

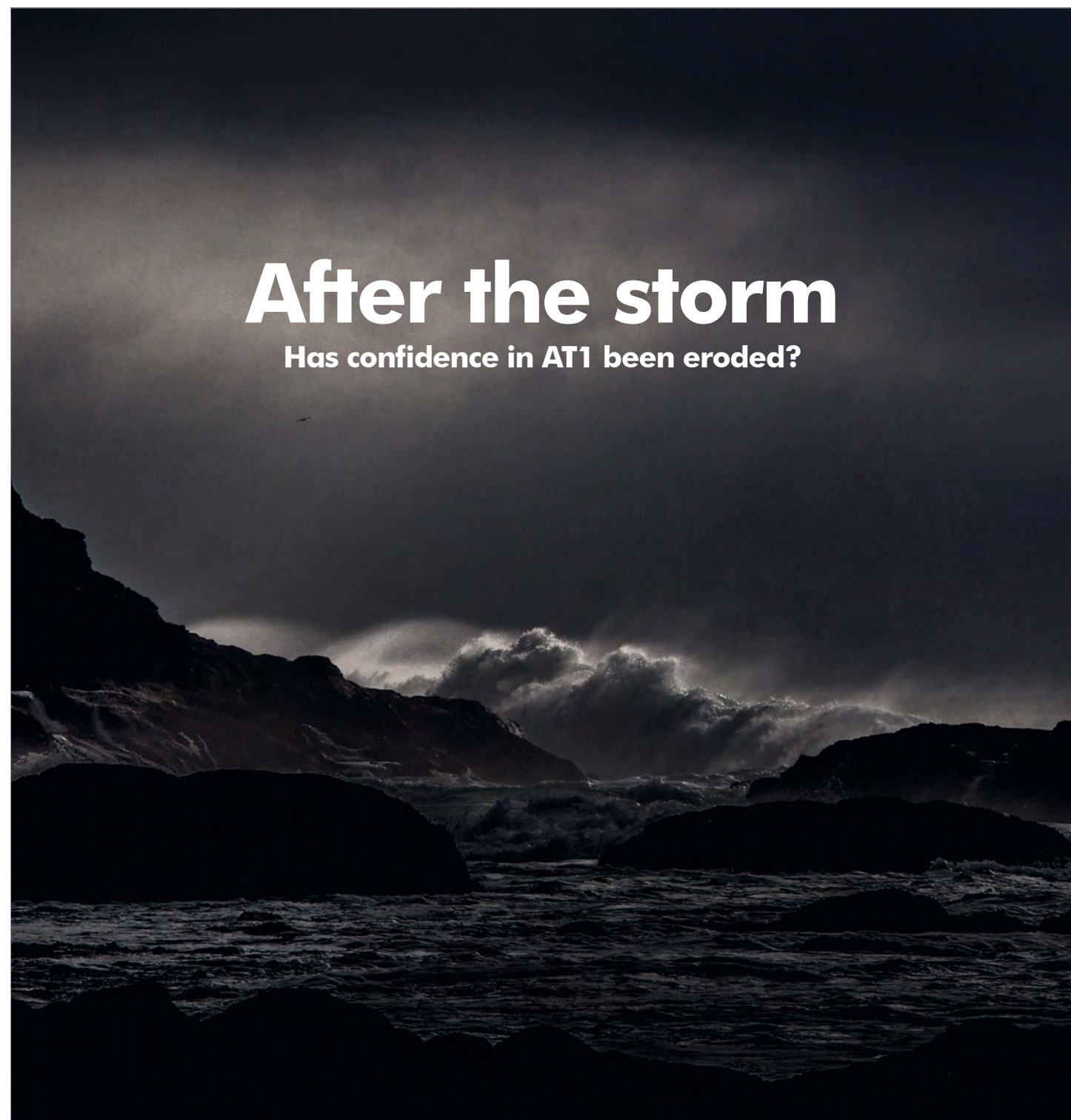
Bank+Insurance HybridCapital

Jan-Feb 2016

With  **CRÉDIT AGRICOLE**
CORPORATE & INVESTMENT BANK

After the storm

Has confidence in AT1 been eroded?



Roundtable
New headwinds

Intesa Sanpaolo
At the vanguard

Pioneer
In at the deep end



building SUCCESS together ✓

MARCH 2016



CRÉDIT AGRICOLE
HOME LOAN SFH

EUR 1,750,000,000

0.375% Covered Bond
Due 2023

EUR 1,500,000,000

1.250% Covered Bond
Due 2031

Joint Bookrunner

MARCH 2016



RABOBANK NEDERLAND

EUR 2,000,000,000

1.25% Senior Unsecured
Due 2026

Joint Bookrunner

FEBRUARY 2016



ROYAL BANK OF CANADA

EUR 1,500,000,000

0.125% Covered Bond
Due 2021

Joint Bookrunner

FEBRUARY 2016



NATIONWIDE BUILDING SOCIETY

EUR 1,250,000,000

0.125% Covered Bond
Due 2021

Joint Bookrunner

FEBRUARY 2016



LANDESBANK HESSEN-THÜRINGEN

EUR 1,250,000,000

0.00% Mortgage
Pfandbrief
Due 2020

Joint Bookrunner

FEBRUARY 2016



BANCO SANTANDER S.A.

EUR 1,000,000,000

1.375% Senior Unsecured
Due 2021

Joint Bookrunner

FEBRUARY 2016



KBC BANK

EUR 1,250,000,000

0.375% Covered Bond
Due 2022

Joint Bookrunner

FEBRUARY 2016



ABBAY NATIONAL TREASURY
SERVICES PLC

EUR 1,000,000,000

0.250% Covered Bond
Due 2021

Joint Bookrunner

FEBRUARY 2016



SKANDINAVISKA ENSKILDA BANKEN AB

EUR 1,500,000,000

0.150% Covered Bond
Due 2021

Joint Bookrunner

JANUARY 2016



LANDESBANK BADEN-WÜRTTEMBERG

EUR 750,000,000

0.05% January 2016
Mortgage Pfandbrief
Due 2020

Joint Bookrunner

JANUARY 2016



DNB BOLIGKREDITT AS

EUR 1,500,000,000

0.375% Covered Bond
Due 2021

Joint Bookrunner

JANUARY 2016



CAISSE FRANÇAISE
DE FINANCEMENT LOCAL

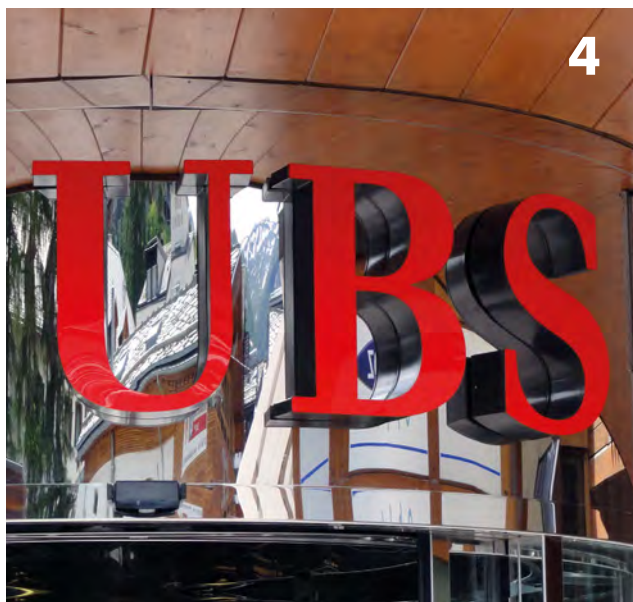
EUR 1,000,000,000

0.500% Covered Bond
Due 2022

EUR 500,000,000

1.500% Covered Bond
Due 2031

Joint Bookrunner



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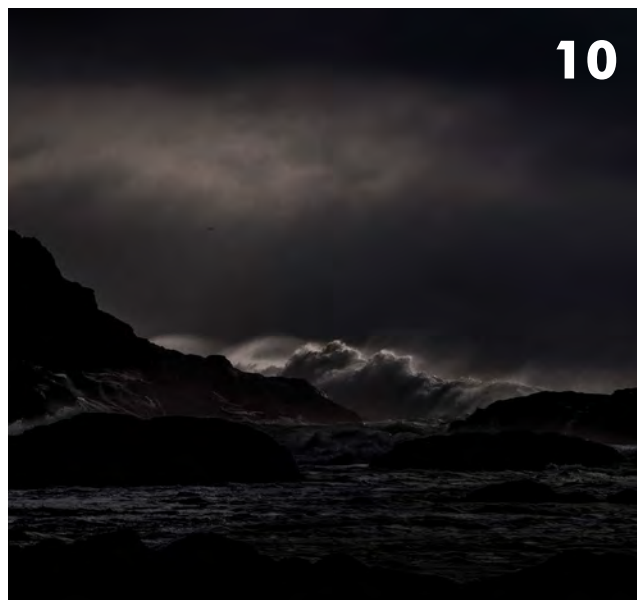
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Beyond the headlines



Bombshells! Death spirals! Blood in the streets! Events in the Additional Tier 1 market made for a perfect storm of journalistic clichés in the opening months of the year, and for once their use was justified. Maybe prices didn't *literally* fall off a cliff, but AT1 were left in a critical condition.

At the turn of the year few would have predicted the horrendous collection of factors that afflicted markets barely a week into 2016: negative news on oil, China and bank earnings — combined with bewildering regulatory pointers from the “competent” authorities.

AT1 found itself centre stage for all the wrong reasons, with issuers' earnings falling short of expectations just as the bar for distributions was being bumped up — while a lack of understanding of the instruments amplified the negative sentiment being fed back into the broader markets.

Value hunters put a bottom under the market after others had capitulated, but a substantial recovery in the sector had to await the latest instalment of Mario magic — leading to round two of cliché bingo: bazookas, game-changers, etc.

Again, these did not overstate the impact of the ECB's actions; after disappointing at its December meeting, the Governing Council overdelivered in March, paving the way for UBS to reopen AT1 issuance.

However, while the cutting of rates and boosting of QE undoubtedly stole the headlines, it was Draghi's footnote regarding Pillar 2 that could ultimately prove the most important for the AT1 market, drawing attention to a European Commission review of the aspects of the instrument that had been the most contentious during the volatility.

The ECB has arguably bought time for the authorities to sort things out and provide the clarity the market desperately needs.

Will they get it right? No comment.

Neil Day,
Managing Editor
**Bank+Insurance
HybridCapital**

Bank+Insurance HybridCapital

Published by Newtype Media

Neil Day
Managing Editor
+44 20 3269 2058
nday@bihcapital.com

Tom Revell
Reporter
+44 20 8961 8220
trevell@bihcapital.com

In association with



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

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

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

Visit us at
bihcapital.com

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Celeritas Solutions

Newtype Media
184 Acton Lane
Park Royal
London NW10 7NH
United Kingdom
+44 20 3269 2058

Market news

UBS unlocks market as AT1 steps back from brink

UBS breathed life into the Additional Tier 1 market on 14 March with the first such issue in more than two months, making a move to sell a \$1.5bn AT1 that was bold even if the asset class had been a beneficiary of European Central Bank measures that lifted credit markets.

Only a few days earlier the new issue would have been all but unthinkable, after a disastrous start to the year for the AT1 market. Intesa Sanpaolo and Crédit Agricole were able to launch euro and dollar benchmarks, respectively, on 12 January, but the market subsequently shut down, initially on the back of macroeconomic worries and then as a result of issues central to the asset class.

New year equity and credit markets were spooked by sharp falls in the oil price that took it to the first of several new lows, while concerns about Chinese growth added further downward pressure. The volatility left the financial institutions market — with the exception of covered bonds, but including insurance — increasingly moribund as January progressed into February.

Into this cocktail of negative exogenous headlines came bad news from the financial sector itself, with concerns growing over bank results leading to fears that some issuers might be restricted from paying coupons — particularly with the European Banking Authority having in mid-December apparently



raised the bar for making such distributions (*see separate article*). The resulting deterioration in sentiment hit credits from the periphery to the Nordics, although Deutsche Bank found itself centre stage (*see separate article*).

'Such is the power of the sentiment change'

The sharp fall in the AT1 market on the back of the fears over non-payment of coupons was compounded by concerns that, as prices fell, the likelihood of the instruments being redeemed on their first call date — which, like coupons, is a discretionary feature of AT1 — fell.

"What that does is cause some negative gamma in the whole sector because the further away you move from par, the less likely they are to be called," said Crédit Agricole CIB credit financials trader Nigel Brady. "If you flip from pricing them to a call date — i.e. you are going to get your notional back in five years' time — and start pricing them as a longer term perpetual, they actually become a lot more expensive at the margin."

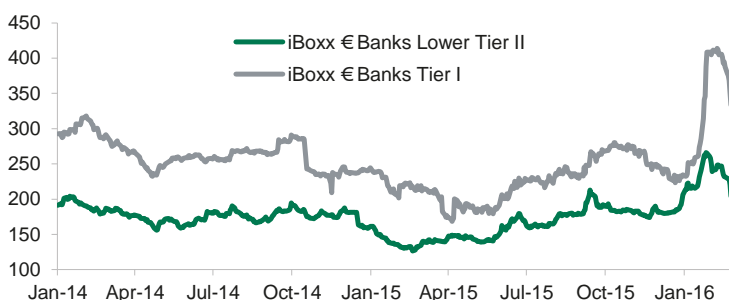
"That is the kind of dynamic we saw in February. Indeed, there were several factors conspiring against the sector, which is why we fell between 10 and 20 points broad-based between January and mid-February."

Exacerbating the pressure on prices was, according to various market participants, the liquidation of positions from among the biggest holders of AT1.

"There was some capitulation selling due to outflows from specific funds," said one, "and that caused yet another very negative dynamic for the whole market just when it didn't need it."

Headlines about a CoCo "death spiral" soon emerged in the wider press amid warnings that the risks afflicting the AT1 market could contribute to dragging the European banking sector back down to the darkest days it suffered during the financial crisis.

Secondary bank subordinated indices



Source: Markit, Crédit Agricole CIB

ECB changes the game

Credit markets and AT1 prices improved in the second half of February, but it was not until the “game changer” of the ECB measures on 10 March that market participants considered sentiment suitably constructive for a reopening of the bank capital market. And while senior and Tier 2 issuance revived in the wake of the central bank meeting, it was UBS that stole the headlines with its AT1.

The Swiss bank attracted over \$8bn of demand to its \$1.5bn perpetual non-call five issue, with the level coming in from initial price thoughts of 7%-7.125% to 6.875%.

“Consider this,” said Eoin Walsh, partner and portfolio manager at TwentyFour Asset Management, “the same group of investors that were reluctant to buy the old UBS AT1 at a yield of over 9%, and a price of 85.0, just a few weeks

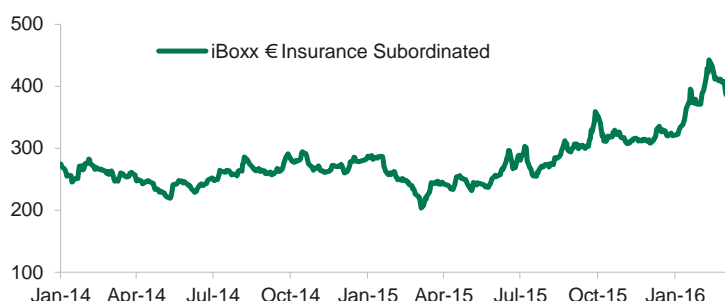
ago, pumped over \$8bn of orders into the new, \$1.5bn deal, which was only paying a coupon of 6.875%. Such is the power of the sentiment change.”

While he acknowledged the strength of post-ECB price moves as a factor in the market’s recovery, he also attributed it to other encouraging central bank comments, strong bank results and a

Deutsche Bank senior buyback.

“However,” he added, “the biggest factor was probably the realisation that the yields on most AT1s were pricing in scenarios that were highly unlikely and were giving scant regard for the capital strength of most European banks, and creating some of the best opportunities seen in years.” ●

Secondary insurance subordinated index



Source: Markit, Crédit Agricole CIB

Santander reopens Tier 2 post-ECB, Commerz follows

Santander on 15 March reopened the Tier 2 market in the wake of the European Central Bank’s boost to its QE programme the previous Thursday, and Commerzbank was able to successfully launch a long-planned Tier 2 benchmark the next day.

Banco Santander’s Eu1.5bn 10 year non-call five transaction on the Tuesday followed a \$1.5bn AT1 for UBS the previous day (see lead article), but was the first European Tier 2 issue since BNP Paribas on 4 March sold a Eu750m long 10 year Tier 2 that was in turn the first such benchmark since January.

The Spanish bank moved quickly ahead of other anticipated supply, according to a banker at one of the leads, and was able to attract some Eu3.1bn of orders from some 200 accounts, allowing an increase in the size of the trade to Eu1.5bn and a tightening of the spread from initial price thoughts of the mid-swaps plus 275bp area to a re-offer of 268p.

“Santander took advantage of a move tighter in its secondary curve following the ECB’s actions, and moved forward towards filling the 2% Tier 2 bucket to optimise its capital structure,” he said.

The banker attributed the strong demand for the paper to the choice of structure and tenor, as well as the credit’s broad support from investors. Santander’s benchmark was also the first Tier 2 issue from Spain of the year.

The next day, Commerzbank issued a Tier 2 transaction that had initially been mandated in January and then roadshowed. The deterioration in sub debt markets combined with internal matters at Commerzbank — including the appointment of new chairman Martin Zielke on 6 March, and its blackout period — however, delayed the new issue. Meanwhile, the German bank also enjoyed upgrades from S&P and Fitch.

Commerzbank was then able to tap into the post-ECB market with its Eu1bn 10 year trade and attract Eu2.3bn of demand, with pricing tightened from IPTs of the 360bp area to 340bp — equivalent to a new issue premium of some 10bp-15bp.

Viet Le, financial institutions syndicate manager at Crédit Agricole CIB — joint books with Barclays, Commerzbank and UBS — said investors had shown themselves keen to buy into Commerzbank’s recovery story.

“Broad market stability and increased conviction from investors in terms of adding risk allowed us to proceed with what was ultimately a very successful transaction,” he added, “paying a tight concession in the context of recent comparable transactions.”

He said that the size of the order book allowed Commerzbank to comfortably hit the upper end of a Eu750m-Eu1bn size range that was under consideration. ●

Commission review raises hopes after EBA bombshell

A key contributing factor to the Additional Tier 1 market's turbulent start to 2016 was a European Banking Authority (EBA) Opinion that would potentially tighten the rules on an issuer's ability to pay AT1 coupons, although the European Commission on 10 March announced a review that market participants hope will address their concerns.

On 18 December the EBA issued Opinion 24/2015 on the interaction of Pillar 1, Pillar 2 and combined buffer requirements, and how they play into restrictions on discretionary distributions based on the Maximum Distributable Amount (MDA). As per Art. 141 CRD, discretionary distributions encompass economic transfers of benefits to shareholders (e.g. dividend payments/share buy-backs), to employees (e.g. discretionary bonuses and pension contributions), and distributions on AT1.

"The Opinion clarifies that the MDA should be calculated taking into account both minimum (Pillar 1) and additional (Pillar 2) capital requirements which should be met at all times, as well as the combined buffer requirement," said the EBA.

The positioning of Pillar 2 in the capital stack for such calculations had not previously been clear and the regulator's Opinion ran counter to what some market participants had understood.

Andrea Enria, EBA chairman (*pictured*), said that the Opinion provided clarity and consistency in the mechanisms for the trigger and calculation for MDA across the EU.

"Consistency in supervisory outcomes is a cornerstone of the Single Market," he said. "Clarity about the implications of supervisory decisions is similarly vital for banks undertaking capital planning and for investors in banks."

The fallout from the EBA's declaration was compounded by the lack of transparency around Pillar 2 require-



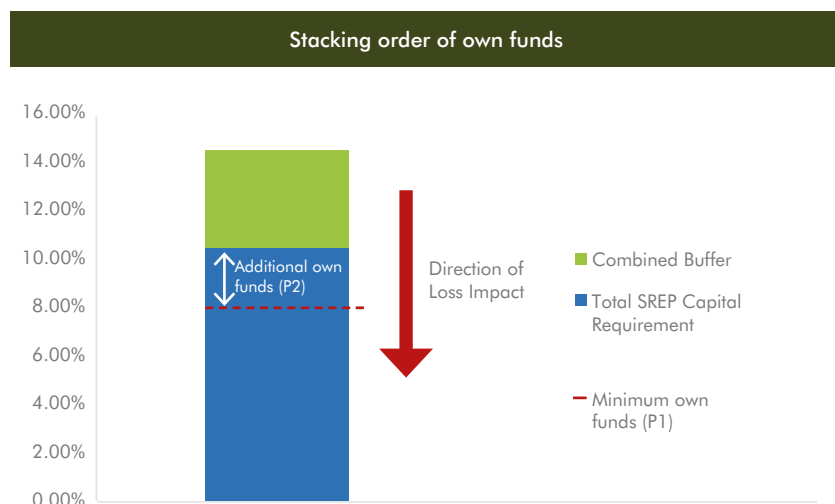
ments and their application, which have typically not been disclosed, meaning that AT1 bondholders were unable to calculate the likelihood of restrictions being triggered – although the Opinion also included a call for greater transparency on this front. This was seen as particularly acute within the Single Supervisory Mechanism (SSM) area, where only a few issuers had at the time disclosed Pillar 2 requirements.

