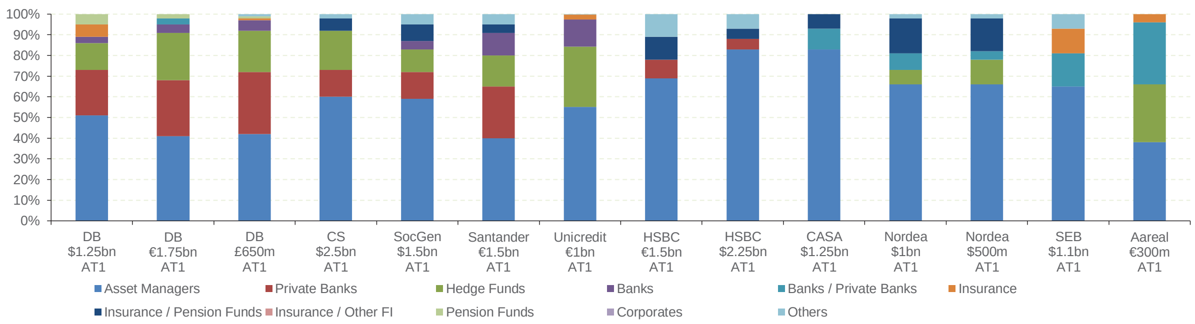


Insurance issuance by instrument/structure (2013-2014 ytd)

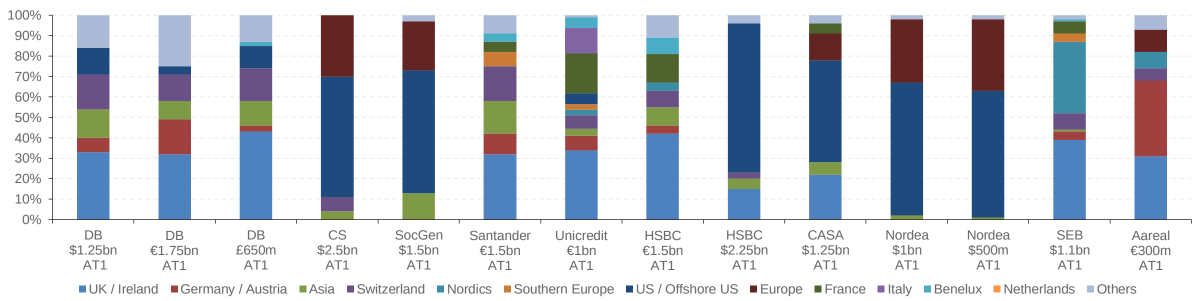


Source: Crédit Agricole CIB

Distribution by investor type



Distribution by geography



Source: Crédit Agricole CIB

AT1, Tier 2 CoCos

Launch	Issuer	Issue ratings	Currency	Amount (m)	Coupon	Maturity date	First call date	Principal loss absorption	Trigger	Price	I-Spread	Yield to call
AT1 performance monitoring (as at 1/12/14)												
13-Nov-14	AARB	-/-/B+	EUR	300	7.625%	Perpetual	30-Apr-20	TWD	7.000%	99.75	725	7.70
10-Sep-14	HSBC	Baa3/-/BBB	EUR	1,500	5.250%	Perpetual	16-Sep-22	CE	7.000%	100.50	455	5.17
03-Sep-14	UCGIM	-/-/BB-	EUR	1,000	6.750%	Perpetual	10-Sep-21	TWD	5.125%	97.75	673	7.17
02-Sep-14	SANTAN	Ba1/-/-	EUR	1,500	6.250%	Perpetual	11-Sep-21	CE	5.125%	97.50	631	6.71
13-Jun-14	BACR	-/B/BB+	EUR	1,077	6.500%	Perpetual	15-Sep-19	CE	7.000%	97.63	689	7.09
20-May-14	DB	Ba3/BB/BB+	EUR	1,750	6.000%	Perpetual	30-Apr-22	TWD	5.125%	96.75	592	6.56
01-Apr-14	ACAFP	-/BB/BB+	EUR	1,000	6.500%	Perpetual	23-Jun-21	TWD	7%/5.125%	102.25	567	6.08
28-Mar-14	SOCGEN	-/-/BB	EUR	1,000	6.750%	Perpetual	07-Apr-21	TWD	5.125%	99.00	653	6.95
20-Mar-14	LLOYDS	-/B+/BB	EUR	750	6.375%	Perpetual	27-Jun-20	CE	7.000%	103.00	541	5.74
12-Mar-14	KBCBB	-/BB/BB	EUR	1,400	5.625%	Perpetual	19-Mar-19	TWD	5.125%	98.00	595	6.16
05-Mar-14	SANTAN	Ba1/-/-	EUR	1,500	6.250%	Perpetual	12-Mar-19	CE	5.125%	98.75	640	6.59
05-Mar-14	DANBNK	-/BB+/BB+	EUR	750	5.750%	Perpetual	06-Apr-20	TWD	7.000%	101.75	500	5.37
11-Feb-14	BBVASM	-/-/BB	EUR	1,500	7.000%	Perpetual	19-Feb-19	CE	5.125%	102.00	627	6.45
19-Jun-14	VIRGMN	-/-/-	GBP	160	7.875%	Perpetual	31-Jul-19	CE	7.000%	102.20	596	7.31
19-Jun-14	COVBS	-/-/BB+	GBP	400	6.375%	Perpetual	01-Nov-19	CE (*)	7.000%	97.25	559	7.05
13-Jun-14	BACR	-/B/BB+	GBP	698	7.000%	Perpetual	15-Sep-19	CE	7.000%	96.25	659	7.95
20-May-14	DB	Ba3/BB/BB+	GBP	650	7.125%	Perpetual	30-Apr-26	TWD	5.125%	96.75	537	7.55
01-Apr-14	ACAFP	-/-/BB+	GBP	500	7.500%	Perpetual	23-Jun-26	TWD	7%/5.125%	98.75	568	7.66
20-Mar-14	LLOYDS	-/B+/BB	GBP	1,481	7.000%	Perpetual	27-Jun-19	CE	7.000%	100.25	559	6.93
20-Mar-14	LLOYDS	-/B+/BB	GBP	1,494	7.625%	Perpetual	27-Jun-23	CE	7.000%	101.00	569	7.47
20-Mar-14	LLOYDS	-/B+/BB	GBP	750	7.875%	Perpetual	27-Jun-29	CE	7.000%	102.13	550	7.63
04-Mar-14	NWIDE	-/BB/BB+	GBP	1,000	6.875%	Perpetual	20-Jun-19	CE (*)	7.000%	98.25	593	7.33
18-Nov-14	DB	Ba3/BB/BB+	USD	1,500	7.500%	Perpetual	30-Apr-25	TWD	5.125%	99.75	507	7.54
06-Nov-14	SEB	-/-/BBB-	USD	1,100	5.750%	Perpetual	13-May-20	TWD	8%/5.125%	-	407	5.77
16-Sep-14	NDASS	-/BBB/BBB	USD	1,000	5.500%	Perpetual	23-Sep-19	TWD	8%/5.125%	99.88	396	5.53
16-Sep-14	NDASS	-/BBB/BBB	USD	500	6.125%	Perpetual	23-Sep-24	TWD	8%/5.125%	100.50	377	6.06
11-Sep-14	ACAFP	Ba2u/BB/BB+	USD	1,250	6.625%	Perpetual	23-Sep-19	TWD	7%/5.125%	98.00	561	7.12
10-Sep-14	HSBC	Baa3/-/BBB	USD	2,250	6.375%	Perpetual	17-Sep-24	CE	7.000%	102.00	382	6.10
10-Sep-14	HSBC	Baa3/-/BBB	USD	1,500	5.625%	Perpetual	17-Jan-20	CE	7.000%	101.00	376	5.40
19-Jun-14	SOCGEN	Ba2/-/BB	USD	1,500	6.000%	Perpetual	27-Jan-20	TWD	5.125%	93.00	602	7.67
13-Jun-14	BACR	-/B/BB+	USD	1,211	6.625%	Perpetual	15-Sep-19	CE	7.000%	98.10	560	7.10
10-Jun-14	CS	-/BB/BB+	USD	2,500	6.250%	Perpetual	18-Dec-24	PWD	5.125%	-	433	6.63
20-May-14	DB	Ba3/BB/BB+	USD	1,250	6.250%	Perpetual	30-Apr-20	TWD	5.125%	98.50	478	6.58
08-May-14	SANTAN	Ba1/-/-	USD	1,500	6.375%	Perpetual	19-May-19	CE	5.125%	-	508	6.51
07-Apr-14	LLOYDS	-/B+/BB	USD	1,675	7.500%	Perpetual	27-Jun-24	CE	7.000%	102.75	490	7.10
27-Mar-14	UCGIM	-/-/BB-	USD	1,250	8.000%	Perpetual	03-Jun-24	TWD	5.125%	101.00	559	7.85
15-Jan-14	ACAFP	-/BB/BB+	USD	1,750	7.875%	Perpetual	23-Jan-24	TWD	7%/5.125%	103.75	515	7.31

Launch	Issuer	Issue ratings	Currency	Amount (m)	Coupon	Maturity date	First call date	Principal loss absorption	Trigger	Price	I-Spread	Yield to call
T2 CoCo performance monitoring (as at 1/12/14)												
08-Mar-12	CS	-/-/BBB-	CHF	750	7.125%	22-Mar-22	22-Mar-17	CE	7.000%	107.57	362	3.63
23-May-14	NYKRE	-/BBB/BBB	EUR	600	4.000%	03-Jun-36	03-Jun-21	PWD	7.000%	99.55	353	4.08
06-Feb-14	UBS	-/BBB/BBB+	EUR	2,000	4.750%	12-Feb-26	12-Feb-21	PWD	5.000%	106.50	304	3.56
11-Sep-13	CS	-/BBB/BBB+	EUR	1,250	5.750%	18-Sep-25	18-Sep-20	PWD	5.000%	112.50	286	3.34
29-Jul-11	BKIR	-/-/-	EUR	1,000	10.000%	30-Jul-16	-	CE	8.250%	108.73	420	-
08-May-14	UBS	-/BBB/BBB+	USD	2,500	5.125%	15-May-24	-	PWD	5.000%	100.05	280	-
12-Sep-13	ACAFP	-/BBB-/BBB-	USD	1,000	8.125%	19-Sep-33	19-Sep-18	PWD	7.000%	113.00	305	4.36
01-Aug-13	CS	-/BBB/BBB+	USD	2,500	6.500%	08-Aug-23	-	PWD	5.000%	110.00	289	-
15-May-13	UBS	-/BBB/BBB+	USD	1,500	4.750%	22-May-23	22-May-18	PWD	5.000%	101.13	313	4.39
03-Apr-13	BACR	-/BB+/BBB-	USD	1,000	7.750%	10-Apr-23	10-Apr-18	PWD	7.000%	109.34	352	4.70
17-Jan-13	KBC	-/BBB-/-	USD	1,000	8.000%	25-Jan-23	25-Jan-18	PWD	7.000%	-	255	3.67
14-Nov-12	BACR	-/BB+/BBB-	USD	3,000	7.625%	21-Nov-22	-	PWD	7.000%	110.25	389	-
10-Aug-12	UBS	-/BBB/BBB+	USD	2,000	7.625%	17-Aug-22	-	PWD	5.000%	118.60	265	-
15-Feb-12	UBS	-/BBB/BBB+	USD	2,000	7.250%	22-Feb-22	22-Feb-17	PWD	5.000%	108.10	260	3.39
17-Feb-11	CS	-/-/BBB-	USD	2,000	7.875%	24-Feb-41	24-Aug-16	CE	7.000%	-	329	3.86

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

Source: Crédit Agricole CIB

Latest bank Tier 2, insurance hybrids

Latest Tier 2 performance monitoring (as at 1/12/14)

