

# Bank+Insurance HybridCapital

With  **CRÉDIT AGRICOLE**  
CORPORATE & INVESTMENT BANK



## 2021 OUTLOOK A NEW HOPE

### **AT1 Roundtable**

Vaccines boost recovery expectations, as banks' resilience, crisis measures support asset class

DECEMBER 2020

# 2021

## A new hope

Vaccines look set to offer the world a way out of the pandemic, but the damage wrought by Covid-19 should ensure monetary and fiscal support persist. How will banks and AT1 fare in light of this and the regulatory response to the crisis? Investors, issuers and Crédit Agricole CIB reps shared their insights into the big trends in bank capital in our 2021 roundtable.

**Neil Day, Bank+Insurance Hybrid Capital:** A second Covid-19 wave has struck, but lockdowns have been less stringent than previously, while vaccines are expected to be available soon. What is your outlook for the economic recovery in light of these developments?

**Stéphane Herndl, La Banque Postale AM:** Our view on 2021 is split into two halves. For the first six months, going into the summer, we'll have a gradual improvement in economic growth, trying to make the most of the vaccine hopes and catch up some of the lost output. The ECB is going to need to be supportive for this. It's going to take some time for the vaccine to be available and in such a quantum necessary to have a positive impact.

The second half of the year is where we will probably have a much stronger catch-up in terms of lost output for 2020. But at the same time, that's where we could potentially see some risk from the political front. Why do we say this? Just because we have the German elections coming around September and the key question there is, what will the political agenda be? Is it still going to be a European agenda as we've seen recently, which was positive for a lot of peripheral countries, or are we going to have something that is more domestically focused? I'm not saying it's going to be a bleak outlook for the second half of the year, but it's more of a question mark, I would say.

**Matthieu Loriferne, Pimco:** We are cautiously optimistic on growth for next year. This obviously hinges on successful Covid-19 containment and the timing of vaccine roll-out, and the success of such roll-out. We have three serious candidates that have demonstrated high efficacy, so it will be important to see how the roll-out is handled logistically by governments, and also what the level of acceptance will be among the population. So, we are cautiously optimistic, acknowledging, though, that the long term challenges that we have previously highlighted re-

main, which should introduce a few additional question marks over the long term growth potential of the global economy.

**Franz-Josef Kaufmann, Commerzbank:** At Commerzbank, we expect the vaccine to play a key role in forecasts. We believe that the winter will be difficult and will still be very much influenced by Covid-19, whether that be a second wave or possibly a third — that depends on when vaccination starts and how it will be received.

We expect the beginning of the year, Q1, to be weak, and our economists are of the opinion that should meet the definition of a technical recession. A positive reaction is then expected for Q2, and then clearly the second half of the year should be more positive, benefiting from lower infections, and we should then see the effect of the vaccination. We also believe consumers will then increase consumption they held back during the winter period.

**Grégoire Pesques, Amundi:** The vaccine is very good news — there will, of course, probably be challenges in terms of implementation, with some reluctance towards it, but it arrived relatively soon and it should, as a result, deliver positive growth momentum — that's what we're expecting over the next quarter. We are not expecting something like a V-shaped recovery, but a progressive normalisation.

What will be very interesting to monitor going forward is inflation, particularly in the US. It's probably not an issue for the next six months, but something we do need to monitor, as well as how the Fed will implement monetary policy given its new type of target.

**Day, BIHC:** There is a strong disconnect between "Wall Street and Main Street" — and between equities and fixed income at times. What explains this? And how long can it persist?



The roundtable was held on 3 December, with the following participants:

Ervin Beke, bank analyst, BlackRock

Olivier Bélorgey, head of Crédit Agricole SA group funding and chief financial officer, Crédit Agricole CIB

Bernard du Boislouveau, FI DCM, Crédit Agricole CIB

Doncho Donchev, DCM Solutions, Crédit Agricole CIB

Bruno Duarte, portfolio manager, Algebris

Stéphane Herndl, senior credit analyst, La Banque Postale Asset Management

Vincent Hoarau, head of FIG syndicate, Crédit Agricole CIB

Franz-Josef Kaufmann, head of capital markets funding, group treasury, Commerzbank

Matthieu Loriferne, bank credit analyst, Pimco

Grégoire Pesques, CIO credit, Amundi Alpha Fixed Income

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

**Bruno Duarte, Algebris:** To help figure out what's going on, we need to go back to the global financial crisis and look at how central bank liquidity has developed since then: balance sheet expansion has just been unprecedented. The latest number I read was that there is close to \$1bn injected every trading hour. Let's just repeat that: one billion dollars every trading hour. In the face of that, we have the potential for lower highs in global rates. Consider that in the global financial crisis the Bund yield was 3% — it's now minus 50bp; the US 10 year was 4% — it's now at 1%.