"It is imperative that the appropriate degree of disclosure of the institutions' own funds requirements is reached," said the EBA.

The European Central Bank, the au-

thority in charge of bank supervision within the SSM, on 6 January confirmed the EBA's approach. At the same time it left investors in the dark as to several important parameters, raising questions such as:

- How should investors understand the SREP CET1 numbers communicated by banks? I.e. the Pillar 1 CET1 minimum of 4.5% is included, but what else? Investors were forced to second guess that the SREP CET1 number consisted of (i) the Pillar 1 CET1 minimum, (ii) the Capital Conservation Buffer, and (iii) the SREP



Source: EBA, BIHC

Pillar 1 CET1 add-on.

- Is the imposed Pillar 2 add-on under the SREP 2015 exercise only referring to CET1 capital or does it also entail add-ons for AT1 and Tier 2 capital?

- And are AT1 and Tier 2 deficits under Pillar 1 additive on top of the SREP requirement? On a phased-in or on a fully-loaded basis?

The EBA nevertheless in its Opinion also recommended to the European Commission that it review the automatic limitation on distributions via the MDA, “notably insofar as it relates to AT1 instruments, in all circumstances when no profits are made in any given year”.

Combined with macroeconomic headwinds and somewhat weak bank profits, the AT1 market entered a period of crisis in January until mid-February (see separate article).

The ECB then — possibly prompted by the dramatic market impact — publicly addressed the issue twice. On 19 February it published its SSM SREP

Methodology Booklet, which clarified that the Capital Conservation Buffer sits within the overall SREP requirement, that the 2015 SREP exercise resulted in requirements only relative to CET1, and that AT1 and Tier 2 Pillar 1 deficits were not taken into account. Then, in a not widely publicised conference call on 25 February, the ECB expressed that it may take into account AT1 and Tier 2 deficits under Pillar 1 in the 2016 SREP exercise (valid for 2017), and it also said that it is cur-

‘We may expect some relaxation’

rently considering whether to express Pillar 2 add-ons across all capital tiers or only via CET1.

Amid this fraught situation, the European Parliament on 10 March added its voice to growing calls for the issue to be addressed, in a resolution regarding increasing capital requirements, criticising the ECB Supervisory Board

and solutions that are “too rigid and affect negatively the AT1 bond market and hence financial stability”, and seeking a review of the MDA mechanism. Jonathan Hill, Commissioner for financial stability, financial services and Capital Markets Union, responded directly to the Parliament by announcing that the Commission would undertake such a review.

“Together with the EBA recommendations on the subject and the SSM’s own recently-published observations, we may expect some relaxation around automatic AT1 coupon cancellations upon buffer breach,” said Doncho Donchev, capital solutions, debt capital markets, at Crédit Agricole CIB, “and potentially a move towards the UK Pillar 2 system, currently the most advanced and transparent within the EU, with Pillar 2 expression across all capital tiers and a split of Pillar 2 into a ‘hard’ component, sitting below all buffers, and a ‘soft’ component, sitting on top of the buffers for e.g. adverse stress test scenarios and initially not binding for MDA restrictions.” ●

League tables

Bookrunners all European FI hybrids (all currencies)
1/1/2016 to 18/3/2016

	Managing bank or group	No of issues	Total EUR m	Share (%)
1	UBS	7	2,353	15.7
2	HSBC	8	1,718	11.5
3	Crédit Agricole CIB	2	1,396	9.3
4	BNP Paribas	2	997	6.7
5	Barclays	4	994	6.6
6	BAML	4	893	6.0
7	Citi	4	888	5.9
8	Goldman Sachs	4	835	5.6
9	JP Morgan	3	793	5.3
10	Deutsche Bank	5	691	4.6
11	Credit Suisse	4	451	3.0
12	Intesa Sanpaolo	2	439	2.9
13	Lloyds	1	337	2.3
14	Santander	1	298	2.0
15	Morgan Stanley	2	285	1.9
	Total	21	14,975	

Source: Dealogic, Thomson Reuters, Crédit Agricole CIB

Bookrunners all financials (euros)
1/1/2016 to 18/3/2016

	Managing bank or group	No of issues	Total EUR m	Share (%)
1	Goldman Sachs	15	7,783	12.0
2	HSBC	13	5,801	9.0
3	BNP Paribas	15	5,771	8.9
4	Société Générale	14	4,985	7.7
5	Barclays	18	4,757	7.3
6	Natixis	6	3,165	4.9
7	Crédit Agricole CIB	8	3,018	4.7
8	UBS	8	2,647	4.1
9	RBS	6	2,475	3.8
10	Citi	7	2,239	3.5
11	Morgan Stanley	7	2,070	3.2
12	Santander	9	1,708	2.6
13	JP Morgan	8	1,676	2.6
14	Credit Suisse	6	1,670	2.6
15	Deutsche Bank	11	1,607	2.5
	Total	105	64,815	

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

Deutsche gets back on its feet after AT1 blow

Deutsche Bank was at the eye of the storm that hit the Additional Tier 1 market in February when its outstanding securities fell to as low as the mid-60s because of fears about its ability to pay coupons, but was able to cap a recovery in its standing by re-accessing the senior unsecured market on 15 March.

On 20 January Deutsche announced its first annual loss since 2008, Eu6.8bn for the year, including Eu5.2bn of regulatory and litigation provisions. Despite the bank saying on 28 January that it expected to have sufficient payment capacity to service its AT1 coupons, the price of its outstanding issues fell to new lows at the beginning of February.

Deutsche responded by on 8 February publishing updated information on its 2016 and 2017 AT1 coupon payment capacity, and Deutsche co-CEO John Cryan (*pictured*) said the next day that the bank remains “absolutely rock solid, given our strong capital and risk position”.

S&P, however, cut Deutsche’s AT1 from BB- to B+ later in the week.

A recovery in Deutsche’s spreads alongside the general AT1 market



through the rest of the month came in parallel with rumours that it would launch a buy-back of senior debt, and it subsequently did so, on 12 February. The bank tendered for up to Eu3bn of five euro-denominated securities and \$2bn of eight dollar-denominated securities, and announced on 14 March that it had bought back Eu1.27bn and \$740m of each, respectively, for a total of Eu1.94bn equivalent.

“The tender offer enabled us to take advantage of market conditions to re-

purchase debt at attractive prices,” said Deutsche Bank CFO Marcus Schenck on completion of the euro buy-back, which closed before dollar part. “We also used our strong financial profile to provide liquidity for bond investors while continuing to manage our funding levels

“This relatively low level of investor take-up reflects improving market sentiment and a preference by investors to retain their investment in Deutsche Bank.”

Its AT1 securities had meanwhile recovered to trade around the mid-80s.

A first Deutsche Bank Pfandbrief benchmark since August 2012 was launched on 1 March, with the bank finding Eu1.1bn of demand for a Eu750m eight year covered bond, before Deutsche launched its senior unsecured issue on 15 March. The Eu1.5bn three year deal was priced at 110bp over mid-swaps on the back of more than Eu2bn of orders and at a new issue premium of some 25bp, following initial price thoughts of the 115bp area. ●

Photo: Mario Andreyra/DB

Crédit Agricole tenders for Tier 2 amid reorganisation

Crédit Agricole launched a tender offer for up to Eu2bn of euro and sterling high coupon Tier 2 bonds on 14 March.

It is seeking to buy back four series of Tier 2 bonds issued between 2008 and 2010. It is also tendering for up to Eu2bn of covered bonds followed by a consent solicitation aimed at converting the remaining covered bonds to soft bullets.

The four Tier 2 bonds included in the tender offer are: Eu2.364bn 5.971% February 2018 XS0343877451, Eu1.192bn 5.875% June 2019 XS0432092137, Eu1.122bn 3.90% April 2021 XS0550466469, £450m 7.375% December 2023 XS0405953257.

The tender opened on 14 March and expires on 21 March, with the settlement date expected to be on 24 March. The Tier 2 bonds purchased in the context of the Tender Offer will be cancelled immediately following settlement.

Crédit Agricole said the tender offer is part of its plan to

optimise its balance sheet through the partial reinvestment of capital gains expected from a simplification of the Crédit Agricole group’s corporate structure planned for this year. It said the tender offer also provides a liquidity opportunity for holders of the bonds.

“For holders of Tier 2 Bonds, the Tender Offer is being made for outstanding high coupon Tier 2 Bonds, some of which are inefficient with respect to prudential requirements,” it said. “The reorganisation of the Group allows for the purchase of these Tier 2 Bonds without any need for new issuances to replace them.

“This will result in a reduction of Crédit Agricole SA’s subordinated indebtedness, while preserving the Group’s favorable position with respect to TLAC requirements.”

Crédit Agricole is global coordinator and joint dealer manager with Citi, Credit Suisse and Morgan Stanley. ●

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Intesa Sanpaolo

At the vanguard

Italy's Intesa Sanpaolo led the short-lived reopening of the bank capital market in the opening weeks of 2016 with \$1.5bn Tier 2 and Eu1.25bn AT1 benchmarks. Here, head of treasury *Camilla Tinari*, explains the issuer's approach to the markets and shares her views on the evolution of the asset class and its regulations.

What was the rationale for Intesa issuing the euro AT1 transaction straight after the Tier 2 benchmark denominated in US dollars?

January is traditionally one of the most liquid months of the year. However, in January the market window available was very narrow, considering the beginning of our black-out period due to the publication of the year-end results and the Epiphany bank holiday on 6 January (which is a bank holiday in most European countries). In this context, we drew benefit from the fact that in the US market the first week of January was a full working week (being open on 6 January) and we gave priority to the Tier 2 transaction. Notwithstanding volatile market conditions at the beginning of the year, on 8 January we approached the US market with the Tier 2 transaction thanks to a favourable market window following the announcement of the NFP.

Within the scope of our Business Plan, by 2017 we envisage the issuance of Eu4bn of Additional Tier 1 to optimise our capital structure, filling the 1.5% AT1



Camilla Tinari, Intesa Sanpaolo

regulatory bucket and therefore taking advantage of the various regulatory capital buckets. Having in mind our Business Plan targets in terms of total AT1 issuances, we decided to issue our first euro AT1 transaction before the beginning of our black-out period in order to benefit from the good demand for AT1 instruments.

So far, we have issued about Eu2.2bn out of the foreseen Eu4bn, but present market conditions are not a major source of concern for us as our Business Plan provides for the issuance of the remaining amount of AT1 by December 2017.

What influenced the structure of the Additional Tier 1?

The structure of the new Additional Tier 1 is the same of the AT1 in US dollars we launched in September 2014, except for the first call date, which has been set after five years for the purpose of diversification from the US dollar AT1, which has its first call date in 2025.

You did not execute any roadshow before those two major trades. Why?

We believe the structure of Tier 2 and AT1 instruments are now quite standard and well known to the investors, and as far as our name is concerned, we meet fixed income investors on a regular basis. Nonetheless, even if we did not execute any specific roadshow, in the context of the AT1 transaction we held a global investor conference call and we were available for one-to-one calls with investors. In addition, we distributed the marketing material to the investors through the "net roadshow" platform.



Piazza San Carlo, Turin
Photo: GJo/Wikimedia Commons

Were you satisfied with the result and the granularity of the order book?

Yes, we are satisfied. The Tier 2 transaction gathered momentum and built up a solid and granular book, attracting a high quality and well diversified investor base. High investor interest allowed us to price a final \$1.5bn size at T+360bp, the lower bound of the guidance range.

The Additional Tier 1 transaction built up a solid final book, too, which closed at 12:30 with orders in excess of Eu3.25bn. High quality investors and the granularity of the book allowed us to set the final size at Eu1.25bn with a coupon of 7%.

Did you feel significant differences between the euro and US dollar transactions?

Although the structures were different, we noticed good demand from investors both in Europe and in the US. In particular, the new Tier 2 deal confirms our strong placing power on the US market and the validity of the strategy which

dates back several years, with our first Yankee deal issued in summer 2010.

This is an important competitive advantage: we are the only Italian bank and one of the few European banks to have an MTN programme dedicated to the US market.

The timing of the transactions was extremely favourable given the evolution of the Additional Tier 1 market after the execution. In your opinion what was the main driver of the turmoil?

The implementation process relating to TLAC/MREL mechanisms immediately after the Novo Banco/BES case caused concerns among investors. In addition, we believe the high volatility in the first weeks of 2016 has also been due to macro issues (such as China growth expectations, oil price decline and so on).

What is your opinion about the current evolution of the bail-in regulation in Europe in general and in Italy in particular? Were you surprised by

the recent move and position taken by the Bank of Italy?

The introduction of the new regulatory framework relating to the absorption of losses and bank recapitalisation cast doubt among investors and, consequently, induced pressure among investors not only around the bail-in mechanism but also around the non-harmonised introduction of the BRRD among European countries. Furthermore, investors express their concern about the national authorities' discretionality (such as in the Novo Banco/BES case).

The new regulatory framework will induce investors to focus more and more on issuers with the best credit and capital profile. In a nutshell, the cost of funding will be affected but such an increase will be more significant for smaller issuers with limited access to the institutional markets.

In any case, the non-harmonised introduction of the BRRD together with the unclear picture about the TLAC/MREL implementation features might have a larger impact on issuers based in riskier countries. ●



Photo: Storm surge, south of Cape Perpetua,
Oregon Coast; Source: Matt/Flickr

2016

New headwinds hit

The year began inauspiciously, with regulatory pronouncements casting a pall of fear and uncertainty over an AT1 market already spooked by macroeconomic news. We asked leading market participants how they expect key narratives behind the volatility to unfold and what strategies they are adopting in light of the latest developments.

AT1 AND THE SUBORDINATED DEBT MARKET

Neil Day, Bank+Insurance Hybrid Capital: The correction of the AT1 market intensified at the end of January. What have been the main drivers of the turmoil?

Amundi: In our view, a number of factors were at play. These included a flow of regulatory publications — the EBA's opinion on the SREP, the SSM's subsequent publication — that indicated the bar had been raised further in limiting banks' ability to pay coupons on AT1s, but also left room for varying interpretations as to the treatment of Pillar 2 capital requirements. There was also disappointment on fourth quarter earnings from the equity investor community, which further exacerbated fears that some banks may be unable to make AT1 coupon payments.

Until last year, the AT1 market had been supported by the search for yield of some investors and the highly accommodative central bank measures. The tensions observed in recent weeks are the first shock to affect this not yet matured market and some investors are likely trying to adapt.

Vincent Hoarau, Crédit Agricole CIB: From a pure market perspective, AT1 indeed in February suffered its worst performance. Cash price moves were exacerbated when negative headlines sur-

Participants:

Wim Allegaert, general manager, finance, KBC Group

Frédéric Baudouin, head of regulations, liquidity and solvency, financial management department, Crédit Agricole SA

Aravind Chandrasekaran, senior analyst, Camares

Antoine Cornut, CIO, Camares

Doncho Donchev, capital solutions, debt capital markets, Crédit Agricole CIB

Nadine Fedon, global head of funding, Crédit Agricole SA

Stéphane Herndl and Dung Anh Pham, banks analysts, credit research, Amundi Asset Management

Vincent Hoarau, head of FIG syndicate, Crédit Agricole CIB

Olivia Perney Guillot, senior director, financial institutions, Fitch Ratings

Isabel Rijpkema, capital management, Rabobank

Tim Skeet, board member, International Capital Market Association, and chairman of the ICMA Asset Management & Investors Council bail-in working group

Neil Day, managing editor, Bank+Insurance Hybrid Capital

Note: Participants kindly responded to questions in the second half of February as market and regulatory positions were developing — please see the news section for updates on some of the key developments.

rounding Deutsche Bank hit screens. The price action has been phenomenal, with losses of four full points in a single trading session in some particular names. There were some forced sellers in the market. And in such circumstances investors who have taken significant mark-to-market hits are obliged to sell while there is nobody on the other side of the trade. In the meantime, in financials' equity, people were selling on hard facts — i.e. global

growth and oil concerns, negative interest rates, etc — that affect bank earnings. This cocktail encouraged the downward spiral in financial institution-related securities, whether that be equities, senior, Tier 2 or AT1. To cut a long story short, the collapse in AT1 was strongly correlated with equities and amplified by the negative convexity. Meanwhile, nobody felt ready to do some bottom-fishing given the too concentrated investor base.



Dung Anh Pham, Amundi
 'We remain constructive on the AT1 segment, but we remain selective'

But the sector should rebound. From a pure fundamental perspective it looks extremely cheap versus high yield, while — from a capital standpoint — banks have never been so robust.

Antoine Cornut, Camares: On AT1 the main issue has been the complexity of the product, especially after the EBA announcement. I'm not sure that everyone has really understood what the criteria are for the coupon to be paid or not.

The consensus at the start of 2016 was that the AT1 market was an asset class to own, especially after the performance of last year. It contributed to the bad positioning of investors whereby effectively everybody is long and nobody is short, meaning that only small selling needs create some very large movements in the AT1 market.

At the same time, I note that the AT1 market has outperformed the equity market. Is the equity market getting tainted because of the AT1? Probably. I don't think equity investors fully understood the way AT1 works either, the way that coupons and dividends interact.

So I think all this amounts to a lack of transparency and understanding, which is creating a lot of confusion and even more repricing.

Since the AT1 market started there has been a lack of distinction between issuers. It was very well behaved, but I don't think the individual credits were actu-

ally taken into account. As soon as people have concerns regarding the capacity of one bank to pay a coupon, we'll see much more the differentiation between credits. Hence the headlines around a few names — Deutsche Bank, UniCredit or Popular. In that respect, it is good news for the AT1 market to the credit consequences of what you buy. I think that's a positive development for this asset class.

Doncho Donchev, CACIB: As an investor you are at the coalface of the market, and I fully agree on the point about idiosyncratic risks, which must reflect individual credit quality — with this being more pronounced in AT1, because it is the highest beta debt product in the capital structure of banks. And you are certainly right about some market participants perhaps not having such a detailed understanding of the product, which is complex.

Indeed, we have seen an unfortunate confluence of events, with the other point being pronounced regulatory uncertainty, apropos the EBA announcement. The whole Pillar 2 process has been quite unclear and full of contradictions for investors and hence troubling for the asset class, and has certainly also been a contributing factor to the sell-off. How do you view that?

Cornut, Camares: This is going to make it very complicated for new people to actually look at the AT1 market, and I would argue that the existing buyer base is pretty much full on the product, or close to being full. I think raising new money for the product is going to remain challenging.

Tim Skeet, ICMA: There has been movement across all the classes of bank paper, especially the AT1. This may prove to be a temporary correction, and markets may well stabilise again. Nevertheless, the volatility has once more forced the debate on where spreads should be for investors in bank paper given the heightened levels of risk under bail-in

The events of late 2015, added to cur-

rent market noise, suggest that there is an unpredictable element of risk that has spooked the market. There appears to be a lingering suspicion that investors are being asked to take the risk of a bank not fulfilling its capital requirements in a variety of ways — the immediate focus perhaps being on potential non-payment risk on AT1 instruments.

It is unclear how exposed investors might be to this risk. Issuers can certainly claim they are rock solid, but ultimately this is the regulator's call. The public debate between Governor Carney in the UK and John Vickers, author of the Independent Banking Commission Report, for example, suggests that there may not yet be a real consensus on capital levels. This potentially exposes investors to the risk of moving goalposts.

Many of the terms imbedded in the original AT1 instruments appear superfluous and outdated in today's market. Reset levels and triggers look irrelevant given market moves and capital requirement levels.

It is likely that the European market will be fragmented, with differing perceptions of risk depending on the perceived robustness of individual banks and local systems. Outstanding levels of legacy NPLs will have to be examined.

There may not yet be a real consensus on capital levels

Day, BIHC: In the current circumstances, what are the main parameters/metrics you use in the valuation of the AT1 instrument?

