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May-Jun 2015

With  **CRÉDIT AGRICOLE**
CORPORATE & INVESTMENT BANK



Get used to it!

Investors share their strategies on learning to
live with volatility

ABN Amro
Pricing it right

Aviva
Friendly reopener

CreditSights
European insurers



We offer you our world of solutions ✓

JUNE 2015



LBBW

EUR 500,000,000

3.625% June 2025
Subordinated Tier 2

Joint Bookrunner

JUNE 2015



SCOR

EUR 250,000,000

3.250% 32NC12
Subordinated Notes
Due 2047 NC 2027

Joint Bookrunner

APRIL 2015



INTESA SANPAOLO S.P.A.

EUR 500,000,000

Tier 2 Subordinated Notes
2.855% Notes
Due 2025

Joint Bookrunner

MARCH 2015



ALLIANZ SE

EUR 1,500,000,000

2.241% 30 NC10
Subordinated Notes
Due 2045 NC 2025

Joint Bookrunner

MARCH 2015



CRÉDIT AGRICOLE S.A.

CREDIT AGRICOLE S.A.

EUR 2,000,000,000

2.625% Tier 2 Subordinated
Notes Due 2027

USD 1,500,000,000

4.375% Tier 2 Subordinated
Notes Due 2025

Sole Bookrunner

JANUARY 2015



CRÉDIT AGRICOLE ASSURANCES

EUR 1,000,000,000

4.25% Subordinated Notes
PNC10

Global Coordinator,
Sole Structuring Advisor and
Sole Bookrunner

NOVEMBER 2014



AXA S.A.

**Exchange Offer for
2 EUR and 2 GBP Undated
Deeply Subordinated Notes**

Exchanged into EUR Undated
Deeply Subordinated Resettable
Notes and GBP Undated Deeply
Subordinated Resettable Notes

Joint Dealer Manager

NOVEMBER 2014



CNP ASSURANCES

EUR 500,000,000

4.000% Subordinated
Notes
PerpNC10

Joint Bookrunner

SEPTEMBER 2014



CRÉDIT AGRICOLE S.A.

CREDIT AGRICOLE S.A.

USD 1,250,000,000

6.625% Additional Tier One
PerpNC5

Global Coordinator and
Sole Bookrunner

SEPTEMBER 2014



HANNOVER RÜCK SE

EUR 500,000,000

3.375% / 3mE+325bp
Subordinated Notes
PerpNC2025

Joint Bookrunner

SEPTEMBER 2014



UNICREDIT S.P.A.

EUR 1,000,000,000

6.75% AT1
PerpNC7

Joint Bookrunner

MAY 2014



BANCO SANTANDER S.A.

USD 1,500,000,000

6.375% AT1
PerpNC5

Joint Bookrunner

Choose a bank which engages its expertise in hybrid capital
for the sole benefit of serving its clients.



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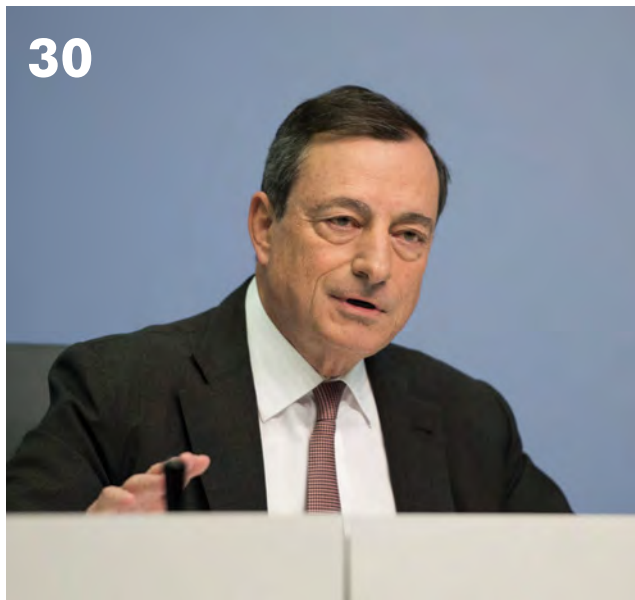
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Bond markets have since mid-April been hit by unprecedented volatility – and, in the words of ECB president Mario Draghi, everyone had better get used to it. Here, investors and Crédit Agricole CIB representatives share their views on what has been driving markets, how they have been coping with the turmoil, and what to expect in the months ahead.

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A vote for volatility



Deals barely subscribed. New issue premiums soaring. Execution windows ever slimmer. And market volatility at unprecedented levels. Could it get any worse? You bet.

When the Greek government late on Friday, 26 June announced it would hold a referendum on any potential debt agreement, it capped a second quarter many fixed income investors would rather forget. For even before the talks collapsed bond markets had moved into uncharted and hostile territory.

The end of the QE rally in mid-April and the severity of the reversal caught almost everyone off guard. But even Super Mario could not come to the rescue on this occasion — indeed, Draghi told everyone to “get used to periods of higher volatility”. A renewed back-up in yields and more pain ensued.

Many issuers chose to give the primary market a wide berth, and several of those who did venture out with new issues — whether covered, senior or subordinated — failed to live up to expectations.

But if we are entering a new era of volatility, it has already been shown that issuers can survive and even thrive in the sub space.

Witness an almost brazen Eu1.5bn 10 year non-call five Tier 2 issue for ABN Amro on 23 June that attracted Eu8bn of demand. Given the circumstances, a new issue premium of 35bp seems a small price to pay. And two weeks earlier the financial institution that most successfully issued into an almost as hostile market was none other than Bank of Ireland with an inaugural AT1.

Complementing these encouraging signs has been a relatively stable performance from bank capital instruments that has certainly not gone unnoticed on the buy-side. “This has gone a long way to making investors more comfortable about the asset class,” says one.

So perhaps it is not all doom and gloom, for bank capital, at least. Tom Ranger, director of funding and collateral management at Santander UK, perhaps captured the mood of the times best after an inaugural £750m HoldCo AT1 for the UK group.

“I guess the very interesting thing, which goes against everything you learnt at school, is that in such volatile markets, the less volatile product is the higher risk product,” he says. “To a certain extent, I would probably have more faith in issuing a hybrid capital instrument today than a triple-A covered bond, which makes no sense from everything I learnt, but that is the life we’re in.”

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Market news

Right ABN Amro premium clears Greek blockage

ABN Amro unblocked the primary market for subordinated bank debt on 23 June with a Eu1.5bn Tier 2 issue that attracted some Eu8bn of orders, raising hopes that a heavy pipeline of delayed AT1 and Tier 2 projects might be possible — if issuers are willing to accept that the market is requiring substantial new issue premiums to reflect the higher volatility and uncertainty.

The Dutch bank's transaction was the first in almost a fortnight as the latest pronounced bout of volatility, on the back of rising Bund yields and Greek fears, had stymied issuance. However, it was followed by subordinated deals in euros and sterling from HSBC Holdings and The Co-operative Bank, respectively, as well as further FIG supply.

The reopening came after hopes of a resolution to the Greek crisis rose early in the week. Although these were dashed and the odds on Grexit rose as negotiations in Brussels reached an impasse, the Dutch bank's strategy of offering initial price thoughts with an enticing new issue premium of as much as 50bp showed that even the most fraught market conditions could perhaps be overcome.

Leads ABN Amro, Bank of America Merrill Lynch, Deutsche Bank, Morgan Stanley and UBS went out on the Tuesday morning with IPTs of the mid-swaps plus 250bp area for the 10 year non-call five issue, which bankers said implied a NIP of 40bp-50bp. After taking some Eu8bn of orders, the leads were ultimately able to price the Eu1.5bn deal at mid-swaps plus 235bp, equivalent to a NIP of up to 35bp.

"The Eu8bn of demand for ABN Amro's Tier 2 showed that deals can get done," said a syndicate official at one of the leads.

"Encouraged by Monday's Greek deal prospect headlines, a huge rally across stocks and bonds, plus a decent new issue premium, investors opened their wallets to take out some of the



piled up money that is waiting to be used for something after weeks of low supply, rates volatility and Greek uncertainty."

Daniëlle Boerendans, head of long term funding and capital issuance at ABN Amro Bank, said that the bank had received regulatory approval for the transaction at the beginning of the month and then monitored the market

'In hindsight we couldn't have done it better'

for an appropriate execution window.

"The market was closed for quite some time and when we saw the tone in credit and equities improve on Monday we were keen to take advantage of the window," she said. "Like everyone else, we were also aware of the pipeline and summer is coming up, too."

"Given that we have a well-established name in the capital markets, including the euro subordinated space, we thought that it would work if ABN Amro would reopen the market. That turned out to be quite a success if you look at the order book of Eu8bn and the ability to upsize to Eu1.5bn and tighten pricing."

ABN Amro's tightening from IPTs to re-offer contrasted with comparable supply in the previous flurry of FIG issuance two weeks earlier, when several issuers remained stuck at IPTs on the back of weak order books.

"We saw some trades that struggled to achieve their ambitions," said Boerendans, "so together with the joint leads, we decided that this was probably the best strategy and then to take it from there. In these kinds of markets, you should really choose the right execution strategy, that is to get investors' attention and I think that ours was the correct approach."

"For us, it was all about the execution risk, and balancing size and price within the market context," she added. "Price is always important, but maybe the new issue premiums we are talking about are the new reality."

And with the outlook for Greece worsening as the week progressed, Boerendans said that the timing appeared even more opportune.

"From the start, when we saw that there were Eu2bn of orders in the book after one hour, we were already quite happy," she said, "and now we are even more pleased."

"I think it's quite hard to get the timing right nowadays, but in hindsight we

couldn't have done it better."

Other financial institutions followed ABN Amro's example the next day, with HSBC issuing a Eu1.5bn 10 year bullet Tier 2 at 195bp over mid-swaps, again showing investors a NIP of up to 50bp and attracting a multi-billion order book, if not as large as its Dutch peer's. The Co-operative meanwhile priced a £250m 10 non-call five with a coupon of 8.5%.

In contrast to the optimism at the beginning of the week that helped the market reopening, the Greek government's announcement of a referendum on a potential bail-out deal at the end of the week darkened the outlook again, with uncertainty reaching new levels. And the shadow cast by the heightened risk of Greece leaving the euro is set to exacerbate the main other factor looming over the market: heavy supply.

"There could be a poor last minute deal on Greece," said Vincent Hoarau, head of FIG syndicate at Crédit Agricole

CIB, "and then investors will focus on the other problem: the backlog in the euro primary market and how much it can digest.

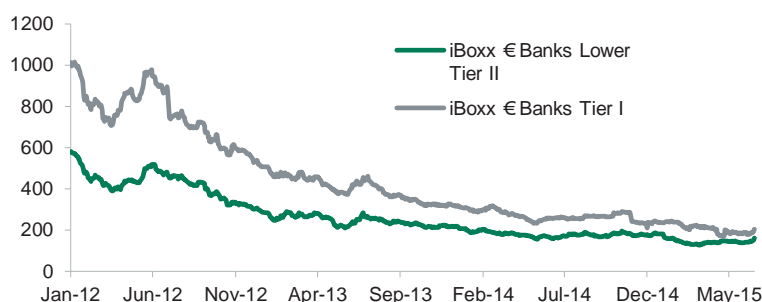
"It has been extremely difficult to print as investors again and again do not like the shape of the market even if they like the deal and are cash rich. So there are tonnes of deals that have been announced but not executed, and as a result there are many just waiting for an issuance window."

Among names to have completed Tier 2 roadshows but not yet tapped the market are Banco Popolare, Belfius, DekaBank, Ibercaja and Pohjola.

"New issue premiums are at historic highs and windows have become tiny," said Hoarau.

"But, as ABN Amro has shown, when you get it right on timing and strategy, with a responsible attitude and generous new issue concession, you can get away with big size." ●

Secondary bank subordinated indices



Source: Markit, Crédit Agricole CIB

SWEDEN

LF Bank in tight Skr1.2bn AT1 debut

Länsförsäkringar Bank (LF Bank) sold its inaugural Additional Tier 1 issue on 2 June, a Skr1.2bn (Eu128m) perpetual non-call five issue that achieved tight pricing relative to international markets and also LF's Swedish peers in the domestic market.

LF Bank announced its deal the week before launch and with lead manager SEB then held investor meetings in Sweden the two days before execution, as well as an investor call for other Nordic accounts, before launching the transaction on the Tuesday.

LF was able to price the Skr1.2bn floating rate note — which, like most Swedish AT1, is structured with a temporary write-down mechanism — at 325bp over three month Stibor on the back of an almost twice oversubscribed order book. A syndicate banker away from the deal noted that this was the same level at which SBAB sold its first AT1 issue in March, although this has since tightened.

"For LF, this is a fairly tight print," he said, "particularly given that they have a smaller buffer to trigger."

Martin Rydin, head of treasury at LF Bank, said that the overall execution represented a strong result, noting that the

market had not been in as good shape as when SBAB issued in March, and also that the pricing was just 10bp wider than where Nordea issued AT1 in Swedish kronor before SBAB.

"We can be very pleased with the result," he said.

The deal was driven by Swedish demand, according to Rydin, although some other Nordic investors participated.

LF chose to issue in Swedish kronor, he said, because the size it required was more suited to the domestic market, and because the pricing available was equivalent to some 75bp inside where dollar AT1 paper from the larger Swedish banks has been trading.

"There is currently a big pricing advantage in the domestic market," he said.

Rydin said that, like its peers, the issuer launched its inaugural AT1 issue to optimise its capital structure and to make sure it is able to meet requirements such as the leverage ratio with a good margin.

He said that the Skr1.2bn issue meets all the bank's AT1 needs for the foreseeable future.

"We communicated to investors that this is their only chance to buy LF Bank AT1 in the next few years," he said. ●

Santander in £750m UK HoldCo AT1 first

Santander UK sold an inaugural public £750m (Eu1.03bn) AT1 at the group holding company level at the end of May in conjunction with a tender offer for a variety of its operating company's capital instruments, in a move an official at the issuer described as ground-breaking for the UK group.

The liability management exercise included three sterling and one dollar instruments and some £308m equivalent of outstandings were accepted when the tender closed in early June. Meanwhile, Santander UK Group Holdings plc had on 28 May issued its £750m perpetual non-call seven permanent write-down 7%, CET1 trigger securities after a roadshow.

Leads Bank of America Merrill Lynch, Barclays, Morgan Stanley, Santander and UBS attracted over £5bn of demand for the trade and were able to tighten pricing from initial price thoughts of 7.5%-7.75% to a coupon of 7.375%. On top of the £5bn book, parent Santander SA had pre-committed to buy £100m of the issue, which was rated Ba2/B+/BB+.

The capital transaction is the first public issuance out of the group's UK holding company.

"Going forward, for Santander UK all of our capital instruments will be issued from our holding company," said Tom Ranger, director of funding and collateral management at Santander UK (pictured). "It's important that as a UK bank with a holding company, which is our single point of entry, we start to optimise as much as possible our capital structure and therefore start issuing new debt out of the holding company



and at the same time try to minimise any existing inefficient capital instruments we have out of the operating company.

"The other rationale was that in the UK the direction of travel for the leverage ratio has moved to a point in excess of 4% and, although that's still a few years away, a very important part of that journey is to issue AT1. If you look at our leverage ratio, which we are very happy with, it was 3.7% at the end of Q1 and this issuance gets us well on the way to being around the 4% number."

Ranger said that the transaction also put down an important and successful marker for the UK arm of Santander.

"The overriding takeaway that we have is that investors and the market really seem to take comfort from our business model," he said. "For the last two years we've had many discussions internally about the fact that we have to do a per-

manent write-down security because we don't have public equity out there, so to some extent this was a pretty ground-breaking transaction.

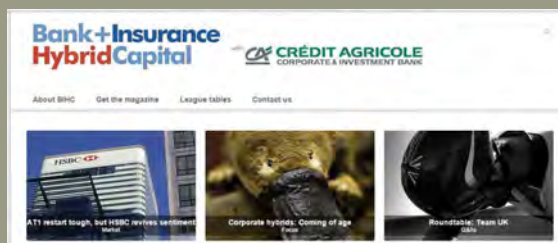
"It is a high trigger, fully-loaded, permanent write-down instrument – we did a lot of research and a lot of fine tuning on this – so it was really pleasing when you look at the pricing that we were not penalised for the structure and that people looked through and saw the underlying strength of our balance sheet. It wasn't an issue of what happens when you get to the triggers, which is incredibly unlikely, but more a question of accepting the way we're run and thus the remoteness of getting close to the triggers."

The choice of the non-call seven structure was based on "resounding" investor feedback after meetings with over 140 investors and also Santander having issued two non-call five year AT1 transactions last year, he added, with the choice of currency reflecting Santander UK's balance sheet.

Ranger acknowledged the issuer had been somewhat fortunate in its timing, issuing before volatility resurfaced, and with the sterling market being somewhat insulated from the Eurozone's problems.

"I guess the very interesting thing, which goes against everything you learnt at school, is that in such volatile markets, the less volatile product is the higher risk product," he added. "To a certain extent, I would probably have more faith in issuing a hybrid capital instrument today than a triple-A covered bond, which makes no sense from everything I learnt, but that is the life we're in." ●

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Bank of Ireland in AT1 debut despite turmoil

Bank of Ireland sold its first Additional Tier 1 issue in the second week of June, a Eu750m perpetual non-call five issue that was more than seven times oversubscribed even as high rated issuers struggled to cope with a deteriorating market.

The deal is only the second AT1 from Ireland, after Permanent TSB sold a Eu125m club-style deal in April.

Leads Bank of America Merrill Lynch, Credit Suisse, Davy, Deutsche, Morgan Stanley and UBS took more than Eu5bn of orders for the Eu750m deal and were able to tighten pricing from initial price thoughts of the 7.625% area to 7.375%. Almost all, 98%, of the paper was placed internationally.

"This is yet another milestone in the bank's evolution," said Sean Crowe, group treasurer, Bank of Ireland. "The significant international demand for this transaction underlines the continued investor confidence in the bank's progress."

The transaction, rated B2/B-, has temporary write-down loss absorption at a 5.125% CET1 trigger.

The Irish success came on the Thursday of a week that, after a promising opening, had become increasingly difficult for execution across the spectrum of bank instruments, with a deteriorating market progressively affecting the pricing and book sizes of deals from covered bonds to AT1.

Landesbank Baden-Württemberg had hopefully opened the subordinated euro market on the Tuesday with the first Tier 2 issue since mid-April, going out with a 10 year bullet. However, with market conditions starting to deteriorate the Eu500m deal was priced flat to IPTs, at 240bp over mid-swaps.

According to Jörg Huber, head of funding and investor relations at LBBW, the issuer had been looking to issue — in either dollars or euros — since April, but only came to market after getting a variety of preparations out the way, such



as updating its EMTN programme, announcing its Q1 results, and roadshowing — and navigating a variety of public holidays.

"Early on in the process, the markets were still quite receptive, such that a transaction was easily doable," he said. "We did quite an intensive roadshow in Asia and Europe, and received positive feedback."

However, after the roadshow a further technical hurdle then had to be overcome before issuance, and Huber said that in

'The market more or less turned sour and shut down'

the meantime sentiment worsened and investors became more hesitant.

"We already got some kind of vibe that they are a bit more cautious and that in the volatile market they would expect a higher new issue premium, which is normal," he said. "And then we had to take the decision what we would do: are we prepared to pay a bit of a higher new issue premium, or wait until markets are calming down?"

"And we came to the decision that, OK, we were prepared to pay the addi-

tional new issue premium which would be necessary because with a pipeline building it was quite clear that markets and levels would certainly not develop in a more favourable environment again for the time being. But we were also prepared to postpone the transaction if things deteriorated completely."

But despite checking on Monday that investors would still be on board, demand fell short of expectations as the deal hit the market on the Tuesday.

"On Tuesday morning nothing had changed in comparison with the day before and the feeling was that with the feedback we had and with IPTs of 240bp it would be attractive enough for all the investors to come in, and even to get a bit of momentum to perhaps price a transaction inside the 240bp area," said Huber. "But it turned out that what we been told didn't come through and this was one of the somewhat rare days when the feedback and intelligence you have changes exactly at the time that you go forward."

"The transaction was subscribed, but we didn't have enough interest in the order book to have momentum and bring the pricing down a bit. And it turned out that it was one of the last transactions that could be done at decent levels, because the market more or less turned sour and shut down."

Indeed when BNP Paribas launched a long-awaited debut AT1 the next day, a Eu750m perpetual non-call seven deal, it also priced its issue in the middle of IPTs, at 6.125%, on the back of an order book modest by AT1 standards, while in the senior market Credit Suisse dropped a proposed 10 year tranche from a senior HoldCo offering, instead pricing only a Eu1bn three year FRN.

Others chose to steer clear of the market altogether, with Pohjola, for example, delaying a Tier 2 deal it had announced on the Monday and which had been expected that week. ●

Aviva ends sub drought, peers hit window

Aviva reopened the European market for not only insurance company subordinated debt but more generally financial institutions sub debt after a six week hiatus on 28 May with a dual tranche Eu900m and £400m Tier 2 offering that was followed by a flurry of insurance deals as issuers took advantage of the market window.

The UK insurer's deal was the first subordinated FIG trade in European markets since mid-April but it was soon joined by others from the sector: Prudential, SCOR, KLP and Swiss Life.