There is growing excitement that inflation could come back and rates are going to have to go higher. But the reality is that in the current environment, the previous valuation tops — whether peaks in equities, or troughs in rates and spreads — need to be rethought, because it's a very different risk-free rate world. And when we've had significant wealth creation, especially in Asia, and there is insatiable appetite for real returns in a world that is getting progressively starved of yield because of central bank actions, I struggle to see what breaks the current set-up. Sell-offs are becoming shallower and shorter and this is simply a function of too much liquidity being injected into the system.

While there is a consensus that normalisation will probably

begin to happen in 2021, the reality is there are a lot of sectors that have lost their *raison d'être*, which don't need to be around anymore. There's going to be a big bump up in structural unemployment, and if potential GDP has been hamstrung by 10%-15% as a result, it's going to take until 2024-2025 to fully recover. This means that these fiscal and monetary measures will have to remain in place until then. Therefore, it's very difficult to foresee how this disconnect actually reconnects in the short term.

**Ervin Beke, BlackRock:** I would echo Bruno's comments, that the disconnect is driven by monetary stimulus, by the liquidity that has been injected over the last quite a few years and was even ramped up this year. When you've got a buyer who is lifting the market at a constant pace, it just makes our losses shallower and recoveries faster. That's different to Main Street, where someone who lost their job is not really benefiting from the central bank buying bonds that he or she does not own.

How long can this persist? It just comes down to central banks and their support for the market: this disconnect can last until they run out of firepower, or their willingness stops — but it depends on the recovery, too.



Vincent Hoarau, CACIB: 'A vaccine with an efficacy rate of more than 90% is another form of stimulus'

**Pesques, Amundi:** One of the key factors is that we are in an administered market. The fact that central banks are completely squeezing the market and creating an eviction effect explains a lot of the dislocations that we can see. What appear to be obvious relative value arbitrage opportunities are a consequence of the inefficiencies and this can endure.

**Loriferne, Pimco:** What has been very surprising this year is the strong fundamental performance of banks in conjunction with a defining regulatory intervention. If you think about it, it's almost "Bizarro" banking amidst one of the biggest shocks we've had in a century. If you look at bank fundamentals from a balance sheet standpoint, they've actually largely improved, in particular when it comes to

capital and the various buffers, as opposed to there being the destruction of capital that you might have feared, since prior to this crisis striking many of the stress tests were suggesting this. But at the same time, you've had earnings collapsing and the regulatory intervention to suspend common equity dividends altogether. Given that European bank equities in particular were already under severe pressure from a challenging operating environment, taking away — rightly or wrongly — the dividends basically removed the last anchor that was supporting those investments. And so, to me, if you combine the two — the improvement in fundamentals and the very low rate environment, but then at the same time no distributions and very high pressure on earnings — it's not that inconceivable to see such a disconnect between the two asset classes — which just confirms the trend we have seen for several years now, with AT1 largely outperforming equities.

**Hoarau, CACIB:** Financial markets are behaving like a secular bull market, as the gains since the March lows consistently show. Lately, any retreats have been short lived and always fol-

lowed by a solid recovery. Globally, technical supports exist in the strong imbalance in the demand-supply dynamic, further evidenced by limited funding needs and by the situation in the CP market where activity has slowed down significantly. This is here to stay and further fuels the disconnection between Main Street and Wall Street.

This unprecedented situation is the result of the unconventional monetary policies in place, namely the extremely favourable TLTRO terms, PEPP, but also the increased flexibility offered by regulators in terms of funding and bank balance sheet management. The excess liquidity in the Eurozone topped the €3 trillion mark mid-year, while needs for regulatory capital remain relatively limited, with issuers having to manage relatively undemanding MREL targets. This is the bull case for credit investors.

Looking ahead, the ECB will on 10 December likely announce the extension of TLTRO facilities, while economies worldwide benefit further from government support measures. We are likely to see a €400bn-€500bn increase in PEPP, and a loosening of asset eligibility criteria. The immediate impact on markets will be negligible. Nonetheless, the quasi-unlimited back-stop bid from the central bank should be reinforced. Meanwhile, we now have the European Union funding budget policies partially at negative rates, which makes the explosion of budget spending more sustainable and solidifies the disconnection case.