Amundi: We consider the risk of coupon skip to be the main risk, given our view on fundamentals and as it would materialize ahead of a conversion/write-down of the principal, barring any exceptional case. The main parameters we consider are therefore the firm's earnings generation capacity and volatility (e.g. stability of earnings, litigation risks), the headroom to a breach of the Combined Buffer Requirement (CBR) but also the capacity to service AT1 coupons in case of restrictions on Maximum Distributable Amounts (a

function of the amount of coupons and the firm's dividend policy).

For now, the market's interpretation is based on the banks' disclosures. But the European regulatory bodies have yet to confirm their position on a number of critical aspects, such as the treatment of AT1/Tier 2 instrument shortfalls and whether these do reduce the headroom to a breach of CBR.

Cornut, Camares: What I find amazing is the way that the sell-off in AT1 is actually lower than the sell-off in Lower Tier 2 securities when adjusted by beta — if you look at Deutsche Bank, for example — its AT1 securities have traded lower on par with the sell-off in Lower Tier 2, so the price differential between the Lower Tier 2 and the AT1 basically is not that big. Are you meant to be buying AT1 securities today at 75 cents or Lower Tier 2 securities at 84 cents? Lower Tier 2 where there is no uncertainty regarding payments or final maturities, an asset class that is the core holding of many asset managers and insurance companies? I don't think valuing the recent sell-off in AT1 is as trivial as some people would want to portray it.

Day, BIHC: What importance do you give to the reset spread levels after the recent significant market correction?

Amundi: The market is seemingly pricing a growing risk of AT1 extension beyond their first call dates. This repricing is arguably driven by the more challenging macroeconomic environment and the resulting lower earnings expectations, as well as more demanding solvency requirements. Should this repricing become the norm, this would maintain yields higher in the longer-term for AT1s, as investors would seek compensation for extension risk. And the higher the incremental cost of issuance, the greater the likelihood that issuers think twice before calling an AT1.

Hoarau, CACIB: AT1s have a perpetual structure with a call option, and the extension risk is more pronounced when the instrument trades well below par with a low and "off market" reset spread at the

call date. This implies a "negative convexity", with a greater probability of extension risk. This was another source of the downward spiral in the asset class, because for many securities the first call dates are just a few years away. Investors trade on the assumption that those bonds won't be called. So basically, low reset spreads, i.e. negative convexity, leads to further weakness in valuations in a distressed situation. So yes, reset spreads are a very hot topic in AT1 valuations, and we will have a two tier market in that regard as soon as the AT1 sector reopens in primary.

Day, BIHC: What could drive a rebound of the segment? What would make you open to buying new AT1 issuance?

Cornut, Camares: I just want to understand what I am buying. What are the rules for the payment to be made or not? Some issuers don't even publish the amount of MDA and ADI that they have.

Ultimately there is a risk-reward conversation to be had. For some issuers who are seeing their AT1 bonds trading 10 points lower purely because of the sell-off,



Antoine Cornut, Camares
'Raising new money for the product is going to remain challenging'

the AT1 segment, albeit potentially at the expense of the rapid capital build-up that is being pushed by regulators.

We remain constructive on the AT1 segment, but we remain selective on the fundamentals and with regards to relative value.

Hoarau, CACIB: Clarity and the softening of regulatory constraints will cer-

Reset spreads are a very hot topic in AT1 valuations

I would be happy to buy now. If you look at some of the UK names or some of the Swiss names, for example, I find the conversation to be a little easier. I'm not sure that they would be interested in issuing — I don't think they want to pay a 10% coupon yet — but some secondary levels are attractive. It's purely a question of risk-reward at the end of the day.

For some of the names where there are still some concerns regarding the amount of disclosure or what you are truly buying, making an investment decision is far less easy.

Amundi: We would welcome greater clarity from regulators on the treatment of Pillar 2 for European banks, as discussed earlier. Furthermore, a smooth phasing-in of the recently announced requirements would also likely provide some relief on

tainly help, but this is not on the agenda of regulators. Interest rates and yields across the board remain extremely low. So we should reach a bottom simply because the correction in the security is overdone in terms of relative value. Elsewhere, any improvement in the global market backdrop and market sentiment will re-boost the segment, which is highly driven by the equity market. Central bank messages and actions, and less negative economic data points could be a short term catalyst of a rebound and retracement of January losses.

SREP, PILLAR 2 AND MDA

Day, BIHC: What is the long term impact of the current concerns surrounding SREP and potential coupon restrictions?



Wim Allegaert, KBC: 'It remains to be seen under which conditions AT1 coupons indeed are actually cancelled'

Wim Allegaert, KBC: The uncertainty over coupon risk hampers a correct pricing of AT1 risk while the uncertainty regarding required capital levels going forward makes capital planning a complex task. These uncertainties also complicate matters on portfolio fit for these products for the money management firms. The recent EBA clarification removed the uncertainty whether MDA is only applicable under Pillar 1 or also under Pillar 2, and although coupon risk — strictly speaking — is higher since MDA also applies under Pillar 2 now, the coupon risk actually has always been there, since AT1 coupons are anyhow fully discre-

selective, all the more so as regulatory publications remain subject to a number of interpretations and the macro environment remains fragile.

Isabel Rijpkema, Rabobank: The disclosure of SREP requirements reduces uncertainty for investors and creates more transparency, which is positive. The recent market movements made it clear that investors are concerned about the risk of coupons not being paid. Taking into account the fundamentals of the bank you are investing in will be an important assessment for investing in this type of product.

Skeet, ICMA: Investors will go on asking for transparency, predictability and fairness in how they will be called upon to take the pain of a restructuring or capital rebuild. As noted earlier, there is still a lack of clarity over the precise levels of capital tripwires being imposed on banks and how they are measured. The EBA's Adam Farkas rightly asks that investors are told what they are and how they are met. Investors have to be able to measure and price their risk.

Any suggestion of moving goalposts, capriciousness or political impact on regulatory decisions for headlines rather than hard economic reasons will worry investors further. There is a need to a level playing field.

of market discipline, but regulators must also take into account that harsh handling might inadvertently lead to loss of confidence in an otherwise sound institution, potentially leading to a death spiral.

Market speculation and rumour cannot be regulated away. But the more investors are confident that they know the risk and are assured that regulators will be consistent, the hope should be that markets will stabilise more rapidly after scares and irrational fears.

Consistency between different regulatory measures and points of intervention is crucial. Any suspicion that regulators may not be predictable, consistent or transparent would have a hard impact on the market.

Day, BIHC: What is the impact of the EBA classification on the interaction between Pillar 2 and MDA restrictions on AT1 coupons?

Rijpkema, Rabobank: As already assumed by many European market participants, the fact that the EBA has clarified that Pillar 2 requirements "sit" below the combined buffer requirement increases transparency, which is a positive. On the other hand, there is not a real level playing field in Europe with regards to Pillar 2.

Allegaert, KBC: It is interesting that EBA recognizes that a cancellation of AT1 coupons does not support access to the financial markets. This is very important as market access is key as one of the measures to remedy the solvency situation. It remains to be seen under which conditions AT1 coupons indeed are actually cancelled.

Amundi: It has had a nuanced impact. On the one hand, it provides more information (and sometimes some reassurance) for those issuers that published their SREP requirement. But on the other hand, the EBA's opinion remains subject to a number of interpretations. Equally importantly, when it comes to Pillar 2 and MDA restrictions, supervisory authorities failed to follow a unique approach, with the SSM stating it would follow the EBA's opinion (for now...)

Consistency between different regulatory measures and points of intervention is crucial

tionary, and investors have always clearly understood this item and taken this into account. The recent turmoil is hence not linked to this in my view.

Amundi: As the AT1 market develops and banking solvency requirements continue to be raised further, investors are increasingly factoring in the risk of a first-time AT1 coupon skip. This risk was exemplified by the recent movements in the AT1 markets on concerns that a coupon may be skipped due to insufficient Available Distributable Items. Over time, this may push some investors to become more

Investors will continue to ask for the ECB to be open and accountable. The ICMA investor bail-in working group was set up to provide a platform for investors to work with regulators and engage in a constructive dialogue to ensure that regulatory policy fairly takes into account investor needs. Ultimately investors and regulators will want to work together to ensure risk is fairly and correctly priced under the new rules.

Naturally regulators will have to accept that this may result in some financial institutions becoming shut out of certain types of funding from time to time. This is part

and some national supervisors saying they would not abide by it. This uneven playing field makes it more difficult to compare AT1s across jurisdictions, in our view.

Cornut, Camares: It is unfortunately not very clear. When you look at BNP's earnings presentation, for instance, they noted that they were not including Pillar 2 in their calculations because apparently the ECB told them not to. This is not what the EBA implied in early January. So are you meant to trust what the ECB tells some banks privately — don't worry about it — or are you meant to be following what is a public document from the EBA? This complete lack of transparency makes investing in this asset class a difficult task. Thankfully not all AT1 have been issued under the ECB/EBA framework.

Donchev, CACIB: It's definitely not an easy question, and we will see how the clarifications turn out. Clarity and transparency about the application of the



Olivia Perney Guillot, Fitch
 'We believe fully discretionary coupons to be the most easily activated form of loss absorption'

stresses, as evidenced recently. Hence, we would not expect the SSM to push banks to publish more than what has been disclosed thus far. Instead, we would expect the SSM to communicate more on how they would deal with SREP requirements and breaches, practically speaking.

This complete lack of transparency makes investing in this asset class a difficult task

rules is key in this context and regulators should be in a position to deliver on these key items. A level playing field is also a key concern — how can Pillar 2 be binding for MDA in the SSM from the outset, whilst in Sweden, a member of the EU, it can only become eventually binding upon a "formalisation" of the Pillar 2 requirement? What about deficits on AT1/Tier 2 under Pillar 1?

Day, BIHC: What disclosure requirements are you anticipating from the ECB in relation to Pillar 2/SREP?

Amundi: Following the publication of the SREP requirement for a number of banks within the Eurozone, we would expect others to follow, absent any legal prohibition to do so.

Notwithstanding this, supervisors have to balance the much-needed public disclosure in this respect with maintaining room for manoeuvre for dealing with

Allegaert, KBC: KBC already disclosed SREP before the EBA paper regarding Pillar 2, given our assessment that this is stock price-sensitive information that we have to communicate.

Rijkema, Rabobank: Rabobank disclosed SREP requirements in a press release dated 18 January 2016.

Day, BIHC: Has the recent publication of Pillar 2 requirements affected your perception of the sector? Does the SREP requirement inform ratings?

Olivia Perney Guillot, Fitch: For securities with going-concern loss-absorption characteristics, it is not so much loss severity, as the probability of non-performance relative to hitting the point of non-viability that is the biggest rating variable. Activation of a going-concern loss-absorption feature does not mean a bank has failed, but is treated as "non-

performance" at a security-level rating.

We believe fully discretionary coupons to be the most easily activated form of loss absorption. Although in many instances it is unclear at exactly what point a bank will be "required" by its regulator to omit coupons, this is likely to arise (and may even automatically kick in) when a bank is within a capital buffer zone.

Bank hybrid securities with fully discretionary coupons are likely to exhibit the widest degree of notching in a bank's liability structure, irrespective of any other features.

For issuers with investment-grade Viability Ratings, Fitch's base case will be to notch down by three notches for incremental non-performance risk. However, more notches may be assigned where Fitch has particular concerns, for example over a bank's flexibility in avoiding falling into a capital buffer zone whether due to internal (e.g. capital management policies) or external (e.g. regulatory/SREP/Pillar 2) influences.

Day, BIHC: How should one go about deciding on the appropriate size of the management buffer?

Aravind Chandrasekaran, Camares: We don't even know what the target is pre-the management buffer to have a view on what the management buffer should be for a generic issuer. It's jumping the gun, right? We don't even understand how Pillar 2 works, because there's no clarity, we don't know whether there'll be relevant grandfathering... Unless you have a view on what the current surplus or deficit is, it's very difficult to work out what the excess you need on top of that is.

Rijkema, Rabobank: Rabobank capital strategy focuses on a minimum CET1 ratio of 14%, subject to regulatory requirements. On a fully phased-in basis, this provides a management buffer of at least 1.5%, which should give sufficient comfort, especially given that Rabobank has always been profitable and showed a stable earnings/profit pattern. Current SREP (9.5%) plus phased-in Systemic Risk Buffer (0.75%) requirement adds up to 10.25% with a CET1 ratio of 13.5% (FY 2015), so

this provides a comfortable buffer over and above the minimum requirement.

Allegaert, KBC: The appropriate size of the management buffer should take into account some or all of the following elements: the impact of adverse economic conditions; the capital needed to absorb regulatory uncertainty (e.g. Basel IV); and non-organic and organic growth expectations versus expected profit. This is a dynamic exercise, taking into account timings of events and different scenarios (fly, float, sink scenarios). In the end, it remains a risk appetite decision.

Amundi: Sizing the management buffer is likely to be based on several aspects. To start with, one should measure existing capital and earnings generation capacity against the level of capital required. This management buffer needs to factor in the complexity of the group's structure and its risk profile. It should also be compared to that of its peers.

Frédéric Baudouin, Crédit Agricole: Regarding Crédit Agricole, at group level our management buffer above our Pillar 2 is quite high, more than 350bp. At Crédit Agricole SA level this buffer is smaller, but we have committed to reach a buffer of 150bp by the end of the year, which we think is enough to manage the prudential constraints on Crédit Agricole SA in



Nadine Fedon, Crédit Agricole
'The communication is perfectly clear about the binding constraints for the two entities'

versus a surplus in another place. You therefore have to rely on some degree of management or issuer flexibility in being able to ensure capital fungibility between the two levels.

Nadine Fedon, Crédit Agricole: We have been communicating quite regularly on that topic when disclosing our quarterly results — for both equity and bond holders — so I think the communication is perfectly clear about the binding constraints for the two entities. In our press release issued last December, we disclosed that Pillar 2 at Crédit Agricole group level includes the G-SIB buffer which is phased

more systemic, more complex, more diversified across jurisdictions and so forth, and where there are difficulties with capital flows across it — especially banks that also have large investment banking operations — should have a higher buffer. For banks that are smaller and have a more clearly defined model, the buffer could be smaller, from a certain perspective, because they are clear and easier to understand for investors. But this comes with a flipside that could be a negative point, which is that if you are less diversified, then obviously you have less diversification benefits. So it's difficult to say where the buffer should be. This is an issuer-specific discussion.

But what we have clearly witnessed since the SREP decisions of 2015 started to become public is that anyone who has pure buffer of less than 100bp in their reported ratio versus the fully-loaded SREP target, including any buffers that can apply on top, has suffered disproportionately in terms of AT1 price with investors taking fright.

Chandrasekaran, Camares: My point is that if you say you are 200bp higher but you still need to issue 2% of Lower Tier 2 and some AT1, that buffer means nothing, because we don't know what the constraint on coupon payments is.

Donchev, CACIB: Yes, absolutely. Are deficits in either AT1 or Tier 2 additive on top of the SREP requirement plus fully-loaded buffers? This is a question that only the ECB can answer — or the ECB, the EBA, I'm not sure who. But clearly we need clarification on this, absolutely. And communication on this point has been lacking. There is no clear communication from issuers, probably because they also cannot make such communications or have judged that they cannot. All they say is that, well, actions speak louder than words: they've paid the coupon and they show you the SREP requirement versus CET1, and they ignore AT1 or Tier 2 deficits for the time being. Unfortunately, yes, I agree with you on that point.

Day, BIHC: Are AT1/Tier 2 deficits additive on top of the SREP

Absent any official clarification, we ought to err on the side of caution

an environment where Crédit Agricole benefits from the support of the regional network. Please note as well that Crédit Agricole group must respect its Pillar 2 constraints from 1 January, but the Pillar 2 constraint for Crédit Agricole SA will apply only from 30 June this year.

Chandrasekaran, Camares: It's quite complicated this whole concept with the two entities that you have. From the outside it's very difficult to work out exactly where the binding constraints are in terms of each entity, and how much flexibility you have to address a deficit in one place

in resulting in a 9.75% requirement, and at Crédit Agricole SA level we do not have a G-SIB buffer, and that's why we have a 9.5% requirement. So it's perfectly clear in our press release.

Donchev, CACIB: When we talk about the management buffer, it's about the buffer above SREP — the Pillar 2 requirements or any binding constraints on AT1 coupons, which is probably one of the main criteria investors look at.

This should depend on the credit profile of the institution and what risk it carries. Technically, a bank that is bigger,

Amundi: Based on the disclosure of a number of banks for their fourth quarter results, this seems not to be the case. But absent any official clarification, we ought to err on the side of caution.

Allegaert, KBC: Reading CRR/CRD IV and the EBA opinion 16/12/2015, the answer is clearly positive. But this does not yet show up in the SREP letter from the ECB, which is limited to CET1 requirements.

Rijpkema, Rabobank: The uncertainty around this point was not helpful for the AT1 market, but it is good to see that for 2016 at least it will not impact the MDA intervention point. For Rabobank this is not an issue as Rabobank has fulfilled its AT1 and Tier 2 requirements with 16.4% Tier 1 capital and a Total Capital Ratio of 23.2%.

TLAC VS MREL: SIZING THE CHALLENGE

Day, BIHC: How do you expect MREL and TLAC to be implemented in the EU?

Allegaert, KBC: The recent Information Note for the European Commission created some uncertainty, on top of the existing one given the different national initiatives. Clearly more time will be needed to come to a common platform for the Member States. Ultimately, this uncertainty may slow down the issuance of MREL and TLAC-eligible instruments by EU banks.

Rijpkema, Rabobank: MREL requirements have not been defined yet, but are expected to be compatible with the TLAC requirements for G-SIBs. MREL requirements could in a conservative scenario end up higher than TLAC requirements. Rabobank is not directly impacted by the TLAC requirements as we are not a G-SIB, but we expect TLAC requirements to be included in the MREL assessment.

Amundi: Unlike the Basel capital requirements, TLAC and MREL introduce bail-in tools for a wider variety of debt classes and therefore need to interact with local insolvency laws. This explains why thus

far we have seen diverging proposals put forth by European Member States, in order to transpose BRRD in a way that would make domestic banks TLAC-compliant. In addition, the proposals made by each Member State clearly appear to be tailor-made to fit best with their banking systems' structures and funding mix.

Despite recent discussions held at the European Commission, the prospects of a convergence appear minimal, for now.

Market participants meanwhile expect a convergence of MREL and TLAC rather than MREL surpassing TLAC.

Skeet, ICMA: Whatever is promulgated needs to work with every country's insolvency laws. Better cooperation and communication between all the regulators bodies and governmental agencies is imperative to avoid regulatory clash, overlap and inconsistencies. It may not be possible for TLAC to find a single common definition, but the basis has to be fair, respect the waterfall of creditor rights and be transparent.



Isabel Rijpkema, Rabobank
'MREL requirements could in a conservative scenario end up higher than TLAC requirements'

2.5%, takes us to 18.5%, call the systemic buffer somewhere around 1%, so between 19.5% and let's say around 22%, 24% depending on the bank. Obviously, the sizing of MREL is under discussion, notably the now publicly acknowledged now difference in opinions between the

Uncertainty may slow down the issuance of MREL and TLAC-eligible instruments

If the level is to be set high, regulators must take full account of refinancing risk and investors' appetite and line availability. They should not be complacent about this.

What investors expect is as clear as possible definition of where the triggers and tripwires will be set for each bank by whatever measures the regulators apply. Transparency on this is the key to confidence.

Day, BIHC: Are we heading towards MREL of 25%-30% RWA required capital?

Donchev, CACIB: I think we have clarity on where TLAC will be, so 16% in 2019 rising to 18% of RWAs in 2022, with the applicable buffers on top, so you have the capital conservation buffer on top of that, so 2.5%, and the systemic buffer, and potentially any other buffers which may apply, so we are talking... 16% plus

EBA on one side and the Commission on the other side, on the RTS for MREL. MREL has a certain specificity such that it doubles up Pillar 1, plus Pillar 2 requirements, plus certain buffers... there's upward, there's downward adjustments, but as said, there is no clarity about how it may work and how high the capital requirements may be. It could be something that goes more in the region of 25%-30%, so clearly there is also regulatory clarity needed on that point.

Amundi: MREL of 25%-30% of RWA would imply 10.8% of total liabilities in own funds and eligible liabilities while the market still expects a minimum of 8%. Although the MREL level will be set on a case by case basis, the gap seems to be too large.