Aviva's trade came after it closed its acquisition of Friends Life in mid-April and, according to Susan Sharrock Yates, deputy group treasurer at the insurer, the issuer was keen to go on the road to present its story to investors and lock in the prevailing low rates. It therefore held a roadshow, from 21 May, and considered the market thereafter.

"And then we thought, well, markets are volatile, but we can't see that improving over the short term at all, and we were keen to get something done before the summer," said Sharrock Yates. "Fortunately, once we were ready to go we saw a slightly easing of volatility, and to be honest given our banking group and given our story, and the feedback that we had received from investors on the road, we were confident that we would be able to get something done."

The issuer was able to attract Eu5bn equivalent of demand for the combined 3.375% 30 non-call 10 euro and 5.125% 35 non-call 15 sterling tranches, the latter being added instead of a long-dated euro tranche, with pricing of 255bp over mid-swaps and 290bp over Gilts, respectively.

"We are very happy indeed," said Sharrock Yates. "The pricing is historically the lowest rate we have issued at. And given the market backdrop I was very pleasantly surprised by the size and quality of the order book, which was al-



most Eu5bn equivalent, and we managed to tighten pricing 10bp inside the initial price thoughts.

"Just two weeks later book sizes were falling and price tightening of that order became very challenging, so we were fortunate in getting a bit of a sweet spot in the market before Greece and other concerns started rearing their heads."

Other insurance companies also managed to do so. Prudential sold a £600m 40 non-call 20 the following week in sterling at 260bp over Gilts following IPTs of the 265bp area. On the same day in euros KLP tapped the market (see separate article) and SCOR SE priced a Eu250m 32 non-call 12 issue. SCOR's issue was more than three times oversubscribed with over 100 accounts in the book, allowing the issuer to tighten pricing from the 240bp area to 225bp over mid-swaps.

"We moved 15bp from IPTs to landing, which not many transactions have done recently," said Robert Chambers, FIG syndicate at joint bookrunner Crédit Agricole CIB. "That's reflective of, firstly, the interest in the credit and, secondly, the deal size being smaller, which meant that given the oversubscription levels we could move in a bit further."

"We saw the NIP at 15bp, which is a touch inside some of the other subs, and it tightened a healthy 5bp on the break. So on the face of it a very good result, es-

pecially ahead of the latest ECB meeting and Greek repayment date."

Swiss Life rounded off the series of insurance sub debt issues with a Eu750m 4.375% perpetual non-call 10 issue the following week, on 8 June, launched after a roadshow. The deal was priced in the middle of IPTs, at 330bp over mid-swaps, with the books twice oversubscribed.

"In spite of the volatility we managed to issue what was the maximum amount we considered, and I would say this is a sign that investors have confidence in our credit," said Luca Pescatore, head of capital management at Swiss Life. "I think it worked out well."

"Again, the issuance window was very short, and already the day after we issued the markets started getting tougher, with widening credit spreads, so I think we issued with the right pricing."

Indeed, no further European insurance sub debt emerged in the following weeks. Uniqa Insurance Group had on 1 June announced a roadshow for a potential Eu500m dated subordinated offering, but, like many financial institutions' subordinated projects, this remained in the pipeline as volatility and uncertainty increased. ●

Please see our individual Q&As in this issue with representatives of Aviva, SCOR and Swiss Life for further insights.

Norway's KLP in rare Eu600m Tier 2

Kommunal Landspensjonskasse (KLP) sold a Eu600m 30 year non-call 10 Tier 2 transaction on 2 June that, according to an official at the issuer, is its first bond issue in nine years and the largest ever from a Norwegian life insurance company in the international markets.

KLP — Norway's largest life insurance company with a 70% market share — last tapped the international markets in May 2006, with a Eu300m perpetual bond. The issuer therefore went on a roadshow ahead of its new issue after the mandate was announced on 20 May.

"We are a rare issuer, so there was a bit of educational work to be done on the credit," said Oliver Siem, director, finance, at KLP. "We found the investor meetings extremely useful and we see that reflected in our book as well: the investors we spoke to were also the main participants in the deal."

Credit markets had been volatile in mid-May but settled down in the week in which KLP announced its mandate.

"Volatility is always a concern, but towards the end of that week it was fairly stable compared to the volatility we had seen in the previous weeks," said Siem. "Rates were stable, swaps were stable, and we were ready with all the documentation, so we felt there was an opportunity for a KLP transaction and we felt we were well prepared to speak to investors."

KLP was seeking Eu500m-Eu600m, according to Siem, given the two drivers of the transaction.

"Firstly, we have had extraordinary growth over the last three years, with Nkr45bn in new premiums from new clients," he said. "And also we have two outstanding loans that have call dates in 2016 and 2017. So you could say half of this is a refinancing, and half is due to growth in assets."

A banker at one of leads Citi, Danske, Natixis and UBS noted that KLP has experienced extraordinary growth in 2013-2015 with the withdrawal of two of its main competitors from the market.



The leads went out with initial price thoughts of the mid-swaps plus mid-300s area for the 30 year non-call 10 issue the Tuesday after the roadshow finished. The book grew to above Eu800m within two hours, according to the lead banker, and after the spread was fixed at 340bp orders grew to a total of over Eu1bn, comprising more than 100 accounts, allowing KLP to hit its maximum Eu600m size.

"We are very pleased that we were able to do the deal on Tuesday as we have seen rates moving quite significantly today," noted Siem.

A syndicate official away from the leads said that it was good for KLP to have gotten its deal away, but noted that the spread was "juicy" compared with similarly rated paper from better known issuers such as

Axa, citing a 2043 non-call 2023 from the French company trading at around 160bp over mid-swaps.

Siem said that discussions around the appropriate pricing had been lengthy.

"It's hard to compete with the largest insurance companies in Europe, who are much more frequent than us," he said, "but we were prepared to give a little bit of a new issuance premium and we felt that the price was fair, particularly given the volume of orders coming in — investors were willing to play at this level but I'm not sure that we could have gone much tighter for what is almost an inaugural transaction."

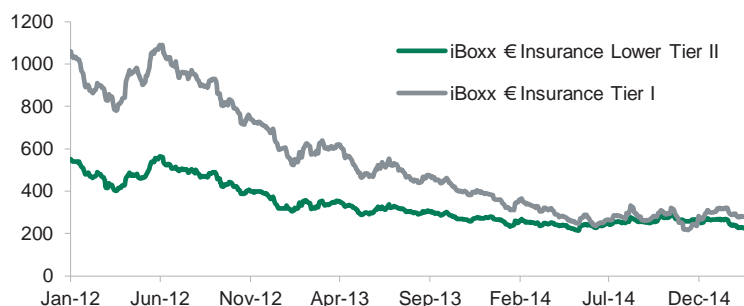
Robert Chambers, FIG syndicate at Crédit Agricole CIB, noted at the time that insurance paper had been relatively unscathed by the recent market moves.

"The good news is that it has been a lot more stable than bank AT1 paper, for example," he said. "And whereas there has been some widening in senior spreads, all of the subordinated financial paper has been holding up reasonably well."

KLP has no further plans for subordinated issuance, according to Siem.

"We have a facility to capitalise the company by calling in equity from the owners, and we call in small portion of equity every year to cover organic growth," he said. "This transaction is more about extraordinary growth and the redemptions." ●

Secondary insurance subordinated indices



Source: Markit, Crédit Agricole CIB



SCOR successfully executed a Eu250m 32NC12 Tier 2 issue on 2 June and here Marco Circelli, head of group capital and treasury management, SCOR SE, explains the thinking behind it.

SCOR, Paris
Photo: Nathalie Oundjian

What was the rationale behind this transaction? Do you have any solvency issues, particularly under Solvency II?

Marco Circelli, SCOR: We wanted to benefit from exceptional market conditions with low rates and attractive credit spreads. SCOR's solvency is very strong, and the contemplated debt issuance has nothing to do with our solvency position and Solvency II. It will be positive for our solvency ratio, since part of the proceeds will be used to refinance debts which had no capital credit in Solvency II.



Marco Circelli, SCOR SE

Why did you not hold a roadshow? Was there any other marketing ahead of the transaction?

Circelli, SCOR: SCOR actively meets credit investors during conferences and roadshows, on an ongoing basis. Over the past few years we have been able to build a strong reputation in the credit and financial markets. For this transaction, we decided to launch a global investor call, which was put online a day before issuance. The feedback from investors was very positive – they appreciated being updated on the status of our company before launching the trade.

You issued into a relatively volatile market. How did the current volatility in interest rates and the Greek turmoil affect your decision to issue? How, if at all, did the market conditions ultimately affect execution?

Circelli, SCOR: In a volatile credit market, it is very important for us to act fast. In addition, we were also anticipating coming ahead of a heavy insurance issuance pipeline. So, we monitored the market very closely and found an optimal window the day before the ECB rate announcement in June. Due to SCOR's reputation and our proposed structure, our transaction was very well received by investors.

Were you satisfied with the level you achieved, the quality of the order-book, and the performance in the secondary market?

Circelli, SCOR: Yes, we were very satisfied. The order book was largely dominated by insurance companies and investment managers. We also believe that we priced the transaction at the right level, facilitating a decent performance in the secondary market despite ongoing market volatility.

This was the first fully-compliant Solvency II Tier 2 offering from a French issuer since the end of the grand-

fathering period. How did it affect the structuring of the transaction?

Circelli, SCOR: Obviously it affected the structuring of the transaction a lot. Solvency II Level 2 texts have been in force since January 2015, therefore any issuance conducted from this time onwards cannot benefit from the transitional arrangement under Solvency II. Any future debt structure, qualified as capital, by insurance companies needs to be compliant and to follow Solvency II rules.

Why did you choose a 32NC12 structure?

Circelli, SCOR: Firstly, it fits perfectly into our overall debt maturity/call date table, and secondly, we chose it due to the rather flat swap rate and credit spread curve between years 10 and 12. For the additional two years we just paid 25bp more. Last, but not least, over the past two years there have been a large number of issues with a call date in 2025, so we anticipate significant refinancing from insurance companies for this period.

Interest rates are currently extremely volatile. To what extent does this affect your capital requirement/capital planning?

Circelli, SCOR: We are closely monitoring interest rates and their impact on our solvency. Since the duration of our liabilities is much longer than the duration of our assets, and our business focuses mainly on traditional underwriting, excluding saving products and other types of business that depend on financial performance, the interest sensitivity on our solvency is relatively low. A decrease of 100bp would negatively impact our solvency ratio by 9 points, whereas an increase of 100bp would improve our solvency ratio by 10 points. Both scenarios would keep SCOR's solvency position in the optimal zone of 185%-220%, as defined by the company under its current three year strategic plan "Optimal Dynamics".

Would you like to comment on how you are preparing your issuance plans for the rest of the year or for 2016, as we understand that you have limited funding needs?

Circelli, SCOR: Indeed, SCOR's refinancing needs are remote. We already pre-financed the refinancing of the Eu350m (outstanding amount Eu257m) subordinated debt that is callable in 2016, a year ago. The other debt of Sfr650m, callable in 2016, is a retail placement on the Swiss market. Together with our management team we closely monitor the market and decide on our financing plan, subject to market conditions. ●

German BRRD implementation

Ahead of partners, but important details to be decided

In spite of a clear, early signal of its direction of travel, the German government has yet to finalise implementation of the BRRD, in particular details as to how and just which senior unsecured creditors will be subordinated. Here, Moody's analyst Bernhard Held, assistant vice president in the financial institutions group, assesses the state of play and possible ratings impact.

Germany has been an early adopter of the Bank Recovery & Resolution Directive (BRRD) within the EU. It finished its original parliamentary implementation process in November 2014, and the BRRD and bail-in tool took effect on 1 January 2015. In Moody's view, this early introduction of the bail-in regulation — one year before the 1 January 2016 deadline — sent a clear signal that the German government intends to limit government support for banks and to share potential losses with owners and creditors.

Even so, some details of the precise implementation remain in flux, in particular the proposed amendment of Article 46f of the German Banking Act (KWG), as outlined in a draft law (Abwicklungsmechanismusgesetz) that the German Finance Ministry published on 30 April. If amended as proposed, KWG-Article 46f would introduce a legal distinction within the senior unsecured class that creates a separate layer of senior unsecured bonds containing "tradable" capital market securities that would absorb losses ahead of other senior unsecured debt, whether in insolvency or in bail-in. It remains uncertain which instruments would form the tradable debt layer, but we expect that the majority of senior unsecured debt would be included.

A direct consequence of this proposal would be that German bank liability structures would contain an additional building block immediately senior to Lower Tier 2 debt, but subordinated to operating debt and wholesale deposits,



Bernhard Held, Moody's

because no form of "grandfathering" is foreseen for outstanding issuances. For large parts of the German banking sector, this would imply a head-start in the quest to build sufficient amounts of Minimum Required Own Funds & Eligible Liabilities (MREL) and Total Loss Absorbing Capacity (TLAC). This would not only buy German issuers additional time to build an adequately tranching debt structure compliant with regulatory bail-in amount requirements, but the TLAC and MREL-compliant status of senior debt would furthermore broaden the issuance options of banks beyond the range of instruments eligible for regulatory capital purposes.

That being said, the draft law is subject to the ongoing parliamentary process in Germany. It has already undergone one important change since the first min-

isterial proposal, as the proposed tranche of future subordinated senior debt has been broadened to include promissory notes and registered bonds in addition to bearer bonds. Initial feedback from both houses of the German Parliament suggests that the envisaged priority treatment of issued certificates with variable payment promises will be subject to intense parliamentary scrutiny.

If enacted, depositors would — in insolvency as well as in bail-in — benefit from the subordination of senior unsecured debt instruments, reducing further the loss severity or, in the words of Moody's new bank rating methodology, the "loss-given-failure" (LGF) expectations for deposits. In contrast, the subordination of senior unsecured debt instruments would increase the LGF expectations for senior debt instruments, offering lower protection for senior bondholders.

In Moody's ratings for German banks, this proposed depositor preference has been reflected since 19 June with mostly positive rating outlooks for bank deposit ratings and for the most part negative outlooks for the same entities' senior unsecured ratings. According to Moody's estimates, the average pari passu ranking volume per bank for senior unsecured instruments would decline by five percentage points, while it would increase the subordination volume for deposits by 15 percentage points, driving the potentially diverging future LGF notching outcomes for debt and deposits. ●

BANKING

Global bodies review risk frameworks

Joint Forum releases report on credit risk management across sectors: The Joint Forum of the Basel Committee on Banking Supervision, the International Organisation of Securities Commissions (IOSCO) and International Association of Insurance Supervisors (IAIS) on 2 June released a report on credit risk management (CRM) across banking, securities and insurance sectors following a survey it conducted. Following its analysis of the responses and subsequent discussions with firms, the Joint Forum made the following recommendations:

- Supervisors should be cautious against over-reliance on internal models for credit risk management and regulatory capital.
- Supervisors should be alert to the growth of risk-taking behaviours in the current low interest rate environment, confirming the need for firms to have appropriate risk management processes.
- Supervisors should be aware of the growing need for high-quality liquid collateral to meet margin requirements for OTC derivatives sectors.
- Supervisors should consider whether firms are accurately capturing central counterparty exposures as part of their credit risk management.

FSB

FSB publishes review on Supervisory Frameworks and Approaches for SIBs: The Financial Stability Board (FSB) on 26 May published a thematic peer review on supervisory frameworks and approaches for Systemically Important Banks (SIBs). The review, which was conducted in collaboration with the Basel Committee on Banking Supervision, assesses progress towards enhancing supervisory frameworks and approaches for SIBs since the financial crisis, in particular for Global Systemically Important Banks (G-SIBs).

The peer review found that national authorities have taken significant steps to enhance supervisory effectiveness within their institutional frameworks, including



FSB chair Mark Carney
Photo: Bank of England

broader and more sophisticated supervisory tools and an expansion of the scope of supervision. The 13 G-SIBs surveyed as part of the peer review noted an increase in the intensity of supervision, particularly with regard to capital and liquidity. The report sets out a number of recommendations from the findings of the review where further work is needed. It recommends that supervisory authorities:

- Clearly define their supervisory strategy and priorities, establish a formal process for evaluating supervisory effectiveness against the stated strategy and priorities, and make further progress in attracting and retaining skilled supervisory resources.
- Further strengthen their engagement with banks, particularly at the board level and with senior management, with the objective of informing supervisory risk assessments through enhanced understanding of G-SIBs' business models.
- Press banks to improve their information technology and management information systems to provide robust and timely information on the institutions' risk on an enterprise-wide basis.
- Continue to ensure that data requests are effectively targeted and evaluated for purpose and intent, including via coordination between home and host authorities.

FSB launches second peer review on resolution regimes: The FSB on 13 April launched the second review of resolution regimes in FSB member jurisdictions, following the first review, in April 2013. The review aims to examine the range and nature of resolution powers that are available in FSB jurisdictions for the banking sector, and to take stock of any requirements for recovery and resolution planning for domestically incorporated banks in FSB jurisdictions that could be systemically significant or critical in failure. The FSB is inviting feedback from financial institutions, industry and consumer associations as well as other stakeholders on the implementation of reforms to resolution regimes in the areas covered by the review. This could include comments with regard to:

- the adequacy and nature of national resolution regimes for banks in FSB jurisdictions, including the institutional arrangements for resolution authorities and the role of the court in the resolution process;
- the scope and design of guidance by the authorities for entry into resolution and for the exercise of bank resolution powers;
- factors that may affect the way that resolution powers may be exercised in different resolution regimes and their implications for the effectiveness of those powers; and

- experiences and challenges with undergoing recovery or resolution planning and resolvability assessments.

The deadline for submission of feedback was 8 May.

BASEL COMMITTEE

Basel Committee consults on interest rate risk in the banking book: The Basel Committee on Banking Supervision (BCBS) on 8 June issued a consultative document on the risk management, capital treatment and supervision of interest rate risk in the banking book (IRRBB). The document expands upon and is intended at ultimately replacing the Basel Committee's 2004 "Principles for the Management and Supervision of Interest Rate Risk".

The Committee's review of the regulatory treatment of interest rate risk in the banking book is driven by two objectives. First, to help ensure banks have appropriate capital to cover potential losses from exposures to interest rates changes. Second, to limit capital arbitrage between the trading book and the banking book, as well as between banking book portfolios that are subject to different accounting treatments. The proposal presents two options for the capital treatment of interest rate risk in the banking book:

A Pillar 1 approach: the adoption of a uniformly applied Pillar 1 measure for calculating minimum capital requirements for this risk would have the benefit of promoting greater consistency, transparency and comparability, thereby promoting market confidence in banks' capital adequacy and a level playing field internationally.

An enhanced Pillar 2 approach: a Pillar 2 option, including quantitative disclosure of interest rate risk in the banking book based upon the proposed Pillar 1 approach, would better accommodate differing market conditions and risk management practices across jurisdictions.

The Basel Committee is seeking comments on the proposed approaches, which share a number of common features. The deadline for submission of comments is 11 September.

The BCBS publishes its 8th progress report on adoption of the Basel regulatory framework: This report sets out the adoption status of Basel II, Basel 2.5 and Basel III regulations for each Basel Committee member jurisdiction as of end-March 2015. The EU's and the US's adoption status regarding Basel II, Basel 2.5 and Basel III risk-based capital and Leverage Ratio is "adoption completed", whereas Basel III Liquidity Coverage Ratio (LCR) is still rated "adoption in process" for both jurisdictions. Canada and Switzerland have completed the adoption of all Basel components.

Basel Committee removes selected national discretions: The Basel Committee agreed to remove a number of national discretions from the Basel II capital framework on 21 April. The removal of certain national discretions was carried out in order to improve comparability across jurisdictions and reduce variability in risk-weighted assets. The relevant discretions relate to:

- Treatment of past-due loans;
- Definition of retail exposures;
- Transitional arrangements for corporate, sovereign, bank and retail exposures;
- Rating structure standards for wholesale exposures;
- Internal and external audit; and
- Re-ageing.

In addition, the national discretion with regard to the internal ratings-based treatment of equity exposures will expire in 2016. The Basel Committee intends to continue monitoring national discretions

and considering further removals from the framework.

Basel III implementation assessments of Hong Kong, Mexico and others:

On 16 March, the Basel Committee published reports assessing the implementation of the Basel risk-based capital framework and the LCR for Hong Kong SAR and Mexico. Overall, the assessment outcomes for both Hong Kong SAR and Mexico are positive and reflect various amendments to the risk-based capital and LCR rules undertaken by the authorities during the assessment. The Basel Committee noted that several aspects of the domestic rules in both countries are more rigorous than required under the Basel framework.

The Committee also published overviews of post-assessment follow-up actions by Brazil, China, Japan, Singapore and Switzerland. These five jurisdictions were assessed in 2012 and 2013 for their regulatory implementation of the risk-based capital standards. The follow-up reports summarise where the jurisdictions have taken, or plan to take, further actions to address findings raised in the Regulatory Consistency Assessment Programme (RCAP). The follow-up reports are based on self-reporting and have not been evaluated by the Basel Committee. The next post-RCAP monitoring report will be published in 2016 and will cover jurisdictions that were assessed in 2014.

EUROPEAN COMMISSION

European Commission extends transitional period for CCP exposures:

The European Commission (EC) on 4 June adopted an implementing act that will extend the transitional period for capital requirements for EU banking groups' exposures to central counterparties (CCPs) under the Capital Requirements Regulation (CRR). The CRR introduced a capital requirement for the exposures of EU

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

banks and their subsidiaries to a CCP. The transitional period was set to expire on 15 June, although as the authorisation and recognition processes for existing CCPs serving EU markets will not be fully completed by that date, the EC has adopted an implementing act that will now extend the transitional phase to 15 December 2015. The extension period is intended at smoothing implementation for CCPs that are still in the process of reauthorisation under the EC's new rules.