Launch	Issuer	Issue ratings	Currency	Amount (m)	Coupon	Maturity date	First call date	I-Spread	Yield to call
19-Nov-14	ERSTBK	-/BBB-/BBB	USD	500	5.500%	26-May-25	26-May-20	409	-
18-Nov-14	KBCBB	-/BBB-/BBB+	EUR	750	2.375%	25-Nov-24	25-Nov-19	190	-
14-Nov-14	STANLN	A3/BBB/A+	EUR	500	3.125%	19-Nov-24	-	233	-
14-Nov-14	YBS	Baa2/-/BBB+	GBP	250	4.125%	20-Nov-24	20-Nov-19	252	-
29-Oct-14	LLOYDS	Baa3/BB+/BBB+	USD	1,000	4.500%	04-Nov-24	-	215	-
06-Oct-14	BNP	Baa2/BBB/A	USD	1,000	4.250%	15-Oct-24	-	182	-
06-Oct-14	BNP	Baa2/BBB/A	EUR	750	2.625%	14-Oct-27	14-Oct-22	198	2.67
09-Sep-14	SOCGEN	Baa3/-/BBB+	EUR	1,000	2.500%	16-Sep-26	16-Sep-21	222	2.79
08-Sep-14	BPCEGP	Baa3/-/A-	USD	1,250	4.500%	15-Mar-25	-	243	-
08-Sep-14	ISPIM	Ba1/BB+/BBB	EUR	1,000	3.928%	15-Sep-26	-	262	-
05-Sep-14	BACR	Ba1/BB+/A-	USD	1,250	4.375%	11-Sep-24	-	248	-
03-Jun-14	BPCEGP	Baa3/BBB/A-	USD	800	4.625%	11-Jul-24	-	261	-
26-Jun-14	BPCEGP	Baa3/BBB/A-	EUR	1,000	2.750%	08-Jul-26	08-Jul-21	217	2.72
19-Jun-14	ISPIM	Ba1/BBB-/BBBe	USD	2,000	0.05017	26-Jun-24	-	221	-
04-Jun-14	BKIR	Ba3/B/-	EUR	750	4.250%	11-Jun-24	11-Jun-19	406	4.43
03-Jun-14	STANLN	A3/BBB/A+	GBP	900	5.125%	06-Jun-34	-	302	-
22-May-14	SEB	Baa2/BBB/A	EUR	1,000	2.500%	28-May-26	28-May-21	162	2.16
21-May-14	RBS	Ba3/BB/BBB-	USD	2,250	5.125%	28-May-24	-	264	-
20-May-14	LBBW	Baa2/-/-	EUR	500	2.875%	27-May-26	27-May-21	226	2.80
14-May-14	BFCM	Baa1/BBB/A	EUR	1,000	3.000%	21-May-24	-	150	-
14-May-14	RABOBK	A2/BBB+/A+	EUR	2,000	2.500%	26-May-26	26-May-21	178	2.32
14-May-14	RABOBK	A2/BBB+/A+	GBP	1,000	4.625%	23-May-29	-	205	-
13-May-14	BKIASM	-/B-/B+	EUR	1,000	4.000%	22-May-24	22-May-19	388	4.25
12-May-14	DANBNK	-/BBB/A-	EUR	500	2.750%	19-May-26	19-May-21	175	2.29
02-Apr-14	FRLBP	-/BBB-/-	EUR	750	2.750%	23-Apr-26	23-Apr-21	181	2.34
08-Apr-14	BPCEGP	Baa3/BBB/A-	GBP	750	5.250%	16-Apr-29	-	241	-
02-Apr-14	BBVASM	Baa3/BB+/BBB+	EUR	1,500	3.500%	11-Apr-24	11-Apr-19	235	2.71
26-Mar-14	NDB	Ba1/-/-	USD	500	6.250%	10-Apr-24	-	387	-
21-Mar-14	STANLN	A3/BBB/A+	USD	2,000	5.700%	26-Mar-44	-	239	-
20-Mar-14	RBS	Ba3/BB/BBB-	EUR	1,000	3.625%	25-Mar-24	25-Mar-19	295	3.31
13-Mar-14	BNP	Baa2/BBB/A	EUR	1,500	2.875%	20-Mar-26	20-Mar-21	191	2.43
11-Mar-14	AARB	-/-/BBB-	EUR	300	4.250%	18-Mar-26	18-Mar-21	275	3.27
05-Mar-14	HSBC	A3/BBB+/A+	USD	2,000	4.250%	14-Mar-24	-	160	-
05-Mar-14	HSBC	A3/BBB+/A+	USD	1,500	5.250%	14-Mar-44	-	175	-
18-Feb-14	INTNED	Baa2/BBB/A-	EUR	1,500	3.625%	25-Feb-26	25-Feb-21	182	2.34
17-Feb-14	SWEDA	Baa2/BBB+/A	EUR	750	2.375%	26-Feb-24	26-Feb-19	139	1.74

Insurance performance monitoring (as at 1/12/14)

Launch	Issuer	Issue ratings	Currency	Amount (m)	Coupon	Maturity date	First call date	New issue spread	I-Spread
18-Nov-14	BNP	-/BBB-/-	EUR	1,000	4.032%	Perpetual	25-Nov-25	293	279
14-Nov-14	ASSGEN	Ba1/BBB /*-/BBB-	EUR	1,500	4.596%	Perpetual	21-Nov-25	350	332
12-Nov-14	CNPFP	-/BBB+/-	EUR	500	4.000%	Perpetual	18-Nov-24	310	287
06-Nov-14	AXASA	Baa1/BBB/BBB	EUR	984	3.941%	Perpetual	07-Nov-24	290	289
06-Nov-14	AXASA	Baa1/BBB/BBB	GBP	724	5.453%	Perpetual	04-Mar-26	300	330
23-Oct-14	LLYDIN	-/A-/A-	GBP	500	4.750%	30-Oct-24	-	-	240
07-Oct-14	ACAFP	-/BBB-/-	EUR	750	4.500%	Perpetual	14-Oct-25	335	309
02-Oct-14	RSALN	Baa1/BBB+/BBB	GBP	400	5.125%	10-Oct-45	10-Oct-25	-	264
02-Oct-14	HELNSW	-/BBB+/-	CHF	400	3.500%	Perpetual	17-Apr-20	322	241
02-Oct-14	HELNSW	-/BBB+/-	CHF	225	4.000%	17-Oct-44	17-Oct-24	318	283
01-Oct-14	MACIFS	Baa1/-/-	EUR	124	3.916%	Perpetual	06-Oct-24	280	298
25-Sep-14	SCOR	A3/A-/-	EUR	250	3.875%	Perpetual	01-Oct-25	270	266
24-Sep-14	ASRNED	-/BBB-/-	EUR	500	5.000%	Perpetual	30-Sep-24	395	371
16-Sep-14	ISPIM	Ba1/BBB-/BBBe	USD	2,000	0.05017	23-Sep-44	23-Sep-24	403	221
11-Sep-14	ALVGR	A2/A+/A	EUR	1,500	3.375%	Perpetual	18-Sep-24	220	237
11-Sep-14	SRENVX	A3/A/-	USD	500	4.500%	11-Sep-44	11-Sep-24	-	225
08-Sep-14	HANRUE	-/A/-	EUR	500	3.375%	Perpetual	26-Jun-25	225	223
18-Jul-14	ADMLN	-/-/BBB-	GBP	200	5.500%	25-Jul-24	-	-	286
08-Jul-14	NNGRNV	Baa3/BBB-/-	EUR	1,000	4.500%	Perpetual	15-Jan-26	300	339
26-Jun-14	PICORP	-/-/-	GBP	300	6.500%	03-Jul-24	-	-	412
25-Jun-14	AVLN	Baa1/BBB/-	EUR	700	3.875%	03-Jul-44	03-Jul-24	-	262

Source: Crédit Agricole CIB

CNP Assurances
Perpetual return

CNP Assurances returned to the subordinated debt market on 12 November to price a Eu500m perpetual non-call 10 issue, with CA-CIB as a joint bookrunner. Vincent Damas, director for ALM and funding, and Stéphane Trarieux, funding and rating agencies department, CNP Assurances, explain the rationale for the company's follow-up to its 31NC11 in May, and discuss structural and market developments.

Bank+Insurance Hybrid Capital (BIHC): After your dated subordinated transaction in May, what was the rationale for returning with a perpetual transaction at this time?

Vincent Damas, CNP Assurances: The outstanding subordinated debt of CNP Assurances currently amounts to Eu5.7bn, which ranks us in line with the average of listed European insurers in terms of volume. It is important to note that CNP Assurances has never issued any senior unsecured debt because the issuing entity is the main operational entity of the group and has excellent liquidity, and hence does not require any senior funding.

Our issuing strategy is generally to flatten our maturity profile by distributing our outstanding debt across various maturities. We aim for a benchmark size to ensure investors the liquidity they require, but do not issue in jumbo size as it does not suit our maturity profile and secondary performance is more uncertain. We also look for diversification in terms of currencies, investor bases and formats. A new undated Eu500m transaction was perfectly in line with this strategy and was all the more interesting since prevailing conditions are in issuers' favour.

Stéphane Trarieux

BIHC: Insurance perpetual instruments experienced strong volatility at the end of September/beginning of October. Do you see any particular reason for this? How did it affect your decision to go ahead with the project?

Stéphane Trarieux, CNP Assurances: We have indeed observed that the market was not ideal in September and this continued until mid-October. The international context and disappointing growth figures of different regions have led to a correction on a number of risk assets. Needless to say, subordinated issues suffered from this a bit, as is to be expected.

We still thought that there would be some issuance windows open until the end of 2014. As a result, we prepared ourselves in terms of issue documentation to be ready to seize the first opportunity after our quarterly results' release.

BIHC: Pricing with a premium of just 40bp over your dated transaction seems to be a very good result — how would you compare the outcome versus where your peers are trading?

Photo: CNP Assurances

Damas, CNP Assurances: We have noted that the spread differential between dated and perpetual debt has varied between issuers and is not constant over time. This can be driven by technical factors. The 40bp that you mention includes both the perpetuity cost and the new issue premium. We view the final outcome as very satisfactory in light of market conditions.

BIHC: With over 400 investors involved in this transaction, have you seen any change in the distribution of this deal compared with your previous transactions?

Trarieux, CNP Assurances: Compared to our euro 31NC11 issue in May, the book was bigger in terms of total amount (Eu6.5bn versus Eu5bn) and the number of investors (400 versus 340). We continue to observe a high level of granularity within our investor base and good geographic diversification. This is the results of CNP's efforts over the last two years to strengthen the relationship

Vincent Damas

with credit investors by means of non-deal roadshows.

BIHC: You achieved a very nice 4% coupon — how does it compare with the average cost of your solvency capital?

Damas, CNP Assurances: This new issue, as well as the dated one from May, enables us to reduce the average cost of our subordinated debt, which currently stands at 5.4% before tax. Of course the current level of interest rates is very favourable for issuers. We also see that credit spreads are at their lowest levels of the last five years — although they are still wider than before the 2008 subprime crisis. This level of coupon enables us to keep a significant safety margin in our interest coverage ratio, which is closely looked at by rating agency Standard & Poor's.

BIHC: What is your view of future Solvency 2 Tier 1 instruments?

Trarieux, CNP Assurances: We think that primary markets will soon be ready to absorb fully compliant Solvency 2 Tier 1 from insurance companies, as they did for bank AT1s.

However, since the final technical guidelines are not yet finalised, it is still too soon to say when the first transaction will take place. We will closely follow the upcoming regulatory developments (Level 3 measures) in order to be ready when needed. ●

S&P

Increasing bail-in risk drives change

Investors in hybrid capital instruments face increasing bail-in risk as regulators around the world expand their toolkits for dealing with future bank failures. Increased bail-in risk is what's behind Standard & Poor's Ratings Services' recently updated criteria for bank hybrid capital instruments and here Michelle Brennan, S&P's European Financial Services criteria officer and a key architect of the new criteria, explains the increased bail-in risk, how this has been factored into the criteria and the ratings implications.

On 18 September, Standard & Poor's published its updated criteria for assigning issue credit ratings to bank hybrid capital instruments. This followed a request for comment and many months of market consultation around the proposed changes.

The changes reflect our view that the emerging global regulatory and legal environment leads to a greater risk of loss absorption by hybrid capital instruments — and therefore of D (default) issue credit ratings — than our previous criteria recognised.

As a result, we have adopted wider downward notching of the issue credit ratings on some hybrid capital instruments from the stand-alone credit profile or long term issuer credit rating on the issuer.


Michelle Brennan, S&P

Regulatory reform agenda is driving increased bail-in risk

The evolving regulatory and legal frameworks for banking sectors around the world are the driving factor behind our changes. The broad themes of the global regulatory reform agenda are clear. Authorities expect bank regulatory capital instruments to fulfill their basic purpose of absorbing losses for a bank undergoing distress, a role that hybrid capital instruments did not always provide through the financial crisis. Many governmental authorities and regulators are also in the process of expanding bank resolution options, in many cases through encouraging the use of "bail-in" instruments, which will provide additional tools to deal with looming bank failures in order to preserve financial system stability and lessen the need for taxpayer-funded bailouts.

These themes are core concepts in the policy frameworks for bank capital and resolution policy frameworks promoted by the Basel Committee on Banking Supervision and the Financial Stability Board. At the same time, different jurisdictions are following somewhat divergent paths, reflecting a range of factors, including industry structure, policy preferences, and political will shaped by experiences of the financial crisis. These different jurisdictional approaches are reflected in the new criteria.

Key changes in the new rating approach

The revisions in our criteria are primarily focused on the heightened risk to holders of regulatory capital instruments, arising from the increased likelihood that the instruments will absorb losses as a bank progresses toward — but in advance of — a point of non-viability. This risk is especially prevalent in countries that have implemented, or are in the process of implementing, Basel III, where loss-absorbing hybrid capital instruments are expected to play a more significant role in recapitalisation of troubled banks than what occurred during the recent financial crisis. Potential routes of loss absorption include coupon non-payment, principal write-down, conversion into common equity, and distressed exchanges.

The main changes to the criteria include revised standard notching to take into account the heightened risk of loss absorption for regulatory Tier 1 hybrid capital instruments. This revised notching for coupon-deferral risk recognises the increased risk of loss absorption on Tier 1 instruments when capital levels approach specific capital triggers, or fall within the Basel III regulatory capital conservation buffers or other capital buffers that regulators may apply.

The new criteria also provides further clarity around how we apply notching for a range of other instrument features, such as the risk of conversion or write-down, including statutory mechanisms, and for proximity to going concern conversion or write-down triggers. We have provided further examples of circumstances where we could apply additional notches, such as contractual narrow earnings tests, payment clauses linked to distributable reserves, statutory restrictions, and other risks that the issuer's stand-alone credit profile or the standard instrument notching do not otherwise address. Finally, we have provided further clarification around how we handle notching for non-operating holding company issues.