Allegaert, KBC: You can build up a metric that comes to those 25%-30% numbers. We anticipate, though, that European Res-



Doncho Donchev, CACIB
 'When you invest in senior
 unsecured you may not know
 what you are investing in'

olution Authorities will not aim for these ratios in the years to come and focus first on phasing in 8% MREL (as a percentage of liabilities) by 2019. MREL in the 25%-30% of RWA range would not necessarily accommodate a recovery of the European economy which the ECB aims to achieve through its expansive monetary policy. Market participants are very preoccupied with the whole MREL-TLAC debate.

Rijkema, Rabobank: Anticipating TLAC/MREL, Rabobank targets a total capital ratio with a minimum of 25% of RWA. MREL requirements will be determined on a bank by bank basis but we see the 25%-30% as a potential range where requirements could end up.

Baudouin, CASA: I think it is important to remember that Crédit Agricole's MREL ratio was already 8% excluding eligible senior debt at 30 September, which means it would be possible for the group to have access to the Single Resolution Fund in case of resolution. I agree there is still uncertainty about regulation and SRB decisions regarding the implementation of TLAC and MREL in the European legislative framework. The Commission is likely to make a legislative proposal on TLAC/MREL implementation in 2016. We strongly hope that the EU legislative framework (BRRD) will be amended consistently with the TLAC international standard adopted last November by the

G20 and that the TLAC/MREL duplication will not remain. This overlap between two ratios that have the same goal confuses investors and needs to be clarified as quickly as possible. The market disturbances caused by the recent Commission proposal on Tier 2 have shown the need for a clear and quick proposal of TLAC implementation.

BRRD AND NATIONAL LAWS/EU COMMISSION PROPOSAL *(See France box for more)*

Day, BIHC: There is a proliferation of national solutions regarding the role of senior unsecured within MREL/TLAC. What does it mean for the integrity of the European bank senior unsecured debt market? A return to pre-euro days? A complexity premium?

Perney Guillot, Fitch: EU countries are adopting diverging paths to establish workable foundations for bank resolution, but coordination is important because national laws and the characteristics of each country's banking system are being married with EU-wide regulation and Banking Union.

The EU authorities are encouraging countries to explore an EU-wide solution to remove obstacles that could hinder an effective bail-in in the event of bank failure.

of resolution under BRRD. These options contrast with the UK, which is requiring structural subordination through holding company structures for the country's large banks, as is the case in Switzerland and the US.

Other EU countries have provided little detail about their preferences. All proposals will have to consider both existing national insolvency laws and the specific features of a country's banking system. We believe resolution authorities will maintain a high degree of flexibility when dealing with each resolution case for deciding which liabilities will be bailed-in or not transferred to a bridge bank, subject to the overriding "no creditor worse off than in liquidation" principle. Clear and credible agreed group-wide resolution plans would smooth the process and avoid the additional risk of unilateral intervention by host regulators.

The BRRD came into force on 1 January 2015, but some EU countries are still determining what legislative changes, if any, need to be made, while others are already amending national insolvency laws and changing bank group structures.

Skeet, ICMA: As noted earlier, a proliferation and differing standards of subordination language might be inevitable. The hope is that investors will face consistent and predictable measures.

Complexity is already posing enough problems. Some investors question the need

We expect the market to adopt some simple standards for pricing each solution

Recent proposals for legislative changes in Germany, France and Italy provide clues about the likely paths for these countries. Germany is ensuring TLAC-eligibility of existing senior bank debt by subordinating it to all other senior liabilities from 2017. Italy is considering full deposit preference whereby senior bank debt still be TLAC-eligible if equally ranking excluded liabilities are small. France is proposing to create a new class of senior bank debt, "non-preferred", which will be subordinated to existing senior debt and bailed in more quickly in the event

to increase complexity through the introduction of new instruments whose status may not be clear versus other instruments and whose risk may be difficult to price.

Amundi: The proliferation of national solutions has definitely rendered the senior unsecured debt market more difficult to assess. Unlike pre-TLAC, investors now need to understand the implication each national law (i.e. of each transposition of the BRRD into national insolvency law) has on their position in resolution or liquidation and their loss severity.

One also needs to understand the interaction of various insolvency laws and each resolution strategy. Indeed, for now one can doubt whether the Single Resolution Board would be able to impose the bail-in of senior unsecured debt without risking breaching the BRRD's "no creditor worse off" principle, if the resolution entity has debt written in both German and French insolvency laws, for instance.

Notwithstanding these fundamental questions, we expect the market to adopt some simple standards for pricing each solution, similarly to what has been observed for the senior unsecured debt issued by UK and Swiss holding companies, with a 40bp-70bp premium across the board, irrespective of the issuers' fundamentals and of the overall capital structures.

Rijkema, Rabobank: Rabobank's capital strategy is focused on protecting senior unsecured for the unlikely event of bail-in and Rabobank has therefore built up a comfortable capital stack and plans to target a Total Capital Ratio in the range of 25%-30%. With regards to national solutions, Rabobank has published a position paper on the "German" solution in which it does not support such a proposal as Rabobank is in favour of building of a stack that protects senior unsecured debt.

Rabobank supports the "French" solution as it gives all institutions the flexibility to match their capital stack to their business model and at the same time make sure that no creditor is worse off. A European solution is preferred to create a level playing field.

Chandrasekaran, Camares: There was the European Commission document saying that you basically need to satisfy all the requirements with Lower Tier 2, and I think the EBA dissented to it. So, even from the perspective of how much Lower Tier 2 an issuer needs to have, there is actually no clarity, because ultimately the European Commission is responsible for putting into legislation the TLAC and MREL regulations, and if their proposal is that it all needs to be Lower Tier 2... It's highly unlikely to happen, but there is a large amount of uncertainty about how much Lower Tier 2 banks need.



Aravind Chandrasekaran, Camares
'There is a large amount of uncertainty about how much Lower Tier 2 banks need'

Donchev, CACIB: We have seen three different routes: the German route, where they take the senior unsecured, existing and future, and from 1 January 2017 it ranks below all the other problematic liabilities like derivatives, corporate deposits and so forth; there is the French route, which will effectively split senior unsecured, with the old stock of senior not changing in the ranking and remaining

pari passu, and new senior unpreferred instruments that are in essence economically like Tier 3 but still called senior; and the Spanish with the Tier 3 solution. So we have this proliferation of national solutions, and then you have the European Commission coming out saying actually we would like to have Tier 2 as the liability of choice for eligible liabilities and ignoring what has been happening in the individual Member States.

Again, I can only agree with what others have been saying, that we need more regulatory clarity and we need to see in which direction this journey will go. Unfortunately, now as an investor you don't know — in terms of pure demand and supply dynamics — how much Tier 2 will be needed on a systemic level versus senior unsecured, and when you invest in senior unsecured you may not know what you are investing in.

Perney Guillot, Fitch: Although several EU countries are adopting diverging paths to establish workable foundations for bank resolution, it is also possible that European authorities might propose a harmonised solution at the euro area or even EU level as an alternative to individual national approaches. This could even go as far as revisiting the MREL and/or depositor preference aspects of BRRD, in order to harmonise TLAC/MREL bail-in buffer approaches for all member states.

Day, BIHC: In the absence of law, are we seeing individual issuers draft their own strategy?

Allegaert, KBC: The intention of having a clear hierarchy for creditors is obviously a good and necessary one. The multitude of different systems doesn't necessarily add to clarity and puts a challenge on portfolio fit, grandfathering risk and spread pressure.

Nevertheless, looking through this, KBC has already drafted and communicated its MREL strategy, in which the HoldCo KBC Group is positioned as issuing entity to satisfy MREL. Previously,

The multitude of different systems doesn't necessarily add to clarity

KBC also moved up the AT1 and T2 issuance from KBC Bank to KBC Group. KBC Group will issue senior debt insofar as it is needed to reach its MREL target. The target has not yet been decided by the Resolution Authority, but it is assumed to be at least 8%, in line with BRRD. Also, our existing 17% total capital target remains. KBC Group will downstream the proceeds in subordinated format to KBC Bank. What adds to our benefit is the fact that, compared with other financials, KBC Group is a diversified holding company with investments in KBC Bank, KBC Insurance and KBC Asset Management. This diversification mitigates the structural subordination for investors in senior debt of KBC Group.

Rijkema, Rabobank: In the absence of specific law in The Netherlands the Ra-

The French solution: non-preferred senior

Are you satisfied with the French solution that has been come up with to address the MREL/TLAC issue?

Frédéric Baudouin, Crédit Agricole SA: Yes. The French solution is really similar to what we had advocated for during the negotiations with other banks, other French G-SIBs, and the French Treasury. So we are very satisfied with the French solution. It presents many advantages over solutions that have been decided in other European countries, such as Germany or Italy.

First of all, there is no retroactivity for investors, as the stock of existing senior unsecured instruments will be preferred, which means that the ranking of existing senior unsecured debt will remain unchanged. Furthermore, it really clarifies the eligibility of debt for TLAC, because liabilities excluded from TLAC, like short term instruments and structured liabilities, cannot be issued in this new category of senior junior debt, which means that this new category of debt qualifies as TLAC with no ambiguity, and while it is less risky than subordinated debt, it is certain that it will qualify as TLAC. And finally, the French solution gives flexibility for French issuers, since they will have the option to issue preferred senior unsecured debt or non-preferred senior unsecured debt after the French law has come into force. So given those three big advantages of the French solution, we are really satisfied.

Olivia Perney Guillot, Fitch: We think the French proposal will provide banks with flexibility in their funding plans, assuming investor demand: non-preferred senior securities could help French G-SIBs comply with TLAC requirements, whereas more cost effective preferred senior securities would be issued to fund the banks' structural deficit in deposits.

BNP Paribas is likely to be an active issuer of the new non-preferred senior debt because its current total capital adequacy ratio is far lower than its anticipated TLAC requirements. Other French G-SIBs either have smaller or no TLAC shortfalls. But they might issue some non-preferred senior debt, depending on pricing and market appetite.

Nadine Fedon, Crédit Agricole SA: The French solution is

in our view superior to the German solution because the existing stock of debt is preferred. It is also clearer for investors in terms of the hierarchy of creditors when compared with the Italian solution. The Spanish proposal is not optimal because firstly, there are legacy ranking clauses in Tier 2 debt that prevent the issuing of Tier 3, and secondly given the EU momentum towards eligible liabilities being senior unsecured debt rather than subordinated.

We think that the majority of the Member States that have not adopted any solution for the moment could also follow the French route, in particular the Dutch central bank could be interested as well as Belgium, even if certain Benelux issuers benefit from legacy HoldCo/OpCo company structures and could use those. And even Spain could follow the French route because of the aforementioned complexities.

Aravind Chandrasekaran, Camares: Perhaps the design is advantageous for the reasons you mentioned, but do you think the market is going to let you sell non-preferred senior somewhere close to exiting senior or where Lower Tier 2 is?

Fedon, CASA: Regarding pricing, we think that the pricing should be set looking rather at the existing HoldCo-OpCo differential than at Tier 2 pricing. In fact, it should be a good proxy for pricing the new French non-preferred debt, and we think that the thickness of the tranche will not be the main driver of the pricing.

Chandrasekaran, Camares: Why? There is no element of structural subordination. It is entirely a function of the thickness of the tranche.

Fedon, CASA: Compare, for example, two issuers: the first one is completing its TLAC obligation with 90% of Tier 2 and 10% of senior non-preferred, and the second one is completing the same TLAC obligation with 50% of Tier 2 and 50% of senior non-preferred. For the first one, there is very little non-preferred debt protected by a lot of Tier 2, resulting in case of resolution in a low probability of failure, but a higher loss given

bobank capital strategy targets high capital ratios to protect senior bondholders.

MARKET IMPACT AND PRICING OF NATIONAL LAWS

Amundi: In many Member States, some banks have long made public their strategy for complying with MREL. This is notably the case for banks with a high structural reliance on senior debt funding, which seek to meet an 8% MREL ratio with more subordinated instruments. These issuers may reassess their current strategy as their local insolvency laws are changed, though.

Day, BIHC: What are the implications of the Novo Banco/BES senior unsecured debt transfer?

Amundi: The transfer of the Novo Banco senior debts to BES was not expected and came as a further evidence that regulators have broad powers to resolve a bank and can be unpredictable. This has

harmed the relative trust of the market vis-à-vis regulators and has also partly driven the recent sell-off in the banking sector.

Perney Guillot, Fitch: The Bank of Portugal's decision to transfer almost Eu2bn of senior bonds out of the Novo Banco bridge bank and back to Banco Espírito Santo (BES), which is to be liquidated, shows bridge bank investors can face legacy retransfer risks until resolution is

failure, and therefore the pricing of the first issue of senior non-preferred should not be worse than the pricing of the tenth issue. And furthermore, if you have just one issue of senior non-preferred it will have a scarcity value. So the difference of HoldCo/OpCo should probably be a better proxy.

And you also have to bear in mind that the rating of the instrument will be involved in the relative valuation of the new instrument, as ratings are meaningful in the pricing rationale, just as they are for HoldCo-OpCo spreads.

Antoine Cornut, Camares: We will see. We think it is going to depend on the rating agencies, what type of rating you have, and hence what kind of real money guys are involved. Depending on their constraints, can they actually allocate to senior preferred or Lower Tier 2? I think that will be the main driver. And then how much the market is going to be excited about this new unpreferred asset class.

Do you have a sense from the rating agencies whether the new senior unpreferred will have the same rating as Lower Tier 2, or the current senior unsecured?

Doncho Donchev, CACIB: The rating agencies have publicly provided only initial views on the proposed French legislation, but not profound analyses. I think the good news perhaps is that for French banks this instrument will be largely rated investment grade. Obviously it will be between classic senior unsecured and Tier 2, and if you look at all the French banks these ratings are all investment grade – even if the differential varies widely according to the rating agencies' different methodologies. If you have a particularly large differential in terms of notches, it might be close to Tier 2 and then over time increasing towards the preferred senior unsecured rating. But obviously it should not be the same rating as classic senior unsecured, this new non-preferred senior, because that does not appear to make sense (although, here, again, this will depend on each rating agency's rating methodology).

concluded. In our opinion, the handling of Novo Banco's resolution process raises questions about how future bank resolutions might be dealt with in the EU, particularly because the timeframes could prove quite lengthy. The Novo Banco experience also means that any future ratings we might assign to bridge banks might be constrained to reflect legacy re-transfer risks to investors until that risk is sufficiently remote.

When announcing resolution pro-



Frédéric Baudouin, Crédit Agricole
'The French solution gives flexibility for French issuers'

ceedings, the Bank of Portugal said that it could transfer assets and liabilities between Novo Banco and BES at any time during the resolution process, and this has now taken place. The re-transfer of the five senior bonds announced in December 2015 aimed at addressing Novo Banco's solvency shortfall. We do not rate Novo Banco. But if we did, we would probably have viewed the retransfer of the bonds into BES as a restricted default of Novo Banco.

We are talking here about debt which is supposed to be explicitly bail-in-able after Tier 2, but bail-in-able, so there are no systemic considerations to factor in. What all the rating agencies have in common is that to the extent that whatever state support they may still factor into the ratings of classic senior unsecured debt or old-style preferred senior unsecured debt, this will not apply to the new debt instrument, so it will be notched or it will be rated based on the standalone credit rating of the issuer, whatever this is called for each rating agency.

Perney Guillot, Fitch: The new French non-preferred senior debt class would effectively become the reference debt class used by Fitch for setting a bank's Long-Term Issuer Default Rating (IDR). This is

because our IDRs rate to the third-party, private sector senior debt category with the highest risk, and the default risk on the new class of non-preferred senior debt would be higher than the risk associated with preferred senior debt and other senior liabilities like large, wholesale deposits.

In theory, if a bank issued very large and stable volumes of non-preferred senior securities and built up a considerable buffer, the default risk of the preferred senior debt would reduce and it could be notched up from the non-preferred debt rating. But we are some way off this, as the French option still requires debate and we think legislation is unlikely to be passed before end-June 2016.

To what extent will the fact this solution is now available change your plans?

Fedon, CASA: With the new liability class, we get complete flexibility to fulfil our TLAC obligations without increasing the cost of our regular funding, and in fact we might effectively issue less Tier 2 in the future and replace it partially by senior non-preferred issues. But it also remains to be seen what, if any, rules emerge at the EU level with respect to eligible liabilities for MREL and TLAC purposes. ●

Cornut, Camares: Draghi discussed the case of Novo Banco in the European Parliament and made the point that BRRD can only apply to certain bonds in a case where it actually does create some kind of systemic risk for the financial system. So does he mean that some bonds that are retail-held — which can create some kind of systemic risk, being a run on the bank — should be removed from the BRRD? Does he mean that the Novo Banco example where they excluded some of the



Tim Skeet, ICMA
'Predictability is a key ask of investors and credit analysts'

retail-held bonds will actually happen going forward? He really placed a strong emphasis on the fact that we will not do it for some bonds, some liabilities if it actually creates some kind of financial instability. So haircutting bonds held by a large asset manager like a BlackRock, a Pimco is fine because they can bear the losses; but doing it for some smaller investors who have their life savings in these bonds is out of the question? How are we meant to interpret these comments?

Fedon, Crédit Agricole: I think it is unfortunate that the Novo Banco case has given the impression that *pari passu* securities might be treated differently. But we think that this case cannot be taken as a general one for the Banking Union, and as you know the ECB has stated publicly that it was not involved in the decisions around the senior debt transfer from Novo Banco to BES.

Cornut, Camares: Unfortunately for us it doesn't mean that the ECB did agree or disagree on the way Novo Banco was recapitalised in December.

Fedon, Crédit Agricole: Well, it's not a general case.

Day, BIHC: What is the future for retail Tier 2, if there is one?

Perney Guillot, Fitch: The bail-in of re-

tail junior bondholders in the liquidation of Banca Romagna Cooperativa (BRC) highlighted the increased likelihood that losses will be sustained by bank creditors now that effective resolution tools are available in the EU. When the Italian authorities began BRC's liquidation in July, they decided to bail in its equity and junior debt, all of which was held by retail depositors. This first-time bail-in of retail creditors in Italy shows how bank resolution procedures have changed under BRRD. The initial plan was to use funds from Italy's Deposit Guarantee Insurance Fund to make up the shortfall between BRC's assets and liabilities. But the European Commission ruled that this would constitute state aid. Bail-in followed, while retail insured depositors, protected under BRRD, suffered no losses. Despite the bail-in of junior debt, no loss was ultimately suffered by the retail bondholders as the Italian mutual sector's Institutional Guarantee Fund decided to reimburse them in full to preserve the reputation of the sector. But junior creditor losses are far more likely under BRRD and we believe this will reduce retail investors' appetite for this type of bank debt instru-

ment. Also, bailing in subordinated debt can be done outside (i.e. before) formal resolution action on a bank.

Amundi: In some countries, notably Italy, retail Tier 2 funding is significant and imposing a ban on retail Tier 2 placement would be detrimental to the system. However, as the resolution of some Italian banks has recently shown, regulators need to make sure that the instruments are only sold to retail customers who clearly understand the risks and are capable of absorbing potential losses. Regulators will therefore need to ensure the placement of regulatory capital within retail networks does not create any material risk of mis-selling, notably by carefully monitoring the retail investor base, ensuring fair pricing and strong legal documentation.

THE SHADOW OF BASEL IV AND IFRS 9

Day, BIHC: Mario Draghi also told the European Parliament: "No Basel IV" — what do you make of this? What impact might RWA inflation otherwise have on absolute required levels of capital? And IFRS 9?

Cornut, Camares: I think it is difficult for Mario Draghi to say publicly there will be "no Basel IV" when people are talking about Basel IV. He cannot say in private conversations to dismiss the EBA recommendation and that the ECB will take a more pragmatic and lenient view, and then say publicly that he will follow EBA recommendations (which no-one really understands). He is trying to please everybody. People are concerned that there will be more capital requirements for European banks — which is what the equity market is pricing in — so he's trying to create a circuit-breaker for the recent sell-off in banks' equity on the basis that no more capital is needed — which would be positive. But it goes against the work done by the Basel Committee, so maybe he means

People are concerned that there will be more capital requirements for European banks

no Basel IV for the next two years, which is probably true, and then Basel IV when the market can actually cope with it. But he cannot please everybody. Clearly there will be Basel IV one day.