EBA

EBA issues amended technical standards on Leverage Ratio disclosure and reporting:

The European Banking Authority (EBA) on 15 June published its updated Implementing Technical Standards (ITS) on disclosure and supervisory reporting of Leverage Ratio for EU institutions. The ITS include changes to templates and instructions to update the Leverage Ratio disclosure and reporting framework following the European Commission's adoption of the Delegated Act on the Leverage Ratio on 10 October 2014. These ITS aim to harmonise reporting and disclosure of the Leverage Ratio across the EU by providing institutions with uniform templates and instructions. The EBA final draft ITS include all items relevant for Leverage Ratio disclosure. The disclosure framework set out in the ITS consists of four templates:

- A table reconciling the figures of the Leverage Ratio denominator with those reported under the relevant accounting standards
- A table providing a breakdown of the Leverage Ratio denominator by exposure category
- A table providing a further breakdown of the Leverage Ratio denominator by group of counterparty
- A table with qualitative information on leverage risk

Compared to the version submitted to the European Commission on 5 June, the amended version has been updated



to reflect the changes introduced by the Commission's Delegated Act on the Leverage Ratio while ensuring consistency with the reporting templates. In addition, the review of the existing reporting templates structure has been made in line with the new requirements in the Delegated Act. The amendments will, on aggregate, lead to a reduction in size, with a lower number of cells as a result. Validation rules, Data Point Model (DPM) and XBRL taxonomies reflecting the amended templates are being finalised and will be published in the near future. The draft ITS will become applicable as of the day following their publication in the Official Journal of the European Union.

EBA issues technical advice on contributions to the Single Resolution Fund:

The EBA on 10 June issued technical advice to the European Commission on the criteria and principles to be used in determining the uniform level of contributions by banks in the participating EU Member States to the Single Resolution Fund (SRF). The core objective of the advice is to ensure that the SRF has sufficient means to support resolution measures in the participating EU Member States. The advice provides a number of recommendations on which safeguards should be in place to ensure

that the target level of the SRF (at least 1% of the amount of covered deposits of all credit institutions authorised in all of the participating EU Member States) is achieved by the end of the initial period. This means by the end of eight years from 1 January 2016 or from the date on which this provision is applicable. Contributions may, to the extent possible, exceptionally take into account pro-cyclical effects, and vary accordingly instead of being spread out evenly over the initial period. The EBA's advice recommends a number of indicators for determining the phase of the business cycle and the risk of pro-cyclical effects and specifies constraints for the variations of the contribution level. The advice also specifies the criteria for determining the contribution level after a significant amount of the fund has been used to support resolution measures and the SRF needs to be replenished. In this case, similar considerations as for the initial build-up of the fund apply. However, the process may be sped up quite significantly to ensure that the target level is achieved as soon as possible, which could result in contributions of up to twice the amount of the contributions made in previous years. Pooling financial resources into this common fund will be crucial for a successful implementation of the Banking Union. The technical advice will inform a delegated act to be adopted by the Commission on the initial period for the contributions to the SRF.

EBA publishes final draft standards on assessment methodologies to use Advanced Measurement Approaches for operational risk:

The EBA on 5 June published its final draft Regulatory Technical Standards (RTS) specifying the qualitative and quantitative criteria that competent authorities need to consider before permitting institutions to use Advanced Measurement Approaches (AMAs) for calculating their capital requirements for operational risk. These RTS also set out criteria for the supervisory assessment of the key methodological components of the operational

risk measurement system, ensuring this methodology effectively captures banks' actual and potential operational risk, is reliable and robust in generating AMA regulatory capital requirements, and is comparable across institutions. The RTS also provide common standards for the supervisory assessment of a bank's operational risk governance with respect to the role and responsibilities of the operational risk management function and the reporting system, and establish criteria for the supervisory assessment of banks' data quality and IT systems, the requirements and terms for an institution to use its AMA in the running of its business, and the terms and scope of audit and internal validation of the AMA framework. The revised RTS take into account feedback received during the public consultation period in 2014. In particular, clarifications and amendments have been introduced to clarify the scope of operational risk, as well as the scope of operational risk loss, the treatment of fraud losses in the credit area, and the perimeter of conduct risk events. These RTS will be part of the Single Rulebook aimed at enhancing regulatory harmonisation in the banking sector across the EU.

EBA consults on passport notifications for mortgage credit intermediaries: The EBA on 4 June launched a consultation on the draft guidelines for passport notifications for mortgage credit intermediaries under the Mortgage Credit Directive (MCD). The guidelines seek to ensure that information about credit intermediaries carrying out business in one or more Member States is exchanged consistently between the national authorities of the home and host Member States. In line with the MCD, passport notifications will need to be exchanged between national authorities competent for the registration and/or supervision of mortgage credit intermediaries across Member States. This will ensure that information on the provision of services and the establishment of branches, as well as on the transmis-



sion of notifications, the registrations, and the notifications of changes is shared consistently across the EU. This public consultation period runs until 4 July. The EBA expects to be able to deliver the final guidelines in Q3 2015, which would apply from 21 March 2016, the transposition date of the MCD.

EBA updates risk dashboard for EU banking sector: The EBA on 3 June published the periodical update of its risk dashboard. The risk dashboard is part of the regular risk assessment carried out by the EBA and complements the semi-annual risk assessment report. It is based on Q4 2014 data and takes into consideration the evolution of a set of key risk indicators from 55 EU banks that the EBA has been collecting on a quarterly basis since 2009. The risk dashboard notes the following:

- EU banks' capital remained strong in Q4 2014, with a CET1 ratio of 12.1%;
- the quality of banks' loan portfolios is largely unchanged;
- profitability showed a mildly positive trend on a year over year comparison, but return on equity remained subdued and materially below banks' average cost of equity; and
- the EU average loan-to-deposit ratio decreased in Q4 2014.

EBA publishes equivalence questionnaire: The EBA on 2 June published a questionnaire to guide its assessment of non-EU countries' equivalence with the EU prudential supervision and regulatory requirements specified in the Capital Requirements Regulation (CRR) and Directive (CRD). The questionnaire, which will be sent to selected countries in a number of rounds, will facilitate data collection and allow the EBA to provide technical advice on their supervisory regimes

EBA publishes guidelines on contributions and payment commitments to deposit guarantee scheme: The EBA published on 28 May its final guidelines on contributions to deposit guarantee schemes (DGSs) and on payment commitments. The guidelines assist in ensuring consistent application of the new funding mechanisms provided for in the new Deposit Guarantee Schemes Directive (DGSD). The DGSD aims to increase the resilience of DGSs and improve depositors' access to compensation. All DGSs in Europe will now have to be pre-financed by credit institutions. Depositors will be compensated quicker and in case of failure at a branch of a bank established in a different Member State, will benefit from the assistance of their own local DGS acting as a one-stop-shop.

- **DGS contributions:** The guidelines confirm that contributions will be risk-based, reflecting the risk-profile of each credit institution and not only the amount of guaranteed deposits it has collected, therefore encouraging risk discipline and addressing moral hazard. Under the guidelines, calculations will include risk indicators covering aspects such as capital, liquidity, asset quality, and business model and asset encumbrance. These obligatory indicators will represent 75% of the risk-assessment, meaning that authorities and DGSs are able to allocate the remaining 25%, either by increasing the weights of some core indicators above the minima, or by introducing additional risk indicators, to take into account the specificities of credit institutions. However, any new indicator or increase in the weight of an existing obligatory indicator may not exceed 15%, except for qualitative indicators in the risk category “business model and management”, where full flexibility is allowed in order to properly reflect the diverse characteristics of institutions.

- **DGS payment commitments:** The guidelines on payment commitments further specify the option for DGSs to authorise credit institutions to contribute up to 30% of the required contributions in the form of secured commitments to pay upon request. The unfunded commitment will have to be collateralised with low risk assets that could be easily mobilised in case the institution was unable to meet its commitment. The guidelines also outline that that these assets should as much as possible be uncorrelated to events that might result in a bank failure, hence a risk of compensation payment by the DGS. Collateral will be subject to regular marking to market and precautionary haircuts in order to cater for possible losses at the point of failure.

Institutions will have to contribute to DGSs at least annually from the transposition deadline on 3 July. The implementation of the guidelines by DGSs and designated authorities is scheduled before the end of 2015. Whilst a full review of DGSs by the EBA is scheduled by 3 July 2017, the EBA is to assess progress in the convergence of national practices in calculating contributions to DGSs before that date.

EBA publishes guidelines on triggers for resolution:

The EBA on 26 May published its final guidelines on the circumstances under which an institution shall be considered as “failing or likely to fail”. Although determining whether an institution is failing or likely to fail remains the discretionary assessment of the relevant authority, the guidelines outline broad elements on the basis of which this judgment should be based. The guidelines aim to promote convergence of EU supervisory and resolution practices in order to ensure a consistent approach to triggering resolution, especially for cross-border groups. The guidelines are addressed to supervisors and resolution authorities and will apply from 1 January 2016 following the implementation of the EBA guidelines on common procedures and methodologies for the supervisory review and evaluation process.

EBA issues guidance on resolution tool implementation: The EBA on 20 May published three sets of final guidelines that aim to facilitate the implementation of resolution tools in the EU banking sector. The three sets of guidelines comprise of:

- **Guidelines on the sale of business tool:** these guidelines specify that authorities may deviate from standard marketing requirements for the sale of the business of an institution under resolution on the grounds that the failure of the institution represents a material threat to financial stability and there is a conflict

between the effectiveness of the tool and the marketing requirements;

- **Guidelines on the asset separation tool:** these guidelines outline the three steps involved in analysing assets for the purposes of transferring them under the “asset separation tool” to an asset management vehicle (“bad bank”). The three steps consist of assessing the market situation for the assets concerned, the impact that their liquidation may have on markets, and the effects that may result on financial stability; and

- **Guidelines on the minimum list of services:** these guidelines define a minimum list of necessary “critical” services that resolution authorities may require under resolution. The guidelines stem from the Bank Recovery & Resolution Directive (BRRD) and intend to promote convergence on resolution matters by giving detailed guidance to resolution authorities regarding the circumstances they should assess when taking resolution decisions. The guidelines are addressed to competent authorities and will apply from 1 August. Competent authorities will be required to confirm their compliance status within two months of the publication of the translated guidelines, which will be disclosed on the EBA website.

EBA consults on derivatives valuation:

The EBA on 13 May launched a public consultation on its draft RTS defining the valuation of derivative liabilities for bail-in in resolution. The standards were developed within the BRRD framework and use a statutory valuation methodology based on the costs or gains that would be incurred by the counterparty in replacing the contract. Derivative counterparties can provide evidence of commercially reasonable replacement trades and determine the close-out amount within a certain deadline; and, if they do not, resolution authorities will apply their valuation based on mid-market prices and bid-offer spreads. The consul-

tation also covers timings of valuations and potential exemptions from the requirement. The framework proposed in the EBA standards will allow resolution authorities and independent evaluators to effectively conduct a reliable valuation in a short timeframe. The consultation runs until 13 August.

EBA updates list of closely correlated currencies: The EBA on 13 May updated the list of closely correlated currencies under Article 354 of the CRR. The list was first published in December 2013 as part of the ITS that were drafted for the purposes of calculating capital requirements for foreign-exchange risk according to the standardised rules. The list was updated according to the procedure and methodology laid down in the ITS.

EBA consults on specialised lending exposures: The EBA on 11 May launched a consultation on RTS on specialised lending exposures. The proposed RTS seek to specify how institutions should take into account several factors when assigning risk weights to specialised lending exposures (project finance, real estate, object finance, and commodities finance) and how they should treat these factors. The consultation runs until 11 August, with a public hearing taking place at the EBA premises on 6 July.

EBA publishes final Guidelines on triggers for use of early intervention measures: The EBA published on 8 May its final Guidelines on triggers for the use of early intervention measures following its public consultation. The Guidelines aim to promote convergence of supervisory practices for the application of early intervention measures provided for in the BRRD. The Guidelines establish a link between the ongoing supervision conducted by the competent authorities according to the CRD and the early intervention powers set out in the BRRD.

EBA issues final guidance on recovery indicators: Following consultation in

September, the EBA on 6 May published its final guidelines on the minimum list of qualitative and quantitative indicators that credit institutions and investment firms across the EU should include in their recovery plans and will function as triggers for the recovery plans, as prescribed by the BRRD. The list comprises indicators grouped into different categories such as capital, liquidity, profitability, asset quality and macroeconomic/market-based indicators (where relevant to the characteristics of the specific institution). These indicators will serve to identify the points at which appropriate recovery measures should be considered. The guidelines are addressed to competent authorities and will enter into force on 31 July.

EBA consults on a revised data template for the identification of G-SIIs: the revision is prompted by the template introduced by the Basel Committee on Banking Supervision in January. The consultation proposes amendments to EBA's (i) RTS for identifying Global Systemically Important Institutions (G-SIIs), (ii) ITS on special disclosure rules applicable to G-SIIs, and (iii) final guidelines on special disclosure rules for large institutions. The consultation ran until 20 May.

EBA updates its report on the monitoring of AT1 instruments: On 4 May, the EBA published an update of its report on the monitoring of Additional Tier 1 (AT1) instruments. The first report was published in October 2014. The EBA has now reviewed the terms and conditions (T&Cs) of 15 AT1 instruments (from 9 in the first report) for a total amount of €21.4bn.

This monitoring, based on Article 80 of the CRR on the continuing review of quality of own funds, will necessitate several iterations. As such, future AT1 issuances may influence the EBA's conclusions. Furthermore, the EBA will develop standardised T&Cs for AT1 issuances that will cover the prudential parts of

the terms and conditions. This update contains some final conclusions on issues previously flagged as being under investigation. Below, a summary of the main changes/new point addressed from the first report:

- Disapplication of the mandatory interest cancellation: not allowed. Although the EBA acknowledges the benefits of debt accounting (e.g. hedging) under IFRS permitted by this feature, the EBA recommends disallowing this type of contingent clause.
- Shareholder claw-back right: The EBA has changed its stance and now agrees that this feature is acceptable.
- Relationship between instruments with different triggers (e.g. 5.125% and 7%): losses corresponding to the amount required to go back to 5.125% should be absorbed by both the low trigger and the high trigger instruments on a pro rata basis. Losses above 5.125% will only be supported by the high trigger instruments.
- Tax gross up clauses: EBA clarifies that the clause gets activated by a decision of the local tax authority of the issuer, not of the investor; increased payments should only be possible if they do not exceed distributable items; gross up cases should be allowed only in relation to dividend/coupon withholding tax.
- Regulatory call: Partial derecognition from AT1 capital owing to write-down or conversion will not be considered as an eligible trigger for a regulatory call.
- Potential changes in the regulatory assessment cannot be considered as valid triggers for regulatory or tax calls.
- AT1 issuances by group subsidiaries: the instruments issued by an institution controlled by a holding company should include a trigger event on the basis of the consolidated CET1 of the parent financial holding company or parent mixed

financial holding company to ensure the recognition of the AT1 at the holding company level.

The updated report was initially published as a draft final report and after a public hearing on 18 May the EBA published the final version with no changes from the draft.

EBA reviews EU colleges of supervisors for cross-border banking groups:

The EBA on 16 April published its annual assessment of EU colleges of supervisors, responsible for the oversight of cross-border banks. The report reviews how colleges functioned during 2014 and also identifies key activities for the effective oversight of EU cross-border banking groups in 2015. The report introduces items for supervisory attention in 2015, including conduct risk, information technology risks, and the need for effective decisions on recovery plans. In 2015, close monitoring of capital plans, as part of their regular assessments, will also be vital as a follow-up to last year's stress tests. This is to ensure that EU banks preserve their strong capital positions and facilitate investigations of potential future weaknesses. In addition, supervisors will closely monitor credit risk management and undertake benchmarking of internal model outcomes.

EBA publishes first annual report on supervisory convergence:

On 9 April, the EBA published its first annual report to the EU Parliament and the Council on the convergence of supervisory review practices in the EU banking sector. The report follows a three year assessment and focuses on Supervisory Review and Evaluation Process and assessment of risks (SREP), supervisory stress testing, ongoing review of internal models, and supervisory measures and powers. The report highlights that while supervisory authorities across the EU have made significant progress in improving the convergence of their supervisory practices since 2011, further steps are needed in

order to reduce differences in methodologies, practices and supervisory measures. The EBA will provide training and use monitoring tools to assess implementation in the next report on supervisory convergence in 2016.

EBA publishes equivalence recommendation:

The EBA published on 1 April a recommendation regarding the confidentiality regime of several non-EU supervisory authorities to facilitate their participation in supervisory colleges overseeing international banks, led by EU supervisors. The paper looks at the conditions that need to be met in terms of confidentiality requirements and gives an overview of equivalence to EU standards. The work aims to harmonise the application of Article 116(6) of the CRD in the composition of supervisory colleges. The authorities included are from Bosnia & Herzegovina, Brazil, Canada, China, FYR Macedonia, Mexico, Montenegro, Serbia, Singapore, Switzerland, Turkey, and the US. Competent authorities were requested to notify the EBA as to whether they comply or intend to comply by 2 June.

EBA consults on exposures to shadow banking:

According to Article 395(2) of CRR, the EBA has a mandate to develop guidelines to set limits on EU institutions' exposures to shadow banking entities. The consultation was launched on 19 March and closed on 19 June. There is no definition of shadow banking entities in the CRR. Therefore the EBA proposes that all funds would be considered as falling in the scope of the definition of shadow banking entities except if they are non-MMF (money market funds) UCITS. The guidelines foresee two approaches for setting limits. Under the principal approach, the limits will be set using criteria based on sufficient information about counterparties. Where the level of information is insufficient, the fallback approach will be used and sets a limit of 25% of the eligible capital.

The EBA advises on resolution procedures for EU banks:

On 6 March, the EBA issued advice to the European Commission on the resolution framework for EU banks, covering the definition of critical functions and core business lines, as well as rules for the exclusion of liabilities from the application of the bail-in tool. The EBA advice on critical functions is based on its work on rules for recovery planning and on a comparative analysis of the recovery plans of 27 European cross-border banking groups, which identified key strengths and weaknesses in banks' approaches. The EBA delivered advice that will inform delegated acts on the BRRD.

Technical advice on the delegated acts on critical functions and core business lines:

the substitutability of a function for the real economy, risk of contagion and loss of market confidence should be taken into consideration by national authorities, which should evaluate the potential impact that the resolution of an institution can have on financial markets and the real economy. Such analysis should be based on the analysis carried out by the concerned institution and complemented by a critical review by competent authorities and resolution authorities. This work is based on the EBA's work on rules for recovery planning and its "Comparative report on the approach to determining critical functions and core business lines in recovery plans".

Technical advice on the delegated acts on the circumstances when exclusions from the bail-in tool are necessary:

the EBA pointed out that the characteristics of an institution (e.g.: size, interconnectedness or complexity) should not automatically justify such exemptions. These should in fact be considered on a case-by-case basis, rather than by considering the specific nature of concerned institutions in isolation. The advice also recommends that

exclusions should be used restrictively, as they are exceptions to the principle of equitable treatment of creditors of the same class and with a view to the no-creditor-worse-off principle the resources for absorbing losses despite exclusions are limited.

Technical advice on delegated acts on the deferral of extraordinary ex-post contributions to financial arrangements: regarding the deferral of ex post contributions to the “resolution fund” provided by the BRRD and to which all EU institutions have to contribute, the EBA recommended that national authorities analyse the impact on solvency and liquidity of institutions before allowing for ex post contributions, which should only be applied in exceptional cases

EBA delivers benchmarking package:

EBA on 2 March published a set of papers for benchmarking the internal approaches used to calculate own funds requirements for credit and market risk exposures. The EBA final draft RTS and ITS specify in detail the framework for EU institutions and competent authorities to carry out the annual supervisory benchmarking foreseen by the CRD. The EBA also issued its response to a call for advice by the European Commission on the benchmarking process. This work is part of the EBA's efforts to address possible inconsistencies in the calculation of risk-weighted assets across the EU Single Market. The first benchmarking exercise conducted under the ITS and RTS framework will be based on data referred to Q4 2015 observations. Institutions shall report the information by 11 April 2016.

NATIONAL AUTHORITIES

Austrian FMSB recommends systemic risk buffer of up to 3%: On 1 June, the Austrian Financial Market Stability Board (FMSB) recommended to the Austrian Financial Market Authority (FMA) the introduction of a systemic risk buffer of up to 3% over the 8% minimum SREP-



ratio for large Austrian banks by 1 July 2016, with a transition period of one year until 20 June 2017 to comply with the 3% buffer. The 3% comprises a 1% buffer to take account of the systemic vulnerability of Austrian banks and a buffer of up to 2% to address systemic risk concentration.

Denmark seeks inclusion in the EU Banking Union:

The Danish government supports a plan to join the EU Banking Union. According to the Ministry of Justice, the parliament will be able to vote on Denmark's participation in the Banking Union without a Referendum. It would be the first non-Eurozone country to submit its banking sector to European Central Bank supervision.