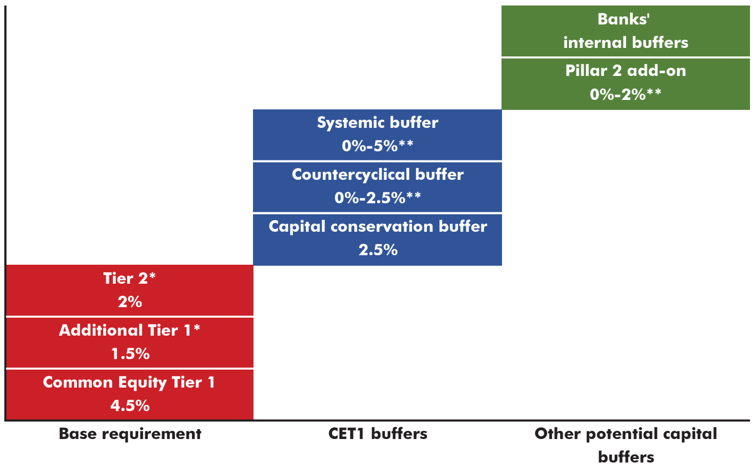
Ratings impact

Following publication of the new criteria, S&P updated its ratings on 1,871 bank hybrid capital instruments globally. Rating changes were communicated through a series of regional media releases, which can be found on the website listed at the end of this article.

We lowered the majority of issue credit ratings on hybrid capital instruments that are classified by regulators as part of Tier 1 regulatory capital. In addition, we lowered the ratings on instruments in jurisdictions where we anticipate that the statutory framework, including bank resolution regimes, would likely lead to the conversion of hybrid capital instruments and non-deferrable subordinated debt into bail-in capital as a bank approaches a state of non-viability.

Overall, we lowered by one notch the ratings on about 65% of the instruments within the scope of the updated criteria, and by two notches on about 15%.

Basel III capital structure



*Must be filled by CET1 if the bank has insufficient Additional Tier 1 or Tier 2 capital
**May be higher

Source: Standard & Poor's

Different jurisdictional approaches lead to different rating outcomes

The rating impact varied between regions and jurisdictions, reflecting notable differences in instrument features and in the expected behavior of the relevant regulators. The ratings impact in some instances also varied between legacy instruments and new instruments compliant with the Basel III framework.

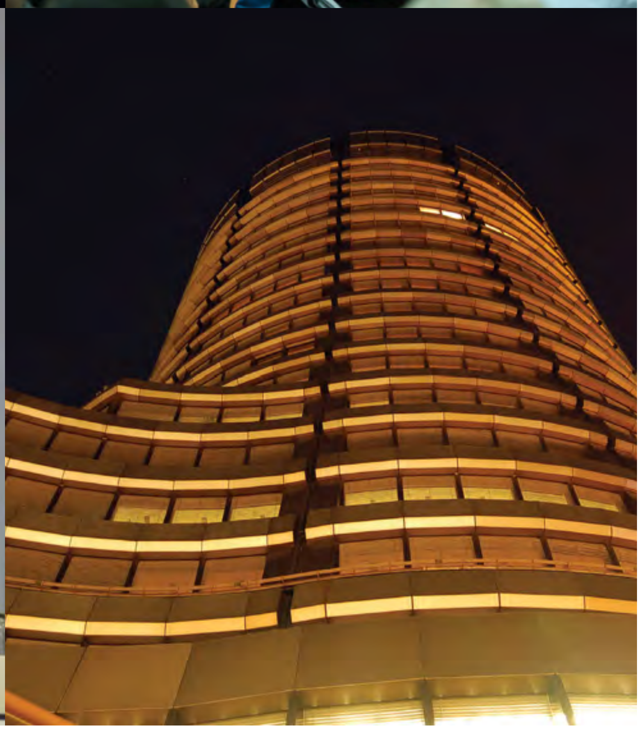
For example, the high proportion of downgrades in Europe relates to the regulatory reform agenda, with bail-in mechanisms as a key element of the EU Bank Recovery & Resolution Directive (BRRD). In our view, these mechanisms will apply to legacy instruments as well as more recent issues. As a result, we applied a one notch deduction to European hybrids, due to the risk of conversion or write-down and reflecting the contingent capital nature of these instruments, whether the related mechanisms have a contractual or statutory basis, in addition to the additional notching to reflect Tier 1 status.

In contrast, our rating adjustments in the US were somewhat more incremental and reflected the expected impact of the Basel III capital conservation buffer mechanism on the risk of coupon non-payment (and hence of an issue default). Other jurisdictions show varying balances between downgrades and affirmations, reflecting the differing and largely moderate progress toward the implementation of regulatory reforms.

In sum, our updated criteria highlight the potentially significant differences in risk between bank hybrid capital instruments with different features. Of equal importance, we expect to factor into issue credit ratings under the criteria framework both gradual and sometimes rapid changes in bank credit quality that could have magnified impacts on hybrid instruments given their regulatory roles to absorb losses. ●

Further information

Visit S&P's *https://www.spratings.com/financial-institutions/banks/Hybrid-Capital.html* hot topic at *www.spratings.com* where the new criteria, along with press releases, commentary, FAQ and short videos providing further background can be found.



Clockwise from top left: Meeting of G20 finance ministers, Brisbane; Danièle Nouy, chair of the supervisory board of the Single Supervisory Mechanism; Bank for International Settlements, Basel; Gabriel Bernardino, EIOPA chair.

Michel Baud, portfolio manager, BNP Paribas AM

Dierk Brandenburg, senior credit analyst, Fidelity

François Gignoux, portfolio manager and vice president, and Dan Karsenty, portfolio manager and vice president, Eiffel Investment Group

Francesco Castelli, head of investments, Method Investments & Advisory

Ghislain Cortina, portfolio manager, credit strategies, Boussard & Gavaudan

Örjan Pettersson, portfolio manager, credit markets, SEB Investment Management

Lloyd Harris, senior financials credit analyst, Old Mutual Global Investors

Vincent Hoarau, head of FIG syndicate, Crédit Agricole CIB

Robert Montague, senior financials analyst, ECM

Participants responsed in late October and November

2014 Review 2015 Outlook

After a year of two halves, *Bank+Insurance Hybrid Capital* surveyed leading players in the hybrid market, primarily on the buy-side, to find out what lessons can be learned from the highs and lows of 2014, and what they expect in 2015. While there are reasons for optimism, the participants suggest that the market's limits have become clear.

The mood in the AT1 market lately is in stark contrast to the frenzy of January. What were the main triggers for the turnaround in sentiment mid-year?

Vincent Hoarau, CA-CIB: Primary market supply in AT1 format was high during the first half of 2014, reaching Eu32.5bn equivalent. The market was one way, and it was just too fast and too furious for the nascent asset class. We approached the 5% headline coupon in euro PerpNC5 format in primary, where more and more issuers printed the biggest possible size at the tightest possible spread. In the secondary market bonds stopped performing. At the beginning of the summer the correction was overdue.

The geopolitical situation in the Ukraine, the Banco Espírito Santo misfortune, the recurrence of some negative macroeconomic headlines, and of course Bank of America Merrill Lynch's decision to pull AT1 securities from the global high yield index offered an explosive cocktail. The purge kicked off with requests for bids by forced sellers and this spread with opportunistic bondholders urged to take profits. On average, we are still trading 75bp-100bp off the pre-summer lows.

You only have to look at the decrease in oversubscription levels in primary to gauge the overall damage and the drop in demand. Take the recent Deutsche Bank, for example: it pushed the size of its PerpNC10 AT1 to its upper limit of $1.5bn in early November and the bonds have traded down since. The total books closed at $3.6bn, compared with a total deal size of Eu3.5bn equivalent for their inaugural, multi-currency AT1 in May.

Örjan Pettersson, SEB: There is still a limited amount of natural buyers of AT1. We believe this, in combination with heavy supply, explains the sell-off. Contagion effects from the weak high yield market might also have played a part.

Michel Baud, BNP Paribas AM: Firstly, valuations were too tight: at an average yield of 5.2% for the Barclays Contingent Capital index at the beginning of June, investors did not feel sufficiently compensated for the risk.

Secondly, Banco Espírito Santo this summer served as a reminder to investors of the risks of loss absorption.

Lloyd Harris, Old Mutual: Geopolitical fears probably had something to do with it, but ultimately the initial turnaround was everything to do with high yield outflows and positioning. Everyone was fairly long high yield and AT1, but because AT1 issuances are large, they tend to be the most liquid, so in the event of high yield outflows they are the first to go because they are basically easier to sell than your typical illiquid high yield bond. So I am pretty sure that when we saw the high yield outflows in the middle of the summer, that was the reason AT1 got hammered.

I don't really believe it had anything really to do with the fundamentals of the issuers. You've only got to look at the difference between the performance of the AT1 market at the time and at the other parts of the bank capital structure: if you look at Lower Tier 2, it didn't move a great deal; it was confined to AT1. And that tells me it hasn't got a great deal to do with bank fundamentals, frankly.

Francesco Castelli, Method: From a quantitative perspective, AT1 market performance looks very much like a slightly higher beta version of the High Yield market: most of the BAML Contingent Capital Index returns can be explained by the US High Yield Index behaviour. Digging a little deeper into the statistical evidence, we find that the causality link runs from HY to CoCos and not vice versa. This confirms the widespread feeling that high yield funds have recycled heavy inflows into the AT1 market at the beginning of

Lloyd Harris, Old Mutual: "The initial turnaround was everything to do with high yield outflows and positioning"

the year. With the sharp reversal of fortune in the last few months, outflows were met by limited market-making commitment from the dealer community, resulting in a painful underperformance of the bank capital sector.

Dan Karsenty, Eiffel: It is worth noting that the AT1 asset class benefited from an overall benign market in the first half of 2014. At that point, we saw what seemed like a growing investor base and a buoyant asset class. Back in June, it felt like every single investor was looking to invest in AT1. Then nervousness and weakness emerged in July and several events reminded the market of how new that asset class was.

We think several reasons explain the reversal: negative macro figures impacting the whole market; tourist money exiting the AT1 market; liquidity and shrinkage of dealers' balance sheets; decent supply in the AT1 market; and last, but not least, idiosyncratic stories (BES).

AT1 have proven to be a very volatile asset class, and often the first asset class to be divested by investors in difficult times. A lot of investors without knowledge of the products have started trading these products. Those people have been the first to sell.

The whole BES debacle came as a surprise, but it taught the market a few things: in spite of the whole European supervision and regulation framework being put in place, events like that do happen again, and when they do, they have a significant impact on the AT1 market.

Ghislain Cortina, Boussard & Gavaudan: The birth of the AT1 market occurred in a very supportive environment for credit. Against that backdrop, AT1s' unfriendly features were progressively dismissed as the primary market grew and attracted new types of investors principally driven by a hunt of yield.

Following the summer choppiness, AT1s experienced their first period of sustained risk-off sentiment. This was the first test for a still immature market and clearly the AT1s revealed their equity-like behaviour in more volatile environments. In addition, concomitant specific newsflow did not help improve sentiment: e.g. retail restrictions, BAML indices exit — not to mention less favourable supply/demand dynamics ahead of AQR, as well as the evolving regulatory framework (leverage ratios, TLAC, etc).

Robert Montague, ECM: There had been a lot of issuance, and if you have repeat issuers coming two, three times in a year or more, people get a bit full on them and so they want a pick-up to secondaries. If that's not really there, they are going to say no. You are finding that unless it's a new name, or it's very attractively priced, deals are suffering. Until we had HSBC and Nordea, who were two new names — and also investment grade, which made a huge difference as well — investors were largely indifferent to the supply when it was just the same banks coming back to the market again.

> Unless it's a new name, or it's very attractively priced, deals are suffering

You had BES in the summer, as well, which didn't help sentiment, and obviously the closer you got to the AQR the more some people became a bit nervous. You also had the likes of Banco Popular and Aareal trying high trigger CoCos and some people thought — wrongly — that Popular would be a marginal pass candidate. In fact they passed quite comfortably, but people weren't willing to take on an unrated high trigger AT1.

Brandenburg, Fidelity: We found the HSBC deals attractive, simply because they are, in our view, going to be one of these low risk benchmarks for the sector as a whole, and I think they have done reasonably well. Nordea would fall into the same category, but their issuance volume is going to be far lower, so you don't really have to take a view on them if you don't want to, whereas HSBC is something you really need to add if you want to be exposed to the sector. So those went well.

As for Santander and the other euro deals, they looked pretty rich when they were priced.

We did see the size of books decreasing post-summer, while a purge took place in the secondary markets. Why was this?

Baud, BNP Paribas AM: Demand for new issues was very strong on the first CoCo issues, with books several times oversubscribed: from three times for the second tier Spanish bank Banco Popular Español AT1 — one of the earliest transaction in 2013 — to 14 times for the Crédit Agricole AT1 issued in January 2014, or even as much as 17 times for the AT1 of Danske Bank issued in March.

Books were not so strong post-summer, with only Eu3bn for Santander and Eu2bn for UniCredit.

We see several explanations for this weakness. Firstly, we must recognise that some new issues that came in September were expensive: Santander came at only 6.25%, after IPTs of the 6.375% area. Secondly, some technical pressures emerged, as Bank of America Merrill Lynch ruled that CoCos are no longer be eligible for high yield indices.

Thirdly, there is less appetite from retail investors. Asian retail investors, which were strongly committed to the very first issues, especially in US dollars, are less attracted by current yield, and seem more focused on forthcoming new issues from Asian banks. For the recent issue from Bank of China, private banks were 29% of the book, and investors were 94% Asian. For lower yield issues, the involvement of private banks was minimal: only 9% of the book for HSBC, for example, while Asia was less than 10%. Meanwhile, in the UK a ban was announced by the Financial Conduct Authority on retail investors buying CoCos from 1 October.

Finally, according to the Street, the weakness was exacerbated by fast-money investors who still weigh on the asset class by selling out at the first sign of macro trouble. Some hedge funds may also have unwound positions hedged with equity options.