Baudouin, CASA: Our view is that you have a lot of work underway on the revised standardised approach in the Basel capital framework for credit markets and counterparty risks. All that work is likely to be implemented by 2019, and indeed may have an important impact on the RWA calculation. We are participating in different consultations, and what we can see is that you have a lot of new different rules — like the application of input and output floors based on the standardised approach to be applied on the internal approaches; the fundamental review of the trading book, with revised boundary between the trading book and

banking book; also revised internal models approach for market risk; and there are also changes in the revised standardised framework for credit risk in the second consultation document — for example, there is a reintroduction of the use of external ratings for exposures to banks and corporates, and also the use of LTV ratios in order to risk weight real estate loans. Therefore our opinion is that these changes to the Basel III framework are quite important, so we agree that we are heading towards a Basel IV framework rather than a modified Basel III framework.

Donchev, CACIB: Looking at numbers from Pillar 3 disclosures — which are actually quite helpful since banks started providing them, with LGD and PD ratios, risk weights, etc — for certain banks there is no impact, but for other banks, depending on jurisdiction there could be a 20%, 30%, 50% and sometimes as much as 100% estimated increase in risk weighted assets — so a potential doubling of RWAs. Based on this estimated quantitative impact there is clearly a mismatch with saying that there will be no Basel IV.

Perhaps the authorities are trying to be reassuring by saying there is not going to be Basel IV. My personal reading of this is that perhaps the final impact will be somewhat smoothed over, and that perhaps there will be kind of a transitional period that will be appropriate. But if we are talking about an overall increase in RWAs, let us assume, of above 10%, then you cannot say that is neutral. So while public regulatory statements might be getting gradually less hawkish over time, I therefore think that yes, we can clearly talk about Basel IV.



Allegaert, KBC: At this point, it is challenging to quantify the impact, given the uncertainty there still is around issues like floor levels, aggregation issues, etc. However, we understand European supervisors (e.g. the Bank of England, ECB) have indicated that the objective of such new requirements is not to significantly raise the capital in the system but to install a

the regulators now seem more concerned by the macroeconomic environment to which banks' lending capacity is critical.

IFRS 9 is a major overhaul of the accounting standards that is due to be implemented in 2018 (effectively "tomorrow"). Yet its day-one impact on banks' regulatory capital and the volatility it will induce on banks' earnings are far from clear. IFRS 9 provisioning will be based on internal models. Paradoxically, this comes at a time when regulators are calling for a lower reliance on internal models for banks' regulatory capital. The degree of oversight banking supervisors will have also remains a key unknown: unlike for Internal Ratings-Based capital requirements, IFRS 9 models will be validated by external auditors and not supervisors.

Skeet, ICMA: Investors have raised the issue that capital triggers/tripwires might be activated by movements in the risk asset weightings and recalibration of a bank's capital base through regulatory intervention, leaving investors potentially exposed. This might be another example of moving the goalposts in the name of

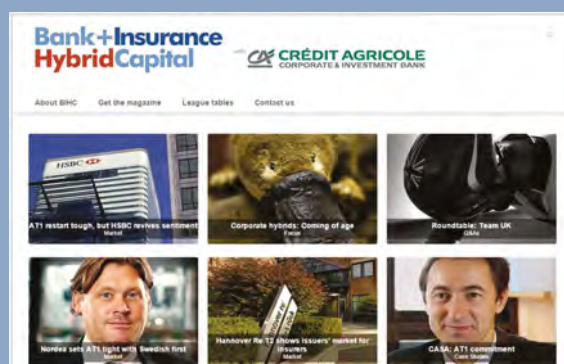
Perhaps the final impact will be somewhat smoothed over

level playing field. This could be achieved through the calibration/floors and/or lower Pillar 2 add-ons. As such, it seems that Basel IV should mainly be a concern for banks that are outliers today.

Amundi: The potential rise in RWA will definitely impact capital. Nevertheless,

macroeconomic policy or prudential supervision that subsequently leads to losses for investors. Predictability is therefore a key ask of investors and credit analysts — who nevertheless accept that there are unpredictable market and operational risks that regulators will legitimately need to address. ●

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The Road from Supervision to Resolution

A proper understanding of the post-crisis supervisory process is an essential angle for assessing banks' credit risk, argues *Sam Theodore*, group managing director, financial institutions, at Scope Ratings — even if the likelihood of resolution should not be overstated.

European banks' enhanced regulatory ecosystem remains centre stage for investors and other market participants. Scope Ratings identifies two main components in the new regulatory architecture: the metrics, and the process. In most cases, analysts focus primarily on the impact of prudential metrics (capital, leverage, liquidity, or, more recently, bail-in capacity) when assessing banks, neglecting the equally essential role of the supervisory process itself.

Based on historical evidence, for banks — unlike other credit sectors — it is mostly regulatory action that leads to default-like scenarios. Bank credit ratings must therefore assess the probability of regulatory action. Ours do exactly that (we detail that in our research and methodologies). For investors and other market participants, it should be evident that a proper understanding of how supervisors operate and what they aim to achieve is an essential component of evaluating banks.

Post-crisis bank supervision has moved from being largely procedural ("box-ticking") to being more substantive and intrusive — although the latter is still a work in progress. As banks have had to become more receptive to the feedback and demands of supervisors, the latter's role is also becoming more catalytic (agents of change). This should be reassuring for investors — to the extent that they trust the system — as supervisors' main brief is to keep banks safely away from regulatory borderline situations.

Unlike the pre-crisis years, the bank

supervisory process now starts upstream, with the assessment of business models, governance, and risk culture and management, before focusing on the downstream assessment of capital and liquidity risk. Another significant difference from the past is the increasing use of stress tests as a supervisory tool.

SREP explained: moving to a more dynamic and comprehensive assessment of individual bank risk

Under EU regulations, the Supervisory Review & Examination Process (SREP) includes guidelines on procedures and methodologies for bank supervisors. As of the start of this year it is a mandatory process, although in practice it has already been followed last year by EU supervisors, including the European Central Bank (ECB). SREP entails a dynamic and comprehensive assessment of a bank's risks and viability over a supervision cycle (from 12 to 36 months, based on proportionality). The supervisory work relies on resolution and recovery plans, on regulatory reporting (COREP and FINREP), on banks' internal reporting and strategic plans, as well as on third-party reports (e.g. from equity analysts and rating agencies) — in addition to ongoing dialogue with bank management teams.

SREP is based on four core areas of supervision:

a. Business model analysis (geographies, legal entities, business lines, product lines)

b. Governance (including remuneration and risk culture) and controls

c. Risks to, and adequacy of, capital

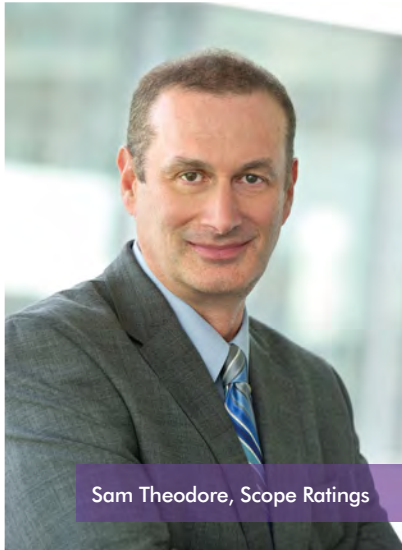
d. Risks to, and adequacy of, liquidity

Each of the four areas is scored from 1 ("no discernible risk") to 4 ("high risk"), or alternatively F ("failing or about to fail"). Based on the results of this assessment, supervisors may ask banks to take various actions, such as allocating more capital or liquidity, adjusting business models or governance, and implementing management changes.

SREP is used by supervisors to determine individual banks' Pillar 2 capital requirements, the additional capital needed to cover risks not captured or only partially covered by Pillar 1 requirements. SREP capital requirements that include both Pillar 1 and Pillar 2 are becoming a more definitive regulatory indicator. And as we have seen, SREP capital requirements are increasingly being disclosed by banks (with the prior agreement of their regulators) in the UK, Nordic region, and also increasingly in the euro area. Going forward, we expect SREP capital, to the extent that it is more consistently disclosed, to become in fact the overriding solvency metric for the market to focus on.

Early intervention as a distinct step prior to resolution

Triggers for early supervisory intervention may be: (i) an overall SREP score of 4 (or 3 overall with a 4 on one of the main areas of supervision); (ii) material anomalous



Sam Theodore, Scope Ratings

lies identified by SREP even in the absence of a formal re-scoring; or (iii) the occurrence of “significant events” (including a material rating downgrade that might trigger market-access problems).

Early intervention can include more severe steps, such as the removal of management, temporary administration, cancelling coupon payments on capital instruments, or the conversion or write-down of principal on capital instruments — thus reaching the point of non-viability (PONV).

Should early supervisory intervention be insufficient to prevent a bank from sliding into a “failing or about to fail” situation, placing it into resolution would then be considered. Below we highlight the normal supervisory process before the resolution scenario is reached.

Resolution is a very extreme scenario for a bank with decent-to-good fundamentals, therefore senior debt should be relatively safe

Often, in the heated market debate about the ranking of senior unsecured debt in resolution (partially fuelled by suboptimal clarity from regulators), the degree of comfort with a particular bank’s credit fundamentals seems to be falling by the wayside. In the end if being placed in resolution remains a very remote probability for a bank with decent-to-good fundamentals, exactly how senior debt would be treated in this extremely unlikely scenario, while definitely worth knowing, should not perhaps be the central concern for investors.

Conversely, if being placed into resolution became a plausible scenario for a bank with deteriorating fundamentals, investor concerns should go well beyond the eligibility of senior debt in MREL/TLAC. Said otherwise, a sufficient number of lifeboats on deck will not convince anyone to board a ship in a creaky condition.

We have to assume that a modern-day bank supervisor worth its salt will do its utmost and then some to prevent a bank from sliding into a situation of structural weakness in which resolution would be necessary. A large bank being placed in resolution would undoubtedly be a costly and painful outcome for the financial stability of a country. Even if taxpayers were not to recapitalise the bank, a ripple effect on market sentiment and a likely wider panic affecting other banks could be envisioned. Depositors may well be exempted from bail-in, but general fear would undoubtedly spread.

A resolution authority’s main brief should plausibly be ex ante resolution avoidance (through planning) rather than ex post resolution management.

To conclude, the intense debate about the process of resolution and bail-in should

not translate in investors’ minds into a heightened conviction of a resolution scenario actually occurring. As the details of resolution are clarified and to the extent possible made public — MREL/TLAC levels, composition of eligible liabilities, timing, etc — investors should again focus on assessing the fundamentals of banks. Extensively debating funeral arrangements if the person is healthy can go only so far.

This should be all the more true in the case of the euro area, where supervisors and resolution authorities are two separate bodies (the ECB in Frankfurt and the Systemic Risk Board (SRB) in Brussels, respectively) — unlike, for instance, the UK, where the Bank of England is both resolution authority and prudential supervisor (the latter via the Prudential Regulation Authority (PRA)). Placing a large euro area bank in resolution is likely to be a far messier process than elegantly passing the baton from competent authorities (ECB) to resolution authorities (SRB). ●

Sam Theodore
Managing Director
Scope Ratings
s.theodore@scoperatings.com
+44 7769 321043

Supervision process all the way through resolution

A. Normal supervision (competent authorities)

SREP	Score: 1-4 or F
a.	Business model/strategy
b.	Governance/controls
c.	Capital (ICAAP)
d.	Liquidity (ILAAP)

Stress Test

Supervisory outcome (including Pillar 2 decision) through:

Ad hoc supervisory judgment
Supervisory colleges
Crisis management groups

B. Early intervention (competent authorities)

Based on:	Low SREP score (overall 4; 3-4 on individual factors)
	Material anomalies
	Significant events

Can represent PONV

C. Resolution (resolution authorities and competent authorities)

Based on:	Institutions failing or about to fail
	No alternative (private sector or further supervisory action)
	Public interest

Source: Scope Ratings

Banco Popular

Ahead of the game

Having been a pioneer of Additional Tier 1, Banco Popular Español has lived the ups and downs of the asset class since its birth in 2013. Here, *Francisco Sancha*, CFO at Banco Popular, shares his views on the market's latest growing pains and related regulatory developments, and explains the Spanish bank's capital position and strategy.

Popular has been involved in the AT1 market since its early days. What are your thoughts on how the asset class has developed?

Investors have analysed this product in depth. Initially investors' attention was focused on how this instrument absorbed losses (write-off, conversion) and what the distance to trigger was.

Then, loss-absorption interaction between instruments with different trigger levels emerged as an issue. The complexity of having different local regulators establishing higher triggers than the CRD IV 5.125% requirement (Sweden, UK, etc) added up. On this point, Banco Popular has pioneered with the only AT1 7% trigger issuance so far in Spain.

Lately, the focus has shifted to the probability of having any sort of restriction on distributions, which is a natural evolution as the loss absorption risks become less of a concern.

With a very weak market backdrop and significant uncertainty evident to all, the performance of AT1 has shown the ongoing need for further consolidation in the asset class.

What do you see as the challenges of the instrument going forward?

From our dialogue with new investors, I would say the most recurring concern is the sluggish development of a deeper and diversified investor base. Of course, this

would require a better understanding of the instrument — backed by consistent regulation — and the improvement of liquidity conditions for the noteholders. I am positive that as we see strong appetite, we will see new investors getting involved in a more stable market position.

Investors are conscious of the improvement of the banking industry in the last few years, as almost every entity has increased its capital ratios. This will continue going forward, as issuers are targeting higher funding plans reinforcing their ratios and fulfilling Total Capital buckets in the phase-in of the CRR and MREL/TLAC requirements. We will certainly continue working in that direction.

How would you describe Popular's capital position today?

Popular has been making great progress in steadily building up its capital position. In the last two years, it has been able to generate close to 200bp of capital in a challenging environment thanks to its business model and strong franchise. In fact it has seen one of the highest capital generation progressions, at least in Spain.

I would highlight the bank's remarkable capacity to maintain a very strong and stable top line throughout the crisis, building on its profitable business mix, which is focused on SMEs and professionals, and where it is able to grow and gain market share.

As a result, the bank now enjoys a

CET1 phased-in ratio of 13.11% and Total Capital of 13.83%. Both are deemed very satisfactory to meet current as well as forthcoming regulation.

You have recently disclosed a 10.25% CET1 phased-in SREP requirement. How do you value this in comparison with your present capital position?

I think the outcome is extremely positive. The SREP requirement communicated by the ECB was quite clear; Popular has been required to meet a minimum CET1 phased-in of 10.25% for 2016, which compares very well with our CET1 of 13.11% as of year-end, so we currently hold a robust headroom to MDA of 286bp. It's a strong starting point for our capital strategy, giving Popular total discretion for the payment of distributions.

The EBA opinion published in December on the interaction of Pillar 1, Pillar 2, the Combined Buffer Requirement and MDA restrictions has been interpreted by some investors and analysts so that AT1 and Tier 2 deficits will withdraw from the CET1 capital available to meet the SREP number. What is your view?

In my opinion, there is still work to be done to align the different regulatory developments in a credible way. In this regard, Competent Authorities are developing different work-streams in response

to investors' calls for clarity, which is key to allow entities to continue building up their capital buckets in anticipation.

Nonetheless, the requirement communicated by the ECB is clear and give us a sizeable headroom to MDA, as noted earlier.

You have said that Popular has been very proactive in building up its capital stack — could you explain why?

The bank is committed to deploying a strong and sound capital base, and we started from the very bottom of the capital stack, growing CET1 at a quick pace as shown earlier, and filling up the AT1 bucket requirement promptly.

In this respect, Popular has been well ahead of schedule in the build-up of its buckets, which is in our view a competitive advantage. It launched the first euro AT1 transaction in the EU and was also the first Spanish bank to fully top up the AT1 bucket. It launched the first high-trigger AT1 structure in Spain with a view to obtaining the maximum regulatory recognition on its quest to improve the quality and quantity of the capital base.

What can you tell us about your capital plans?

Our aim is to keep on building CET1 capital on the back of organic growth and RWA model calibration and, as we already filled up the AT1 bucket, we will move to continue growing the Tier 2 bucket, which stands at 73bp at the end of 2015. We would probably do a Tier 2 transaction in 2016, but without urgency, when the markets would be receptive.

What would you see as your target capital ratios?

In terms of Total Capital, Popular reported a year-end ratio of 13.83%; meaning 183bp improvement during the year — which is a quite remarkable performance. Taking into account our recurrent organic growth and the proactive fulfillment of our Tier 2 bucket, we have a strong growth potential that would take us well above the 14% mark at the end of 2016,



Francisco Sancha, Banco Popular

with the aim to be always well ahead of the minimum requirement given that this is a moving target.

Your 8.25% callable perpetual debt reached a trading level as wide as 11.5% YTM. Is there any message you want to pass on to investors?

Yes, as I said before, recent hybrid capital market turmoil has to do, among other reasons, with concerns on coupon payments restrictions.

In connection with this, I would recall that fundamentals on Popular remain strong and emphasize that we have no restrictions on distributions whatsoever. As a matter of fact, we have published a statement on our website to confirm the first AT1 2016 calendar payment had been done, and we have paid a dividend on 25 January. Headroom to MDA is a healthy 286bp and our ADIs are over Eu3.8bn, not forgetting that we enjoy a profitable business model that will allow us to keep on building both capital and reserves buffers.

Markets have been very volatile during the development of the AT1 market. As you have filled your AT1 bucket, would you give any suggestions to banks with AT1 issuance plans?

As the AT1 market developed, investors became more and more sophisticated and demanding of what banks had to face in

terms of enhancing communication and marketing activities, while wanting to see progress on their ability to build the quantity and quality of their capital base.

Since mid-January, volatility in the AT1 market has been especially harsh due to several factors. Uncertainties on the regulatory front continue to be the main driver, but we recently observed the lack of liquidity as another relevant factor further increasing volatility. In this regard, we would suggest banks intensify communication and interaction with investors, whilst trying to enlarge the investor base.

What are your views on the Spanish approach to MREL/TLAC and senior subordinated/Tier 3 issuance? Should there be a European solution?

The Spanish approach is another feasible solution to address eligibility in the bail-in ratios, though it is not free of uncertainties as to how that could impact the cost of funding and may not be feasible until legacy Tier 2 are gone. In any case, it is not the only approach, as you noted. The Germans, French and Italians have their own, each with different nuances.

In my view, and looking to the efforts already undertaken by the EU in order to eliminate fragmentation and secure financial stability (such as the creation of the bail-in tool, the Single Supervisory Mechanism, or the Single Resolution Fund) it makes sense to reach a harmonized approach, which would also help pave the way towards a level playing field.

Are there any other regulatory developments that are of particular concern to Popular?

As I said, Popular has been working well ahead of requirements and will continue to do so. Given our current capital position and a proven track record on building the capital stack, we are in a very comfortable position to face this challenging era. Nonetheless, we have to be well aware of any future developments such as the implementation of IFRS9, expected TLAC and MREL convergence, and any potential changes to RWA calibrations, among others. ●

Solvency II Disclosure Raising the Bar

Disclosure by insurance companies has improved in the run-up to the implementation date of Solvency II, but the complexities of the new European capital framework coupled with investors' expectations means that there is still room for improvement when it comes to reporting, writes *Michael Benyaya*, DCM solutions at Crédit Agricole CIB.

1 January 2016 was no big bang in the insurance space. The length of the Solvency II (SII) process gave insurance companies lead time to adapt to the new regulatory framework, while the various SII tweaks have certainly helped smooth the transition. Still, SII entails numerous challenges, one of them being communication. The fundamentals and dynamics of the insurance sector have not changed because of SII, but stakeholders will have to put on new glasses to assess the sector. Therefore, insurers need to educate investors to a complex framework which will affect reporting and potentially the perception of the sector. Communicating clearly and consistently will also underpin success in the transition to SII.

Converging towards investors' expectations

With the exception of a very few idiosyncratic situations, a relatively benign SII outcome was expected. Indeed, the large insurers and reinsurers have long disclosed an economic capital position that was generally viewed as a guide to the SII outcome. But this was clearly insufficient as investors did not wait for the formal SII implementation date to form a view on the level and type of disclosures needed. The sector had to raise the bar in terms of disclosures to meet expectations and avoid unnecessary speculation.

Timing-wise, the best practice was to communicate ahead of January 2016 by means of dedicated investor days (often in conjunction with an announcement

of regulatory approval of the SII model). Some other companies (e.g. CNP Assurances, Aviva) have released the SII position (or are expected to do so) together with full-year 2015 results. Bancassurers will also probably come out of the woods at some point. SII communication within a conglomerate may entail additional challenges (e.g. the appropriate set of sensitivities given the predominance of a life business) but Danica Pension's and KBC's presentations may provide a blueprint.

Overall the sector conforms to investors' minimum requirements. The level of disclosure has dramatically improved, although it remains uneven and key items such as sensitivities are not uniform.