Swedish FSA proposes to amend countercyclical capital buffer regulations:

Finansinspektionen, Sweden's financial supervisory authority, on 26 May made a proposal to amend regulations on the countercyclical capital buffer. Finansinspektionen made the decision in September to set a countercyclical capital buffer for Sweden at 1.0% (FFFS 2014:33), which shall apply from 13 September 2015. Finansinspektionen is now proposing that the countercyclical capital buffer for Sweden should be set at 1.5% from 27 June 2016, given the present economic conditions. The proposal is based on a qualitative assessment that takes ac-

count of quantitative factors, including the buffer guide. Comments regarding the proposal were accepted until 8 June.

UK PRA not to take forward IRB proposals:

On 10 March, the UK Prudential Regulation Authority (PRA) announced that it would not take forward at this time proposals to amend SS11/13 “Credit risk – Internal ratings-based (IRB) approaches” on which it consulted in CP12/14 “CRD IV: updates for credit risk mitigation, credit risk, governance and market risk”. The PRA has considered feedback received on its consultation and the Basel Committee's announcement of its intention to develop specific policy proposals, and will consider this issue further, particularly in light of international developments, and may revert in due course.

HKMA announces D-SIBs designation:

The Hong Kong Monetary Authority (HKMA) on 16 March announced the designation of five authorised institutions as Domestically Important Systemic Banks (D-SIBs). Each of the authorised institutions designated as a D-SIB will be required to include a Higher Loss Absorbency (HLA) requirement into the calculation of their regulatory capital buffers within a period of 12 months. In line with the phase-in arrangements in the frameworks issued by the Basel Committee for assessing D-SIBs and G-SIBs, the full amount of the HLA requirement will be phased-in from 2016 to 2019 in parallel with the capital conservation buffer and countercyclical capital buffer. Ultimately, the HLA requirement applicable to a D-SIB (which is expressed as a ratio of an authorised institution's Common Equity Tier 1 capital to its risk-weighted assets as calculated under the Banking (Capital) Rules) will range between 1% and 3.5% (depending on the assessed level of the D-SIB's systemic importance). However, under the phase-in, the levels of HLA for 2016 will be within a range of 0.25% to 0.875%. The HKMA intends to update the list of D-SIBs and their applicable HLA requirement annually.

RATING AGENCIES

S&P applies its ALAC criteria to UK, German, Austrian, and Swiss banks:

On 9 June Standard & Poor's took various rating actions on several systemically important banks domiciled in the UK, Germany, Austria and Switzerland on the back of the first implementation of its Additional Loss-Absorbing Capacity (ALAC) criteria.

S&P had published the final ALAC criteria on 28 April. ALAC is a new rating component that can provide extraordinary external support for banks and hence potentially mitigate the expected removal of government support currently embedded in banks' Issuer Credit Ratings (ICRs). The final criteria contained some important changes and clarifications compared to the request for comment (RFC) published in November 2014:

- **ALAC uplift:** A bank with an SACP of "a-" may receive two notches of ALAC uplift. In the RFC, the ALAC uplift was limited to one notch for banks in the whole "a" Stand-Alone Credit Profile (SACP) range. In addition, ALAC thresholds (in % of S&P RWA) vary by anchors (the starting point of a bank's SACP). The ratings of non-operating holding company are eligible to ALAC uplift subject to certain conditions.
- **ALAC-eligible instruments:** Hybrids and common equity in excess of the minimum threshold needed to maintain a Risk-Adjusted Capital (RAC) ratio consistent with S&P's capital and earnings score (e.g. Adequate for 7% RAC ratio). Excess common equity was not eligible as ALAC in the RFC. The eligibility of excess equity will reduce ALAC needs to retain current ratings.
- **Adjustments to ALAC thresholds:** S&P has clarified the nature of upward/downward adjustments criteria to ALAC thresholds. For example, any concentration of maturities or lack of ALAC fungibility within a group may lead to higher ALAC thresholds. ALAC threshold may be lower for a

bancassurance group because S&P may restate the impact of insurance capital in S&P's RWA. S&P may also take into account the benefit a pre-funded resolution fund.

- **Transition period:** For a bank whose ramp-up of ALAC in response to regulatory requirements will continue beyond the two year projection period, S&P may consider the potential for extraordinary government support to make up for a shortfall in ALAC, relative to the level required for the first notch of uplift. In this situation, the potential for extraordinary government support provides a maximum of one notch of uplift over the SACP and may be considered over a projection period of only three to four years. This is particularly relevant to G-SIBs subject to TLAC requirements expected to be implemented in 2019.

Key takeaways of the S&P rating actions on systemically important banks in the aforementioned countries included:

- In Germany, Austria and the UK, S&P considers that government support is now "uncertain", meaning that S&P now includes no such uplift in the ratings of systemic banks domiciled in these countries. For some banks, the ALAC buffer has mitigated the removal of government support (e.g. Barclays, Nationwide, Lloyds, HSBC and Standard Chartered in the UK).
- For Deutsche Bank, S&P includes no notches of ALAC uplift. Proposed changes in German law will likely subordinate certain senior unsecured bonds but S&P does not expect to include these senior unsecured bonds in ALAC.
- In Switzerland, the outlook on Credit Suisse AG, UBS AG and their core subsidiaries was revised to stable from negative. This reflects S&P's view that the banks' sizeable and growing buffers of ALAC are likely to offset any decline in the prospect of extraordinary government support.

- Of note, S&P has adjusted upwards (25bp or 50bp) the ALAC thresholds where it considers that loss-absorbing capacity may be positioned in a way that would make it challenging for them to deploy it flexibly in a stress scenario (e.g. HSBC, CS, UBS, SC). Lloyds benefits from a lower threshold (4.5%) because of the adjustment for the portion of Lloyds' insurance operations expected to be outside the scope of required bail-in capitalisation.

Fitch downgrades European bank ratings on sovereign support:

Fitch downgraded the Long Term Issuer Default Ratings (IDRs) of around 45 EU banks and their subsidiaries on 19 May. The rating actions include revisions to Fitch's assessment of sovereign support for banks globally and follow peer rating reviews in several European countries and sectors. For US IDRs, the review includes considerations of the relative ratings of operating companies and holding companies. In line with Fitch's expectations announced in March 2014, it believes legislative, regulatory and policy initiatives have significantly reduced the likelihood of sovereign support for commercial banks in the US, Switzerland, the EU and Hong Kong. Fitch believes this development is being balanced to a large extent by stronger balance sheets and buffers to senior debtholders at banks, with this progress reflected in Fitch's rating actions. For banks with long term, strategic state ownership, Fitch has conducted bespoke analysis of the likelihood of continued support for the individual banks given the increased regulatory and legal constraints.

Moody's publishes new bank rating methodology:

Moody's on 16 March published its updated methodology for rating banks globally, which incorporates several new components:

- a Loss Given Failure (LGF) analysis; the introduction of a Macro Profile into the elements that Moody's considers when it assigns a bank's base-

line credit assessment (BCA);

- a BCA scorecard that now incorporates not only financial ratios but also a broader range of metrics and qualitative considerations; and
- a Counterparty Risk Assessment (CR Assessment).

The LGF analysis addresses expected loss and assesses the impact a bank's failure would have on its various debt instruments and deposits in the absence of any support. For banks subject to operational resolution regimes, the LGF analysis will incorporate the cushion against loss that each creditor class derives from the amount of debt subordinated to it in a resolution. The notching will be based on:

- (1) the likely bank-wide loss rate in failure;
- (2) the amount of subordination below a given instrument class; and
- (3) the volume of a given instrument class itself.

INSURANCE

EUROPEAN COMMISSION

The European Commission adopts its first third-country equivalence decisions under Solvency II: On 5 June, the European Commission (EC) published the delegated acts on equivalence under Solvency II for the following jurisdictions:

- Switzerland: granted full equivalence in all three areas of Solvency II: solvency calculation, group supervision and reinsurance. Equivalence is granted for an indefinite period.
- Australia, Bermuda, Brazil, Canada, Mexico and the US: granted a provisional equivalence covering solvency calculation for a period of 10 years.

After receiving equivalence, EU insurers can use local rules to report on their operations in third countries, while third-country insurers are able to operate in the EU without complying with all EU rules.

European Commission discusses a possible proposal for an EU recovery and resolution regime for insurance:

On 5 March, the Expert Group on Banking, Payments and Insurance (EGBPI) held a meeting to discuss a working document on a possible proposal for an EU recovery and resolution regime for insurance. The key topics discussed in this document are:

- Rationale for an insurance recovery and resolution regime: In the absence of a resolution regime, the document points out the possible risks to financial stability as well as social risks associated with the winding-up of an insurer. A resolution regime should seek to address these risks. It is also noted that the absence of an EU recovery and resolution framework may also limit policyholders' trust and freedom of choice.
- Scope and tools of a possible EU recovery and resolution framework: The scope of an EU resolution proposal could be (i) limited to the systemic (re)insurers that have been designated by the FSB only, (ii) include all cross-border insurers, or (iii) include all insurers. The following tools could form the core of a possible proposal: transfer of portfolios of insurance contracts, creation of a bridge institution, suspending policyholders' rights to withdraw from their contracts, and restructuring of any liabilities (including guarantees to policyholders and beneficiaries). The document states that additional capital and minimum loss-absorbing capacity requirements (akin to the TLAC or MREL rules in banking) do not appear to be necessary in the context of insurer resolution.
- Insurance guarantee scheme (IGS): There is currently no specific EU IGS legislation and the existing IGS models vary extensively across Member States. The document discusses various options relating to the timing and the scope of intervention.
- Interplay with the Solvency II framework: The Solvency II Directive

contains a title on the reorganisation and winding up of (re)insurance undertakings, but does not address recovery and resolution.

EIOPA

EIOPA issues opinion on internal model applications: EIOPA on 14 April published an opinion on internal models directed at National Competent Authorities (NCAs). The opinion provides the following recommendations:

- NCAs should require the risks related to sovereign exposures to be appropriately taken into account in internal models;
- Guidance for NCAs to assess applications prepared in the absence of some related formal decisions, including decisions on granting equivalence to third countries; and
- NCAs should carry out comparative studies at the NCA level and contribute to and make use of corresponding studies on the EU level coordinated by EIOPA. EIOPA believes that it is good practice that NCAs gain insights from the comparison of different internal models.

EIOPA plans to continue monitoring the approval processes of internal models and working on their convergence to ensure a common union supervisory culture and consistent supervisory practices.

UK

PRA sets expectations on EIOPA Set 1 Guidelines:

The Prudential Regulation Authority (PRA) on 22 April published a supervisory statement (SS22/15) on applying EIOPA's Set 1 Guidelines on Solvency II to PRA-authorised firms. The statement confirms the PRA's expectation that firms comply with all of the Set 1 Guidelines in a proportionate manner. It also provides further commentary on certain guidelines where additional considerations, largely set out in previous PRA supervisory statements, should be taken into account by firms. The further commentary concerns

ancillary own funds; classification of own funds; ring-fenced funds; treatment of related undertakings, including participations; loss-absorbing capacity of technical provisions and deferred taxes; and group solvency calculation.

PRA publishes supervisory statement on volatility adjustment: PRA on 1 June published a supervisory statement on the approval for the use of the volatility adjustment (VA). The statement provides the following clarifications:

- Items that should be included in an application to use the VA, including various risk management related assessments
- Three statutory conditions for approval to use the VA:

- (1) the VA is correctly applied to the relevant risk-free interest rate term structure in order to calculate the best estimate
- (2) the firm does not breach a relevant requirement as a result or consequence of applying the VA
- (3) the application of the VA does not create an incentive for the undertaking to engage in procyclical investment behaviour

- Interaction with other Solvency II approval processes. The PRA will consider matching adjustment (MA) and VA applications in parallel, if requested to do so by a firm. Firms must make clear in their applications which is the preferred measure, and which is the alternative measure in the event that the preferred measure is not approved.

The PRA consults on the consistency of UK GAAP with the Solvency II directive: On 10 April, the PRA published a consultation paper setting out its expectations of firms in relation to the valuation of some assets and liabilities using the UK GAAP for Solvency II purposes. This derogation stems from Article 9 (4) of the Delegated Acts subject to the following conditions:

- UK GAAP is consistent with Article

74 of the Solvency II directive

- The valuation is proportionate of the nature, scale and complexity of the firms' business
- The use of IFRS principles would impose disproportionate costs

The consultation is addressed at firms reporting under UK GAAP rather than IFRS and closes on 10 July.

PRA consults on the treatment of sovereign debt in internal models: On 31 March, the PRA published a consultation paper on the treatment of sovereign debt in internal models (CP14/15) under Solvency II. The purpose of the PRA statement is to ensure that firms using an internal model take into account material risks associated with sovereign debt. The statement expands on the PRA's general approach as set out in its insurance approach document. The paper addresses the following points:

Definition of sovereign debt:

Bonds and loans issued or guaranteed by counterparties including but not limited to central banks, central governments and supranational organisations.

Compliance with Solvency II requirements:

The PRA considers that sovereign debt as an asset class can give rise to market risk and credit risk. The PRA also expects firms to consider a particular basis risk that arises under Solvency II when sovereign bonds are used to back liabilities. This is because the spread between sovereign bond yields and the "risk-free rate" (used to discount liabilities) can fluctuate, thereby leading to assets and liabilities mismatches. If a firm does not include these risks, where material, in its internal model, the model will not fulfil the requirements.

PRA issues policy statement on Solvency II implementation: This document, published on 20 March, provides feedback on the responses received in

relation to the following consultations to implement Solvency II: CP16/14: Transposition of Solvency II: Part 3; CP22/14: The PRA's approach to with-profits insurance business; CP23/14: Solvency II approvals; CP24/14: Solvency II: further measures for implementation; and CP3/15: Solvency II: transitional measures and the treatment of participations. In this document, the PRA comments on the most significant issues raised by respondents and introduced the following notable changes:

- Transitional measures: Amendments reflecting recent changes to statutory legislation which has simplified the approach.
- Third-country branches: deletion of the proposed Third-Country Branches 13.2 concerning restrictions in calculating worldwide financial resources from the final rules. The PRA intends to consult in the summer of 2015 on the adoption of EIOPA's Guidelines for branch supervision.
- With-profits: amendments to the definitions of "with-profits fund" and "with-profits policy liabilities", and to the supervisory statement in order to clarify the material regarding affordable and sustainable distribution strategies.

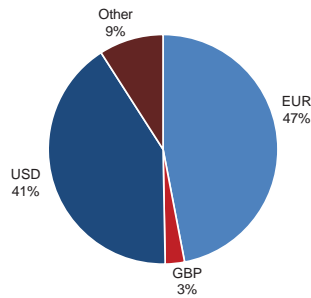
FRANCE

Update on Solvency II implementation in France: The order transposing the Solvency II directive in France was published in the Official Journal on 3 April. Separately, on 1 April, the Autorité de contrôle prudentiel et de résolution (ACPR) communicated on the use of the matching adjustment. This measure is not compatible with the transitional arrangements relating to interest rates nor the volatility adjustment. ●

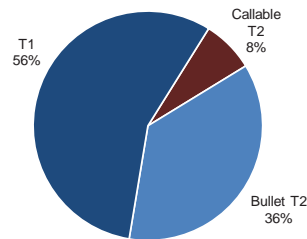
Michael Benyaya, Jonathan Blondeau, Julian Burkhard, Cyril Chatelain, Victor Laidler
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Currencies, structures and distribution

Bank hybrid issuance by currency (2015 ytd)

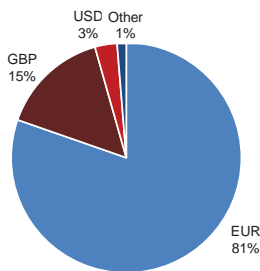


Bank issuance by instrument/structure (2015 ytd)

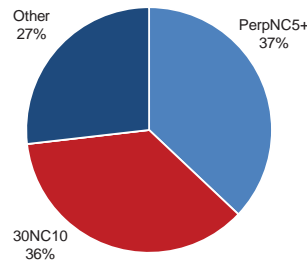


Source: Crédit Agricole CIB

Insurance hybrid issuance by currency (2015 ytd)

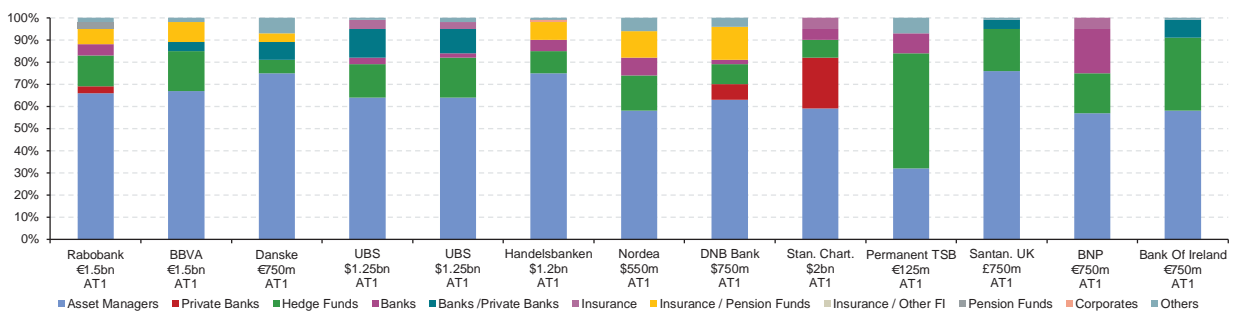


Insurance issuance by instrument/structure (2015 ytd)

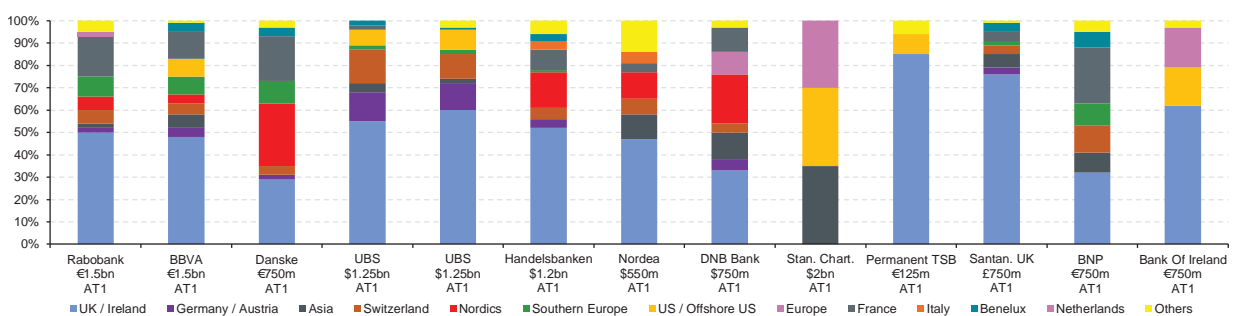


Source: Crédit Agricole CIB

Distribution by investor type



Distribution by geography



Source: Crédit Agricole CIB

AT1, Tier 2 CoCos

AT1 performance monitoring (as at 19/6/15)