Castelli, Method: As discussed, we see the sell-off as mostly determined by the same macro drivers that are putting pressure on the high yield market. In particular, the change in Fed monetary policy looks like the single most important cause. AQR in Europe has certainly been an additional source of concern, but the successful conclusion of the exercise will not, in our view, change the big picture, where negative drivers remain. Going forward, differentiation among US dollar and euro-denominated AT1 is likely, with the latter likely to find support from ECB monetary policy.

Harris, Old Mutual: It's related to what I said before — ultimately it comes down to positioning. I doubt there was much paper sold in August and so the market was still pretty long. So when those guys reopened the market after the August wobble and the realisation that this was going to be a volatile asset class, the book sizes were a lot more realistic than those back at the start of the year when everyone was just grabbing for AT1 and risk. Maybe in May there was some padding of orders, but once it got to September I don't think there would have been any padding at all, and that had a lot to do with the smaller order books.

François Gignoux, Eiffel: The volatility and the repricing that we have experienced since the summer have pushed investors to be more cautious when looking at the AT1 market.

The scarcity in liquidity proved that no matter the size of those instruments, it can get very hard to trade them. On a few days during the summer, it felt like a 5m clip of an AT1 was very hard to execute.

The BES fiasco did not help either: what would have happened if BES had issued an AT1 instrument back in June, instead of the capital raise they did? The repricing in the whole asset class would have been massive. That market is a nascent and untested one so far, and until it does get tested, the whole asset class will remain very sensitive to any adverse event on a financial institution.

The AQR has also been the main focus of attention in the last months, and this has probably prevented investors from adding risk in the AT1 space. We see the AQR and stress test as a positive catalyst for bank credit that should add transparency and liquidity to the AT1 market, as well as credit tightening over time.

Cortina, Boussard & Gavaudan: Technicals have been clearly less favourable. Besides the reasons stated above, continued heavy supply occurred whereas the investors base had not yet sufficiently stabilised. The summer volatility and lower liquidity might have pushed some types of investors to either exit the market or reconsider the size of their holdings. This was particularly evident when repeat issuers did not get much support, with limited incentives for investors to add on those names via primary versus secondary.

The secondary performance was disappointing, not only in absolute terms but also in the limited differentiation between names, circumstances, features. Essentially all AT1s indiscriminately behaved as a beta play echoing the broader market sentiment. This is not necessarily encouraging as a scenario of specific stress on the asset class (e.g. effective coupon cancellation) remains untested.

François Gignoux, Eiffel:
"We see the AQR and stress test as a positive catalyst"

Dierk Brandenburg, Fidelity: It's related to the supply/demand mechanics. Banks are very clearly incentivised to issue this debt, while on the buyside it's not yet clear where the natural home for these bonds is. I think that makes people a bit wary of engaging with the asset class, whether they like the instrument or not. The question is: where do you properly price the supply relative to the funds that are available to be invested in it?

Meanwhile, after the summer there was this retail ban and then the index exclusion from the Merrill Lynch index at the end of September, which again meant that a lot of people found themselves overweight.

On the buyside it's not yet clear where the natural home for these bonds is

Hoarau, CA-CIB: Book sizes dropped mainly because valuations were judged too rich and order inflation in primary almost disappeared. In the meantime, a lot of fast money investors, opportunistic buyers or low quality hedge funds simply quit the asset class during the purge. And as Michel pointed out, the demand from private banks in Europe as well as in Asia has also drastically diminished. Their contribution to the overall order volume pre-allocation was significant during the first half of the year. Most of the time inflated, it could easily reach three to four billion. You don't see that anymore.

UniCredit: an issuer's perspective

Waleed El Amir, Head of Strategic Funding and Portfolio, shares his thoughts on developments.

The downbeat mood in the AT1 market lately is in stark contrast to the frenzy of January. What were the main triggers for the turnaround in sentiment mid-year?

The factors for the more downbeat mode in AT1s are several. First, investors have further understood that these are highly subordinated instruments and as such can exhibit significant volatility in terms of secondary market prices, and furthermore there is a view in the investor community that there is significant supply to come and thus investors can be more selective as to the instruments that they buy in both the primary and secondary markets. Given that these instruments are perpetual, in US dollars there is concern should interest rates start to rise.

We have seen the size of books decreasing in primary markets post-summer, while a purge took place in the secondary markets. Why was this?

For the same reasons as above. A large number of investors who had entered the asset class had underestimated the potential trading volatility of these securities and thus are unwilling to put up with the mark-to-market swings

Are current valuations and relative value metrics interesting for you?

AT1s tend to trade more on technicals and sentiment rather than a valuation of the underlying risks in the structure. Given current sentiment, where investors can purchase AT1 securities from major GSIBs at a yield of over 6%, I think there is decent value here.

How much of an impact did the BAML index change have?

Baud, BNP Paribas AM: Bank of America Merrill Lynch ruled recently that CoCos were no longer to be eligible for high yield indices. This change had a negative technical impact in the sector, as benchmarked investors ended up with off-benchmark positions that increased their tracking error.

However, we view this impact as limited and temporary: high yield funds are not natural investors for financial issuers and a number of high yield funds are benchmarked against non-financial indices.

In the long term, specific demand for AT1 should emerge from dedicated financial hybrids funds. We can notice that, following Merrill Lynch, Barclays has recently launched its own Global Contingent Capital index, which should help asset managers work on these projects.

Karsenty, Eiffel: The removal of AT1 instruments from the BAML corporate bond index may indeed have had an impact on the trading price of these instruments, but we believe that it was a healthy development. The inclusion of CoCos in broad indices brought in new money from investors that were not all familiar with the complexity of these products. AT1 are a nascent asset class and, as such, should be handled by knowledgeable investors, prepared for the underlying risk and volatility.

Castelli, Method: Like many other investors in this space, we do not follow a benchmark and our strategy was not impacted by this change.

Valuations of the newly-issued AT1 instruments look attractive

Montague, ECM: It's hard to say, because it happened in September when there was a lot of noise in the market. It's easy to post-event rationalise, you know: blame the index, blame that. But there were lots of other things going on, negative macro news as well, the geopolitical situation with Ukraine and the Middle East. So it's very difficult to pin it on that totally, I'd say. There might have been some effect, but it's hard to split out the various causes.

Are current valuations and relative value metrics interesting?

Gignoux, Eiffel: Compared with a couple of months ago, valuations of the newly-issued AT1 instruments look attractive. On average, they currently yield 6.5% (Z spread of 515bp), more than 1% above their lowest yield reached in mid-June this year. In terms of cash trading price, they have on average recovered 3 points from their lows reached in mid-October, but are still trading 6 points below their June highs.

We have a constructive view on the banking sector. Banks raised a significant amount of capital ahead of the ECB AQR and EBA Stress Tests. For instance, on a fully-loaded basis, only one AT1 issuer would have breached its conversion trigger at the end of the stressing period in the adverse scenario (i.e. 2016 Adverse Fully-loaded CET1 ratio < AT1 trigger). The AQR/stress test results thus give us comfort on the fact that conversion risk of AT1 is remote.

One of the major caveats, however, remains the AT1 instruments' volatility, which undermines their attractive returns.

Pettersson, SEB: After the massive sell-off since the beginning of the summer, spreads have started to look attractive again. Supply will continue to be an issue, as it will put pressure on secondary market trading. However, even without

Are you satisfied with how the market is developing?

No. We have seen a contraction in the amount and size that investors have been playing in the AT1 market and less willingness from the broker/dealer community to provide more liquidity to the asset classes.

Did you consider alternative instruments for your capital planning?

We are close to already filling up 1% of our AT1 basket. We may look at another transaction in 2015 but there is no rush.

Do you have further plans to diversify in terms of currencies or to build-up your hybrid curve?

We have issued in both euros and US dollars. Decisions on currency will be based on market sentiment and execution certainty.

We view AT1 as a surrogate to equity and thus believe it is cost efficient for us in terms of our capital structure.

What can you say about your plans to use the variety of hybrid instruments available in 2015?

What are the main challenges over the coming years?

The main challenge for many of the banks will be managing to the varying and sometimes conflicting requirements being imposed: LCR, TLAC, leverage ratio, NSFR, MREL. ●

spread tightening, the AT1 market offers a nice carry which is not that easy to get these days.

Harris, Old Mutual: It's certainly getting there. It's a lot more interesting than it was, put it that way. You've only got to look at the CoCo index and it's as low as it has ever been. That's not to say that it couldn't go a little bit lower. But it's certainly looking more interesting.

We've obviously got some concerns around European growth, but I don't think that'll be enough to lead to coupon deferrals on AT1 or anything like that.

Cortina, Boussard & Gavaudan: The repricing since the summer has clearly created opportunities in the AT1 market. However, in an overall more cautious and volatile environment, AT1s have proved to be very macro and market sentiment-driven instruments. Also the risks of heavy supply are likely to weigh on overall valuations: the highs of between May and July might not be reached again in the near future unless the broader market and macro sentiment were to change dramatically for the better.

Given the high correlation within the asset class, we feel the market is still too young to put in place efficient fundamental relative value strategies within the space. Having said that, some opportunities exist, especially on the instruments issued by names that have positively surprised in the ECB stress tests. Some of these holdings can be efficiently hedged with other asset classes like stocks or even to some extent new sub CDS contracts. In addition, the market correction has been indiscriminate between duration and structures: given the first wave of issuances of perpetual non-call five structures were issued in the second half of 2013 with a very high back-end (hence a very high probability of call) we believe that shorter call AT1s with low triggers deserve to be less volatile and to trade at a much steeper spread curve versus longer dated call structures.

The highs of between May and July might not be reached again in the near future

Baud, BNP Paribas AM: We are positive on AT1 at current levels. The Asset Quality Review and Stress Tests published on 26 October were an important step for banks. All major European banks passed, which should reassure investors in the near term.

Third quarter results were positive for most banks: at Deutsche Bank, the Common Equity Tier 1 ratio was 11.5% at the end of the third quarter, on a fully-loaded CRR/CRD IV basis. This ratio was 10.2% for Barclays for the same period, an advance compared with 9.9% at the end of June and good progress towards its 11% 2016 target.

We believe that hybrid securities can be seen in a good light: as of 28 October, Contingent Capital securities can provide an average yield of 6.18 % according to the Barclays index (82 securities) and 5.97% according to the Merrill Lynch index (76 securities), with an average rating of mid to high double-B, and an average duration of 4.97.

This really provides an attractive pick-up compared with the rest of the capital structure. Bank subordinated (83 securities within the Barclays Euro Investment Grade index) show an average yield of 2.03%, with an average rating of mid to high triple-B, and an average duration of 4.56. The average yield for the Merrill Lynch Euro Subordinated Financial index (188 issues, also restricted to investment grade, but including insurance and financial companies) is 2.38% for high triple-B ratings on average and an average duration of 4.67.

Dierk Brandenburg, Fidelity: "The regulators are probably going to move away from these 5.125% triggers"

Are all of the structural elements correctly appreciated? What are your priorities when evaluating AT1 instruments?

Harris, Old Mutual: This element of the market is quite well understood. I don't come across many investors who have no idea about the intricacies of MDA language and that type of thing and are just investing in AT1 blind — although anecdotally you hear that maybe there are some.

For me, it's credit fundamentals that are an absolutely number one priority. That is absolutely paramount when investing in an AT1. The structure of a bond is secondary.

> For me, it's credit fundamentals that are an absolutely number one priority

Take a very strong issuer like HSBC, for example, it has a 7% fully-loaded trigger, it's one of the tightest trading names, and that's because it's an incredibly strong institution, whereas if you look at Barclays, it's again got a 7% fully-loaded trigger, but it trades much wider because it is much weaker. So it's credit fundamentals first and structure second. And then things like issue size are again further down the list.

Pettersson, SEB: Before we get too distracted by technicalities, we need to remember that the most important thing is first and foremost our credit assessment of the issuing bank. The second step is to evaluate the structural elements but also the technical picture in the market. Lastly, we add our relative value analysis to decide if it is a potential buy.

Baud, BNP Paribas AM: CoCos are complex instruments that require more detailed analysis than standard bonds. The starting point of our analysis is the classic fundamental credit analysis of the issuer. In addition, for such securities, it is key to review the structure of each bond. We analyse the risk of hitting the trigger (dependent on the solvency of the bank and its risk profile), the risk of non-payment of coupons (for AT1 CoCos, coupons are discretionary, but cancellation could become mandatory below a certain level), and all other relevant items (loss absorption, jurisdiction risk, the risk of modification of prospectus under tax or regulatory events…).

The distance to trigger is our first metric for quantifying the risk of such securities. AT1s are usually classified under "low" or "high" trigger, but this is not so simple: some bonds are coming with a "dual trigger" structure, like Crédit Agricole, with a low trigger at the issuing entity (CASA), or a high trigger at the group level — which needs be analysed in view of intra-group guarantees.

Furthermore, the transition into Basel III adds to the complexity: the distance to trigger under Basel III phase-in could be different to the Basel III fully-loaded ratio. Besides, expected ratios need to be extrapolated for future years, especially during the transition period: those projections until 2019 require several hypotheses, like the internal capital generation. Finally, the probability of an adverse scenario should also in theory include the Point Of Non-Viability, which is even more difficult to quantify.

The coupon risk can be measured by the distance to mandatory coupon restriction. This is a significant risk that is probably underestimated by market participants; however it is not an immediate concern, as a transitional regime will be in place between 2016 and 2019. As a result, distances to mandatory coupon restriction are high until 2016 and are then progressively reduced by the progressive inclusion of the capital conservation buffer and G-SIB systemic buffers. For instance, for Crédit Agricole, a distance to mandatory restriction of 7.5% is projected until 2016.