Some of the topics and minimum disclosures expected by investors are:

- Type of model used: internal models or standard formula depending on the business line and equivalence, particularly for a US business.
- The sensitivities to interest rates and equities are the minimum items required to gauge the potential volatility and resilience of the Solvency Capital Requirement (SCR) margin. Insurers often go beyond this and include credit spreads, real estate or natural catastrophes.
- Breakdown of the SCR modules and available capital, including the grandfathering treatment of subordinated debt: this is needed to assess financial flexibility. Investors were seeking assurance as to the robustness of the grandfathering treatment, particularly

following Prudential's announcement that it will use the variation clause of a US dollar perpetual debt issue to cure a capital disqualification event. There was no negative surprise and the fear of a wave of regulatory call exercises has now vanished. Some investors continue to question the rating agencies' treatment of grandfathered instruments, but the risk of rating methodology events also seems marginal.

- Impact of the various SII arrangements, e.g. volatility and/or matching adjustment, ultimate forward rate, transitional measures: longer term, some of these measures might be discounted by investors in their credit assessment.
- There is an increasing focus on local capital requirements because this can affect dividend sustainability, although this is currently of primary relevance for equity investors. However, this could gain in importance for credit investors if and when insurance companies start issuing Restricted Tier 1 (RT1).

No SCR comparison, but absolute thresholds remain

Investors are fully conscious that SII ratios cannot be compared across the industry and the approach to assessing the strength of an SCR ratio has evolved significantly. The headline ratio now seems to be de-emphasised in investors' analyses and there is an increasing focus on its mechanics as well as consistency with the company's business model. For example, Standard Life reported a 162% SII ratio,

which may appear at the low-end in a European peer group; it is actually very comfortable in light of the company's fee business model, which results in a stable SII position.

Yet absolute thresholds remain anchored in investors' minds. In most instances, an SCR margin in the 130%-140% range (or below) will be deemed too low. In this regard, the capital increase announced by Delta Lloyd when it reported an SCR of 136% is not really surprising. This also raises the question of the communication of an SCR target by insurance companies as well as capital generation (and depletion) under SII. Few insurance companies have a set a SCR level target, and when disclosed, the range remains relatively wide. This is because the SCR ratio is expected to be volatile and insurance companies want to avoid taking strategic decisions on the back of short term volatility. Likewise, the quality of communication on capital movements will be crucial because it will be affected by a number

of non-cash items and the unwinding of SII-specific items (e.g. risk margin, transitional measures).

More clarity on the SII capital position, more visibility on Restricted Tier 1 issuance?

As expected, the implementation of SII will not trigger an increase in insurance capital issuance volumes and 2016 supply should primarily be driven by refinancing in the Tier 2 formats. It is not clear whether 2016 will see the first RT1 issues as issuance drivers are elusive. Indeed, the size of the Tier 2 bucket is optically large enough to allow for the refinancing of all existing subordinated debt. The capacity to tap the Tier 2 market remains an important factor of financial flexibility, including from a ratings perspective. Issuers are therefore expected to retain some Tier 2 headroom.

However, EIOPA's Opinion on the calculation of tier limits for insurance groups that use the combination of the consolidation and deduction/aggrega-



Michael Benyaya, CACIB

tion methods might be a game-changer. A few issuers may actually have a lower than anticipated Tier 2 capacity and hence may be forced to turn to RT1.

But before the RT1 market opens, a few structuring issues need to be sorted out and the subordinated market, bank AT1 in particular, will need to recover. ●

Solvency II Communication Benchmark

	SII Ratio at YE-15 (type of model)*	Stated Management Target	Type of Sensitivities
Aegon	160% (PIM, US Equiv.)	140-170% (Group level)	Equity +/-20%, Rates +/- 100bp, US credit defaults 200 bp, UFR divided by 2, Dutch mortgage spread +50 bp
Allianz	200% (IM, SM 14% SCR, US Equiv)	180%-220% before stress Div. Policy (>160%)	Rates +/- 50 bp, Equity +/-30%, Credit spreads (+100 bp gvt./other), Credit/Reserve strength./ NatCat event (1-in-10y), Impact on distributable earnings (-50 bp rates)
Axa	205% (IM, US Equiv)	170-230%	Rates +/- 50 bp, Equity +/-25%, Corporate spreads (+75 bp), historical shocks , UFR -100 bp
CNP	192% (SM)	None	Rates +/- 50 bp, Equity -10%, Corporate spreads (+75 bp)
Munich RE	260% (Q3-15, Full IM)	175%-220%	Rates +/- 100 bp, FX -10%, Equity +/- 30%, Spread +100bp, Atlantic hurricane
NN	239% (PIM)	None	Rates +50 bp (parallel, steep. 20-30y), Equity -25%, Credit spreads +50 bp (all, govies, corp), Real estate -15%, UFR (down to 3.2%)
Prudential	190% (H1-15, IM, US Equiv.)	None	Rates +100 bp /- 50 bp, Equity -20/40%, Credit spread + 100 bp
SCOR	211% (Full IM)	"Optimal": 185%-220%	Rates +/- 100 bp, USD +/-10%, Equity returns -10%, Corporate and govies spreads +100bp

*Ratio as of year-end 2015 unless otherwise stated; IM: Internal Model; SM: Standard Model. Source: Company reports, Crédit Agricole CIB

CASA

A window of stability

Amid moving regulatory targets and internal constraints, Crédit Agricole found the right moment to launch a \$1.25bn AT1 in January. Here, Crédit Agricole's *Olivier Bêlorgey* and Crédit Agricole CIB's *Bernard du Boislouveau* and *Vincent Hoarau*, explain how they dealt with the complications of the prevailing market uncertainties.

Neil Day, Bank+Insurance Hybrid Capital: Why did you decide this was a transaction to go ahead with at this point?

Olivier Bêlorgey, head of the financial management department, Crédit Agricole: The fundamental rationale was to fulfil the 1.5% Additional Tier 1 (AT1) bucket at Crédit Agricole SA (CASA) level, and now we are done. At the Crédit Agricole group level we will not fill the 1.5% AT1 bucket because at group level we have plenty of Common Equity Tier 1 (CET1) capital in the regional banks, consisting of retained earnings, and as the regional banks have no pressure on ROE this CET1 is in fact cheaper than AT1. At CASA level — the listed company — AT1 is of course cheaper than CET1, so for CASA it is an optimisation of the capital structure.

The rationale for coming to the market in January was then to be as consistent as possible with what we had communicated to the market. We had indicated that we would need roughly Eu1bn of AT1 in 2015 and perhaps Eu1bn more in 2016 — so clearly we were a little late with this AT1 as we didn't issue last year.

Bernard du Boislouveau, FI DCM, Crédit Agricole CIB: This deal was also the concrete outcome of significant reverse inqui-



Olivier Bêlorgey, Crédit Agricole

ries received at the end of 2015 and reconfirmed in early January 2016. This gave a clear positive signal from leading investors in the AT1 space, supportive enough to move ahead with the project.

Bêlorgey, Crédit Agricole: Regarding further AT1 issuance — noting that we had indicated we could issue Eu1bn more — given that AT1 costs are very high and given that we have already filled the 1.5% bucket, we can now say that we will wait and see, in a sense, and only issue more if we have, for example, an increase in our RWAs and consequent increase in our needs.

Day, BIHC: Why did you not do the Eu1bn last year?

Bêlorgey, Crédit Agricole: Last year we began with a Eu3bn issuance in the Tier 2 market in March, and we considered that it was not the best idea to issue both Eu3bn of Tier 2 and Eu1bn of AT1 in the same semester. So we waited for the second semester. Then, during the second semester, we actually decided not to issue because of the ongoing discussions concerning the whole SREP process and the Pillar 2 requirements. We considered it would not be fair to issue AT1 without disclosing the results of these discussions to the market. The main question was whether or not Pillar 2 requirements from the ECB would



Crédit Agricole, Montrouge
Photo: Frédérique Thomas

be binding towards MDA. So that's why we didn't issue last year.

After that, we decided to issue very quickly this year for a variety of reasons. First of all, because we didn't issue last year and were therefore a little late in our programme, so we wanted to do it as soon as possible. Also, the communication we made concerning our Pillar 2 requirement in December was well received by the market, so we considered that it was a good timing to proceed.

And also for a technical reason directly linked with Crédit Agricole's own constraints: this year as we are disclosing a new medium term plan in March, we have a quite long blackout period at the beginning of the year. Indeed, it began on 21 January and we won't be able to issue before mid-March. So clearly, market permitting, we wanted to issue before the blackout period.

Day, BIHC: You must be very happy that you issued when you did.

Bélorgey, Crédit Agricole: The timing was perfect, I would say, because we seized the opportunity of a very small window in this quite hectic market. We also took that risk — and it was a risk — because we have some experience in the AT1 market, and this experience told us that it was possible to do it.

And to be honest we are happy not only to have issued when the market was better and given what has happened since then; we are also happy because the deal went well — for more than one week after launch, at least, the deal was quoted above par, so the deal was well received by the market. We had more than 200

investors in the book, which is a very high number, especially when market conditions are not so bullish. So clearly we were in line with our approach of being investor-friendly. As one of the biggest issuers — and a quite frequent, too — our dialogue with our investor base is indeed key.

Having said that, we are happy to have issued and anyway, in the current market, you simply cannot issue.

Du Boislouveau, CACIB: The current equity market also shows the volatility we observe in the AT1 space. The ups and downs on a given name, but also across countries and jurisdictions, are amplifying dislocations in the secondary market.

Vincent Hoarau, head of FIG syndicate, CACIB: Olivier is right. The timing was decisive. But we benefited from a high degree of flexibility in terms of timing, simply because we anticipated the January rush and volatility, and proceeded with a global — but non-deal related — roadshow in December. This marketing exercise was instrumental in the success of the transaction. The issuer met roughly 60 investors in seven cities in Europe and in the US within a few days. We then waited for the best possible execution window, ensuring a very quick turnaround and competitive outcome in terms of all-in cost. Ultimately, we caught the best trading days of January for the execution of this strategic trade and collected demand in excess of \$4bn for a \$1.25bn (Eu1.14bn) sized deal. The approach to timing and pricing was critical to the process given the global sell-off that kicked off the day after pricing.

Bélorgey, Crédit Agricole: Part of the reason is down to the focus on the Deutsche Bank AT1, but that is perhaps just the event that set alarm bells ringing more loudly in investors' ears — the market is paying more and more attention to MDA and the capacity to pay coupons.

Day, BIHC: What determined your choice of currency?

Bélorgey, Crédit Agricole: Clearly it is investor-driven. As usual, we are rather agnostic regarding euros or dollars. We would prefer euros, because it is our main currency, our accounting currency, but having said that, we clearly try to answer the investor demand, and for that reason we chose US dollars.

Du Boislouveau, CACIB: When it comes to AT1 products, the US dollar market's depth is indeed much more significant than what we can observe in other markets.

Hoarau, CACIB: As Olivier outlined, the overall project was driven by the profile of demand and global investor appetite for risk across currencies. And the level of liquidity is indeed perceived to be lower in euros. But one should also bear in mind the situation in cross-currency swaps for Eurozone issuers and US dollar AT1 spread levels compared with euros. In that respect, the US dollar market demonstrates greater cost efficiency.

Day, BIHC: Is there anything else you would highlight?

Bélorgey, Crédit Agricole: We didn't do a deal related roadshow for this transaction — as you mentioned, we have issued many times in AT1 and are rather well known in this market, but we put in place a non-deal roadshow back in December — as outlined previously — in order to get investors' feelings regarding the latest regulatory developments. Timing-wise, it was just before the release of the Pillar 2 requirement by the ECB and so we were not able to answer all the questions, but it nevertheless gave us the opportunity to test the investors on some scenarios and get a better view concerning their needs. For example, if Pillar 2 requirements are binding or not, what

would your reaction be? If it is binding, what kind of buffer above Pillar 2 requirements would you need in order to invest in the AT1 market? And so on.

So we had a very interesting discussion concerning the potential impact of Pillar 2 requirements on the AT1 market, enriched by experience from both sides. That gave us the final touch in terms of how to define our buffer above Pillar 2 requirement, and the message we wanted to give investors once we received the ECB requirements.

Du Boislouveau, CACIB: Over the last year, CASA has created and reinforced a genuine networking and high quality relationship with its investor base. It was particularly obvious during the roadshow back in December given the quality of the exchanges and the mutual search for the best outcome from both issuer and investors' perspectives.

Hoarau, CACIB: I would like to again emphasize the timing of the transaction and the capacity of the issuer to pull the trigger very rapidly and ensure a quick turnaround in very volatile markets. The context of the reopening of the US dollar AT1 market was fairly complex at the time of launch given the regulatory context and global market backdrop. Poor liquidity in the market kept new issue premiums in the product at fairly high levels, while issuance windows were extremely thin, and almost non-existent for high beta instruments. Any hesitation, and the project would have been postponed sine die. AT1 capitulated and hit unprecedented lows just a few days later. And the market is still closed as we speak.

Day, BIHC: You mentioned your wait and see approach to further AT1 issuance — is there anything else to add regarding what we might see from Crédit Agricole going forward?

Bélorgey, Crédit Agricole: In terms of AT1 needs, everything is now in the market. As I said earlier, any further developments would be linked with other topics, that is to say an increase in RWAs due to Basel IV or other regulatory pressures, or because we would develop part of the business and so on. ●

Crédit Agricole SA Undated Deeply Subordinated Additional Tier 1 Fixed Rate Resettable USD Notes

Rating: -/BB+/BB+

Amount: \$1.25bn

Maturity: Perpetual

Call option: 23 December 2025 and annually thereafter

Loss absorption: Principal writes down (but can be written back up)

Trigger levels: Crédit Agricole SA 5.125% and Crédit Agricole Group 7% (phased-in CET1 ratios)

Fixed/re-offer price: 100.00

Coupon: 8.125% until (but excluding) the first call date;

thereafter reset every five years based on the then prevailing five year USD mid-swap rate plus 618.5bp (no step-up)

Launched: Tuesday 12 January

Sole bookrunner and global co-ordinator:

Crédit Agricole CIB

Distribution by region: North America 76%, UK 14%, France 3%, Asia 3%, other 4%

Distribution by investor type: Asset managers 87%, insurance companies/pension funds 11%, banks/private banks 2%

Regulatory updates

EBA

EBA launches 2016 EU-wide stress test exercise: On 24 February, the European Banking Authority (EBA) released the methodology and macroeconomic scenarios for the 2016 EU-wide stress test. The stress test will be conducted on a sample of 51 EU banks covering 70% of the banking sector in the EU. The key features of the methodology and the scenario are:

The common methodology assesses solvency and covers all main risk types including: credit risk and securitisation, market risk, sovereign risk, funding risk and operational and conduct risks. The stress test is run on banks' models and the results are then challenged by supervisors in the relevant competent authorities (CAs).

The adverse scenario, designed by the European Systemic Risk Board (ESRB), reflects the four systemic risks that are currently assessed as representing the most material threats to the stability of the EU banking sector:

- i An abrupt reversal of compressed global risk premia, amplified by low secondary market liquidity;
- ii Weak profitability prospects for banks and insurers in a low nominal growth environment, amid incomplete balance sheet adjustments;
- iii Rising of debt sustainability concerns in the public and non-financial private sectors, amid low nominal growth;
- iv Prospective stress in a rapidly-growing shadow banking sector, amplified by spillover and liquidity risk.

The EBA expects to publish the results of the results of the exercise in early Q3 2016.

EBA publishes 2016 revised work programme: The 2016 work programme has been revised on the back of budget reduction. The key priorities for 2016 are:

- Promoting a common approach to the calibration of the leverage ratio, enhanc-

ing the framework for credit risk and reviewing the impact of banking regulation, including the promotion of the Capital Markets Union development;

- Promoting convergence in supervisory approaches to ensure comparability and consistency in supervisory outcomes across the single market, including Pillar 2 and banks' internal models.
- Concluding the new crisis management framework, in particular finalising requirements for loss-absorbing capacity and ensuring its consistent implementation across the EU Member States; and
- Enhancing the framework for the protection of consumers and the monitoring of financial innovation and preparing for mandates under the revised Payments Services Directive.

EBA publishes Guidelines on cooperation agreements between deposit guarantee schemes: On 15 February, the EBA published its final Guidelines on cooperation agreements between deposit guarantee schemes (DGSs). These Guidelines specify the minimum content in relation to the three key areas to be included in cooperation agreements: modalities for repaying depositors by the local DGS at branches of banks established in other Member States, modalities for the transfer of contributions from one DGS to another in case a credit institution ceases to be a member of a DGS and joins another DGS, and modalities for mutual lending between DGSs.

EBA expressed dissent over European Commission proposed amendments to the MREL technical standards: On 9 February, the EBA issued an Opinion to the European Commission (EC) expressing its dissent over some of its proposed amendments to the EBA final draft Regulatory Technical Standard (RTS) on the criteria for setting the minimum requirement for own funds and eligible liabilities (MREL) and encouraging the prompt adoption of the standard. The EC's proposed amendments were sent to the EBA last December. Some of the EBA's objections are in response to:

- The EC's proposal to remove an instruction to resolution authorities to ensure systemically important banks have at least enough MREL to facilitate them meeting the minimum requirement to bail-in up to 8% of liabilities before using resolution funds. The EC believes this instruction goes further than the provisions of the Bank Recovery & Resolution Directive (BRRD), which grant discretion in setting individual bank MREL requirements
- The EC's proposed removal of the 48 month transitional period for banks post-resolution to restore the recapitalisation component of MREL and replacing it with more ambiguous language that refers to the transitional period being "as short as possible". This will give local regulators and authorities more flexibility in determining minimum MREL requirements and timeframes but would create more inconsistency of implementation across Europe.

According to Moody's, the EC's proposals will allow resolution authorities to weaken BRRD's mandate and the overall outcome will be negative for bondholders. Moody's states that the ECB (NB: it should be the ESRB) is yet to decide if it will follow the EBA's original RTS or align its approach to the EC's proposed amendments. UK authorities are so far in line with the EBA's proposals.

These updates are split into bank and insurance, and listed according to the relevant body, topic or country, with the most recent first therein.

Michael Benyaya,
Julian Burkhard, Badis Chibani,
Veronique Diet-Offner,
Doncho Donchev,
Samuel Susman
DCM Solutions
Crédit Agricole CIB
Capital.Structuring@ca-cib.com

EBA sets out roadmap for the implementation of the regulatory review of internal models: On 4 February, the EBA published an Opinion specifying the general principles and timelines for the implementation of the regulatory review of the internal ratings-based (IRB) approach:

- The proposed changes aim to address the current concern about the lack of comparability of capital requirements determined under the IRB approach across institutions
- The EBA reiterates its stance in favour of the continued use of the IRB approach and introduces changes aimed at harmonising definitions and supervisory practices in the definition of default, the estimation of risk parameters and treatment of defaulted assets, credit risk mitigation techniques and disclosure in four phases
- The Opinion requires all changes related to the regulatory review to be finalised by the end of 2020

EBA launches an impact assessment of IFRS 9 on banks in the EU: On 27 January, the EBA launched an impact assessment of IFRS 9 on a sample of approximately 50 institutions across the EU. From this exercise, the EBA aims to understand the estimated impact of IFRS 9 on regulatory own funds and the interaction between IFRS 9 and other prudential requirements. The exercise will be repeated ahead of the implementation of IFRS 9 in 2018.

EBA consults on draft guidelines on implicit support for securitisation transactions: On 20 January, the EBA launched a public consultation on draft Guidelines on implicit support for securitisation transactions:

- The draft Guidelines propose an objective test for the definition of arm's length conditions and for assessing when a transaction is not structured to provide support.
- Guidance is provided on those elements that should be considered when assessing whether a transaction is not



European Commission, Brussels

structured to provide support and on the notification requirements applicable to such transactions.

- The draft Guidelines include provisions to avoid a scenario whereby support is provided on behalf of the originator by another entity.
- The consultation runs until 20 April.

EUROPEAN COMMISSION

The EC and the CFTC announce agreement on clearing house supervision:

On 10 February, the European Commission (EC) and the Commodity Futures Trading Commission (CFTC) announced that US central counterparties supervision would be deemed equivalent to the European Market Infrastructure Regulation (EMIR). This will allow European entities to continue clearing at US central counterparties after the start of the European frontloading window on 21 February.