Launch	Issuer	Issue ratings	Currency	Amount (m)	Coupon	Maturity date	First call date	Principal loss absorption	Trigger	Price	I-Spread	Yield to call
11-Jun-15	BKIR	B2/-/-	EUR	750	7.375%	Perpetual	18-Jun-20	TWD	5.125%	99.31	714	7.51
10-Jun-15	BNP	Ba1/BB+/BBB-	EUR	750	6.125%	Perpetual	17-Jun-22	TWD	5.125%	99.55	551	6.21
27-Apr-15	IPMID	-/-/-	EUR	125	8.625%	Perpetual	01-Apr-21	CE	7.000%	100.04	799	8.61
19-Feb-15	NYKRE	-/BB+/BB+	EUR	500	6.250%	Perpetual	26-Oct-20	TWD	7.125%	101.25	550	5.97
13-Feb-15	UBS	-/BB/BB+	EUR	1,000	5.750%	Perpetual	19-Feb-22	PWD	5.125%	99.00	518	5.93
11-Feb-15	DANBNK	-/BB+/BB+	EUR	750	5.875%	Perpetual	06-Apr-22	TWD	7.000%	99.50	528	5.96
10-Feb-15	BBVASM	Ba2/-/BB	EUR	1,500	6.750%	Perpetual	18-Feb-20	CE	5.125%	99.00	672	7.00
05-Feb-15	POPSM	Caa1u/-/-	EUR	750	8.250%	Perpetual	10-Apr-20	CE	7.000%	99.25	823	8.44
15-Jan-15	RABOBK	Baa3/-/BBB-	EUR	1,500	5.500%	Perpetual	29-Jun-20	TWD	7%/5.125%	99.50	518	5.62
11-Dec-14	DEKA	Baa3/-/-	EUR	177	6.000%	Perpetual	20-Mar-22	TWD	5.125%	101.00	505	5.81
13-Nov-14	AARB	-/-/BB-	EUR	300	7.625%	Perpetual	30-Apr-20	TWD	7.000%	97.75	770	8.20
10-Sep-14	HSBC	Baa3/-/BBB	EUR	1,500	5.250%	Perpetual	16-Sep-22	CE	7.000%	100.00	449	5.25
03-Sep-14	UCGIM	-/-/BB-	EUR	1,000	6.750%	Perpetual	10-Sep-21	TWD	5.125%	96.75	686	7.41
02-Sep-14	SANTAN	Ba1/-/-	EUR	1,500	6.250%	Perpetual	11-Sep-21	CE	5.125%	96.25	650	7.00
03-Jun-15	ABBEY	Ba2/-/BB+	GBP	750	7.375%	Perpetual	24-Jun-22	PWD	7.000%	99.50	565	7.47
25-Jul-14	VIRGMN	-/-/-	GBP	160	7.875%	Perpetual	31-Jul-19	CE	7.000%	102.01	587	7.30
19-Jun-14	COVBS	-/-/BB+	GBP	400	6.375%	Perpetual	01-Nov-19	CE (*)	7.000%	95.75	599	7.53
13-Jun-14	BACR	-/B+/BB+	GBP	698	7.000%	Perpetual	15-Sep-19	CE	7.000%	97.50	624	7.69
20-May-14	DB	Ba3/BB/BB+	GBP	650	7.125%	Perpetual	30-Apr-26	TWD	5.125%	95.50	545	7.75
01-Apr-14	ACAFP	-/-/BB+	GBP	500	7.500%	Perpetual	23-Jun-26	TWD	7%/5.125%	98.25	565	7.74
20-Mar-14	LLOYDS	-/BB-/BB+	GBP	1,481	7.000%	Perpetual	27-Jun-19	CE	7.000%	100.25	550	6.93
20-Mar-14	LLOYDS	-/BB-/BB+	GBP	1,494	7.625%	Perpetual	27-Jun-23	CE	7.000%	103.25	517	7.09
20-Mar-14	LLOYDS	-/BB-/BB+	GBP	750	7.875%	Perpetual	27-Jun-29	CE	7.000%	105.75	501	7.22
04-Mar-14	NWIDE	-/BB+/BB+	GBP	1,000	6.875%	Perpetual	20-Jun-19	CE (*)	7.000%	98.75	575	7.24
09-Apr-15	INTNED	Ba1/BB-/BB+	USD	1,000	6.000%	Perpetual	16-Apr-20	CE	7.000%	98.50	469	6.36
09-Apr-15	INTNED	Ba1/BB-/BB+	USD	1,250	6.500%	Perpetual	16-Apr-25	CE	7.000%	95.88	475	7.09
26-Mar-15	STANLN	Ba1/BB/BBB	USD	2,000	6.500%	Perpetual	02-Apr-20	CE	7.000%	100.38	473	6.40
23-Mar-15	HSBC	Baa3/-/BBB	USD	2,450	6.375%	Perpetual	30-Mar-25	CE	7.000%	100.75	394	6.27
19-Mar-15	DNBNO	-/BBB/-	USD	750	5.750%	Perpetual	26-Mar-20	TWD	5.125%	96.83	477	6.54
05-Mar-15	NDASS	-/BBB/BBB	USD	550	5.250%	Perpetual	13-Sep-21	TWD	8%/5.125%	95.75	406	6.09
18-Feb-15	SHBASS	Baa2/BBB/BBB	USD	1,200	5.250%	Perpetual	01-Mar-21	TWD	5.125%	96.54	404	5.98
13-Feb-15	UBS	-/BB/BB+	USD	1,250	7.000%	Perpetual	19-Feb-25	PWD	5.125%	101.50	434	6.78
13-Feb-15	UBS	-/BB/BB+	USD	1,250	7.125%	Perpetual	19-Feb-20	PWD	7.000%	103.38	452	6.25
12-Feb-15	SWEDA	-/BBB-/BBB-	USD	750	5.500%	Perpetual	17-Mar-20	CE	8%/5.125%	97.65	442	6.08
18-Nov-14	DB	Ba3/BB/BB+	USD	1,500	7.500%	Perpetual	30-Apr-25	TWD	5.125%	98.75	520	7.68
06-Nov-14	SEB	Ba1u/-/BBB-	USD	1,100	5.750%	Perpetual	13-May-20	TWD	8%/5.125%	97.85	457	6.27
16-Sep-14	NDASS	Ba1u/BBB/BBB	USD	1,000	5.500%	Perpetual	23-Sep-19	TWD	8%/5.125%	99.50	408	5.63
16-Sep-14	NDASS	Ba1u/BBB/BBB	USD	500	6.125%	Perpetual	23-Sep-24	TWD	8%/5.125%	100.63	374	6.03
11-Sep-14	ACAFP	Ba2u/BB/BB+	USD	1,250	6.625%	Perpetual	23-Sep-19	TWD	7%/5.125%	97.75	576	7.25
10-Sep-14	HSBC	Baa3/-/BBB	USD	2,250	6.375%	Perpetual	17-Sep-24	CE	7.000%	100.50	401	6.30
10-Sep-14	HSBC	Baa3/-/BBB	USD	1,500	5.625%	Perpetual	17-Jan-20	CE	7.000%	99.75	407	5.69

T2 CoCo performance monitoring (as at 19/6/15)

Launch	Issuer	Issue ratings	Currency	Amount (m)	Coupon	Maturity date	First call date	Principal loss absorption	Trigger	Price	I-Spread	Yield to call
08-Mar-12	CS	-/-/BBB-	CHF	750	7.125%	22-Mar-22	22-Mar-17	CE	7.000%	106.55	396	3.20
08-Jun-15	ZKB	-/A/-	EUR	500	2.625%	15-Jun-27	15-Jun-22	PWD	5.000%	99.22	195	2.75
23-May-14	NYKRE	-/BBB/BBB	EUR	600	4.000%	03-Jun-36	03-Jun-21	PWD	7.000%	98.48	365	4.29
06-Feb-14	UBS	-/BBB/BBB+	EUR	2,000	4.750%	12-Feb-26	12-Feb-21	PWD	5.000%	105.16	311	3.72
11-Sep-13	CS	-/BBB/BBB+	EUR	1,250	5.750%	18-Sep-25	18-Sep-20	PWD	5.000%	111.15	284	3.39
08-May-14	UBS	-/BBB/BBB+	USD	2,500	5.125%	15-May-24	-	PWD	5.000%	99.00	294	-
12-Sep-13	ACAFP	-/BBB-/BBB-	USD	1,000	8.125%	19-Sep-33	19-Sep-18	PWD	7.000%	110.00	345	4.75
01-Aug-13	CS	-/BBB/BBB+	USD	2,500	6.500%	08-Aug-23	-	PWD	5.000%	110.25	277	-
15-May-13	UBS	-/BBB/BBB+	USD	1,500	4.750%	22-May-23	22-May-18	PWD	5.000%	100.75	322	4.47
03-Apr-13	BACR	-/BB+/BBB-	USD	1,000	7.750%	10-Apr-23	10-Apr-18	PWD	7.000%	108.77	321	4.38
17-Jan-13	KBC	-/BBB/-	USD	1,000	8.000%	25-Jan-23	25-Jan-18	PWD	7.000%	108.50	339	4.48

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 19/6/15)

Launch	Issuer	Issue ratings	Currency	Amount (m)	Coupon	Maturity date	First call date	I-Spread	Yield to call
09-Jun-15	LBBW	Baa2/-/BBB-	EUR	500	3.625%	16-Jun-25	-	280	-
05-Jun-15	SOCGEN	-/BBB/A-	JPY	27,800	FRN	12-Jun-25	-	156	-
05-Jun-15	SOCGEN	-/BBB/A-	JPY	13,300	1.888%	12-Jun-25	12-Jun-20	161	1.87
27-May-15	BPCEGP	Baa3/BBB/A-	USD	130	5.350%	01-Jun-45	-	288	-
26-May-15	SOCGEN	Baa3/BBB/A-	CNY	1,200	5.200%	03-Jun-25	03-Jun-20	189	5.01
22-May-15	SOCGEN	Baa3/BBB/A-	AUD	125	5.500%	02-Jun-27	02-Jun-22	253	5.53
15-May-15	BNP	Baa2/BBB/A	CHF	100	1.750%	05-Jun-25	-	134	-
13-May-15	VENBAN	-/-/-	EUR	40	6.944%	15-May-25	15-May-20	704	7.54
16-Apr-15	ISPIM	Ba1/BB/BBB	EUR	500	2.855%	23-Apr-25	-	273	-
08-Apr-15	SOCGEN	Baa3/BBB/A-	USD	1,500	4.250%	14-Apr-25	-	273	-
08-Apr-15	BPCEGP	Baa3/BBB/A-	USD	400	4.625%	17-Apr-35	-	266	-
02-Apr-15	DB	Ba1/BBB-/A-	CNY	1,410	5.600%	10-Apr-25	10-Apr-20	239	5.59
27-Mar-15	DB	Ba1/BBB-/A-	USD	1,500	4.500%	01-Apr-25	-	277	-
18-Mar-15	BPCEGP	Baa3/BBB/A-	CNY	750	5.750%	26-Mar-25	26-Mar-20	286	5.99
12-Mar-15	CRDEM	-/-/BBB	EUR	200	3.125%	13-Mar-25	13-Mar-20	312	3.59
12-Mar-15	BPCEGP	Baa3/BBB/A-	EUR	375	2.250%	12-Mar-25	-	184	-
09-Mar-15	ACAFF	Baa3/BBB/A-	USD	1,500	4.375%	17-Mar-25	-	248	-
09-Mar-15	ACAFF	Baa3/BBB/A-	EUR	2,000	2.625%	17-Mar-27	-	218	-
05-Mar-15	SYDBDC	Baa3/-/-	EUR	100	2.125%	11-Mar-27	11-Mar-22	225	3.00
04-Mar-15	KBCBB	-/BBB-/BBB+	EUR	750	1.875%	11-Mar-27	11-Mar-22	203	2.79
04-Mar-15	SANTAN	Baa2/BBB-/BBB+	EUR	1,500	2.500%	18-Mar-25	-	218	-
03-Mar-15	BNP	Baa2/BBB/A	CNY	1,500	5.000%	17-Mar-25	17-Mar-20	176	4.88
19-Feb-15	SOCGEN	Baa3/-/A-	EUR	1,250	2.625%	27-Feb-25	-	226	-
13-Feb-15	ZKB	-/A/-	CHF	185	1.000%	02-Sep-25	02-Sep-20	146	1.20
10-Feb-15	BNP	Baa2/BBB/A	EUR	1,500	2.375%	17-Feb-25	-	198	-
09-Feb-15	DB	Ba1/BBB-/A-	EUR	1,250	2.750%	17-Feb-25	-	239	-
30-Jan-15	BPCEGP	-/BBB/A-	JPY	27,200	2.047%	30-Jan-25	-	159	-
30-Jan-15	BPCEGP	-/BBB/A-	JPY	7,900	1.943%	30-Jan-25	30-Jan-20	158	1.83
30-Jan-15	BPCEGP	-/BBB/A-	JPY	13,200	1.704%	30-Jan-25	-	N/A	-
12-Dec-14	RABOBK	A3/BBB+/A	JPY	50,800	1.429%	19-Dec-24	-	81	-
19-Nov-14	ERSTBK	-/BB+/BBB	USD	500	5.500%	26-May-25	26-May-20	467	6.38
18-Nov-14	KBCBB	-/BBB-/BBB+	EUR	750	2.375%	25-Nov-24	25-Nov-19	169	2.12
14-Nov-14	STANLN	A2/BBB/A+	EUR	500	3.125%	19-Nov-24	-	214	-
14-Nov-14	YBS	Baa2/-/BBB+	GBP	250	4.125%	20-Nov-24	20-Nov-19	235	3.95
29-Oct-14	LLOYDS	Baa2/BBB-/A-	USD	1,000	4.500%	04-Nov-24	-	218	-
06-Oct-14	BNP	Baa2/BBB/A	USD	1,000	4.250%	15-Oct-24	-	205	-

Insurance performance monitoring (as at 9/6/15)

Launch	Issuer	Issue ratings	Currency	Amount (m)	Coupon	Maturity date	First call date	New issue spread	I-Spread
08/06/2015	SLHNXX	-/BBB+/+	EUR	750	4.375%	Perpetual	16-Jun-25	330	373
02/06/2015	SCOR	-/A-/A-	EUR	250	3.250%	05-Jun-47	05-Jun-27	220	206
02/06/2015	PRUFIN	A3/A-/BBB+	GBP	600	5.000%	20-Jul-55	20-Jul-35	-	301
02/06/2015	KOMLAN	Baa1/-/-	EUR	600	4.250%	10-Jun-45	10-Jun-25	340	351
28/05/2015	AVLN	Baa1/BBB/-	EUR	900	3.375%	04-Dec-45	04-Dec-25	255	297
28/05/2015	AVLN	Baa1/BBB/-	GBP	400	5.125%	04-Jun-50	04-Jun-30	-	328
16/04/2015	ZURNXX	A2/A/-	USD	300	4.250%	01-Oct-45	01-Oct-25	-	259
30/03/2015	ALVGR	A2/A+/A	EUR	1,500	2.241%	07-Jul-45	07-Jul-25	165	222
26/03/2015	AGSBB	-/BBB/BBB+	EUR	400	3.500%	30-Jun-47	30-Jun-27	288	342
20/03/2015	SRENVX	-/A/-	EUR	750	2.600%	Perpetual	01-Sep-25	-	246
04/03/2015	STBNO	-/BBB/-	NOK	1,000	4.450%	Perpetual	17-Mar-20	-	N/A
18/02/2015	VIGAV	-/A/-	EUR	400	3.750%	02-Mar-46	02-Mar-26	294	291
28/01/2015	ACHMEA	-/BBB/-	EUR	750	4.250%	Perpetual	04-Feb-25	355	382
08/01/2015	ACAFF	-/BBB/-	EUR	1,000	4.250%	Perpetual	13-Jan-25	350	386
11/12/2014	LAMON	-/BBB/-	EUR	768	5.050%	Perpetual	17-Dec-25	405	397
10/12/2014	ISPVIT	-/-/BBB-	EUR	750	4.750%	Perpetual	17-Dec-24	-	404
09/12/2014	SOGESA	-/BBB/-	EUR	800	4.125%	Perpetual	18-Feb-26	315	380
18/11/2014	BNP	-/BBB/-	EUR	1,000	4.032%	Perpetual	25-Nov-25	293	361
06/11/2014	ASSGEN	Ba1/-/BBB-	EUR	1,500	4.596%	Perpetual	21-Nov-25	350	420
12/11/2014	CNPFP	-/BBB+/+	EUR	500	4.000%	Perpetual	18-Nov-24	310	352
06/11/2014	AXASA	Baa1/BBB/BBB	EUR	984	3.941%	Perpetual	07-Nov-24	290	303

Source: Crédit Agricole CIB

Bookrunners all financials (euros)
01/01/2015 to 19/06/2015

	Managing bank or group	No of issues	Total EUR m	Share (%)
1	Deutsche Bank	16	5,029	10.9
2	Crédit Agricole CIB	6	4,946	10.7
3	UBS	7	4,890	10.6
4	HSBC	12	3,663	7.9
5	BNP Paribas	9	3,475	7.5
6	JP Morgan	15	3,106	6.7
7	Société Générale CIB	12	2,599	5.6
8	BAML	7	2,251	4.9
9	Goldman Sachs	12	2,017	4.4
10	Barclays	9	1,973	4.3
11	Citi	9	1,759	3.8
12	Credit Suisse	6	1,104	2.4
13	Rabobank	5	963	2.1
14	Morgan Stanley	3	785	1.7
15	Natixis	6	777	1.7
	Total	66	46,145	

	Managing bank or group	No of issues	Total EUR m	Share (%)
1	Deutsche Bank	41	10,611	8.6
2	BNP Paribas	36	10,107	8.2
3	UBS	23	9,427	7.6
4	Crédit Agricole CIB	19	7,727	6.2
5	Société Générale CIB	25	7,225	5.8
6	Goldman Sachs	20	6,659	5.4
7	Morgan Stanley	25	5,906	4.8
8	Natixis	16	5,501	4.4
9	Barclays	31	5,185	4.2
10	HSBC	28	5,022	4.1
11	JP Morgan	31	4,893	4.0
12	Citi	20	4,887	3.9
13	UniCredit	23	3,726	3.0
14	Credit Suisse	17	3,347	2.7
15	Lloyds	5	3,022	2.4
	Total	223	123,838	


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Nykredit finds strong demand in opening ARMs offering

Nykredit Realcredit looked for automatic refinancing options in Denmark today (Thursday), with not-indeed-but-hugely interest coming in for an offering of one year ARM bonds, according to an official at the issuer, although an analyst said the outcome was not surprising.

Thursday, 15 August 2013



FROM CRÉDIT AGRICOLE CIB

SWEDEN

Swedish debt office built in proposal seen as credit negative by Moody's

A Swedish National Credit Office (NKO) proposal (see below) to implement the EU bank recovery and resolution framework in Sweden is said to create negative signals about the credit quality of the country's banking, particularly of the four largest, Moody's said today (Thursday).

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Swiss Life

Last hurrah

Swiss Life on 8 June hit a short issuance window to sell a Eu750m perpetual non-call 10 hybrid on the back of a twice oversubscribed order book before conditions again deteriorated and insurance sub debt issuance dried up. Here, Luca Pescatore, head of capital management at Swiss Life, discusses the background to the transaction and its execution.

What was the rationale for your transaction and for the timing?

Luca Pescatore, Swiss Life: We have an outstanding hybrid bond that is callable in November of this year; the main goal of the new transaction was to refinance this instrument. Due to the positive feedback from the roadshow and the room for additional hybrid we have within our capital structure, we went for a larger size — with that we also further optimised our capital structure.

Were there any particular messages about Swiss Life and your strategy that you emphasised on your roadshow? What was the response from investors?

Pescatore: Yes, there are certain points that we emphasised. One is that the company has been successfully improving the resilience of its business model in the past years, which is particularly important in the current environment that is challenging for life insurers, with very low interest rates.

On one hand we managed to keep a fairly stable investment result despite in-



Luca Pescatore, Swiss Life

terest rates that have strongly decreased.

On the other hand we worked on the liability side, reducing the average guaranteed technical interest rates. We did that, for instance, through strengthening the reserves and through improvements to the business mix.

This has had the effect of securing, in this challenging environment, our already strong interest rate margin, i.e. the difference between the investment result and the guaranteed technical interest rates. This message was very well received.

How does the hybrid fit in with your target capital structure?

Pescatore: We have a target capital structure comprising 70%-75% equity (excluding unrealised gains or losses from bonds), 25% hybrid and 0%-5% senior. That target is calibrated to be in line with, for instance, our leverage ratio target and our fixed charge coverage target, which are important from a ratings perspective. At the end of 2014 the share of hybrids was 21%, which is below the 25% target share we have, so the new transaction fits very well into the capital structure.

And it also fits very well into our maturity profile, because we didn't have any call dates in 2025.

Did any other considerations play into the maturity structure?

Pescatore: We know that in euros currently the spread difference between perpetual and dated is relatively small. But the main rationale why we decided to issue in a perpetual format is that we wanted to keep the quality of capital unchanged, and the instrument we plan to



call in November is also perpetual.

It also reflects a particularity of the Swiss regulatory framework, in which we have two hybrid buckets, “upper additional capital” and “lower additional capital”, and the main difference between the two is perpetual versus dated, so this perpetual instrument fits in the upper additional capital bucket.

Regarding the call date after 10 years, as mentioned earlier, that is because it fits well in our capital structure. And 10 years allows you to be compliant with all the various regulatory and rating frameworks.

Besides the fact that it is a perpetual, it is really a Solvency II Tier 2 structure, which investors are already familiar with.

Markets have been very volatile. Did this backdrop affect the timing or execution of the transaction?

Pescatore: You are right, the market has been volatile, but to say we were concerned is overstating it. We were able to use this short issuance window in the week following our roadshow. In spite of the volatility we managed to issue what was the maximum amount we consid-

ered, and I would say this is a sign that investors have confidence in our credit.

One more thing that I think really helped us is that just two weeks before the transaction Standard & Poor's upgraded the firm's rating by one notch from A- to A. That was also very well received by investors — seeing a life insurance company get upgraded in this environment was a signal of the soundness of Swiss Life.

How did you feel the pricing worked out?

Pescatore: I think it worked out well. Again, the issuance window was very short, and already the day after we issued the markets started getting tougher, with widening credit spreads, so I think we issued with the right pricing.

Were you happy with the quality of the order book?

Pescatore: Yes, especially because it was well diversified. What we saw, which I thought was interesting, was strong support from Swiss investors, stronger than is usual in euro deals. They were second in geographical terms in the order book

after the UK. That was particularly notable in this transaction and I think this shows that the name Swiss Life is strong in the domestic market.

Interest rates are extremely volatile. To what extent does this affect your capital requirement and planning?

Pescatore: We have for many years already had a very disciplined asset-liability management, and for many years we have had a duration gap that is under 1%. This of course helps us to reduce interest rate sensitivity in economic terms. So from that point of view I would say our disciplined asset-liability management is really one of our strengths.

Do you have any similar transactions earmarked for the rest of this year or 2016?

Pescatore: As you can imagine, I cannot comment much on future refinancing plans. However, if you look at our maturity profile you will see that we have our following optional call date in October 2016, which is a Swiss franc hybrid bond placed mainly with retail investors. ●



Mario Draghi

3 June press conference

Source: ECB

Volatility

Getting used to it

Bond markets have since mid-April been hit by unprecedented volatility – and, in the words of European Central Bank president Mario Draghi, everyone had better get used to it. Here, investors and Crédit Agricole CIB representatives share their views on what has been driving markets, how they have been coping with the turmoil, and what to expect in the months ahead.