The loss absorption language in the event of the trigger being breached also requires investors' focus: the language could be more investor friendly, with partial and temporary write-down of the principal, or conversion into equity, rather than a permanent full write-down. For temporary write-down, in case of return to financial health, a gradual write-up could then occur under certain conditions (positive consolidated net income, subject to minimum distributable amount), at the issuer's discretion. However, since those instruments have not yet been tested, it seems that market participants are more focused on the frequency (i.e. the probability of reaching the trigger), rather than the severity (potential recoveries after a breach, which is expected to be a remote risk).

Quantifying each of the risks listed above and pricing such a security accordingly is not easy. As CoCos are complex securities with embedded options, it is complicated to tackle their valuations in a straightforward way. Some market participants have developed "in-house" tools, but there is no unanimously recognised standardised pricing methodology.

Cortina, Boussard & Gavaudan: They are not, but admittedly there are still lots of new or moving parts that are still very hard to appreciate or even quantify: Maximum Distributable Amount, Available Distributable Items, combined buffers requirements, Point Of Non-Viability, etc.

The market was also hoping for some standardisation of structures under Basel III: however, we have to live within a still evolving regulatory environment and national discretions. Hence AT1 is actually a very broad and generic concept bringing together various types of instruments (gone/going concern).

Investors have to accept the features of AT1s such as fully discretionary coupon cancellation, the possibility of write-down and bail-in. Hence, fundamental work is key to the investment decision, especially with regard to loss absorption risks: the ability to predict buffers to trigger can vary a lot according to the business mix of the issuer, its RWA profile, its national regulatory environment, and its strategic priorities. The risks of coupon cancellation certainly have a much higher probability of occurring, but remain harder to quantify at this stage. On that front, some companies are more exposed to one-off hits like litigation risks or provisioning adjustments than others.

Castelli, Method: First of all, we have to admit that we find it difficult to evaluate AT1: all CRD IV-compliant bonds are perpetual with a pure discretionary coupon. From a purely legal perspective, there is nothing preventing issuers from transforming those claims into a perpetual zero coupon bond (in this case, the value would collapse to zero for bonds with a write-down/write-up mechanism, or to the premium of a digital option on CET — struck at the conversion trigger — for structures with a convertibility feature). This scenario is, in our view, completely undervalued by the market, and we find this quite remarkable, especially for those of us who still remember the day, less than five years ago, when a large bank decided to skip a call on a Lower Tier 2 security on "economic grounds".

Basel III bonds with a dividend stopper clause are a much more palatable proposition.

Karsenty, Eiffel: We think that as of today, not all structural elements of AT1 are correctly appreciated by investors. For instance, the pricing differential between two products with different conversion features is particularly difficult to assess (for example, equity conversion feature versus temporary write-down). This is especially true in the current environment where conversion risk appears relatively remote, as banks and especially

Michel Baud, BNP Paribas AM: "The distance to trigger is our first metric for quantifying the risk"

AT1 issuers have taken significant measures to reach relatively high solvency ratios. We do, however, believe that pricing differentials could reappear in times of stress (e.g. solvency closer to trigger level on given names).

We therefore favour "credit-friendly" structures with higher prospects of recovery in the event of conversion and prioritise equity conversion features over write-down (temporary or full).

We have to admit that we find it difficult to evaluate AT1

Regarding structures, has anything caught your attention?

Brandenburg, Fidelity: I would pick out three things.

Firstly, the use of AT1 for the leverage ratio, and what structures will be required for that. We're quite keen to know how the regulators see AT1 evolving, if it's to be used to finance the leverage ratio rather than just the 1.5% risk-weighted assets bucket.

I would also pick out the issue of management buffers. If you look at the ECB stress test, it gives you a good idea around sort of what the downside is for banks. We talk to management teams and they still think they need to run management buffers of 50bp or 100bp above the minimums set by regulators, but for a lot of AT1 issuers that is maybe too small.

And then if you look at the stress tests, most of the triggers are well out of the money, because even under those scenarios none of the loss-absorbing features would have been triggered. So in that respect, I get a sense that the regulators are probably going to move away from these 5.125% triggers and up to triggers of at least 7% — we have seen that with some of the issuance out of the Nordics, which has come with 8% triggers. And then you also have some voluntary 7% issuers, like Crédit Agricole. And overall we see that shifting up, because otherwise the triggers are not really worth a lot, right?

Low trigger versus high trigger: to what extent does this matter to you?

Pettersson, SEB: We need to ask ourselves: is there a conceptual difference in the mind of regulators between a low trigger and a high trigger bond? If a bank gets into severe problems, is it easier for regulators to force a conversion of a high than a lower trigger bond? If the answer is yes, the distance between actual capital levels and trigger levels is the most import factor. If no, we should focus more on absolute capital ratios.

Cortina, Boussard & Gavaudan: It matters, even more now that companies will be regularly tested on stress test scenarios assumptions. While you could assume that from a coupon cancellation risk standpoint both instruments are aligned, high trigger instruments are going concern instruments whereas low trigger ones are gone concern. It makes a lot of difference in many circumstances. One could argue that both instruments are subject to Point Of Non-Viability language and that under such a scenario, this point of non-viability would not be far from a high trigger in some jurisdictions. However, having a contractual high trigger is clearly much more restrictive. This is particularly true for those names potentially exposed to one-offs hits (e.g. litigation risks) or for smaller issuers.

As a consequence, it is also difficult to envisage a high trigger structure without equity conversion features for most issuers.

Castelli, Method: Distance to trigger is, according to our structural (fundamental) models, one of the most important drivers of valuation. Looking at our reduced form (trading) models, other market participants seem to share our view.

Gignoux, Eiffel: One could argue that you are better off holding the low trigger instruments, but we have a tendency to focus on buffer to trigger over the trigger level itself.

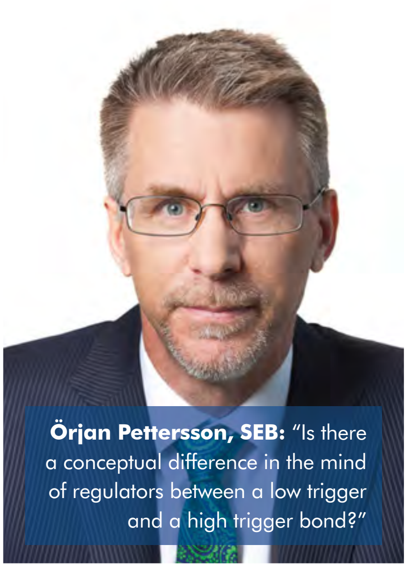
It is not a static picture that we assess, but we try to assess organic capital generation as well as earnings volatility, when looking at the AT1 market. This approach remains the same for the distance relative to the coupon distributions.

So ultimately we are more or less indifferent to the trigger level itself.

What matters the most: issue size, spread, credit or loss-absorbing metrics?

Baud, BNP Paribas AM: Yield appears to be the prime reason why investors buy CoCos. The historic performance of CoCos was still good this year, despite the repricing seen since this summer — the total return has been 4.64% year-to-date, according to the Merrill Lynch index. Current yields are attractive, at 6.18 % on average, according to the Barclays Global Contingent Capital index.

Credit and loss-absorbing metrics should be carefully analysed on a case by case basis, according to the factors I mentioned earlier.



Örjan Pettersson, SEB: "Is there a conceptual difference in the mind of regulators between a low trigger and a high trigger bond?"

Yield appears to be the prime reason why investors buy CoCos

Karsenty, Eiffel: We look at all those metrics but our priority goes to the credit. This is the key parameter that will drive whether or not we invest.

In a second step, we look at other parameters: structure, call period, reset type, currency, spread, issue size, etc.

Cortina, Boussard & Gavaudan: A combination of them all, to be honest. For the largest issuers, the pace of issuance and new issue premiums will increasingly matter, too.

Castelli, Method: Issue size does not seem to be a relevant differentiating factor in a world where most issuers go for benchmark size. It would certainly start to matter with smaller issuers coming to the market.

By the way, illiquidity premium is certainly an issue for the whole fixed income market, but "benchmark size" is apparently offering very little help, so I am very curious to see how the "steepness" of the liquidity curve evolves going forward.

What can you say about the spread differential between Tier 2-hosted CoCos and AT1? Is the value of the deferral element correctly priced in?

Castelli, Method: At the beginning of the year, our models were telling us that deferral risk was mostly overlooked. In recent months however, we saw a shift, with market pricing starting to reflect MDA metrics. Having said that, there are only a limited number of issuers where the full capital structure is available (CoCo and AT1 issued by the same issuer) and where available, triggers are generally different. This makes comparisons a bit tricky, with too many variables to be estimated from a limited number of known variables

Pettersson, SEB: Deferral is one of the main risks embedded in AT1 instruments, but our assessment is that current valuations compensate you well for that risk.

Cortina, Boussard & Gavaudan: One comment is that market size and supply dynamics are going to be very different as the market grows: most banks will be issuing AT1s, whereas Tier 2 hosted CoCos will likely be useful in only a few jurisdictions.

Hoarau, CA-CIB: With supply and volatility increasing, I think the size element — and frequency of appearance — will gain in importance when doing due diligence, providing that the investor feels comfortable with the credit profile of the issuer and the features of the AT1. I have the feeling that more and more portfolio managers weigh the size more than the price element when they gauge the potential for spread performance. A smaller size is a strong contributing factor to relative stability during periods of turbulences. Danske Bank printed Eu750m in PerpNC6 format in May and the bonds have outperformed its peers by far. On a curve-adjusted basis, its AT1 is the only non-investment grade security to trade below the 5% mark in the five year segment.

You are invested across formats in subordinated debt, between bank AT1/Tier 2 and sub insurance — where do you see most value taking into account risk, the profile of the issuer and current valuation levels?

Cortina, Boussard & Gavaudan: We are indeed invested across formats: AT1, vanilla Tier 2 banks, legacy instruments, as well as insurance subordinated bonds. The market has been very focused on

AT1s this year as the new fashionable nascent market, but some of the more interesting opportunities have been rather coming from more investor-friendly structures issued either from lesser known banks or higher betas issuers in credit-normalisation mode.

We also like insurance subordinates where the emphasis has also been on deleveraging and balance sheet strengthening ahead of Solvency II — as in the banking sector with Basel III, but with much less event risk (e.g. AQR, litigation risks, etc.). The language in the prospectuses of bonds currently issued by insurers are among the most bondholder-friendly structures in the hybrid space. We particularly favour Solvency I structures recently issued by higher betas names, especially after the market sell-off in September.

Brandenburg, Fidelity: Regarding Tier 2, a lot will depend on the TLAC requirement, which looks very onerous to us, in the sense that lots of banks have to issue multiples of the supply they already have out in the market. That makes Tier 2 slightly less attractive because of the uncertainty. Although ultimately Tier 2 is in the index, so if it gets issued, people will buy it.

And then on AT1 we find the picture a bit clearer, with the sort of caveat of the leverage ratio requirement. So I would say AT1 looks marginally more attractive — also given where yields on them are at the moment.

Pettersson, SEB: We like the subordinated segment in general. We appreciate the strong improvement in credit quality that the banking sector has achieved — more and better capital, less dependence on short term financing, larger liquidity buffers, etc. OK, government support is something that we can't count on anymore, but we have never invested in banks based on the premise that they will be bailed out by the state if something goes wrong. The insurance sector, on the other hand, has been quite stable throughout the crisis.

What we like within subordinated debt is more based on relative value and will differ from time to time. Lately we have noticed that the sub insurance sector has underperformed the rest of the investment grade market and become increasingly attractive.

Baud, BNP Paribas AM: As explained earlier, we are positive on AT1 at current levels.

On Lower Tier 2, even if the fundamental are still supportive, we think we may see some technical pressure in the near term. Total Loss Absorbency Capital ratios may lead banks to issue Lower Tier 2 instruments.

As far as insurance is concerned, we still like the sector for its fundamentals, with a preference for non-life versus life due to the low yield environment, but liquidity (which could be low for some bonds) should be taken into account for each bond's risk/return profile. We are more cautious on long dated Upper Tier 2 and see tactical value on short dated Tier1: as demonstrated in the Axa exchange, insurers are expected to benefit from Solvency II transition rules in the coming month, as the window for grandfathering Upper Tier 2 into Tier1 will close in 2015.

Harris, Old Mutual: Insurance sub, particularly in sterling, does tend to trade cheap to banks, and I don't think that's quite right, because fundamentally the health of the insurers is very good. They are still carrying excess capital into the introduction of Solvency II. Although some of the UK insurers in particular have got some earnings headwinds, given the amount of capital they are holding I don't think it materially changes the fact that they have still got relatively strong balance sheets, so I kind of see sterling sub insurance as pretty cheap.

Castelli, Method: Recent changes in regulation have contributed to a widespread repricing of anything with a CoCo label. While we share regulatory concerns regarding retail investors, we find preventing the purchase of Credit Suisse or HSBC CoCo bonds (just to mention some of the highest quality bonds we have in mind) odd while the same client can continue to buy HAA subordinated (not to mention shares in peripheral banks). Anyway, we like regulatory anomalies when they create opportunities: in this case, they sparked heightened risk aversion in the investor base, with Lower Tier 2 CoCos moving from expensive to outright cheap with respect to perpetual AT1s. Basel III AT1s with a dividend stopper feature, although rare, are another area where we see good value.

Perpetual issuance from insurance companies is another investment theme we like: it enables us to add diversification while enjoying the protection of Solvency I structures with little mention of explicit bail-in features.