EC adopts Delegated Regulation on exclusion from bail-in: On 4 February, the EC adopted a Delegated Regulation to provide clarification on when it is possible to exclude liabilities from bail-in. The Commission Delegated Regulation includes details on:

- The common rules to be applied

whenever a resolution authority considers excluding a liability from the application of the bail-in tool;

- Clarification as to when a liability can be excluded from bail-in based on the impossibility of bailing in that liability within a reasonable timeframe;
- Elements to determine the reasonable time after which a liability can be excluded from bail-in; and
- Clarification as to when a liability can be excluded from bail-in based on the need to preserve critical functions and core business lines, to avoid widespread contagion, or the need to avoid value destruction.

EC group proposes streamlining major capital rules at the highest level:

On 27 January, the EC's Expert Group on Banking, Payments and Insurance (EGBPI) circulated in Brussels a document that considers integrating existing capital rules for banks into a Basel III regulation, in a proposal that, if implemented, would see more types of debt falling under the definition of Tier 2 capital:

- The EGBPI began its meeting in Brussels by discussing high level options for redressing inconsistencies and any unintended consequences of having different definitions of capital in the CRR, the TLAC and the MREL.
- The EGBPI would like to integrate the three capital regimes, resulting in an increase of the total own funds requirement to 18% of RWAs by 2022, up from the existing 8% minimum. That would include setting a minimum 6% of RWAs Pillar 1 "going concern" requirement plus 12% "gone concern" Pillar 1 requirement. The latter would be met with Tier 2, but a modified definition of Tier 2 that would include MREL and TLAC debt.
- According to EGBPI thoughts, MREL would be a Pillar 2 add-on requirement, sitting on top of Pillar 1 gone concern capital, whereas it now sits parallel to it.

EC reports on review of definition of "eligible capital": On 26 January, the EC

published a report to the European Council and the European Parliament on its review of the appropriateness of the definition of eligible capital pursuant to Article 517 of the Capital Requirements Regulation (CRR). The definition of “eligible capital”, which consists of an unrestricted amount of Tier 1 capital, but limits the inclusion of Tier 2 capital to one-third of the Tier 1 amount, was introduced in the CRR in January 2014 without an impact assessment and, hence, it is subject both to a transitional period (until end-December 2016) and a review prior to its full entry into force.

- The “eligible capital” definition is important for, among other factors, the calculation of the Large Exposure limit of banks subject to the CRR
- The report of the Commission is based on an EBA Opinion issued in February 2015
- The Commission does not find any particular issue with the current definition of “eligible capital”, but states that it intends to continue to monitor this point in the future, in collaboration with the EBA

BASEL COMMITTEE

Basel Committee issues revised framework for market risk capital requirements: On 14 January, the Basel Committee on Banking Supervision (BCBS) finalized its market risk capital framework, the fundamental review of the trading book (FRTB). The final rule, which updates the Basel II and 2.5 approaches and takes effect on 1 January 2019, will increase the transparency and consistency of reporting RWA and capital metrics. The key features of the revised framework include:

- A revised boundary between the trading book and banking book;
- A revised internal models approach for market risk;
- A revised standardised approach for market risk;
- A shift from value-at-risk to an expected shortfall measure of risk under stress; and



- Incorporation of the risk of market illiquidity.

The BCBS estimated that in aggregate, banks would have a 40% higher market risk capital requirement on a weighted average basis and 22% higher on median basis under the new market risk standard versus the existing one.

FSB

FSB sets key 2016 priorities: In a letter published on 22 February, the Financial Stability Board (FSB) discussed its key priorities for 2016. Regarding the completion of the capital framework for banks, the FSB indicates that authorities are now focused on not significantly increasing overall capital requirements across the sector and that “there will be no Basel IV”. By end-2016, the Basel Committee will complete its work to address the excessive variability in risk-weighted assets and will also finalise the design and calibration of the leverage ratio.

BELGIUM

EBA publishes Opinion on an increase in IRB risk-weights introduced by the National Bank of Belgium: On 26 February, the EBA published an Opinion following the notification by the

National Bank of Belgium (NBB) of its intention to extend a measure introduced by the NBB in 2014 to modify capital requirements in order to address an increase in macroprudential or systemic risk. Based on the evidence submitted by the NBB, the EBA said that it does not object the deployment of the macroprudential measures to address this issue.

FRANCE

ECB publishes Opinion on the proposed French law introducing junior senior debt: On 23 February, the ECB published an Opinion on the proposed French law introducing junior senior debt. The ECB Opinion confirms the compliance of the proposed new layer of junior senior debt with MREL/TLAC Eligible Liabilities definitions and welcomes the legal certainty of the new instrument for bail-in purposes (no likely breach of NCWOL and low/no risk of successful claims for compensation). It also clarifies that French junior senior debt will not be eligible for ECB repo operations due to the subordination of the junior senior debt to preferred senior creditors.

GERMANY

BDB banking association commented on the capital rules on German banks: On 25 January, Michael Kemmer, the General Manager of the German banking association Bankenverband (BDB) said that the relentless tightening of bank capital rules by international regulators poses an increasing threat to Germany's banks.

“The Basel IV plans now issued by the Basel Committee, which envisage increasing capital requirements still further, go too far and threaten to overstrain the banks,” said Kemmer.

ITALY

Bank of Italy calls for revision of EU bail-in rules: On 30 January, Bank of Italy governor Ignazio Visco called for the revision of the new bail-in European rules, saying they should have been introduced more gradually. This follows the rescue of four small Italian banks under the new rules,

raising concerns among investors about the health of the Italian banking system.

“A clause in the Banking Recovery & Resolution Directive provides for its review, to be started no later than June 2018,” said Visco. “The opportunity must now be seized.”

“A gradual, less abrupt transition would have been preferable,” added the Bank of Italy governor, stressing Italians were large holders of bank debt due to a favourable tax regime in place until 2011.

Italy and the EC announce agreement on NPL SPVs:

On 26 January, the Italian Government and the EC announced an agreement on a mechanism aimed at providing Italian banks with a tool to reduce their holdings on non-performing loans (NPLs) and thus enable them to increase lending volumes and support economic growth. Both parties agreed on the pricing modalities for a guarantee mechanism facilitating the transfer of NPLs to a specific special purpose vehicle (SPV) of each bank. Any state guarantee for loss absorption on the transferred NPLs above a predetermined threshold will be provided at a market price, thus ensuring no violation of EU State Aid rules.

SPAIN

CRR/CRD 4: Bank of Spain issues circular completing Spanish implementation:

On 9 February, the Bank of Spain published a circular that aims to complete the Capital Requirements Directive (CRD IV) and develops requirements for capital buffers, corporate governance and remuneration, internal capital adequacy assessment and supervisory review by the competent authority, risk treatment, supervision of financial conglomerates, transparency and reporting obligations.

SWEDEN

Swedish FSA: Pillar 2 capital requirements for maturity assumptions:

On 1 March, the Swedish FSA (Finansinspektionen, FI) published two consultation memorandums that will raise capital requirements primarily for exposures to



Ignazio Visco, Bank of Italy

corporates for banks using the internal ratings-based approach:

- FI intends to introduce a floor for maturity assumptions of 2.5 years in the internal models for credit risk. This floor will generate an additional capital requirement under Pillar 2 and will be calculated as the product of the increase in the banks' risk-weighted exposure amounts that would have been the result of a changed maturity assumption under Pillar 1 and the capital requirement as a percent for the exposure types in question
- FI intends to apply the maturity floor to the supervisory capital assessment for banks that have received authorisation to use the advanced IRB approach
- FI's proposed shortest maturity assumption of 2.5 years is expected to increase the total capital requirements of affected banks by between 0.2%-0.7%
- The impact on the CET1 capital requirement on average is 0.2%-0.6%, with an average increase of 0.4%
- As a reminder, the Pillar 2 requirement is not relevant for MDA restrictions and, thus, AT1 coupons in Sweden prior to a formalisation on the Pillar 2 requirement by the FI

Swedish FSA proposes raising counter-cyclical buffer to 2%:

On 5 February, Finansinspektionen proposed to raise the countercyclical buffer for banks to 2%:

- The Swedish FSA had previously said it would raise the countercyclical buffer from June 2016 to 1.5%
- The buffer would rise to 2% from 19 March 2017

UK

PRA publishes approach to identifying O-SIIs:

On 19 February, the Prudential Regulation Authority (PRA) published a policy statement (PS6/16) on its approach to identifying other systemically important institutions (O-SIIs). The policy statement provides feedback to responses to the PRA's consultation launched in October 2015. The criteria and methodology are derived from Article 131(3) of CRD IV and follow the EBA Guidelines. Based on this methodology, the PRA has designated 16 firms as O-SIIs based on data as at 31 December 2014. The PRA is required to identify O-SIIs on an annual basis.

PRA proposes new Systemic Risk Buffer to be applied to ring-fenced banks:

On 29 January, the Bank of England published a consultation paper outlining a framework for a Systemic Risk Buffer (SRB) applicable to UK ring-fenced banks (RFBs):

- The SRB buffer will be applied to the RWAs of the sub-consolidated RFB group and will range from 0% to 3%, depending on the size of a ring-fenced bank's balance sheet. Large banks should have an SRB between 2% and 3%.
- For UK banks, this means an increase in capital requirement and further weight on the MDA buffers by 2019 (Lloyds most impacted, HSBC less impacted). At this stage, though, there are no concerns about the MDA of UK banks.
- The banks concerned will be expected to comply with ring-fencing regulations, including the SRB, by 2019. The consultation period runs until 22 April.

Insurance

EIOPA comments on IFRS 9/IFRS 4: In a letter published on 15 February, the European Insurance & Occupational Pensions Authority (EIOPA) comments on the Exposure Draft: Applying IFRS 9 financial instruments with IFRS 4 insurance contracts – Proposed amendments to IFRS 4.

According to EIOPA, IFRS 9 is a significant improvement for the accounting of financial instruments in the (re)insurance sector but it also warns against increasing complexity due to exemption and/or different effective dates of IFRS 9 and IFRS 4. Therefore, EIOPA agrees with a deferral of the application date of IFRS 9 for entities that mainly write contracts within the scope of IFRS 4. According to EIOPA, the temporary exemption should expire upon the implementation of IFRS 4.

EIOPA consults on the Guidelines facilitating the dialogue between insurance supervisors and auditors: On 3 February, EIOPA published a Consultation Paper on the proposal for the Guidelines on facilitating an effective dialogue between insurance supervisors and auditors that carry out statutory audit of (re)insurance companies:

- EIOPA assessed the current supervisory practices linked with the interaction with statutory auditors and noted that insurance supervisors have regular and ad hoc interactions with statutory auditors, which are currently often not based on clear rules
- The draft Guidelines present relevant principles such as the nature of the information to be exchanged, the form, frequency and timing as well as the representatives involved in such dialogues between supervisors and auditors
- The consultation will end on 28 April 2016

Solvency II: EIOPA issues opinion on calculating group solvency through combined methods: On 27 January, EIOPA published an Opinion that is of relevance for insurance groups that use the combination of the consolidation (method

1) and deduction/aggregation (method 2) methods for group solvency calculation purposes:

- When method 1 (consolidation) is used exclusively, the consolidated Solvency Capital Requirement (SCR) should serve as a basis to calculate the tier limits.
- When method 2 (deduction and aggregation) is used exclusively, the SCR of each undertaking should serve as a basis to calculate the tier limits.

The Opinion aims to clarify certain issues related to the application of the combination of methods, such as the determination of the basis for tier limits. Indeed, the use of the combination methods may lead to unintended consequences if it is used by groups that raise debt at the holding company level. In such a situation, as a consequence of the strict application of method 1, the tier limits would be determined only on the basis of the consolidated part of the group SCR. The group supervisor may need to allow specific solutions to avoid unjustified disadvantages. To ensure that such specific solutions do not eventually place groups in an advantageous position as compared to groups using exclusively method 1, EIOPA recommends that the following conditions should be satisfied:

- i a separate basis for calculation of the tier limits is maintained: EIOPA's opinion is to use distinct tier limits on the one hand for the part of the group covered by method 1 (i.e. consolidated group SCR) and on the other hand for each undertaking covered by method 2 (i.e. individual SCRs);
- ii the amount of eligible subordinated debt at the level of the group should not exceed the one that would have been calculated if the group had applied exclusively method 1;
- iii if an equivalent prudential regime does not categorize own funds into tiers or defines tiers that are significantly different from those established under the Directive, then the own funds brought in by method 2 should be allocated to tiers according to the principles laid down in the Directive. ●

US

Scenarios for 2016 stress testing released: On 28 January, the US Federal Reserve released supervisory scenarios for the Comprehensive Capital Analysis & Review (CCAR) and associated stress tests as mandated by Dodd-Frank for 2016. Bank holding companies participating in CCAR are required to submit their capital plans and stress testing results to the Federal

Reserve on or before 5 April. The results of the supervisory stress tests are expected to be released by the Fed by 30 June at the latest. A list of the banks impacted by the CCAR and stress test exercise has also been released.

The Office of the Comptroller of the Currency (OCC) and the Federal Deposit Insurance Corporation (FDIC) have also released their respective economic, finan-

cial markets and supervisory scenarios.

These will be used by certain financial institutions with total consolidated assets of more than \$10bn for stress tests required under the Dodd-Frank Wall Street Reform & Consumer Protection Act of 2010. They include key variables reflecting economic activity and other economic and financial markets aspects for the baseline, adverse and severely adverse scenarios. ●

Pioneer In at the deep end

Pioneer Investments has launched a new fund into the burgeoning but turbulent subordinated bond markets. Pioneer portfolio manager Vianney Hocquet explains how, leveraging off the firm's experience in the asset class, the fund aims to reduce volatility through fundamental stock-picking and proactive asset allocation across financial and non-financial hybrids.

What was the rationale for launching the global subordinated bond strategy?

Vianney Hocquet, Pioneer Investments: The key aim of this strategy is to allow investors to target returns comparable with those of high yield issuers, investing in subordinated bonds issued by investment grade-rated companies and banks. The current yield environment, depressed by monetary stimulus from the largest central banks in the world, is supportive of a strategy providing a yield pick-up over traditional credit.

The subordinated debt market has increased in size and diversification over the past few years and continues to grow considerably due to the combination of increased demand from investors and desire for corporates to protect their rating (for corporate hybrids) and regulatory-driven issuance on behalf of banks (for financial subordinated debt).

This strategy leverages on the skills and track record of our credit portfolio managers and credit analysts in successfully investing in subordinated debt globally. This is, in our view, one of the key features

of the portfolio, as it allows our portfolio managers to leverage the best ideas of our credit analysts globally without the need to remain invested where we feel the risk-reward not to be compelling enough, and to receive the extra yield from the subordination premium where it is the most attractive. This flexibility allows us to invest in any new structures that might arise in the future — but more importantly does not force us to remain invested in an unappealing asset class/industry/geography due to mandate limitations.

Lastly, this portfolio is managed without any active currency risks. The portfolio currency is euros — and any bond denominated in a non-euro currency is immediately swapped into euros before entering the portfolio. We believe this offers investors the benefit of geographic, structural and sectorial diversification without incurring “implicit” currency risks. As with all Pioneer Investments' products, we can offer solutions for investors who do not want to have euro risk in their portfolios.

Pioneer Investments has been managing dedicated segregated accounts in the subordinated bonds space for more than

four years, with a strong track record, and we have been actively investing in these type of securities in our flagship credit strategies for an even longer timeframe, particularly when considering the so-called “old style” bank capital, which we have been involved in for a very long time.

Our credit analysts can invest and have been investing across the capital structure of both non-financial and financial issuers, and in the case of the latter we've been also very selectively playing the new bank capital instruments introduced by the Basel III Bank Capital Directive.

What does the investment strategy involve?

Hocquet, Pioneer: This strategy combines a strong top-down investment approach by our portfolio managers with a fundamental bottom-up stock picking of subordinated bonds by our global credit research team.

The top-down investment is an asset allocation decision by the portfolio managers, who allocate across the corporate hybrids and subordinated financials space based on valuations, technicals,

outlook and risk profiles of each asset class globally.

The bottom-up selection includes the top-picks — taking into account both the credit profile of the issuers and the legal characteristics of the bond language we invest in — of a team of 25 career credit analysts globally. Our analysts, like the portfolio managers, have a very long experience analysing and investing in subordinated bonds across the European, US and emerging markets — and they look at both investment grade and high yield-rated securities.

It is our strong conviction that the subordination risk embedded in these securities can be mitigated and contained through a strong fundamental analysis and a thorough assessment of the clauses in the offering documents.

What size of assets do you have dedicated to this strategy?

Hocquet, Pioneer: Our clients have already entrusted us with a bit more than Eu300m since the launch of this strategy in December 2015. This remarkable commercial success is a testament to the good track record our analysts and portfolio managers have investing in these asset classes — particularly in the currently depressed yield environment. We also manage more Eu2bn in this space between our flagship credit strategy and segregated accounts.

Despite the volatility incurred in the first few weeks of the year, it is our strong conviction that investors in this asset class can benefit from high carry and target mid-single digit returns over the medium

term — and more importantly that a proactive asset allocation between corporate hybrids and financials subordinated debt (the former having a more defensive profile than the latter) across sectors and geographies can smooth volatility and add much needed diversification for investors.

Is there a total return target for the fund or a benchmark reference?

Hocquet, Pioneer: We measure the performance of this strategy against a mix of 35% Global Investment Grade Non-Financial Hybrids, 15% Global High Yield Non-Financial Hybrids, 25% Contingent Convertible Bonds, and 25% Preferred Shares.

We have a single-digit total return target for this strategy, which compares favourably with Euro Credit (particularly so with Investment Grade, where in our view the default risk is similar to the bonds we hold in this strategy).

It is our policy to set targets that are realistic and ambitious, but to give our analysts and portfolio managers a higher target, which we think they can achieve.

Are there any particular regions/sectors/products that the strategy is currently focused on?

Hocquet, Pioneer: The product does not have a focus towards any specific regions/sectors/products. The product leverages very experienced portfolio management and credit analysis skills Pioneer Investments has across our three global investment hubs of Dublin (where both lead portfolio managers are based), Lon-



Vianney Hocquet, Pioneer

don and Boston. The strategy seeks to be flexible — the only constraint we have is that a maximum of 75% of the portfolio can be invested in financials bonds.

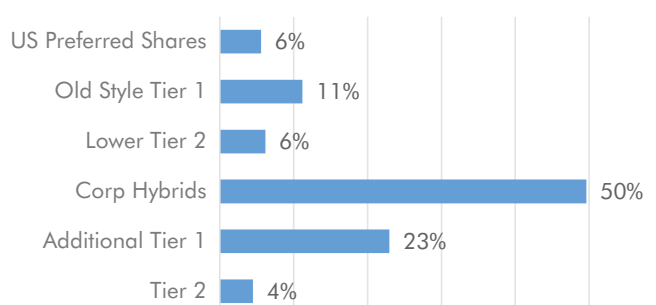
Subordinated markets can and have been very volatile, how will the strategy manage such risks?

Hocquet, Pioneer: We believe that the combination of fundamental stock-picking and a proactive global asset allocation can reduce the volatility of the portfolio. We aim to address the volatility by focusing on the best risk-reward bonds across the global subordinated space — both in the financial and the non-financial space.

While liquidity can diminish significantly when investors become concerned about one particular issuer, we believe the asset class is liquid enough and more importantly a dedicated strategy such as ours can properly exploit any market dislocations and mispricing arising from any of these liquidity-driven movements.