Filippo Alloatti, senior credit analyst, financials,
Hermes Fund Managers

Dierk Brandenburg, senior credit analyst, Fidelity

Mariano Goldfischer, global head credit trading and
syndicate, Crédit Agricole CIB

Craig Guttenplan, global credit analyst,
Rogge Global Partners

Vincent Hoarau, head of FIG syndicate,
Crédit Agricole CIB

Raphael Robelin, co-CIO, BlueBay Asset Management

Julien de Saussure, fund manager, Edmond de
Rothschild Asset Management (France) (EDRAM)

Charles Sanford, co-head of investment grade
corporate credit, Babson

Enrico Scarin, portfolio manager,
Generali Investments Europe

Moderator: Neil Day, managing editor,
Bank+Insurance Hybrid Capital

Participants kindly dedicated their time to responding to these questions in the week leading up to Friday, 26 June – the day the surprise Greek referendum was announced.

Markets have experienced a historical reversal in outright yields combined with an increased level of volatility – how do you explain this turnaround and its magnitude?

Dierk Brandenburg, Fidelity: I would say the main driver is the fact that the investors went long across all fixed income asset classes after the ECB announced QE, including government bonds as well as AT1. The trade unwound as expectations on growth and inflation changed. On top of that there were renewed concerns about Greece that affected risk premiums. These price moves were then exacerbated by the increasing regulatory constraints on market-makers that contribute to poor secondary market liquidity.

Enrico Scarin, Generali: The turna-

round we have been seeing in core real rates has been triggered by a sudden repricing of growth and inflation expectations. However, we believe this fundamental factor was only the trigger for a correction that went well beyond investors' expectations, if not for the absolute movement, for its extreme rapidity. We can only explain such a spectacular drop in fixed income prices with the concurrent unwind of what we can label "the QE-trade", that is the fact that many investors had positioned short euro, long duration, long European risky assets in anticipation of the ECB monetary policy.

Filippo Alloatti, Hermes: The recent repricing in euro area government bonds can be explained by a number of factors: market levels reconnecting with history/fundamentals, as some quarters were expecting

ECB sovereign QE to depress sovereign yields for ever; rising inflation expectations, with the inflation swap five year now at 1.7%; a modest euro area CPI inflation surprise; the cyclical recovery gaining momentum; and a less-than-optimal liquidity environment exacerbating the moves.

Raphael Robelin, BlueBay: The best analogy for what happened in all markets that I can think of is an elastic band that you keep pulling and pulling, and eventually it snaps — extreme valuations that had gone so far they eventually proved unsustainable. There are then two interesting observations one can make about what happened.

Firstly, there wasn't a particularly obvious catalyst for the sell-off. You didn't have, for example, a particularly surprising economic data release, or a change of



Raphael Robelin, BlueBay
 'We almost had a giant Ponzi scheme developing'

tune by the central bank, or anything major that could explain a fundamental shift in the market assessment.

The other interesting observation is about yields. Nominal yields really have two components: you have the real yield you are being paid, and then the inflation expectation. Now we have a pretty efficient way to measure the latter because you have an inflation-linked market in the Eurozone that is quite liquid, so we know how to decompose a nominal yield between the real yield demanded by the market and the inflation expectation over the corresponding period. And what is quite interesting to me is that inflation expectations have not really moved during this sell-off. So it is really the real yield demanded by the market that went from very extreme negative levels to still negative but less extreme levels, and it is this change in term premium or in the real yield demanded by market participants that really explains the back-up in yields. The way I think about this is that, looking at other jurisdictions where QE was implemented, the market eventually becomes more confident that QE can work, and that the central bank will be somewhat successful at fighting the deflation risk and engineering a bit more inflation in the system. Even though bonds are the very asset class that is being used by the central bank to ensure this outcome, nevertheless, because there is a higher conviction that over time the economy is

going to be OK and maybe deflation will be avoided, that typically leads to a somewhat higher yield — that was the case in the US during the QE period and it was somewhat the case in Japan, as well.

Vincent Hoarau, Crédit Agricole CIB:

Markets have gone too far and too fast and got ahead of themselves in anticipation of the full scale QE. The situation was not sustainable anymore and this became obvious when yields were negative nearly everywhere in low beta instruments at the front end of the curve. Draghi offers a quasi-unlimited backstop bid in secondary and, driven by regulatory constraints, many market participants got engaged at outrageous levels in low betas believing in easy capital gains in negative yield territory. Elsewhere, everyone was long duration while convergence was going on in senior and in the subordinated spaces.

The catalyst for the sharp correction emerged in April. Inflation figures released in Europe were much higher than expected, implying the deflation scenario was off table and (low) growth around the corner. This triggered shifts in directional positions and the reversal of "QE trades". At the very same time US GDP figures showed evidence of a slowdown in the recovery and the US dollar sold-off versus the euro. There was a clear change in the perception of the macroeconomic

anticipated a correction in rates, the ability to effectively position in that sense has always been limited, especially for institutional investors with absolute return mandates or legal liabilities to cover, who struggled to satisfy their targets and had no choice other than balancing higher duration, higher credit and liquidity risk. Effectively what helps you as an investor in these cases is the ability to diversify your sources of yield enhancement, and the recent episode was no different in that sense.

Going forward, key risk factors are Greece and growth dynamics in Europe; I would also add that another strong leg down in fixed income prices could trigger some outflows out of the asset class towards equities and less interest rate-sensitive assets such as credit, where risk premia are attractive only in specific sub buckets.

Robelin, BlueBay: The first point to make is that we have had a negative bias on the outlook for interest rates and therefore the beta in core fixed income for a while now. We really felt that valuations had become very artificial and that we almost had a giant Ponzi scheme developing; you can't really buy a 10 year Bund at 0.1% and think that you're making a sound investment; the only reason you'd buy it is either because you're forced to for regulatory reason or as a more mark to market focussed

Key risk factors are Greece and growth dynamics in Europe

environment and this caught everyone by surprise. It marked the start of the strong back-ups in rates combined with the return of great volatility. The resurgence of the headlines on Greece — which were even foreseeable — just exacerbated the situation. To cut a long story short, people don't trade on liquidity parameters anymore but fundamentals. This is a major change.

How do you manage the current situation and what are the greatest risk factors ahead of us?

Scarin, Generali: Even if one had rightly

investor because you believe that you're going to be able to sell it to someone else at a higher price.

And so we have been great believers at BlueBay that the kind of beta opportunity in core fixed income is being challenged, and so over the last few years we've been launching kind of next generation fixed income funds for our clients that really try to generate some absolute return without much beta risk. So we really try to identify market inefficiencies and investment opportunities in the market without having a bias towards having a lot of beta, and so certainly with very little if any interest rate duration exposure because we felt that the

value proposition in core rates was indeed very, very poor.

That being said, we were somewhat taken aback by the rapidity of the sell-off. We were also somewhat surprised by the fact that during the last ECB press conference Mr Draghi basically told market participants that the ECB was happy to look through the period of volatility, and that to them volatility was a kind of pretty rational consequence of the very low rate environment and that market participants basically had better get used to it — even if many market participants, like us, felt that it was counterproductive in going against the central bank's aims under QE.

Regarding the consequences for credit, you know, the more volatility you have, in particular rates volatility, the more risk premium you should demand. So while we started the year with a pretty bullish view for credit spreads, it has been our opinion over the last two months that — what with the heightened interest rate volatility, the uncertainties around Greece, and the uncertainty around the timing of the first US rate hike — when credit spreads in Europe reached 90bp and when the CoCo index was at more than 6% over the first four months of the year, we came to the conclusion that a lot of the upside was now gone and that the right thing to do was to book some profits and move our portfolios to a more neutral position. So that is something that we did over the course of the second half of April and the month of May.

Mariano Goldfischer, Crédit Agricole CIB: Overall the level of volatility has increased significantly in the Eurozone not only due to the Greece situation but also due to the repricing of the “risk free” curve in government bonds (Bunds). On top of that, the regulatory changes and associated capital cost have an impact on the dealers’ ability to warehouse inventory, impacting the liquidity of the market and the ability of investors to shift risk. We strongly believe that some of the structural changes in the market are here to stay, and that the lack of liquidity as we used to know it will be the major impact on the market. In this environment, allocations of scarce resources will be fundamental to service the client base.

Brandenburg, Fidelity: To put it simply, our funds held more cash and thus didn't buy as many securities as we would otherwise have done. That view may change if volatility in government bond yields recedes and the Greek situation is resolved.

How long can the market afford to wait for clarity on Greece? Are you prepared for Grexit?

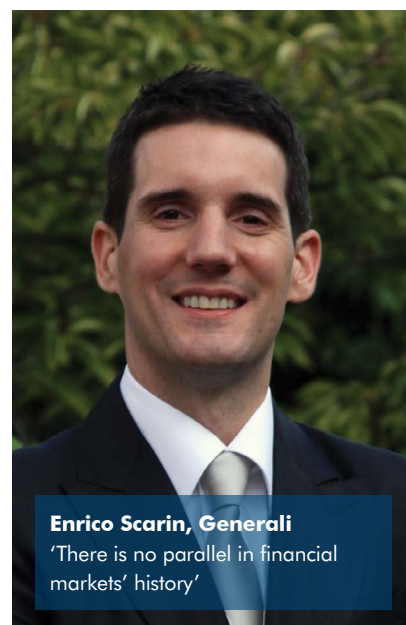
Alloatti, Hermes: At the time of writing, the market is paying quite a bit of attention to the headlines tennis — deal/ no deal — around the protracted Greek negotiations. We have observed a few deals in the financial space being pulled in the last few weeks, some — and understandably so — in the subordinated space.

We tend to think a “rational outcome” would call for an agreement to be found somewhere in the middle. We are cognisant of the counterparties’ different red lines and the need for a new DSA (debt sustainability analysis) from the IMF. We never thought the road to an agreement was going to be smooth. Assuming a compromise of some sort is reached, the market may remain Greek-headline-

dependent for a while longer. This would be a kick-the-can-down-the-road type scenario implying a day-by-day market. Other scenarios include a self-explanatory nuclear one, and an excellent one (sadly unlikely) where everything is sorted.

The direct effect of a worst case scenario should be limited to Greek banks — which by the way were not the cause of the country's difficulties. The second-order effect is nigh on impossible to calculate in advance. Sub financials and peripheral banks are for good and bad reasons often associated as transmission mechanisms for contagion.

Scarin, Generali: The situation in Greece will continue to create volatility and uncertainty because there is no parallel in financial markets’ history of a currency union breaking down in a developed mar-



Enrico Scarin, Generali
‘There is no parallel in financial markets’ history’

ket such as the European one. As such, I do not believe someone can effectively feel “prepared” for such an event.

On the positive side, an accident on the Greece front is not unexpected anymore, and the effects should be more contained than one could have feared some months or years ago. Moreover, it is very important to distinguish between short term market volatility and longer term market

Some of the structural changes in the market are here to stay

reaction. One cannot exclude that the euro area effectively comes out stronger than before after the “existential crisis” the Greek situation is causing.

Brandenburg, Fidelity: Yes, we are fairly optimistic that politicians will want to avoid a big negative market event such as a Grexit. However, the economic weakness and political uncertainty in Greece will persist for some time.

Is the time right for the reopening of the market?

Brandenburg, Fidelity: Yes, absolutely. We have seen it with new Lower Tier 2 and bank senior issuance this week, so that's already happening, and we expect more. We anticipate a last wave of supply before the summer.



Because of the volatility in the market supply was rather less than we had expected. I think there were other banks actively looking at AT1, such as RBS, so we still expect those to come.

Robelin, BlueBay: If we look again at the three key risks I mentioned — the rise in interest rate volatility, the Fed, and Greece — I would definitely say that since we decided to reduce the credit risk in our portfolios valuation have clearly moved wider and the compensation reflecting these risks is in our opinion more appropriate than was the case in early April. And each one of these risks we would argue has somewhat receded.

Supply was rather less than we had expected

The Fed obviously was in our opinion quite meaningfully more dovish at its latest meeting — not only somewhat delaying the likely timing of the first rate hike, possibly to September, more likely to December. And they were also very vocal in saying that not only will they take time before the first rate hike, but they also intend to be extremely gradual in the way they will raise rates when they start raising. So it is difficult to foresee much chance of a big surprise in terms of the pace of rate hikes from the Fed and the timing of the first hike. So that is one concern that,

while not taken out of the equation, is certainly somewhat delayed.

And if you look at rates volatility, you have this Fed outlook but also valuations are now far more appropriate — around 90bp for the 10 year Bund. You've got your five year-five year swap rate in the Eurozone at about 2% now, which we think is not cheap but maybe a fairer valuation, and therefore one that will provide some kind of valuation anchor to interest rates in the Eurozone, which we didn't have 100bp ago. And so we do expect interest rate volatility to somewhat come down over the summer.

And then in Greece, it was our strong view based on our meetings with the Greek government that there was almost an even chance of a Greek default and capital controls being implemented in Greece over the summer. With Prime Minister Tsipras's decision to call for a referendum, and the expected announcement of restrictions on capital flows, we expect Greece to remain a source of volatility in the short term.

Notwithstanding the uncertainty around Greece, we remain positive on the medium term outlook for European credit spreads, given sound credit fundamentals, reasonably attractive valuations, and our expectation that demand for credit will remain strong in a low interest rate environment where investors need incremental spread. However, we are happy to be patient and wait for opportunities to buy

bonds at attractive levels, either from distressed sellers in the secondary market or via new issues. We know there is plenty of supply looming, and we believe that this supply will have to come at attractive levels — the first ABN Amro Tier 2 was a good reflection of that and we had HSBC coming to market with a decent concession as well. That is one of the other reasons we were quite comfortable selling cash bonds in April and May, because we were convinced that with the amount of supply waiting on the sidelines that — even if we were wrong about the outlook for

spreads and even if they didn't widen — we could put this cash back to work in the primary market on pretty good terms.

Would a last minute solution on Greece change your view on the evolution of the subordinated markets?

Charles Sanford, Babson: That's a tricky one. Because it is just as easy to see those instruments strongly benefitting from reduced uncertainty — see the price action on AT1s on better headlines on Monday and the solid appetite for those structures earlier this year — as it is to see a wave of issuance flooding the market. However, our view on the subordinated market remains driven by supply and regulatory developments rather than the situation in Greece. Most national regulators and banks are yet to determine their preferred option when it comes to MREL/TLAC compliance; senior unsecured eligibility is also very much an open question, and those are likely to be among the main drivers for the subordinated market in the next few quarters. We have indeed seen a reduction of issuance since April, but the market is not closed either despite concerning Greek headlines. It's also worth noting that before the sharp rise of volatility of the past two months we saw a fair amount of second/third tier names announcing roadshows for potential Tier 2/AT1 transactions, and we think that we should see a more diversified range of issuers in this market.

Scarin, Generali: Yes in the short term, not much in the long term. In recent weeks high beta assets such as subordinated bonds have been significantly impacted by the Greece saga, especially due to higher liquidity risk and inability to attract marginal buyers in the secondary market or in the primary one for second tier issuers. The disappearance of marginal buyers, however, is more a technical than a fundamental factor and therefore it should reverse when the situation stabilises. As such, in the longer term the primary risk factors impacting the outlook of sub bonds will be regulation, supply and issuers' fundamentals, especially for deeply subordinated securities.

Goldfischer, CACIB: A last minute deal in Greece will not change investors' view of the subordinated space. What it will change investors' view on is a reduction of volatility and a confidence that there is a well-functioning secondary market. Investors want to be able to sell positions if they want without having to pay a significant bid-offer. Contrary to that, new issue premiums will increase as investors will need to price some cost of exiting positions in secondary market.

Julien de Saussure, EDRAM: Contrary to 2011, banks and insurance companies have limited and manageable exposures to Greece or Greek corporates. Based on the data available, a bad outcome would be manageable for most issuers. So a last minute deal would not dramatically change our long term view of the subordinated markets either.

Our long term view is mainly driven by regulatory changes and the creation of the European Banking Union. In this respect, the asset quality review, in particular of Greek exposures, is already demonstrating its merits.

A failure to strike a deal with Greece could, however, have an impact on the long term construction of the European



Filippo Alloatti, Hermes
'It looks like the ECB is intending to stay the course'

around final TLAC/MREL rules and proposed changes to bank creditor hierarchies in national insolvency laws. For most issuers, the benefits of issuing AT1 equal to 1.5% of risk-weighted assets is quite obvious, while it is becoming increasingly clear that Tier 2 materially above 2% is not the concern it once was when the initial TLAC proposal was published as banks without holding companies are likely to issue either German-style senior or else Tier III. The question of Greece and volatility in general

Scarin, Generali: The first potential rate hike before year-end should not come as a surprise, and market participants are anticipating that well. However, it is very important to distinguish between a single rate hike — that will come soon — and a significantly less accommodative monetary policy in the US, which is miles away from the very rational and prudent Federal Reserve's behaviour and utility function. A strong and unexpected shift in US monetary policy would cause an immediate sell-off in risky assets first, with subsequent impact on consumer confidence and growth expectations, thus frustrating all the efforts made in the last six years to stabilise the economy and financial markets; we assign a close to zero probability to such an event.

The much more likely scenario of a smoother exit from the Fed stimulus would not derail US financial markets and growth prospects, even if a dollar appreciation should become the key risk factor for the emerging market assets first, where the higher level of US dollar-denominated debt reached in the last years is a source of concern, and higher default rates could suddenly reverse the flows dynamics and the relative cost of funding.

Brandenburg, Fidelity: Well, we have already seen a rise in US yields. Longer duration Lower Tier 2s underperformed relative to AT1s recently, so from that perspective I thought the AT1 market reacted very well to the back-up in rates. It underlines the fact that the market for USD denominated AT1 appears much deeper in terms of the groups of investors that are involved.

Hoarau, CACIB: The impending Fed interest rate hike — the first since 2008 — is a risk to global markets as the process could become disorderly. The move will likely happen after the summer break. The exact timing still depends largely on the economic outlook. Markets say they are prepared, but when the rate hike actually come to pass it could have very different consequences than in the past simply because the world is really in a different place. Liquidity today is just outrageously poor although vital to absorb the shocks

The impending Fed interest rate hike is a risk to global markets

Banking Union. But conversely, a weak deal with Greece, with perceived concessions from the Troika, could spread anti-Europe sentiment in other countries with elections/referendums in the coming years, namely Spain or the UK.

In the short term, however, a deal with Greece, even though most investors are aware it would not represent a lasting solution to the sustainability of Greek debt, would bring confidence in risky assets and the subordinated market would continue its expansion.

Craig Guttenplan, Rogge: Greece notwithstanding, there is a fairly clear path the subordinated markets should take over the intermediate term — though pending a few important developments, notably

speaks more to the timing of such issuance, but over a multi-year period we think issuance needs are now largely well-known and digestible — absent unforeseen changes to TLAC/MREL rules.

What are your views on the developments in US monetary policy and a potential rate hike before year-end? What consequences do you foresee?

Goldfischer, CACIB: The Fed rate hike that is priced in for later this year will not be a material event for the market on a standalone basis. What will be critical for the market is the pace of the subsequent hikes. In this environment, we believe that High Yield products will outperform Investment Grade products.

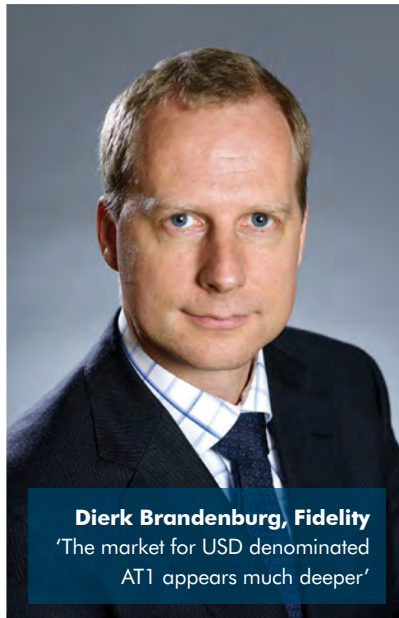
implied by such a material change in monetary policy. Banks have to scale back their “market-making” capabilities to please regulators. When the market gets the shock of the effective start of a round of rate hikes, potentially violent price swings, which a disfunctional secondary market can’t smooth out, may lead to another round of price correction. So keep your seatbelt fastened: volatility in fixed income products is not over and changes in currency equilibrium may exacerbate the situation.

How do you cope with the return of volatility? What adjustments have you made to the way you approach investments, in primary as well as in secondary markets?

De Saussure, EDRA: The main adjustments have been to increase cash balances and reduce exposure to long duration insurance bonds, which are more sensitive to curve steepening.

Our appetite for duration and peripheral exposure at the portfolio level has always been moderate and we have not changed our view in this regard.

As far as primary markets are concerned, we have continued to invest in bank primary deals with decent new issue premiums, considering that spread is a decent protection against rising yield. On the insurance segment, we tend to consid-



secondary when we believe that valuations have overshot fundamentals due to perceived contagion or other technical factors – though timing the entry point is obviously the tricky part. We are particularly wary of the current dearth of liquidity, especially during periods of volatility, so try to position for it when we anticipate volatility picking up.

Scarlin, Generali: Higher volatility in what are theoretically low risk assets is something investors should be prepared for, as highlighted also by Mr Draghi in one of his recent press calls. When you are not compensated at all for assum-

book-yield bonds, avoiding dismissing high quality assets in a way that we know would be quite inefficient.

Sanford, Babson: In addition to heightened rate volatility, idiosyncratic risk has definitely returned to the credit market. We have addressed this by diversifying our investments and allocating our risk budget across a wider range of securities. Given our reliance on fundamental credit analysis to generate investment ideas, we tend to focus more on the secondary market to source investments. While liquidity has been challenging in general, our strong relationships with the sell-side have allowed us to take advantage of specific opportunities our analysts have identified. That being said, there have been some great opportunities in the primary market as well.