We see bank Lower Tier 2s as less compelling (with a few distressed exceptions): Lower Tier 2s have a more stable investor base that seems to underestimate the risk of statutory bail-in (or, more likely, benchmarking and regulatory constraints prevent a large part of the investor base from switching out of Lower Tier 2s into CoCos).

Gignoux, Eiffel: As previously mentioned, we have a constructive view on

Robert Montague, ECM: There'll certainly be a better reception for some of the borderline names"

As far as insurance is concerned, we still like the sector for its fundamentals

Francesco Castelli, Method: "High beta names are likely to remain a rare opportunity"

European banks. We selectively favour AT1 over Tier 2 instruments as they offer higher upside potential, in a sector where issuers are managed in the interest of their creditors. In addition, the recent discussions on Total Loss Absorbing Capital buffers (TLAC) for systemic institutions could also force banks to issue significant amounts of Tier 2 capital, which would provide a negative technical for this asset class. Given the recent AT1 volatility, we lean toward investing in lower beta instruments issued by defensive credits.

In the coming years the regulator will be more demanding

The picture for the insurance sector is slightly different. Insurance companies are not as incentivised as the banks to take credit-friendly actions. They are less scrutinised by investors and the regulatory environment remains benign for now. Solvency II, the new prudential framework, will be more stringent for insurers, but its application is scheduled for January 2016 and the transitional rules appear relatively generous for issuers. We do, however, see value in some recovery stories within the European insurance sector.

Is there much room for much higher beta issuers?

Montague, ECM: Yes, I think so. There'll certainly be a better reception for some of the borderline names. I'm sure some of those who couldn't issue ahead of the AQR will dust down their previous projects and come to market.

If things are priced correctly we will consider them. But obviously it's more than price; it's the name, the structure and the kind of environment we are in.

Harris, Old Mutual: I think these guys can come to market, to be honest. They will have to really pay up. But the thing is, even in the low double-digit yields, it's cheaper than the cost of equity because of the tax-deductibility of coupons. If you think your coupon comes down by 30% compared with the cost of equity, it still probably makes sense for, say, second tier Italians that have comfortably passed the AQR or the Spanish to come at 10% if they need to. Popular came at 11.5%. And I think there'll probably be a market for that at that type of yield at the right time.

But I do have, let's say, wider concerns about the amount of through-the-cycle holders of AT1, the type of holders that hold on to the bonds come rain or shine. I think the asset class is just going to remain volatile because I don't see there being enough through-the-cycle holders — everyone's willing to trade this asset class. As I mentioned before, these are big liquid issuances, and they will continue to be volatile, frankly, especially versus the amount of issuance that is needed. But that's not to say that we can't have second tier, high beta issuances if they come at the right price.

Castelli, Method: For the moment, high beta names are likely to remain a rare opportunity: as we saw with Popular, there may be some special situations where an issuer will be happy to pay double-digit yields instead of diluting shareholders. But this is likely to remain an exception rather than the norm.

Karsenty, Eiffel: It looks to us like most issuances will be coming from the higher quality banks, as institutions that are in some form of restructuring will be incentivised to wait to see an improvement in credit costs to issue these types of yieldier securities. But we do expect some non-core banks to come and tap the AT1 market.

Cortina, Boussard & Gavaudan: With regards to higher beta issuers, we believe there is a market for them! However, only at the right price, right size, right structure and more importantly pace/size of issuance. Timing is important as well, as investors need to feel the issuance is coming from a position of strength rather from a company potentially being forced to issue. Back in October 2013, Banco Popular was actually the first issuer to open the euro AT1 market with a Eu500m unrated low trigger issuance. Since October 2013, their credit story improved, with concrete catalysts for an improvement in their capital metrics (e.g. equity placement, treatment of Spanish DTAs, various disposals). However, the timing of their attempt at a high trigger issuance this summer a couple of months ahead of the AQR results was certainly not optimal as it wrongly raised doubts in the market about their ability to pass the stress tests.

Generally speaking, the AQR exercise and subsequent better disclosure and harmonisation of metrics such as NPL provisioning should also help the investor community to fundamentally better appreciate the resilience of the buffers and risks around coupons cancellation.

How much supply can the market absorb going forward?

Cortina, Boussard & Gavaudan: Regarding better credits, looking back at this year's activity, especially September's issuances, there was a clear discrepancy between the market appetite for very frequent issuers versus newcomers. Those multi-time issuers might have been too optimistic about the ability of the market to absorb a new issuance nearly every quarter on the same name on such junior structures in what is still a very young market.

Gignoux, Eiffel: The market has been struggling to digest the recent issuances — although one can argue that the AQR process and the recent repricing have made the market look safer and attractive again.

Castelli, Method: Our view is that the market has still to overcome its niche nature. We still do not see any "natural" buyer, apart from a few specialised funds like the one we manage.

"Seed money" for the asset class was apparently provided by a mixture of opportunistic investors (hedge fund/total return types) and non-European private banking; a second wave appears to have materialized from HY fund manager s. While this money is certainly welcome, filling a gap in institutional demand, it is far from a stable and committed investor base. As proved by the limited number of euro-denominated transactions, local demand is still very small with respect to the issuance plans announced so far.

Given this lack of structural demand, 2014 issuance will be certainly difficult to beat, especially in a weak environment for the High Yield market.

Baud, BNP Paribas AM: Investment grade funds are increasingly looking at these bonds for diversification. However, allocations to such instruments will remain limited, as the bonds are off-benchmark and mainly high yield.

Insurers are currently almost not involved in the asset class due to their regulatory constraints (only 4% of the book for Danske Bank, and 2.5% for UniCredit).

In the current environment, there is a real opportunity for new funds dedicated to financial subordinated bonds. Asset managers are currently working on such projects: in our global credit team, we have in October launched a mandate dedicated to global hybrid securities for one of our clients.

Besides, it is worth mentioning that higher beta issuers could also rely on highly yield-sensitive retail investors, as demonstrated by the new issue of Bank of China. With a yield close to 7%, investor appetite was strong. Total orders were as high as $21.8bn. In term of investors, Asian retail and sovereign wealth funds comprised the majority of the book (in total, Asian investor were 94% of demand).

Vincent Hoarau, CACIB: "I fear that supply will increase quicker than the investor base in the short term"

In the UK, the ban announced by the Financial Conduct Authority on retail investors directly investing in these complex instruments demonstrate the need for fund managers' expertise.

Montague, ECM: The investor base has grown reasonably well. Some people have adjusted their mandates and there are new funds being set up.

Issuance has been fairly strong. Including exchanges there has been $55bn, and even if you strip out exchanges — which are a sort of captive issuance — you still have over $40bn, which is a chunky number, and there's room for another few billion before year-end. So it's been pretty healthy — even considering how little there was after the summer.

You've had the regulators getting worried about retail involvement, particularly in the UK. To be honest, I don't think UK retail were that heavily involved. It's a red herring because the minimum size on most of these deals is £100,000 or £200,000 clips, and how many retail investors have got £200,000 to put into one issue? That's a high net worth individual territory. It's a private banking investment, really, and those are a brought under the umbrella of professional investors. So I don't really think that's a huge issue.

Brandenburg, Fidelity: We expect the investor base for the instruments to develop. It's just a question of how quickly this will happen, and on the issuer side it went a bit too fast. But it's just a question of pace — the direction of travel is clear.

Hoarau, CA-CIB: I agree with Dierk, but I fear that supply will increase quicker than the investor base in the short term. We need more buy and hold accounts, more dedicated CoCo funds and less fast money and opportunistic buyers if we want the volatility of the asset class to decrease. Looking at the profile of demand globally, I am concerned by the evolution of the investor base in Germany, which is virtually non-existent, and the lack of support from the German regulators.

What are your expectations for 2015?

Harris, Old Mutual: In terms of volumes, I expect them to be somewhat similar, if not exceed this year. Now, that's obviously highly market dependent. If markets settle down and we go back into a hunt for yield mode, then that could drive another rally in AT1, which in turn would probably drive more issuance. But there's that question mark over through-the-cycle holders. And now that the Emperor has cast off his new clothes, and we know how volatile this asset class is probably going to be in the future, that could check somewhat the ability of the market to take this stuff down. But over the course of 2015, yes, if banks are willing to pay up there will be a home for it.

> It's just a question of pace — the direction of travel is clear

Cortina, Boussard & Gavaudan: 2015 will certainly be an interesting year for the AT1 market. We do not think it will be the year when features (loss absorption, coupon cancellation) come to be tested,

especially with MDA kicking-off in 2016. The test will rather be again on supply/demand dynamics, particularly in those jurisdictions still to issue their inaugural transactions.

Hoarau, CA-CIB: The profile of supply will evolve in 2015, with a solid contribution coming from higher beta names, mainly from southern Europe.

Elsewhere, Dutch issuers will make their debuts early in 2015 after having received the official green light from the regulator to issue AT1. Until now the Netherlands had to wait for a law allowing AT1 coupon payments to be tax-deductible and freeing banks from withholding tax on interest payments. ING, Rabobank and ABN Amro are all expected to issue during the first quarter of 2015 — the three banks reported a combined risk weighted asset total of around Eu600m at the end of the third quarter. This implies around Eu9bn of potential AT1 issuance. Austria, among others, has yet to make this clarification.

Elsewhere, Solvency II-eligible subordinated capital transactions for insurers will very likely emerge in 2015.

Last but not least, TLAC, ALAC, MREL or rating agencies' recent moves still need to be fully digested, but all will massively impact supply in subordinated format and lead to a substantial increase of Tier 2 offerings. This will weigh on bond performance and the overall spread situation in Q1 2015.

Montague, ECM: The banks will want to fill their 1.5% AT1 bucket first, and then the question is whether some names will go beyond that because they've got leverage ratio issues. Absolute yields remain low, these instruments are quite attractive from an issuer perspective given where the cost of equity is for some of these banks. Good quality banks are issuing with coupons of the high 5s, low 6s, and the cost of equity is north of that, 8% or 9%, and then you have the tax saving on top of that. Ultimately whether total issuance reaches the same level as this year or surpasses it will be very dependent on market conditions.

> We see the risk of issuers being unable to meet their AT1 issuance targets

Castelli, Method: We see the risk of issuers being unable to meet their AT1 issuance targets: high quality issuers, especially the ones able to achieve solid ratings, will do better, while smaller/weaker issuers will be met with scepticism.

We do not expect the US dollar HY market to recover anytime soon: issuers will be then forced to pay a premium with the whole ML CoCo index repricing 50bp wider in 2015. Repricing is likely to be more contained for euro-denominated AT1s/CoCos, where the market is already requiring a hefty (and somewhat unjustified) premium.

With a 50bp widening and a further 50bp increase in US Treasury rates, US dollar bonds likely to offer a limited, although positive total return. We forecast a much better outcome for euro-denominated bonds, with stable risk free rates and a more manageable 35bp widening in credit spreads. Our expected return for US dollar denominated securities is 0.50% in local currency, increasing to a much more attractive 4.25% for euro-denominated bonds. This should help broaden the local investor base over time.

Karsenty, Eiffel: 2014 has been a critical year for the nascent AT1 asset class. At the end of 2013, eight new-style instruments amounting to only Eu8bn had been issued. Today, more than 40 instruments are actively traded, representing over Eu50bn outstanding.

Excluding a few high profile accidents such as the BES/Novo Banco situation, 2014 has seen positive developments for banks creditors, with improving solvency ratios and issuer transparency. We expect the same path to be followed throughout 2015, with banks focusing on the quality of their core capital (i.e. replacing phased-in with fully Basel III-compliant capital), hence improving issuers' solvency. Issuer transparency should also improve with yearly stress tests now being mandatory for all major European banks.

At the same time, the technical picture for AT1 instruments will remain challenging, as several issuers will come to the market. This additional pressure should limit any material tightening in AT1 credit spreads.

The compelling AT1 carry and European banks credit-friendly behaviour should, however, continue to provide attractive investment opportunities throughout the coming months. ●

EBA
AT1 monitor

The European Banking Authority is playing a lead role in the evolution of hybrid capital, most recently with the publication of an AT1 monitoring report. Here, Delphine Reymondon, head of unit, capital and asset/liability management at the EBA, discusses how the regulator would like to see instruments develop and a planned initiative on standardised T&Cs.

You published the AT1 monitoring report in early October — what was the background to that?

EBA is charged with monitoring the quality of capital, and if we notice a deterioration in the quality of capital then we should report immediately to the European Commission. Until now, we have very much been focused on the regulatory side, on the drafting of the technical standards. We have issued roughly 20 technical standards on capital, so this aspect is now done.

What we want to do now is to move to the implementation and the peer review, and see exactly how these technical standards and the CRR provisions are applied by EU banks. And so we are now focused on more practical issues, such as the terms and conditions of the issuances themselves.

This is within the context of different types of monitoring. We are doing one for CET1 instruments and there published a list of existing instruments in the EU a few months ago that we will update regularly. And we will not add anything to the list without a prior assessment by EBA and peer review, and confirmation that the instrument is compliant with the rules.

Concerning Tier 2, we have so far been less involved, partly because we consider it a little bit more straightforward, and partly for reasons of resources. In some cases we did have a look at some of the provisions. This was the case, for example, with the RAC Tier 2 in particular, where we expressed a specific opinion on the link between the Tier 2 coupons and the AT1. But we have to an extent set aside Tier 2 for the time being as it is less the priority.

So we have really focused on these AT1 issuances. It's preliminary work and based on a limited number of issuances, but there were not so many available. We are continuing the work at the moment and are having a look at more recent issuances. We had a roundtable with some issuers to share our views, for example. And the work is not only on the issuances themselves, because in some cases we realised that there are some interpretational issues with the CRR regarding the triggers, the link between the solo level and the consolidated level, for example. So we need to think a little more about all these types of issues.