Lastly, while we use a large array of tools to manage volatility (for instance options, Index CDS), we invest across the curves of the issuers we like and try to have as diversified an exposure to names we like, we can allocate to corporate hybrids or financial subordinated bonds (the former tends to be a more defensive asset class and outperforms financial subordinated in a risk-off market), these instruments tend to have a higher beta than the senior credit — and therefore higher volatility (and possibly return) should be expected by investors in any such products. ●

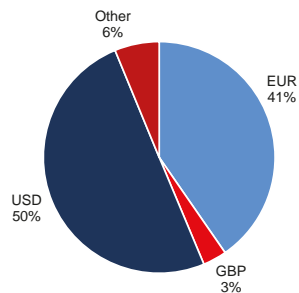
Indicative asset allocation



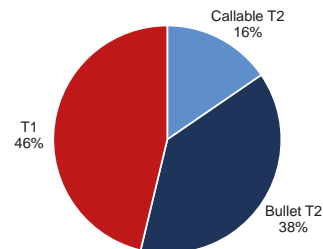
Source: Pioneer Investments

Currencies, structures and distribution

Bank hybrid issuance by currency (2015-2016 ytd)

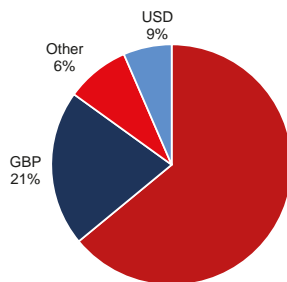


Bank issuance by instrument/structure (2015-2016 ytd)

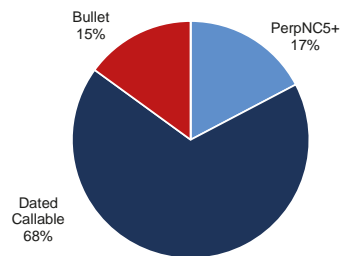


Source: Crédit Agricole CIB

Insurance hybrid issuance by currency (2015-2016 ytd)

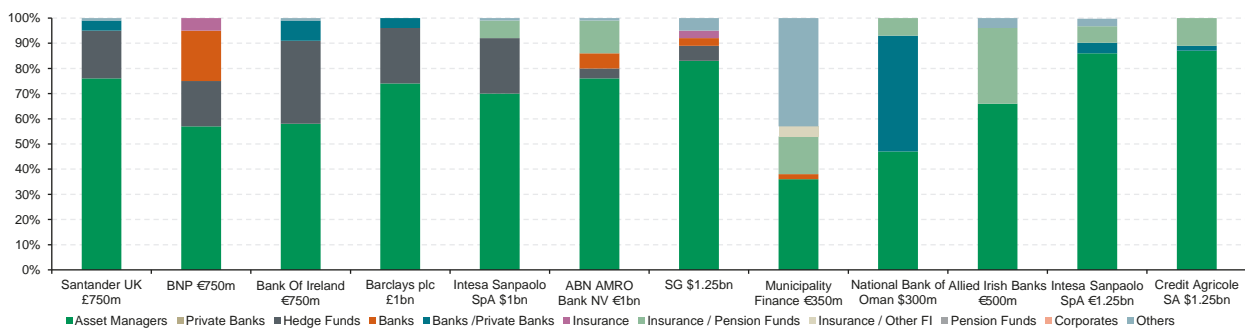


Insurance issuance by instrument/structure (2015-2016 ytd)

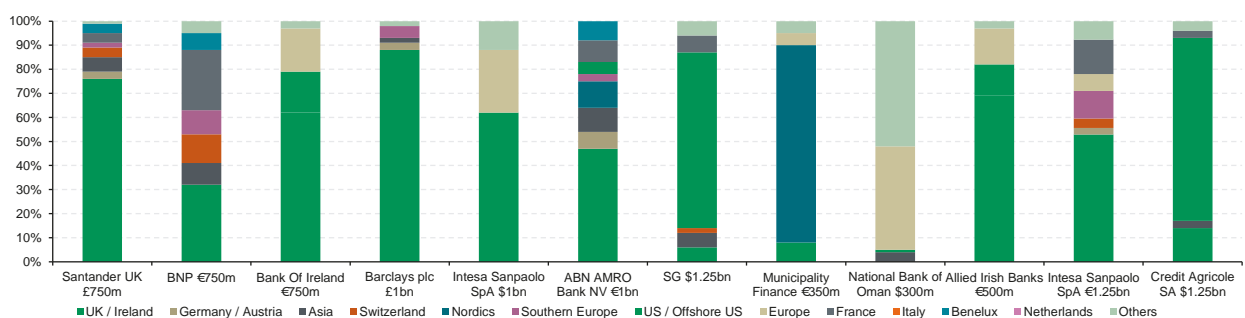


Source: Crédit Agricole CIB

AT1 distribution by investor type



AT1 distribution by geography



Source: Crédit Agricole CIB

AT1, Tier 2 CoCos

AT1 performance monitoring (as at 2/3/16)

Launch	Issuer	Issue ratings	Currency	Amount (m)	Coupon	Maturity date	First call date	Principal loss absorption	Trigger	Price	I-Spread	Yield to call
12-Jan-16	ISPIM	Ba3/B+/BB-	EUR	1,250	7.000%	Perpetual	19-Jan-21	TWD	5.125%	93.50	886	8.66
26-Nov-15	AIB	B3u/-/B	EUR	500	7.375%	Perpetual	03-Dec-20	TWD	7.000%	83.88	1,229	11.91
22-Sep-15	HSBC	Baa3/-/BBB	EUR	1,000	6.000%	Perpetual	29-Sep-23	CE	7.000%	93.38	698	7.15
15-Sep-15	ABNANV	Ba2u/BB/BB+	EUR	1,000	5.750%	Perpetual	22-Sep-20	TWD	5.125%	93.75	757	7.39
11-Jun-15	BKIR	B2/B+/-	EUR	750	7.375%	Perpetual	18-Jun-20	TWD	5.125%	93.00	965	9.36
10-Jun-15	BNP	Ba1/BB+/BBB-	EUR	750	6.125%	Perpetual	17-Jun-22	TWD	5.125%	94.63	719	7.20
27-Apr-15	IPMID	-/-/-	EUR	125	8.625%	Perpetual	01-Apr-21	CE	7.000%	90.99	1,102	11.03
19-Feb-15	NYKRE	-/BB+/BB+	EUR	500	6.250%	Perpetual	26-Oct-20	TWD	7.125%	97.00	717	7.02
13-Feb-15	UBS	-/BB/BB+	EUR	1,000	5.750%	Perpetual	19-Feb-22	PWD	5.125%	99.63	572	5.83
11-Feb-15	DANBNK	Ba1u/BB+/BB+	EUR	750	5.875%	Perpetual	06-Apr-22	TWD	7.000%	97.63	633	6.35
10-Feb-15	BBVASM	Ba2/-/BB	EUR	1,500	6.750%	Perpetual	18-Feb-20	CE	5.125%	89.25	1,056	10.08
05-Feb-15	POPSM	Caa1u/-/-	EUR	750	8.250%	Perpetual	10-Apr-20	CE	7.000%	76.00	1,752	16.40
15-Jan-15	RABOBK	Baa3/-/BBB-	EUR	1,500	5.500%	Perpetual	29-Jun-20	TWD	7%/5.125%	96.00	675	6.58
11-Dec-14	DEKA	Baa3/-/-	EUR	177	6.000%	Perpetual	20-Mar-22	TWD	5.125%	-	589	6.00
13-Nov-14	AARB	-/-/BB-	EUR	300	7.625%	Perpetual	30-Apr-20	TWD	7.000%	89.75	1,088	10.80
10-Sep-14	HSBC	Baa3/-/BBB	EUR	1,500	5.250%	Perpetual	16-Sep-22	CE	7.000%	88.63	745	7.48
04-Aug-15	BACR	Ba2/B+/BB+	GBP	1,000	7.875%	Perpetual	15-Sep-22	CE	7.000%	86.87	975	10.69
03-Jun-15	ABBEY	Ba2/B+/BB+	GBP	750	7.375%	Perpetual	24-Jun-22	PWD	7.000%	91.19	828	9.23
25-Jul-14	VIRGMN	-/-/-	GBP	160	7.875%	Perpetual	31-Jul-19	CE	7.000%	89.51	1,100	11.65
12-Jan-16	ACAFP	Ba2u/BB/BB+	USD	1,250	8.125%	Perpetual	23-Dec-25	TWD	7.000%	95.25	730	8.86
22-Sep-15	SOCGEN	Ba2/BB+/-	USD	1,250	8.000%	Perpetual	29-Sep-25	TWD	5.125%	91.38	774	9.38
10-Sep-15	ISPIM	Ba3/B+/BB-	USD	1,000	7.700%	Perpetual	17-Sep-25	PWD	5.125%	88.88	786	9.50
12-Aug-15	BNP	Ba1/BB+/BBB-	USD	1,500	7.375%	Perpetual	19-Aug-25	TWD	5.125%	92.75	687	8.51
05-Aug-15	RBS	B1u/B/BB-	USD	2,000	7.500%	Perpetual	10-Aug-20	CE	7.000%	90.75	907	10.12
05-Aug-15	RBS	B1u/B/BB-	USD	1,150	8.000%	Perpetual	10-Aug-25	CE	7.000%	91.50	785	9.37
31-Jul-15	UBS	-/BB/BB+	USD	1,575	6.875%	Perpetual	07-Aug-25	PWD	7.000%	95.13	584	7.61
09-Apr-15	INTNED	Ba1/BB-/BB+	USD	1,000	6.000%	Perpetual	16-Apr-20	CE	7.000%	93.13	685	7.99
09-Apr-15	INTNED	Ba1/BB-/BB+	USD	1,250	6.500%	Perpetual	16-Apr-25	CE	7.000%	92.13	611	7.72
26-Mar-15	STANLN	Ba1/BB/BBB-	USD	2,000	6.500%	Perpetual	02-Apr-20	CE	7.000%	79.50	1,203	13.16
23-Mar-15	HSBC	Baa3/-/BBB	USD	2,450	6.375%	Perpetual	30-Mar-25	CE	7.000%	93.25	580	7.41
19-Mar-15	DNBNO	Baa3u/BBB/-	USD	750	5.750%	Perpetual	26-Mar-20	TWD	5.125%	90.75	723	8.54
05-Mar-15	NDASS	Ba1u/BBB/BBB	USD	550	5.250%	Perpetual	13-Sep-21	TWD	8%/5.125%	89.63	617	7.61
18-Feb-15	SHBASS	Baa2/BBB/BBB	USD	1,200	5.250%	Perpetual	01-Mar-21	TWD	5.125%	93.63	545	6.80
13-Feb-15	UBS	-/BB/BB+	USD	1,250	7.000%	Perpetual	19-Feb-25	PWD	5.125%	99.49	536	7.08
13-Feb-15	UBS	-/BB/BB+	USD	1,250	7.125%	Perpetual	19-Feb-20	PWD	7.000%	100.62	570	6.94
12-Feb-15	SWEDA	Baa3u/BBB/BBB-	USD	750	5.500%	Perpetual	17-Mar-20	CE	8%/5.125%	94.50	596	7.09
18-Nov-14	DB	Ba3/BB/BB+	USD	1,500	7.500%	Perpetual	30-Apr-25	TWD	5.125%	80.50	908	10.98
06-Nov-14	SEB	Ba1u/-/BBB-	USD	1,100	5.750%	Perpetual	13-May-20	TWD	8%/5.125%	93.75	636	7.51
16-Sep-14	NDASS	Ba1u/BBB/BBB	USD	1,000	5.500%	Perpetual	23-Sep-19	TWD	8%/5.125%	93.00	672	7.80
16-Sep-14	NDASS	Ba1u/BBB/BBB	USD	500	6.125%	Perpetual	23-Sep-24	TWD	8%/5.125%	91.75	588	7.45
11-Sep-14	ACAFP	Ba2u/BB/BB+	USD	1,250	6.625%	Perpetual	23-Sep-19	TWD	7%/5.125%	89.75	915	10.10

T2 CoCo performance monitoring (as at 2/3/16)

Launch	Issuer	Issue ratings	Currency	Amount (m)	Coupon	Maturity date	First call date	Principal loss absorption	Trigger	Price	I-Spread	Yield to call
08-Jun-15	ZKB	-/A/-	EUR	500	2.625%	15-Jun-27	15-Jun-22	PWD	5.000%	95.41	331	3.45
23-May-14	NYKRE	-/BBB/BBB	EUR	600	4.000%	03-Jun-36	03-Jun-21	PWD	7.000%	96.25	480	4.82
06-Feb-14	UBS	-/BBB/BBB+	EUR	2,000	4.750%	12-Feb-26	12-Feb-21	PWD	5.000%	102.65	415	4.15
11-Sep-13	CS	-/BBB/BBB+	EUR	1,250	5.750%	18-Sep-25	18-Sep-20	PWD	5.000%	105.36	446	4.41
22-Jan-16	RY	Baa1/A-/AA-	USD	1,500	4.650%	27-Jan-26	-	CE	5.000%	100.95	287	-
08-May-14	UBS	-/BBB/BBB+	USD	2,500	5.125%	15-May-24	-	PWD	5.000%	98.75	370	-
12-Sep-13	ACAFP	-/BBB-/BBB-	USD	1,000	8.125%	19-Sep-33	19-Sep-18	PWD	7.000%	105.38	485	5.81
01-Aug-13	CS	-/BBB/BBB+	USD	2,500	6.500%	08-Aug-23	-	PWD	5.000%	104.99	419	-
15-May-13	UBS	-/BBB/BBB+	USD	1,500	4.750%	22-May-23	22-May-18	PWD	5.000%	101.00	329	4.26
03-Apr-13	BACR	-/BB+/BBB-	USD	1,000	7.750%	10-Apr-23	10-Apr-18	PWD	7.000%	101.44	608	6.99
17-Jan-13	KBC	-/BBB/-	USD	1,000	8.000%	25-Jan-23	25-Jan-18	PWD	7.000%	105.50	403	4.92

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

Source: Crédit Agricole CIB

Latest bank Tier 2, insurance hybrids

Latest Tier 2 performance monitoring (as at 2/3/16)

Launch	Issuer	Issue ratings	Currency	Amount (m)	Coupon	Maturity date	First call date	I-Spread	Yield to call
11-Jan-16	ABNANV	Baa3/BBB-/A-	EUR	1,000	2.875%	18-Jan-28	18-Jan-23	267	2.88
08-Jan-16	ISPIM	Ba1/BB/BBB	USD	1,500	5.710%	15-Jan-26	-	465	-
20-Nov-15	BPCEGP	Baa3/BBB/A-	EUR	750	2.750%	30-Nov-27	30-Nov-22	248	2.67
19-Nov-15	BNP	Baa2/BBB+/A	EUR	750	2.750%	27-Jan-26	-	220	-
19-Nov-15	AIB	B1/B+/BB	EUR	750	4.125%	26-Nov-25	26-Nov-20	628	6.25
17-Nov-15	SOCGEN	Baa3/BBB/A-	USD	500	5.625%	24-Nov-45	-	431	-
17-Nov-15	SOCGEN	Baa3/BBB/A-	USD	1,000	4.750%	24-Nov-25	-	408	-
12-Nov-15	SANTAN	Baa2/BBB/BBB+	USD	1,500	5.179%	19-Nov-25	-	437	-
10-Nov-15	NYKRE	-/BBB/A-	EUR	800	2.750%	17-Nov-27	17-Nov-22	320	3.39
10-Nov-15	FRLBP	-/BBB/-	EUR	750	2.750%	19-Nov-27	19-Nov-22	253	2.72
04-Nov-15	BACR	Baa3/BB+/A-	EUR	1,250	2.625%	11-Nov-25	11-Nov-20	406	4.03
02-Nov-15	NDASS	Baa1/A-/A+	EUR	750	1.875%	10-Nov-25	10-Nov-20	177	1.74
29-Oct-15	SNSBNK	Ba2/BB/BBB-	EUR	500	3.750%	05-Nov-25	05-Nov-20	498	4.95
20-Oct-15	BPCEGP	Baa3/BBB/A-	AUD	175	5.400%	27-Oct-25	27-Oct-20	312	5.38
25-Sep-15	VICEN	-/-/B	EUR	200	9.500%	29-Sep-25	29-Sep-20	2,782	25.28
21-Sep-15	BNP	Baa2/BBB/A	USD	1,000	4.375%	28-Sep-25	-	318	-
18-Sep-15	POHBK	Baa1/A-/A	EUR	100	2.405%	25-Sep-25	-	176	-
10-Sep-15	NDASS	-/A-/A+	SEK	1,700	1.212%	17-Sep-25	17-Sep-20	-	1.78
10-Sep-15	NDASS	-/A-/A+	SEK	2,300	1.935%	17-Sep-25	17-Sep-20	238	2.48
08-Sep-15	ABBEY	Baa1/BB+/A-	USD	500	5.625%	15-Sep-45	-	434	-
08-Sep-15	ABBEY	Baa1/BB+/A-	USD	1,000	4.750%	15-Sep-25	-	398	-
03-Sep-15	BFCM	A3/BBB/A	EUR	1,000	3.000%	11-Sep-25	-	179	-
10-Aug-15	HSBC	A2/BBB+/A+	USD	1,500	4.250%	18-Aug-25	-	312	-
28-Jul-15	RABOBK	A3/BBB+/A	USD	1,500	4.375%	04-Aug-25	-	264	-
28-Jul-15	RABOBK	A3/BBB+/A	USD	1,250	5.250%	04-Aug-45	-	292	-
21-Jul-15	ABNANV	Baa3/BBB-/A-	USD	1,500	4.750%	28-Jul-25	-	338	-
21-Jul-15	CAZAR	B2/B/BB	EUR	500	5.000%	28-Jul-25	28-Jul-20	890	8.84
24-Jun-15	COOPBK	-/-/-	GBP	250	8.500%	01-Jul-25	01-Jul-20	939	10.54
24-Jun-15	HSBC	A2/BBB+/A+	EUR	1,500	3.000%	30-Jun-25	-	232	-
23-Jun-15	ABNANV	Baa3/BBB-/A-	EUR	1,500	2.875%	30-Jun-25	30-Jun-20	261	2.54
09-Jun-15	LBW	Baa2/-/BBB-	EUR	500	3.625%	16-Jun-25	-	269	-
27-May-15	BPCEGP	Baa3/BBB/A-	USD	130	5.350%	01-Jun-45	-	430	-
26-May-15	SOCGEN	Baa3/BBB/A-	CNY	1,200	5.200%	03-Jun-25	03-Jun-20	-	-
22-May-15	SOCGEN	Baa3/BBB/A-	AUD	125	5.500%	02-Jun-27	02-Jun-22	290	5.34
16-Apr-15	ISPIM	Ba1/BB/BBB	EUR	500	2.855%	23-Apr-25	-	263	-
08-Apr-15	SOCGEN	Baa3/BBB/A-	USD	1,500	4.250%	14-Apr-25	-	397	-

Insurance performance monitoring (as at 2/3/16)

Launch	Issuer	Issue ratings	Currency	Amount (m)	Coupon	Maturity date	First call date	New issue spread	I-Spread
15-Jan-16	CNP Assurances	-/BBB+/-	USD	500	6.000%	22/01/2049	22/01/2029	-	409.91
02-Dec-15	SCOR SE	-/-/A-	EUR	600	3.000%	08/06/2046	08/06/2026	225	310.97
01-Dec-15	CNP Assurances	-/BBB+/-	EUR	750	4.500%	10/06/2047	10/06/2027	360	484.17
05-Nov-15	Swiss Re	-/BBB+/-	USD	700	5.750%	15/08/2050	15/08/2025	-	424.08
04-Nov-15	RL Mutual Insurance	Baa1/BBB+/-	GBP	350	6.125%	13/11/2028	-	-	482.26
29-Oct-15	Old Mutual	Ba1/-/BB+	GBP	450	7.875%	03/11/2025	-	-	553.04
22-Oct-15	Rothsay Life	-/-/-	GBP	250	8.000%	30/10/2025	-	-	554.00
20-Oct-15	Gothaer Versicherung	-/BBB/-	EUR	250	6.000%	30/10/2045	30/10/2025	504	499.44
20-Oct-15	Assicurazioni Generali	Baa3/-/BBB	EUR	1,250	5.500%	27/10/2047	27/10/2027	435	371.85
19-Oct-15	Legal & General	Baa1/-/-	GBP	600	5.375%	27/10/2045	27/10/2025	-	347.74
24-Sep-15	Humanis	-/-/-	EUR	250	5.750%	22/10/2025	-	-	481.88
22-Sep-15	ASR Nederland	-/BBB/-	EUR	500	5.125%	29/09/2045	29/09/2025	420	418.41
21-Sep-15	Danica Pension	-/BBB/-	EUR	500	4.375%	29/09/2045	29/09/2025	338	346.62
16-Sep-15	FBD Holdings	-/-/-	EUR	70	11.660%	23/09/2025	-	-	-
02-Sep-15	Helvetia	-/BBB+/-	CHF	300	3.000%	Perpetual	23/11/2022	302	259.67
20-Jul-15	UNIQA Insurance	-/BBB/-	EUR	500	6.000%	27/07/2046	27/07/2026	482	439.95
09-Jul-15	Ethias	-/-/BB	EUR	403	5.000%	14/01/2026	-	-	673.52
08-Jun-15	Swiss Life Holding	-/BBB+/-	EUR	750	4.375%	Perpetual	16/06/2025	330	371.08
02-Jun-15	SCOR SE	-/A/A-	EUR	250	3.250%	05/06/2047	05/06/2027	220	201.21
02-Jun-15	Prudential	A3/A-/BBB+	GBP	600	5.000%	20/07/2055	20/07/2035	-	357.05
02-Jun-15	KLP	Baa1/BBB/-	EUR	600	4.250%	10/06/2045	10/06/2025	340	371.00

Source: Crédit Agricole CIB

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