What’s your strategy to cope with the rise of outright yield levels?

Sanford, Babson: We have run a series of scenarios that encapsulate our views on potential rate and spread movements across industry sectors and tenors to help us determine our duration and curve positioning.

Guttenplan, Rogge: In general, we tend to hedge our interest rate exposure when allowed and focus solely on the spread component.

Alloatti, Hermes: High yielding assets such as subordinated financial paper display less hard duration characteristics. On average, AT1, for instance, are closer to par, with 50 bonds wrapped around a mid price of 102 at the time of writing. Also most of them reset at the swap rate. The asset class is much closer to equity hence sizing of position and implied volatility are paramount.

Scarlin, Generali: The direct effect of a rise in yield levels is clearly a mark-to-market one. However, higher yields also implies better reinvestment opportunities, especially for big insurance companies with legal liabilities to cover, and that is a very important point. For sure, what had

Idiosyncratic risk has definitely returned to the credit market

er that syndicates have been slightly pushing deals while rates had already started to rise. We believe it is primarily a reflection that the decision to issue is based on spread levels for a bank, while insurance consider the all-in yields. As a result, having seen the impact of very low yields on their solvency position in Q1 2015, some insurers were quite keen to issue cheap regulatory capital ahead of coming calls and the 2016 start of Solvency II.

Guttenplan, Rogge: Volatility clearly holds up the primary market but can make for interesting opportunities in the

ing a certain risk (duration), you should normally expect small triggers to have significant impacts. In general, the main sources of protection you have in such an environment come from the efficient management of your cash balance (sometimes with high opportunity cost) and, most importantly, diversification. As real money asset managers, mainly covering insurance-related portfolios, we have strategically increased our efforts towards investments with a strong fundamental research backing, especially in the primary market. In the secondary market, we kept on with the usual strategy of keeping high

begun as a pure rates repricing is now having some effects on spread levels across different credit products and on liquidity conditions in the secondary market. Investors will have to take a closer look to these dynamics and decide which logic is best to apply for their purposes. Since 2008, 10 year Bund yield has collapsed from 4.50% to basically zero. Prudent portfolio managers always adopt a medium term perspective in their positioning, and higher yields will prove to be beneficial to the market as a whole when short term volatility will have been absorbed.

We have full-scale QE in place and yet assets sell-off across the board. Is this contradictory? Would you say that the strategy of the ECB is delivering the expected effects?

Scarin, Generali: Theoretically that is contradictory, but in practice we have already seen in the past many episodes of market prices anticipating central banks' announced actions, so that should not come as a big surprise. We believe it is definitely too premature to judge the ECB strategy. European financial markets were pricing a prolonged deflationary environment with no hope of solving the bank lending situation in the periphery market, especially for SMEs. Summing up this fundamental factor with the extensively discussed technicality of negative net supply in the European government bonds market, the resulting squeeze had probably come to an unsustainable level. Markets had to correct and so they did.

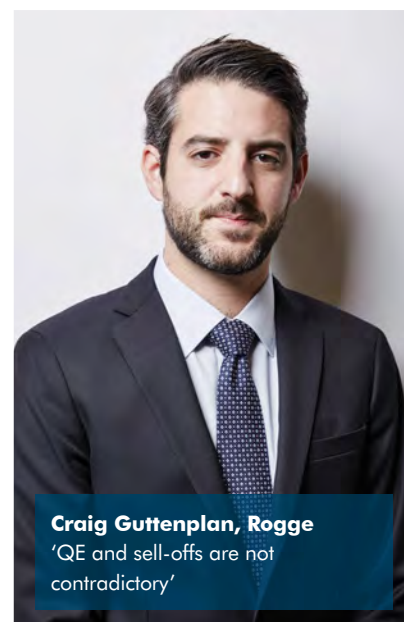
De Saussure, EDRAM: The ECB QE seems to have averted deflationary pressure for now, which was one of its goals. Anchoring inflation expectations is a good thing in that sense.

Guttenplan, Rogge: QE and sell-offs are not contradictory as markets can get ahead of themselves (as we saw with the recent rate correction) and/or legitimate crises can dwarf the positive impact (as with the ongoing Greek saga). ECB actions including both QE and the TLTROs are helping to modestly boost the real economy by lowering borrowing costs and

making exports more attractive, but it will take significant time and more structural reforms to put the Eurozone on track for solid and sustainable growth.

Sanford, Babson: It does indeed feel like the ECB QE impact is now exhausted and that the big squeeze in credit will not happen, with IG credit spreads now largely back to their pre-QE levels. But the sell-off is not too surprising in itself if you consider that the past few months have been fairly eventful (Greece, Russia/Ukraine) and that we saw higher-than-expected issuance fuelled by corporates domiciled outside of Europe. Add to this a sharp rise in Bund yields (and volatility), which you could view as a consequence of higher oil prices and inflation expectations, and it seems only fair to see the recent repositioning. Still, compared to other asset classes, credit has not done too badly, partly thanks to a steady stream of inflows in the asset class — and the ECB is not done buying. So we would not be surprised to see some retrace-ment in spreads in the next few months. What's more worrying for us is the current state of liquidity...

Alloatti, Hermes: It looks like the ECB is intending to stay the course. The jury is



Craig Guttenplan, Rogge
'QE and sell-offs are not contradictory'

A lot could in fact depend on how national regulators will react to those rules: Will more countries follow Germany and make OpCo senior unsecured debt TLAC-eligible? Will we see a new "Tier 3" type of debt emerge? Or, will most TLAC needs be met via Tier 2? Some banks have already indicated they will wait for the final rules before filling their MREL-TLAC buffers, but others may choose to strengthen capital buffers before the final figures are released. French banks have already in-

We're also painfully aware, as are many others, of the lack of liquidity in our markets

still out, but the willingness to fight any risk of deflation is definitely there. And the market shouldn't underestimate this factor.

What would you say are the main risks in the subordinated markets at the moment?

Sanford, Babson: There are several, but supply and liquidity are probably the first ones coming to our mind.

When it comes to supply, the final rules on TLAC and MREL play a big role, but are not expected until the month of November. The final decision around the eligibility of the outstanding senior unsecured debt will notably play a significant role in determining final issuance needs.

dedicated, for instance, their preference for Tier 2 debt in order to protect senior unsecured creditors, which could put pressure on this part of the capital structure. Supply risk appears particularly plausible if you think that investors tend to expect issuers to comply with new requirements as early as possible. Another risk for supply that we see is the increasing issuance from non-European issuers in the euro market, as seen earlier this year, if you expect continued US dollar strength.

We're also painfully aware, as are many others, of the lack of liquidity in our markets and of the swings in prices this has triggered. Price volatility is proving particularly true for the subordinated markets, and shows that a strong domestic investor base matters.

Scarin, Generali: I would say the main risks for sub bonds at the moment are Greece and the worsening liquidity situation of risk assets causing wider credit spreads. We should not forget that subordinated bonds often trade in cash price and as such they should outperform senior unsecured bonds — that tend to trade in spread — in the first stages of a higher yield environment. However, Greece and liquidity are two risk factors with no clear parallels in financial market history, and that is preventing investors from taking excessive risk. If you sum up the two with the significant expected supply of bonds in the subordinated space, it is quite normal to see the current cautious stance going on.

Goldfischer, CACIB: The main risk is the saturation of the market. Regulation is pushing for a lot of expected supply across European banks, and if everyone wants to be “ahead of the curve” we can face a bit of what happened late last year when the primary has far too many deals in a short period of time.

Alloatti, Hermes: Apart from rates volatility, oil price vagaries, spill-over from bond repricing and macro developments (read Chinese slowdown), complacency



Further interest rate shocks could also weigh on longer dated bonds.

And finally, as we move into 2016, MDA restrictions will kick in and could create some risks on specific AT1 issues.

Guttenplan, Rogge: The main risks in Europe are clearly geopolitical (Greece, Russia, oil) and economic (particularly in the Eurozone). Regulatory risk also plays a role for subordinated financials as the

funding needs implied by MREL/TLAC compliance and subsequently heavy supply in subordinated debt may weigh on sentiment at some point. The primary market has been very, very slow in Q2. ABN and HSBC took the advantage of first mover advantage and got it right on timing for their recent Tier 2s. There are tonnes of subordinated deals that have been announced but not executed yet and the summer is looming. So September is going to be buoyant, with a risk of indigestion. July may see negative headlines increasing around the situation on Ukrainian debt, but the major event until year-end remains the timing and the approach taken by the Fed towards hike US rates. Elsewhere, there is a lot of uncertainty surrounding Spain's general election in November. As we speak the risks to markets look contained. But populist movements in Europe are gaining importance and the way Tsipras battles the Troika at the moment tells us not to underestimate the significance of this event.

What's your view in terms of spread evolution and issuance volume in AT1 and Tier 2 during the second half of the year?

Hoarau, CACIB: Given the number and nature of the risk factors ahead of us, I can't see any serious catalyst for a sustainable change in global spread direction before year-end. Discipline, anxiety, sensitivity to price and selectivity will predominate while premia will remain elevated in a rising interest rate environment. Supply prospects are high and volatility — as flagged by Draghi — is set to remain at an elevated level. Non-repeat issuers from core regions will continue to outperform, but globally I doubt we will be back to the levels seen at the end of the first quarter. Only evidence of strong economic recovery in Europe can be a game-changer.

Guttenplan, Rogge: The subordinated debt market will be interesting to watch in the second half as we await two key decisions in the fall that could materially impact issuance volume and potentially spreads — final TLAC/MREL rules and

The main risk is the saturation of the market

and lack of differentiation between issuers are the main risks at the moment.

Brandenburg, Fidelity: I would say — and this applies to AT1 as well as other markets — it is around the question of secondary market volatility and the lack of capacity to trade the product.

The question with liquidity is whether this is purely a pricing issue, or whether there are fundamental problems around secondary market structure. A lot of it has to do with regulatory interventions at the banks, more than anything else.

De Saussure, EDRAM: Political risks are going to weigh at least until the end of the year and the elections in Spain.

quantity and quality of bank capital is being scrutinised and harmonised both at the regional and global levels, with regulators still focused on making the industry safer and more transparent — which in the long term should be positive for the sector as a whole.

The lack of liquidity from dealers holding less inventory is also a major concern for subordinated financials, particularly for smaller-sized and lower-rated issues.

Hoarau, CACIB: We are all focused on the Greece situation and headlines are driving sentiment. A weak deal will be closed at the last minute and thereafter the focus in European debt markets will switch to the issuance pipeline. Additional

approval of the German senior bond subordination law. Material changes to which instruments are eligible for TLAC/MREL could have significant implications for such issuance volumes, while approval of the senior subordination law, first in Germany and then possibly in other countries in Europe, will also dictate whether any incremental debt issuance is required above the existing stock of senior and if so in what form.

We are also wary of the large backlog of issuers in the Tier 2 space as well as the narrow windows for issuance given the typical summer lull as well as blackout periods for much of October.

Alloatti, Hermes: As we get more clarity regarding TLAC and MREL between September and the G20 summit in November we expect the supply of Tier 2 bank paper to gain momentum. Also, barring any catastrophe, it is fairly possible to see in the remainder of the year the same quantum of AT1 supply we have experienced so far this year.

Scarin, Generali: That is extremely difficult to predict. The Tier 2 market is more mature and diversified in terms of issuers (different fundamentals), structures (coupon deferability, perpetual versus dated) and sectors (banks and insurance), and it ranks higher in the capital structure so investors are more confident in taking that kind of risk even in volatile markets. However, issuance levels are possibly less predictable than Tier 1 in light of TLAC regulation and Solvency II developments. Spread levels are currently widening in Tier 2 also because of the quite tight levels it had reached.

The AT1 market is instead very different in nature. It is not a mature one, and many investors are still prevented from participating in it due to regulatory constraints (not always clear due to equity conversion and write-down features) and tail risk of zero coupon perpetuity. Clearly, spread levels are more attractive here and there are some relative value opportunities to exploit, precisely because it is still a dislocated market. In terms of expected issuance, initial calculations of 100bn in the next three years have to be adjusted down-

ward, considering the lower risk appetite, the higher yield levels and the regulatory constraints.

Sanford, Babson: This will depend partly on the situation in Greece and on the volatility going forward. We're closely monitoring supply and liquidity in the subordinated space, but our base case remains for manageable issuance for the second half, supported by banks focusing on meeting their 2% Tier 2 and 1.5% buckets rather than building TLAC buffers ahead of final rules. As a consequence, we currently expect subordinated levels to grind tighter in the second half, but continue to expect a certain amount of volatility in the markets, which could mean a market only open to the largest issuers.

Robelin, BlueBay: We do expect a fair amount of issuance over the next few months, which could be a bit of a headwind for the overall spread direction, because deals will have to be priced reasonably cheaply. On the back of that, having a lot of dry powder to take advantage of the new issues but being quite neutrally positioned in financial sub debt right now makes perfect sense, and indeed our intention — as



Vincent Hoarau, CACIB
'I doubt we will be back to the levels seen at the end of the first quarter'

suitable investments for a kind of plain vanilla classic investment grade corporate bond fund.

If you look at AT1 securities, I think they are attractive, and I would argue they are attractively priced versus Tier 2s, but that being said, they are really hybrid capital and I would argue in particular that with the new regulation and the

We are also wary of the large backlog of issuers in the Tier 2 space

long as the Greek story continues to play out as we now expect — is to be patient and disciplined in the way we will use our dry powder and put cash to work.

You are invested across formats in subordinated debt. Where do you see most value in the market, considering bank AT1, Tier 2 and insurance sub?

Robelin, BlueBay: Well you have to keep in mind that it is a very different investor base for AT1 and Tier 2. I think that Tier 2 bonds are truly going to behave like bonds going forward. They have a fixed maturity date, they have must-pay coupons, so the only risk you face when you buy a Lower Tier 2 bond is the risk of default. These instruments are typically rated investment grade as well, so to us they are perfectly

new type of instrument — with the optional coupon payments, with the ability to pay dividends on equity and not pay the coupons, with the ability for some structures to fully write down while the bank is still a going concern entity — you could argue that, for some structures at least, these instruments are actually subordinated even to equity. And so on our side, because our investment philosophy at BlueBay has always been to make sure that all funds do what it says on the tin and invest in a way that is consistent with the mandate we have been given by clients, we have refrained from these AT1 securities for our benchmarked investment grade funds. We have launched a dedicated CoCo fund, and we do buy AT1s for our next generation absolute return funds, because the mandate we

have been given by clients is consistent with buying these more equity-like instruments, but we really think that the investor base for Lower Tier 2 instruments and AT1 securities is different. And therefore because the investor base is narrower for AT1, you indeed need valuations to be attractive to justify making that investment because there is more of a question mark above the size of the real, underlying dedicated investor base, versus the amount of supply that we expect over the next few years.

That being said, to be honest, I have been very impressed by the resilience and the liquidity demonstrated in the AT1 bond market during the last few weeks, as the concerns around Greece grew. And I think that this has gone a long way to making investors more comfortable about the asset class. Perversely, one could argue that this will increase the risk that more investors who are not dedicated AT1 investors will engage in this market — what we call the famous off-piste investors, if you will, the “tourist” investors — and therefore the next time we have a bit of volatility, maybe AT1 will be a bit more vulnerable because there will be more tourist money that will decide to get out.



Julien de Saussure, EDRAM
‘We still like legacy bank and insurance Tier 1 with short calls’

by IG funds as a risk-on play as well as a duration play. Therefore they have proven the most sensitive to the reversal in both spreads and interest rates. Now, moderately rising yields are fundamentally positive for insurance companies as they reduce the gap between reinvestment yields and guaranteed yields, which is heavily penalised in Solvency II. So while these long duration bonds need to see interest vola-

ger and coupon deferral risk in the near term in light of large capital cushions as well as lower risk business models and credit exposures.

Sanford, Babson: Despite the supply risk mentioned above, we continue to like the Tier 2 space as we feel that the new issuance to year-end will remain manageable in most European jurisdictions — most banks should wait for final rules and national regulators’ guidance to announce plans for TLAC issuance. The space should also benefit from a growing CET1 capital base and improving credit profiles, but still offers a good pick-up versus senior curves. At the end of the year the technical picture could, however, change significantly.

The AT1 space also appears attractive at the moment, and we feel that post-widening a number of AT1s issued by strong credits offer adequate compensation for the risk embedded in those structures. Taking into account the difference in structures, European AT1s also compare favorably to AT1s issued out of the EM space. However, despite the growing size of the market there still isn’t any natural investor base for this market in our view, and we prefer to be opportunistic in the AT1 space.

We are active in the sub insurance space but invest in it more opportunistically. We look at the senior/sub spread relationship of a given credit as well as how it is priced relative to BB securities. Currently, this sector seems tight relative to how it has been priced on both measures over the past one and three year timeframes. Securities with low back ends have had very poor excess returns recently as investors anticipate rising rates and price in extension risk.

Scarin, Generali: When we balance all risk factors, we tend to believe subordinated insurance bonds offer the best relative value. More standardised structures, better company fundamentals and a bondholder-friendly stance. Solvency II should also prevent companies from undertaking excessive asset risk, which has historically been the first driver of spread evolution in insurance bonds. The key mark-to-market

We tend to believe subordinated insurance bonds offer the best relative value

Brandenburg, Fidelity: AT1 has been relatively cheap recently, so I think if deals come now people are going to look at them. However, we need to protect ourselves so we are demanding higher new issue premiums, and we expect that to continue.

De Saussure, EDRAM: We still like legacy bank and insurance Tier 1 with short calls as a carry play with close to zero interest rate sensitivity.

We see value in AT1 and continue to believe that a well-priced deal with decent spread can offer a decent protection in an environment with yields rising moderately.

Long dated subordinated insurance bonds are penalised by longer duration and their IG status. They have been used

tility come down to perform in the long run, we tend to see unwarranted spread widening in this segment.

Guttenplan, Rogge: Absent an exogenous shock, at the moment we like the value in strong peripheral bank Tier 2, recovering core bank Tier 2, and strong core bank AT1. We believe there is a burgeoning fundamental recovery in the periphery (more entrenched in Spain and Ireland while Italy’s is more nascent albeit becoming increasingly tangible) which will benefit bank credit profiles including building high quality capital. In the core, we see several clear recovery plays in the Tier 2 space and also think AT1 of certain strong banks offer attractive carry given what we perceive to be very remote trig-

risks here come from the higher duration and the significant supply of bonds the market has absorbed so far, with subsequent risk of indigestion.

Alloatti, Hermes: At the current juncture we find the sub insurance space to be one of the most attractive in terms of risk/rewards. The insurance industry broadly maintains that Solvency II will not be capital-raising while conceding this new regime could affect the timing of cashflows.

Robelin, BlueBay: If you look purely at valuations, the insurance sector has really underperformed lately, and arguably it looks very, very cheap versus bank sub debt. That said, it is important to recognise that there is a very clear improving trend in banks' credit fundamentals on the back of the new regulatory developments that to us justify the positive trend in bank spreads and an expectation that bank spreads will tighten over time.

Against that, if you look at insurers, I would argue that the new regulation doesn't particularly make them less risky going forward. The combination of new regulation and super low levels of rates actually brings existential issues for the insurance sector, we believe, and a greater risk of consolidation in insurance values in the future. We all remember the famous Equitable Life in the UK and the way guaranteeing high returns to your policyholders can become highly problematic as interest rates fall. And so I would argue — and this is something that is quite obvious to us — that the dramatic fall in interest rates, and the risk that they could stay low for a very prolonged period of time, is to some degree an existential threat to a number of insurers in a number of jurisdictions, and increases uncertainty.

So while you have a clear improvement in the underlying credit profile of banks, it is actually the opposite for insurers. And as much as a snapshot credit profile of a particular sector or a particular issue matters, markets tend to anticipate the direction of travel and price spreads accordingly. So I can't really say we are surprised to have seen insurance spreads underperform bank spreads because of these opposite dynamics in credit fundamentals.

That being said, it feels like the recent move has probably been somewhat excessive and certainly for the strongest insurers, or those with a good specific bottom-up story. So, for example, it is our expectation that Groupama sub debt will be upgraded to investment grade over the next few weeks. We feel that valuations have probably cheapened up too far and we are happy to re-engage in sub-insurance as well.

Would you say that the AT1 market is closed for non-core issuers?

Alloatti, Hermes: With regards to the peripheral issuers, we think the market is not always closed to them. But the clearing price might be somewhat higher than the banks' expectations.

Scarin, Generali: I would not say so, but one has to adjust this judgment in light of the current non-standard investors' base. If the AT1 market were a developed one, with a diversified pool of investors within it, in the current volatile market it would likely be closed for non-core issuers. However, that is really not the case. We had new issues recently from peripheral issu-

ers. That being said, it feels like the recent move has probably been somewhat excessive and certainly for the strongest insurers, or those with a good specific bottom-up story. So, for example, it is our expectation that Groupama sub debt will be upgraded to investment grade over the next few weeks. We feel that valuations have probably cheapened up too far and we are happy to re-engage in sub-insurance as well.

Guttenplan, Rogge: Recent issuance by the Irish banks, in particular the heavily oversubscribed Bank of Ireland deal, which is one of the lowest rated and widest trading AT1s, shows that there is demand for the right name and structure. Second tier banks still need to be opportunistic and find the right investor base, but the range of issuers that have come to market over the past two years shows that there can be demand even for off-the-run names.