What is important is that we wanted to go out very quickly with the report to give initial guidance and really send a signal to issuers and investors that we are monitoring what is happening and that we will not let these issuances go in the wrong direction — the wrong direction being for us far too complex types of engineering, questionable terms and conditions, or doubts on the effectiveness of the loss absorption mechanisms, etc. That is why we wanted to give guidance on this.

Do you have any mandates outstanding in this regard? Will there be a second monitoring report?

Contrary to the vast majority of the reports that we are delivering, this one was an own-initiative report — it was not mandated by the EC or any other body. And yes, we intend to do a follow-up. There are a lot of points in this report that are still open, so we will need to give some clarity on these and confirm our interpretation. In some cases we have reservations about

Photo: EBA

specific terms and conditions and are still reflecting on them, while we have also asked some market participants for some written feedback on certain topics. For example, we asked some roundtable participants about a very specific topic, namely the contingent clause mechanism.

I cannot say exactly when an updated report will come out or what the format will be, but we should not wait too long and it could be around the end of the first quarter. As I said, it's a continuous, ongoing task, so ideally the objective would be to give regular feedback on these issuances.

You also need to bear in mind that there are other workstreams and reports going out on the consumer protection side. For us, as regulators, it is very important to keep the terms and conditions as simple as possible. It's already a complex product, so we would not like to see increased complexity.

Contrary to other authorities, we consider that the investors in these products are well informed investors — it cannot be retail, of course — so we consider that they know the risks, but again there are different views. For example, if you take coupon flexibility, we as regulators wanted this, we are very happy with this full flexibility of coupon, and this is something that is very important for us. Market regulators, for example, may say, yes, but this full flexibility of coupon payments creates a lot of uncertainty for the investors, so this is not something we like because it is complex and the risks are not properly assessed. So this is something important to have in mind for these issuances, that in some cases there may be different views. But what is certain, again, is that simplicity and standardisation of these issuances is key.

How do you coordinate within the EBA and with external authorities on consumer protection-type issues?

There is of course a coordination with the work we published in July, not under the EBA name but jointly with the other two European Supervisory Authorities, on self-placement, and the consumer protection requirements that firms have to fulfil. Then we also of course discussed with ESMA when they published their report on CoCos. As I mentioned, there are different perspectives because we are coming from different sides — the consumer protection or investor side not being the banking regulatory side.

You say that you like simplicity — are you actually trying to achieve standardisation, and do you think that the monitoring reports that you are doing will lead to that kind of standardisation?

Yes. There are two different ways in which it will do this. The first is that through this report and the follow-up report we can show the direction that we want to go in — the fact that we don't like complex terms and conditions, that we don't like certain types of clause because they raise uncertainty, etc.

But then what we will also do next year, but which is not mentioned in the report, is work on standardised terms and conditions for AT1 issuances. We did it in the past on the recap exercise, with the Buffer Convertible Capital Securities (BCCS) term sheet. The idea is really to provide institutions and competent authorities with standardised terms and conditions, especially for the smaller institutions and competent authorities. The idea would be that if a bank were to use these terms and conditions then it would be guaranteed that the issuance is compliant with CRR and the technical standards. It would be an option, it would not be compulsory, but if a bank is doing it then it would definitely be deemed compliant. The issue that could be raised with some of these AT1 issuances is that if the peer review is made on an ex post basis, then some banks and their supervisors will have to take their own risks in terms of compliance with the regulatory provisions. What we are always telling our members is that if you have any doubt or if you have a new clause please come to the EBA to discuss this first, because if you decide on your own you take the risk that at the end the peer review we don't like this clause or have reservations, and then what will you do? When you need to change terms and conditions afterwards it is always extremely difficult. So we will work for these standardised terms and conditions — probably some with write-down, some with conversion, etc.

Is this something you came up with or was it requested?

It is a bit of both. When we discussed this in the past, there was a little more reluctance from some competent authorities about doing this — it is not new from the EBA side, I would say. But there has been clearly a shift in the mood of some of the competent authorities towards these standardised templates. And indeed it has always been an expectation from competent authorities of a smaller size that may have less expertise when institutions in their jurisdictions do not use a lot of these instruments. In the same vein, when you are a small bank and you are not in a cross-border situation, standardised terms and conditions can be really helpful. Some large supervisors are also very interested in getting these standardised terms and conditions because their view is that there should be only one template in a national market – why should there be different templates? We will see how this drives issuances in the future.

Back in February the chairman of the board of supervisor noted that there had been little AT1 issuance in spite of favourable market condition, and you had few issuances to consider for your report. Are you disappointed that there hasn't been more AT1 issuance?

We do not make this kind of judgement. What was maybe a little bit surprising was that for a while it seemed as if there was always something more or less holding back issuance: the CRR was not finalised, then the EBA technical standards were not finalised, then when they had been it was because EBA did not give any guidance on some Q&As, or it was because the fiscal treatment in some countries had not been finalised.

But it was not that we have been disappointed — we just noted this. And now we have seen that there are more issuances, that the market has reopened, and that is why we are getting on with this work.

Delphine Reymondon, EBA:
"For a while it seemed as if there was always somthing more or less holding back issuance"

Under the new ECB supervision, how will the process for approving the structure of upcoming AT1 work? How will the national regulator, the ECB and the EBA work on the approval process?

This is a very good question, and we do not have the answer yet. We will see in the coming weeks and months. It is completely new for the competent authorities themselves, so this is a process that we need to discuss with them and the ECB and that will have to be structured. Let's also see how the ECB will structure itself but I don't see them challenging the work that is currently being done.

What is the likelihood of the EBA considering a potential revision of the maximum write-up formula for AT1 instruments in the medium term, ideally shortening the reinstatement process upon an institution's full return to financial health? Given their potential going-concern loss absorption capacity, could a different formula apply at least to high trigger (7% CET1 or higher) instruments?

We have already had this question a few times and we said, no, not for the time being, we will not change this. This was something that was heavily debated when we finalised the technical standards, so we know that market participants were not happy with this because of course the length of the write-up can be quite long. But to be very honest with you — also keeping in mind all the other streams that I mentioned outside the pure regulatory side and the reservations about these instruments for different types of reasons — I do not think it would be appropriate to change this now. This is definitely not our intention, so for the time being it is not at all on the table. ●

Bank of China Tower, Shanghai
Photo: Remko Tanis/Flickr

Asia
Momentum builds as regulations evolve

As issuance volumes in Asia gain momentum, Fitch Ratings explores some recent developments and likely future trends relating to Basel III capital securities in three key markets: China, India and South Korea.

China: Basel III capital issues may test market appetite

"Planned issuance of Basel III capital securities by China's largest commercial banks through to the end of 2014 could be sizeable and, as a result, may face a challenging market," says Grace Wu, head of Fitch's China team.

The large volume of issuance relative to the size of the market could test investor appetite when there are persisting uncertainties surrounding slowing profitability growth, rising non-performing loans (NPLs) and concerns about the state of the property market.

Issuance in China this year has reached around \$41bn (CNY251bn) to date, including \$12bn issued in offshore markets and denominated in foreign currencies. The majority of these issues were Tier 2 instruments and were mostly used to refinance legacy subordinated bonds.

There is only one AT1 issue in China thus far, by Bank of China (BOC), which amounted to \$6.65bn in October. Based on the announced figures by the five state-owned commercial banks, there are around \$36bn worth of AT1 instruments pending issuance before the end of 2015 from Industrial & Commercial Bank of China (ICBC), BOC and Agricultural Bank of China (ABC).

The issuance of capital securities by Chinese banks will provide a supportive buffer as economic conditions become more challenging. Raising this form of capital is part of the Chinese authorities' plans to fortify balance sheets of systemically important banks amid potential asset quality risks, rising off-balance sheet exposures, tightening profit margins owing to the forthcoming liberalisation of interest rates, and liquidity volatility. Further, this will also better position Chinese banks for ongoing asset growth.

Grace Wu, Senior Director, Financial Institutions

The likely further \$36bn in issuance of capital securities by end-2015 by the big five banks is equivalent to just 3.5% of end-September capital and 0.3% of total assets. While new capital securities may boost confidence in the system, the size of issuance will be small relative to existing capital and assets, and is no substitute for common equity. Chinese banks have lower equity to asset ratios than emerging market peers, and this is before factoring in potential off-balance sheet risks emanating from the shadow banking system in China. As such, the capital raisings alone should only be modestly credit supportive.

An additional challenge for international investors will be the uncertainties around how China will address the point of non-viability (PONV) for banks. Previous international Basel III issuance by Chinese banks has been completed through their Hong Kong-based subsidiaries, which are regulated by the Hong Kong Monetary Authority. In China, the China Banking Regulatory Commission (CBRC) has discretion to determine PONV for Tier 2, but the People's Bank of China (PBOC) and State Council may also play influential roles in determining PONV, particularly when it comes to public sector capital injections. However, for the large, systemic banks, the Chinese government will likely seek to avoid triggering PONV as this would indicate a systemic bank failure.

While Fitch expects all of the big five state banks to issue capital securities, because the final amount to be raised remains unknown it is too early to determine to what extent these issues will offset pressures in the system and have a positive influence on bank standalone strength, reflected by the Viability Ratings (VRs). Fitch's main measure of capital when assessing bank capital strength, Fitch Core Capital, will not be strengthened by these issues.

Korean Basel III terms become more creditor friendly

In South Korea Fitch believes recent modifications to the terms and conditions (T&Cs) of commercial banks' Basel III-compliant capital securities have reduced the likelihood of non-performance risk — particularly for Basel III Tier 2 instruments — and are therefore positive for instrument ratings. As a result of these changes, for banks issuing Tier 2 instruments, the agency will consider notching off the higher of the Support Rating Floor and Viability Rating (VR).

The agency understands that the motive behind these changes is to deepen the pool of investors for capital securities to support a rising trend of issuance.

"For investors, the new instruments are potentially of lower risk relative to earlier Basel III Tier 2 instruments" says Heakyu Chang of Fitch's team in Seoul. "From a quality of capital perspective, these changes make these instruments more like the legacy Basel II instruments and — as a consequence — less likely to absorb losses (and less capital-like) compared with instruments issued in markets where PONV is triggered at an earlier stage of a bank's deterioration in financial position."

The key change to the T&Cs is the removal of a management improvement order (MIO) received from the regulator as one of two PONV triggers. The other trigger — when the bank becomes insolvent — remains. Where instruments have only an insolvency PONV trigger and where support is factored into the Issuer Default Rating (IDR), Fitch would consider using the support-driven IDR or the VR (whichever is higher) as the anchor rating for systemically important banks because we expect pre-emptive support to be provided to avoid insolvency. Upon hitting the PONV, the Tier 2 instruments are to be fully and permanently written off, hence Fitch will continue to notch ratings on these instruments twice from the anchor rating to reflect loss severity (i.e. poor recovery prospects).

A similar change has been made for the write-down of Additional Tier 1 (AT1) instruments. This, however, does not change, in our view, the risk of coupon cancellation, which is still linked to a management improvement recommendation (MIR) or the discretion of the issuing bank. An MIR is usually the first timely corrective action that regulators would activate, for example, in a scenario where the total capital ratio falls below 8%. The bank may decide not to pay the coupon, typically when the bank is unable to pay dividends to its shareholders. Given that skipping a coupon payment is central to our assessment of non-performance risk, we will continue to notch ratings on AT1s five times from the VR (where the anchor rating is investment grade).

The definition of insolvency is less subjective than an MIO, which the authorities have a significant degree of latitude in deciding when to issue. An MIO event is also supposed to be activated when a bank's total capital adequacy ratio falls below 2% (or if the Tier 1 capital ratio drops below 1.5% or common equity Tier 1 capital ratio is below 1.2%). The

Heakyu Chang, Director,
Fitch Australia Pty Ltd, Korea Branch

MIO trigger is more comprehensive and would practically be the first trigger to be hit if both triggers are applicable. This was a factor behind the agency's previous decision to assume that the VR would be the anchor rating.

Fitch expects the revised single PONV trigger (i.e. insolvency trigger only) to be the standard for future Basel III Tier 2 issues by Korean banks. Fitch notes that the Korean authorities have approved a number of proposed Tier 2 and AT1 issues in recent weeks.

South Korea's only offshore Basel III-compliant Tier 2 security, issued in April 2014 by Woori Bank (A-/Stable/bbb), had the two above-mentioned PONV triggers. Had Fitch rated that instrument, the bank's VR would have been used as the anchor rating. In the case of Woori, its IDR is two notches higher than its VR.

In total, \$3bn (KRW3tr) of capital securities have been issued since April 2014, with \$1.6bn in foreign currency and one deal being AT1. The relatively weak capital positions of banks resulting from recent and planned M&A activities have been driving them to issue new securities or refinance maturing legacy bank capital securities. Some policy banks (e.g. Korea Development Bank (KDB) and Industrial Bank of Korea (IBK)) are also under pressure to issue securities to supplement their Tier 2 capital positions. Their capital positions have been under pressure due to their policy role of extending loans and their limited internal capital generation capacity. We estimate the potential supply between now and end-2015 to amount about \$5bn.

India: AT1 Changes May Help Reduce Basel III Capital Gap

"In India recent investor-friendly changes to Additional Tier 1 (AT1) instruments may help the banks to partly fill the sector's large $200bn Basel III capital needs," says Saswata Guha in Fitch's Mumbai office. "But the Indian bank AT1 market remains untested, and the new features may introduce retail investors to a riskier asset class."