Sanford, Babson: We would probably say there is a price at which investors will look at peripheral issuers in the AT1 market and strong business profiles in non-core countries that will meet investor demand, including in difficult market conditions. Earlier this month, and in a context of widening spreads, we saw Bank of Ireland successfully sell Eu750m of an attractively priced low-trigger AT1. The bond was more than seven times oversubscribed and has proven resilient in the current volatil-

There is a price at which investors will look at peripheral issuers

ity. We could easily imagine other top tier peripheral names issuing in the AT1 space with a similar outcome if they offer a sufficient premium for volatility.

ers or second tier banks in general, with structures and sizes probably designed to satisfy the increasing demand from Asian private banks or dedicated mandates. Also, the currency played a crucial role in that sense. But such a situation could possibly change.

De Saussure, EDRAM: No, not necessarily. A well flagged deal like Bank of Ireland AT1 was priced while volatility had already started to increase, because they have a widespread audience of funds closely following the name and already invested in the either the 2016 CoCo or the 10.24% Baggot securities.

Most traditional AT1 issuers would probably want to wait until volatility comes down before they issue. Some issuers have refinancing deadlines or specific

The AT1 market is maturing and investors are getting a better grasp of the risks of this instrument. Strong capital buffers, a supportive domestic investor base, recurrent earnings capacity and limited supply needs are in our view major considerations when investing in those instruments, and with the right premium for volatility the market should be able to absorb AT1 issuance with such features coming to the market, whether from core or non-core countries.

Brandenburg, Fidelity: No, I think the market will reopen for a variety of issuers, so that includes top tier as well as

good second tier names. You saw Abbey National printing in relatively difficult circumstances, which is a good example of what is possible, and also Irish Life & Permanent, which is a tiny Irish bank.

Hoarau, CACIB: AT1 instruments have suffered across the board, but I was positively surprised to see the resilience demonstrated by national champions out of southern Europe. When it comes to second-tier borrowers in non-core jurisdictions, supply should be relatively limited until the end of the year and candidates ready to brave the market should find a fair audience providing that volatility comes down, market sentiment improves, and they are ready to pay levels higher than fair value to capture decent demand. Investors have not gone on strike. The cash is also available for weaker signatures but investors want to get this extra yield to compensate for the greater mark to market risk and more importantly the quasi-non-existent liquidity available for higher beta names in the secondary market. Almost everyone here emphasised the liquidity challenges and in difficult markets you may

Guttenplan, Rogge: We view the Tier 3 approach as simply a Plan B in case the German subordination law fails to be approved first in Germany then across other countries in Europe. Countries and issuers want to keep all options open for meeting TLAC/MREL requirements in the most cost efficient manner and we believe that Tier 3 could be a more expensive form of debt than subordinated senior i.e. more in line with senior HoldCo than senior OpCo given where it ranks in the bail-in waterfall and the likely relative size in the capital stack.

Scarlin, Generali: We could see some new “explorative” issues here, but we tend to believe the market for subordinated bonds has already developed significantly in recent years in its Tier 2 and Tier 1 buckets. Also, one should not forget the strong increase in hybrids issued by non-financial corporates, adding a further investment possibility in a broader diversified portfolio. But all these opportunities in the subordinated space could lose some appeal in a normalised interest rates environment, because many “tourist” investors

cured is now at the center of the debate. Most banks have already amended their EMTN prospectus so that, when old Tier 2 are extinct, they can insert that new layer.

By the way, we believe there is an over-interpretation in the market of the recent changes in the Spanish insolvency law. As far as we understand it, contractually introducing a Tier 3 in Spain would have been superseded by the non-existence of Tier 3 in liquidation. As a result, Spanish banks are now on an equal footing with other jurisdictions and can introduce Tier 3, if the existing stack of Tier 2 does not prohibit them from doing so. Now, there very little amount of Tier 2 in Spain and therefore some Spanish banks could start issuing.

We have quite some sympathy with the so-called German option in BRRD — senior unsecured can be bailed-in and we had a painful consensus on that. So let's work so that it can be TLAC-eligible as well. Obviously, making deposits “preferred” in liquidation may be a more desirable option than making senior unsecured “junior”, so as to avoid mandate restrictions on subordinated instruments. It could have negative consequences on senior ratings, but we would expect most banks to continue to issue capital instruments in due time and credit-enhance their senior unsecured bondholders and protect their rating. But at least they would be more quickly TLAC-eligible with a more limited and more disciplined Tier 2 issuance pipeline in the near term. The European economy is still very intermediated and senior unsecured funding is a major funding tool. Therefore its rating will continue to matter and banks would still be incentivised to maintain superior ratings. In more disintermediated economies like the US, transforming HoldCo senior unsecured into a bail-in-able instrument, i.e. a last tranche of the capital stack, is less of an issue. The recent news that structured funding could be TLAC-eligible under certain conditions, contrary to the initial TLAC term-sheet, may pave the way for some of the French banks to support a “German” solution. The exclusion of vanilla structured notes, heavily used by French banks, was indeed one of their key concerns after the initial TLAC proposal. ●

We view the Tier 3 approach as simply a Plan B

not find any exit strategy when you invest in AT1 bonds issued by smaller borrowers unless you get out at a prohibitive price. So we may see more and more club deals from non-core issuers looking for sub-benchmark size and bought by rare “buy and hold” AT1 investors. In that format you simply avoid the involvement of those opportunistic tourist investors and make the valuation of the bond less vulnerable to phases of volatility. In terms of how they approach primary, non-core issuers should not be shy but be ready to go on the road in difficult markets even if they are forced to wait after they have met investors. There is little harm in doing roadshows, then at least you can act quickly when the issuance window is there and markets stabilise.

There has been a fair bit of talk about Tier 3. How do you see those discussions evolving?

who are currently buyers could go back to traditional senior unsecured investments, being able to satisfy their target returns with lower risk assets.

Alloatti, Hermes: Tier 3 in some instances represents a contractual subordination and as such does not seem fully in sync with the statutory subordination the FSB is advocating.

De Saussure, EDRAM: Since the G20 in Brisbane and the proposed TLAC structure, structuring teams have worked hard on Tier 3.

The option to issue instruments paripassu with Tier 2, but not treated as regulatory capital doesn't seem to have traction anymore, as investors are not ready to price that differently than a Tier 2.

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European insurers

Challenges and potential

Philippe Picagne, senior analyst — insurance, at CreditSights, and University Professor, examines the challenges facing the European insurance sector, and explores how Solvency II is affecting their strategies, not least in the capital markets.

What are the current challenges posed to European insurers?

I think that the current low interest rate environment, together with a marginal deterioration of the property and casualty (P&C) primary insurance market (e.g. commercial motor) has put pressure on European insurers in delivering a satisfying overall level of profitability for their shareholders. For reinsurers, the situation is even more gloomy considering the soft P&C reinsurance market. Even this relatively weak profitability might not be sustainable in the long term. My interpretation of Solvency II is that it will offer European insurers a “plan B” vis-à-vis capital management in order to improve overall profitability. For example, management could look at increasing returns to shareholders via special dividends or buy-backs while issuing Tier 1 debt to maintain an adequate solvency position. In our view, the capital structures of European insurers are far from optimal under Solvency II.

Additionally, one could argue that interest rates will eventually rise in the future considering their present rock bottom levels. If that were to happen, we believe that under the current IFRS rules, some players will be at risk because of the corresponding reduction in the AFS reserve, a significant part of an insurers’ shareholders’ equity. The situation could be particularly critical if interest rates were to increase suddenly and sharply. Ultimately, this situation could lead to a decline in the financial strength of insurers.

In this context, what are the trends in terms of investment strategy?

Over the past few years, we have identified two trends. Firstly, some primary insurers — in their search for higher yield — increased their asset allocations to Italian and Spanish government bonds two years ago. In particular, composite or life insurers with a relatively high guaranteed rate in their liabilities had to increase their return on investment in order to match or minimise the interest rate gap. These insurers are predominantly based in Germany, Austria and Switzerland. One could argue that this strategy has had great results over the last two years, but with the rumblings in Greece ongoing, it will be put to the test again.

Secondly and more recently (i.e. over the last year and a half), European insurers have significantly increased their asset allocation to corporate bonds. This does not come as a major surprise considering the low yield that investors receive on European sovereigns, the staple of an insurer’s investment portfolio. So far, European insurers have focused on high grade corporate bonds with a limited asset allocation to high yield. Prospectively, I would not be surprised if the allocation to high yield continues to grow over time, considering the relatively low marginal cost of capital implied.

Solvency II will be implemented next year. Do you see any major changes in terms of risk profile for European insurers?

After several delays, Solvency II will finally be implemented this coming January. In the very short term, I do not anticipate any significant changes in the risk profile of European insurers, especially with the beneficial transitional arrangements in place. So far, we have seen some insurers optimising their business profiles with Solvency II in mind. In particular, some have broadened their lines of business and geography in order to better benefit from the risk diversification factor under Solvency II. As a matter of fact, the cornerstone of Solvency II is risk diversification; the greater the risk diversification, the lower the required capital. We see Scor as a good example of this approach, given how its business split has evolved following its numerous acquisitions.

But the key question behind Solvency II is whether or not we can rely on the correlation factors that underpin diversification. And to what extent? I fear that some insurers in search of capital optimisation may face financial issues in the medium term.

The value at risk (VaR) approach is sensible in an environment of low volatility. In some regions, such as Japan, insurers quantify their risks through scenarios instead of VaR. More importantly, the key flaw of Solvency II relates to (i) the lack of information to investors regarding the assumptions used in internal models, which impairs the ability to compare Solvency II ratios among European insurers and (ii) the convexity of the 99.5% VaR. In other terms, I believe it would make

sense to disclose the required amount of capital at different confidence levels.

How does Solvency II compare with Basel III?

From a debt perspective, Solvency II Tier 1 and Tier 2 debt are relatively similar to Additional Tier 1 (AT1) and Tier 2 issued by European banks. There are a few minor differences that are not significant, in my opinion. Solvency II is certainly less precise and stringent than Basel III.

The key difference between Solvency II and Basel III stems from the quality of capital. In my opinion, paradoxically, Solvency II promotes a weaker quality of capital through the inclusion of 100% of an insurer's value in force (VIF) as Tier 1 capital, net deferred tax assets as Tier 3 capital (which could account for up to 15% of the company's Solvency Capital Requirement (SCR)), plus letters of credit and reinsurance covers as Tier 2 capital. The VIF can fluctuate significantly due to the presence of high guarantee rates. For example, Allianz's VIF declined from Eu12.5bn in 2007 to Eu2.6bn in 2008. If the VIF fluctuates, then the insurer's capital will change in value, and so will its Solvency II ratio. Correspondingly, I believe that some insurers could be at risk.

Do you think that Solvency II will improve the quality of information disclosed by insurers?

Yes, under Pillar 3 of Solvency II. But I believe insurers will still need to disclose more information to investors if they want to market their debt issuances. In particular, I think there is a need to educate investors on the sensitivity/convexity of the issuer's SCR, especially with the loss absorbency mechanism in a Tier 1 bond.

Traders and asset managers will have to manage the "distance to trigger" for Solvency II Tier 1 bonds, or they risk getting their fingers burnt in the process.

Do you see substantial issuances of Tier 1 and Tier 2 debt in the near future?

Solvency II is a playground for capital optimisation. In contrast to banks that need to have a minimum amount of shareholders' equity under Basel III, insurers could virtually run their business without a mini-



Philippe Picagne,
CreditSights

imum amount of shareholders' equity per se under Solvency II. This situation is likely to lead some insurers to swap their shareholders' equity for Tier 1 debt in order to optimise their overall profitability, as measured through their return on equity. Furthermore, this situation would not materially change the insurer's Solvency II ratio as the total amount of Tier 1 would remain identical after the swap. The only hurdle I see is maintaining their credit ratings in the process; bearing this in mind, rating agencies do not have stringent requirements in terms of hard capital. If this were to happen, then their risk profiles would deteriorate, to the benefit of equity holders. In which case, I would rather be long equity and short bonds of European insurers.

From a demand perspective, we expect Solvency II Tier 1 bonds to be popular among investors. We believe most are already familiar with the loss absorbency mechanism via bank AT1s. Crédit Agricole's recent study on the pricing of Solvency II Tier 1 bonds (anticipated spread at a multiple of c. 1.65x Tier 2 bonds) is consistent, in our view. Although from a theoretical perspective, I challenge the pricing of the loss-absorbency feature of Solvency II Tier 1 debt as insurers rarely file for bankruptcy; instead, they are put into run-off.

Investors in hybrid bonds issued by European insurers will also benefit from the issuers' strong ratings; on average, European insurers are rated in the AA/A range. The current rating methodologies of Fitch, Moody's and Standard & Poor's only assign a three notch difference be-

tween the senior and subordinated debt ratings, compared with up to six for banks. This situation is rather strange as Solvency II Tier 1 debt characteristics are very similar to AT1s, and Solvency II is unlikely to change materially in the very near future. But even if rating agencies were to change their methodologies in future, most Solvency II Tier 1 bonds are likely to be rated high grade, which will provide an extra incentive to invest in this asset class.

What is your view on the G-SII framework?

I think it is too early to comment on this point based on past experiences with the development of Solvency II. There will likely be a few European players impacted by the G-SII rules. This "VIP membership" will require additional capital and face greater regulatory scrutiny, which in theory should improve their financial strength. With the framework far from being finalised, I am sure that there will be intense discussions and lobbying in order to minimise this additional layer of capital or to find alternative solutions such as letters of credit that would not imply an increase in capital.

CreditSights

CreditSights is a leading provider of independent credit research and risk products. For additional information, contact: ppicagne@creditsights.com.



Aviva headquarters,
London

Aviva

Friendly reopener

After six weeks without any financial institutions sub debt issuance, Aviva successfully reopened the market on 28 May with a dual tranche, Eu900m and £400m, Tier 2 offering. Here, Susan Sharrock Yates, deputy group treasurer, Aviva, discusses the UK insurer's business and issuance strategies.

What was the rationale for your transaction and its timing? The lead managers noted at the time that it came after the Friends Life acquisition closed.

Susan Sharrock Yates, Aviva: There were a number of reasons. One was that over the next two years we have a number of opportunities to call existing subordinated debt, and we've also got a senior redemption next year. At the same time, interest rates are currently at historic lows — our funding rate on the most recent transaction is the lowest we have ever funded at in subordinated debt. So, mindful of the attractiveness of rates and mindful of the fact that we've got opportunities to replace existing debt over the next couple of years, we thought it would be good to look at the market.

Over and on top of that with respect to timing, there is the fact that we've completed the Friends Life transaction and we were very keen — regardless, to be honest, of whether or not we were going to be financing — to get on the road and speak to debt investors, and tell them more about the combination and the benefits of the transaction. That was something that they clearly welcomed, and indeed we are going to be more pro-active in keeping in touch with bond investors going forward because they very much appreciated getting that update.

Were there any particular messages about Aviva and your strategy that you emphasised?

Sharrock Yates, Aviva: We particularly wanted to empha-

sise the fact that we have managed to achieve a number of the objectives we set out to do when Mark [Wilson, group chief executive] joined a couple of years ago. We set out our "cash-flow and growth" strategy then, including a focus on balance sheet strengthening. Whilst we had already made progress on the leverage position, the Friends Life transaction helps accelerate the balance sheet transformation and leverage is now within our target range and in line with double-A rated peers. In addition, the Friends Life cashflow, including significant synergy benefits, will increase the strength of the Aviva group cashflow.

Did investors raise any particular points?

Sharrock Yates, Aviva: Not necessarily in regards to what we are doing, but the questions that came up in every single meeting were more about Solvency II, not surprisingly. And there are limits to what anybody can honestly say about Solvency II at the moment because the music hasn't stopped.

Markets have been very volatile. Did the macroeconomic backdrop affect the timing and/or execution of the transaction?

Sharrock Yates, Aviva: Well to be honest we were actually ready to go prior to when we did go. We made sure that our Euro note programme was fully updated and that our regulator had given the necessary clearance for us to issue the debt



Susan Sharrock Yates, Aviva

we were proposing — it's worthwhile getting all that done up front. And then once the Friends acquisition closed we were absolutely ready to go. But there were then a number of bank holidays, as well as our Q1 interim management statement, and we had to get them all out of the way.

And then we thought, well, markets are volatile, but we can't see that improving over the short term at all, and we were keen to get something done before the summer. Fortunately, once we were ready to go we saw a slightly easing of volatility, and to be honest given our banking group and given our story, and the feedback that we had received from investors on the road, we were confident that we would be able to get something done.

We ideally would have liked to do something a little bit longer in the euro space, but given the volatility of markets and the lower rates, there wasn't sufficient appetite in euros to go longer. But we were confident that we could issue the standard non-call 10 within that timeframe. And ultimately we were able to raise the upper end of what we were looking to do in terms of size.

How did the sterling tranche evolve?

Sharrock Yates, Aviva: As mentioned before, we were quite keen on having a longer tranche. Ideally we would have had a longer euro and a standard euro, so the issuance would have been all in euros. Because we have a large European presence it is quite useful to offset that with some debt on the balance sheet. But there wasn't enough appetite from investors to do long euros — that isn't just for our paper: generally it isn't a market that supports longer maturity debt issuance.

We didn't want to go too large on the benchmark 30 non-call 10, but given the level of rates we wanted to take the opportunity to lock in for a little bit longer, so we spoke to some of the investors to say, OK, you don't want to do longer euros, would you do longer sterling? And the answer was, yes, we do have appetite in sterling for that longer paper.

Another thing to note is that now that the Level 2 text for Solvency II is published, there is greater clarity. Issuers are not going to have to potentially rely on grandfathering for deals to qualify for capital treatment. Over the last two years the PRA has — in contrast to other European regulators — been insisting that any debt issuance is absolutely in the direction of travel of the regulations. When we issued subordinated debt in 2013 and 2014 we therefore expected this to qualify directly, but limited the call dates to within the grandfathering period so that, had there been any last minute change, we would have grandfathering as a backstop. Now that the rules have landed we didn't need to think about that backstop, that grandfathering; we could actually go for longer issues callable after the end of the grandfathering period.

So were you satisfied with the pricing and with the quality of the order book?

Sharrock Yates, Aviva: We are very happy indeed. As I said before, the pricing is historically the lowest rate we have issued at. And given the market backdrop I was very pleasantly surprised by the size and quality of the order book, which was almost Eu5bn equivalent, and we managed to tighten pricing 10bp inside the initial price thoughts. Just two weeks later book sizes were falling and price tightening of that order became very challenging, so we were fortunate in getting a bit of a sweet spot in the market before Greece and other concerns started rearing their heads.

To what extent does the prevailing interest rate situation affect your capital requirement/capital planning?

Sharrock Yates, Aviva: That was actually one of the questions that came up on the roadshow. Quite a few of our investors, in particular in continental Europe, asked how we were managing the low interest rate environment and if this was this a major concern for us.

Interest rate risk isn't a risk we want to take, and we match our books accordingly. In our roadshow pack we had a specific slide looking at the low interest rate environment and the impact for us, and highlighting the fact that we've lowered or removed guarantee rates in our participating business throughout Europe.

Our published sensitivities, in our half year 2014 accounts, show that we are relatively insensitive to interest rates. For example, for a 50bp fall in interest rates across the yield curve, our sensitivity on economic capital is only about Eu0.1bn.

We therefore have low interest rate exposure compared to a number of our peers. The biggest risks we have are longevity, which is the nature of the business, and credit risk, which again is largely the nature of the business. However, as a composite with a diverse range of risks, a number of these risks naturally offset each other.

So whilst it isn't a marvellous environment at the moment, we feel that we are better positioned than most. ●

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JUNE 2015	 SEB AB EUR 1,000,000,000 0.750% Covered Bond Due 2022 Joint Bookrunner	JUNE 2015	 ROYAL BANK OF CANADA EUR 1,000,000,000 0.875% Covered Bond Due 2022 Joint Bookrunner	JUNE 2015	 ABN AMRO EUR 500,000,000 0.750% Senior Unsecured Notes Green Bond Due 2020 Joint Bookrunner	APRIL 2015	 CENTRAL BANK OF SAVINGS BANKS FINLAND PLC EUR 500,000,000 1.000% Senior Unsecured Due 2020 Joint Bookrunner
APRIL 2015	 CAISSE FRANÇAISE DE FINANCEMENT LOCAL EUR 1,000,000,000 0.200% Covered Bond Due 2023 Joint Bookrunner	APRIL 2015	 NIBC EUR 500,000,000 0.250% Covered Bond Due 2022 Joint Bookrunner	APRIL 2015	 BERLIN HYP EUR 500,000,000 0.125% April 2022 Green Pfandbrief Joint Bookrunner	APRIL 2015	 DEUTSCHE/HYPO Member of NORD/LB EUR 500,000,000 0.125% April 2022 Mortgage Pfandbrief Joint Bookrunner
MARCH 2015	 AKTIA BANK PLC EUR 500,000,000 0.250% Covered Bond Due 2022 Joint Bookrunner	MARCH 2015	 DEXIA CRÉDIT LOCAL EUR 2,000,000,000 0.250% Senior Unsecured Guaranteed Notes Due 2020 Joint Bookrunner	FEBRUARY 2015	 DANSKE BANK A/S EUR 1,000,000,000 0.250% Covered Bond Due 2020 Joint Bookrunner	FEBRUARY 2015	 NATIONAL AUSTRALIA BANK EUR 1,000,000,000 0.875% Covered Bond Due 2027 Joint Bookrunner

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