The capital requirement also builds in expectations of a pick-up in economic growth, following the advent of a new government with a clear electoral mandate and focus on policy reforms. Banks are still the dominant credit intermediaries in India, and would therefore need to raise capital to support the process of economic recovery. We forecast real GDP to grow by 5.6% in 2015 and 6.5% in 2016.

Large private banks are potentially the best positioned to take advantage of an economic recovery, given their scale, lower funding costs and higher capital levels. They need only 15% of the Basel III capital requirements, and could better fulfil these needs because of stronger internal capital generation and access to equity capital. Public-sector banks would also benefit from a cyclical recovery, but to a lesser extent — in light of their high exposure to structurally weak sectors. State Bank of India and Bank of Baroda are the best placed among the state-owned banks.

Saswata notes that state-owned banks, which represent close to 85% of the capital gap and suffer from weak valuations, would find the capital requirements more challenging. Asset quality pressures and declining profitability have hurt internal capital generation, thus raising their dependence on state capital. We believe AT1 securities would be likely to have to fill state-owned banks' capital needs in the near term — until improvement is evident in asset quality, profits and their ability to raise core capital.

The Reserve Bank of India's (RBI) amendments to Basel III capital norms include allowing AT1s to have a shorter maturity of up to five years, be temporarily written down at a pre-specified trigger point, and sold to retail investors. These features are more creditor-friendly, and would be likely to draw investor appetite for loss-absorbing capital instruments. But they may introduce moral hazard risk, as the RBI may be forced to bail out retail investors should there be a need to impose losses.

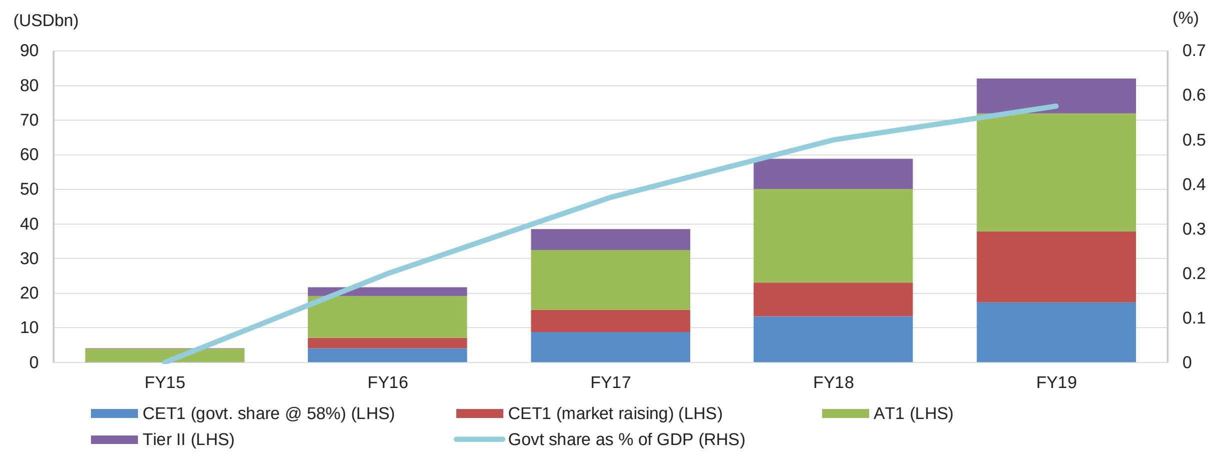
The recent changes would probably lead the banks to switch to the domestic market for issuance of bank capital instruments, though its ability to fulfil the entire AT1 requirements is still uncertain. So far, only two state-owned banks — Bank of India and IDBI Bank (BBB/Stable/bb) — have accessed domestic markets, with each raising INR25bn in AT1 capital in the second half of 2015. In dollar terms, the combined sum ($830m)

Saswata Guha, Director, Financial Institutions, Fitch India Services Pvt Ltd

constituted only about 5% of the combined AT1 requirement expected over 2015 and 2016, implying that a large part of this significant gap is yet to be filled. Steady issuances of AT1 capital will allow banks to bridge near term capital needs, but they may have to tap overseas markets eventually. Simultaneously, banks will also need to raise core equity, which constitutes another 40% of the total capital requirement.

Early signs of asset quality stability are emerging at some large state-owned banks, which should be boosted by a pick-up in economic growth. We expect Indian banks' stressed assets to peak by the financial year ending March 2015, led mainly by cyclical recovery. However, improvements will be slow as it will take time to resolve the large stock of problem loans, particularly in the infrastructure sector.

India: estimated capital requirements under Basel III (FY15-FY19)



Source: Bank Basel III disclosures; Fitch; govt. share represents only CET1

Crédit Agricole Assurances
Going solo

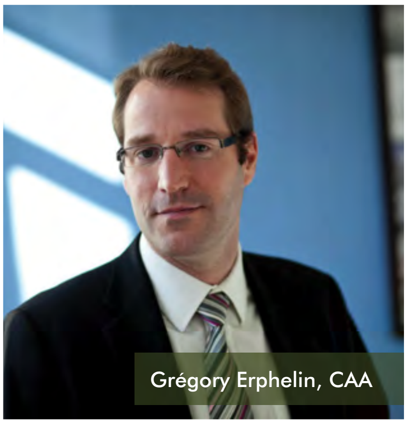
Crédit Agricole Assurances (CAA) marked its debut in the primary market on 7 October with a Eu750m perpetual non-call 11 issue. Here, Grégory Erphelin, chief financial officer at CAA, discusses the execution of the debut transaction, why the insurance company accessed external funding, and how it fits in with rating agency and regulatory developments.

Could you provide us with an overview of CAA's position in the market and within the Crédit Agricole Group?

Crédit Agricole Assurances, 100% owned by Crédit Agricole SA (CASA), is a fully fledged and diversified insurer operating in the savings and retirement, personal protection, and property and casualty sectors. CAA is a key player in the European insurance market: the leading bancassurer in France and Europe, the second largest life insurance provider in France, and the fifth largest European insurer. Its model is based on a high integration within Crédit Agricole Group, notably benefiting from the strength of Crédit Agricole Group's retail banking networks in France, Italy and Poland. To highlight some key figures: Eu26.4bn of premiums at year-end 2013; Eu1bn of net income Group share; roughly one-quarter of normalised total net income of CASA Group; and Eu235bn of assets under management. Insurance activities are a core business for Crédit Agricole Group and its universal customer-focused retail banking model. As disclosed in the Medium Term Plan of the Group last March, the ambition is to continue developing this successful bancassurance model in the coming years.

This is your first transaction in the primary markets and you started with a subordinated issue, which is not always easy. What is the rationale behind this transaction?

Until now, CAA's funding was wholly provided by Crédit Agricole SA. We have decided to change this policy to look for external hybrid funding due to changes in the prudential framework and in Standard & Poor's methodologies. Were


Grégory Erphelin, CAA

the internal funding policy to be maintained, hybrid capital issued by CAA and subscribed by CASA would be deducted from CASA own funds under Basel III, and from CASA Tier 1 own funds in the case of issuance of Solvency 2 Tier 1 insurance instruments. Additionally, in the RAC calculation, insurance hybrids would be deducted from Crédit Agricole's Core Tier 1 ratio due to S&P's new treatment of hybrids issued by insurance subsidiaries and subscribed by Group companies. Therefore, we assessed with CASA the opportunity of meeting the hybrid capital needs of CAA through external investors. In the current market and regulatory conditions, we decided that it would be economically more efficient for the Group to finance the insurance needs of Tier 1 hybrid capital through CAA in the primary market than through CASA AT1 issuances. For CAA, our objective was mainly to anticipate our adaptation to the future Solvency 2 rules by issuing Solvency 2-compliant notes and to finance the expansion of our business activities. The rationale for this transaction must then be considered both at the Crédit Agricole group level and at the insurance level.

Furthermore, even though market conditions were more difficult in September than in the first half of 2014, they remain attractive compared with historical levels. It was a good time to test investors, especially as we wanted to issue a perpetual instrument and the Solvency 2 regulatory grandfathering window was still open.

Could you elaborate on the continuum between the last CASA AT1 and your inaugural perpetual transaction?

The rationales for the last CASA AT1 transaction and for the insurance deal are strongly consistent. Both aim to strengthen Crédit Agricole Group's regulatory capital and the Group's RAC. It is a positive development in terms of the financial flexibility of Crédit Agricole Group to be able to issue subordinated notes at both the CASA and the CAA level.

Turning to the technical aspects of your inaugural deal, what is the exact status of the notes? How do they rank in the waterfall? Could you give us more details on the structuring items embedded in your deal since you are targeting Tier 1 grandfathering?

We issued a perpetual instrument, eligible up to 50% of the required Solvency 1 margin. As it was issued prior to the Solvency 2 delegated act coming into force, i.e. still in the grandfathering window, the deal is expected to be grandfathered as Tier 1 during the transitional period of Solvency 2, until 2025. The note was also designed to be fully eligible as Tier 2 under Solvency 2 after the first call date in October 2025.

As you know, to be Tier 1-grandfathered, the bond should be undated and not fully compliant with Tier 2 rules under Solvency 2. Until the first call date, this instrument features both an optional and a mandatory deferral subject to a dividend pusher and there are optional early calls that can be made at any time. After the first call date, the mandatory deferral will no longer be under the constraint of the dividend pusher, and the optional early calls are automatically deactivated and the instrument becomes eligible as Tier 2.

In terms of your roadshow, what is your experience and feedback after these face to face meetings with key investors? What are the main takeaways from an issuer perspective?

As a debut issuer, we needed to present Crédit Agricole Assurances in depth as well as its plan to issue sub notes to the market. That's why we spent five days on a roadshow explaining CAA's position within Crédit Agricole Group and within the European insurance market, its business model and its strong credit profile. We also elaborated a lot on the disciplined risk and capital management we have developed within CAA, especially in the context of low interest rates and

Photo: CAA

of the upcoming new Solvency 2 rules. It was the first time we gave detailed information on the insurance business line of Crédit Agricole and I think it was necessary and very useful to go and see investors face to face in order to explain directly the credit profile and the strategy of CAA, and to answer their questions. It was also very interesting for us to understand the sentiment of these key investors and how they assess our credit profile compared with our peers.

Moreover, we decided to test investors when market conditions were definitively heavier and more volatile than in the first half of the year. During the roadshow, investors reminded us frequently of the underperformance of recent subordinated deals in the insurance sector as well as of bank AT1s. We carefully took this into account when we discussed pricing thoughts.

In the end, I do believe that investors had a positive image of CAA and of Crédit Agricole's integrated bancassurance model and that the rationale was well understood.

As a newcomer, were you satisfied with the syndicate structure, pricing parameters and the quality of the order book?

Pricing power is now clearly more balanced between issuers and investors. We had to take this into account whilst also considering the context of further issuances from CAA in the future. That's why we adopted a consensual approach in primary, considering that CAA's credit profile was certainly very well received by investors but also that the recent underperforming subordinated deals were still weighing on the market. The FIG syndicate at CACIB did a good job as sole bookrunner, with strong and constant dialogues with investors. Since the beginning of the roadshow, we had positive feedback from investors and some clear interest, which helped us to define the guidance. In summary, even if the market was volatile and the success of the transaction was fairly driven by the spread, the thorough preparation and right attitude towards potential obstacles enabled us to price a strong benchmark transaction at the tight end of the guidance.

Your transaction performed well after the break, creating positive market sentiment towards CAA. Should the market expect regular appearances from CAA? What are your plans for 2015 onwards?

It's true that the transaction performed quite well after pricing and outperformed our peers. We are pleased to note that even dealers away from the deal acknowledged the strong outcome and adhered to our pricing paradigm and relative value scheme.

Looking ahead, our funding in wholesale markets and the size of future transactions are not yet defined, as you can imagine. But it is clear that CAA is going to be a regular issuer in the coming years. ●

League tables

Bookrunners all European FI hybrids (all currencies)
01/01/2014 to 03/11/2014

	Managing bank or group	No of issues	Total EUR m	Share (%)
1	HSBC	22	10,676	11.9
2	Deutsche Bank	24	7,659	8.6
3	UBS	22	6,422	7.2
4	BAML	22	5,560	6.2
5	BNP Paribas	19	5,009	5.6
6	Société Générale CIB	16	4,821	5.4
7	Citi	19	4,467	5.0
8	Crédit Agricole CIB	13	4,389	4.9
9	Credit Suisse	12	4,208	4.7
10	Barclays	17	4,034	4.5
11	Morgan Stanley	17	3,553	4.0
12	Goldman Sachs	17	3,483	3.9
13	JP Morgan	16	3,033	3.4
14	RBS	15	2,953	3.3
15	Natixis	11	2,675	3.0
	Total	121	89,601	

Source: Dealogic, Thomson Reuters, Crédit Agricole CIB

Bookrunners all financials (euros)
01/01/2014 to 03/11/2014

	Managing bank or group	No of issues	Total EUR m	Share (%)
1	Deutsche Bank	68	18,307	9.3
2	BNP Paribas	75	15,890	8.0
3	Morgan Stanley	45	12,262	6.2
4	Barclays	61	12,215	6.2
5	Société Générale CIB	46	12,079	6.1
6	Goldman Sachs	48	11,882	6.0
7	Crédit Agricole CIB	36	10,993	5.6
8	Citi	55	10,660	5.4
9	HSBC	47	10,602	5.4
10	Natixis	31	10,035	5.1
11	JP Morgan	49	8,045	4.1
12	BAML	28	5,764	2.9
13	UBS	27	5,549	2.8
14	Credit Suisse	24	4,798	2.4
15	UniCredit	28	3,881	2.0
	Total	441	197,836	

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

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