But most important is the recent evolution on the medical front, and the news regarding Covid 19 vaccination programmes being in place as early as Q1 2021. They are decisive in the immediate context, a game-changer that justifies the recent equity and credit rally. A vaccine with an efficacy rate of more

than 90% is another form of stimulus, a very powerful one. Broader distribution of vaccines in mid-2021 is still the working assumption of many

economists and financial analysts, so recent headlines suggest we may move towards an upside scenario for the process of medical recovery.

From now on, we think the market will find it difficult to move much higher until the US government transition is completed and Biden formally takes over in the White House. The tone should remain strong, with the implementation of a new fiscal stimulus package in the US next in line. That said, the road might be bumpy, as the pressure for a second major wave of stimulus and an aggressive fiscal injection has decreased with the recent flow of positive news. Staying in the US, we also have Janet Yellen's nomination as Treasury secretary. This is very positive for markets, not only due to her experience as former Fed chair, but also thanks to the constructive stance investors believe she will adopt towards the US trade negotiations with China. All this being said, clearly the disconnection case may gain further relevance. So in answer to your question: yes, this can persist.

**Day, BIHC:** How might the outcome of the US election

One of the key factors is that we are in an administered market



and the expected transition from Trump to Biden affect the outlook?

**Pesques, Amundi:** It's a big relief. The polarisation was so high that people were a bit afraid that demonstrations or riots might occur and turn a bit nasty. All the other scenarios — whether it was a victory for Biden or Trump — were in fact deemed very positive for the market, so it's a big relief that there is a relatively peaceful transition. That's my first point.

Secondly, not only the presidential election, but also the Senate race was anticipated in the various scenarios, because that will define the fiscal package. So Georgia is still something that will be very important, because we could have a surprise. But at least we have the minimum size of the package, and then, going forward, maybe potentially a bigger one if the Senate turns, and that again will have a big impact on rates and inflation.

Apart from that, many of the key people who will be around Biden and his vice president so far seem to be very close to an Obama-like type of administration, so more positive for the markets.

There are two or three topics that we need to monitor. First, as I said, the fiscal package, but then the tax policy, as that will have an impact on the equity market going forward.

Secondly, a lot of people have some hopes around climate policy — that's probably one of the biggest turnarounds or changes, with most notably the US rejoining the Paris Agreement. That can have a big impact on several sectors — the energy sector, of course, but also somehow the banking and the financing sector.

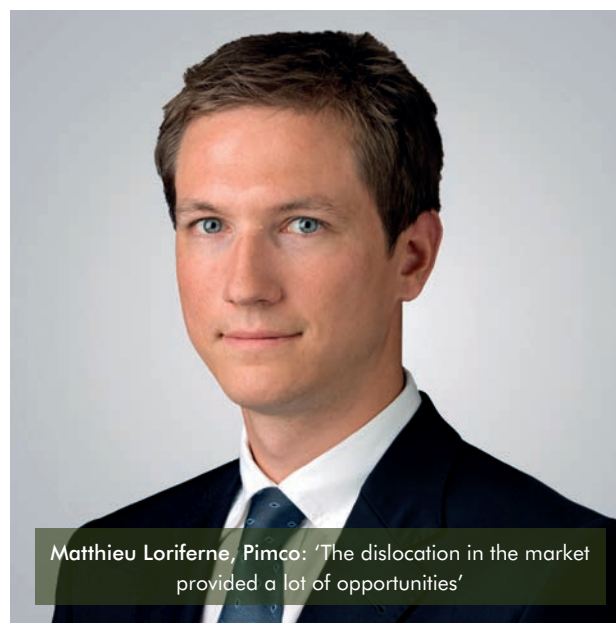
Lastly, although the administration looks a bit like the Obama one

for now, there is still a possibility that there could be a change in the middle of Biden's mandate and a switch towards more social type of policies. We know that there was a big polarisation in the US between Republicans and Democrats, but also within the Democratic party there are strong differences. The next year or two is probably quite settled, but it will be very interesting to monitor this balance and see if there is a shift as we move closer to the next election.

**Day, BIHC:** Now that we have some visibility on the impact of the crisis on banks, how are they faring relative to expectations and what is the outlook for them?

**Doncho Donchev, CACIB:** Banks are touting the great shape they are in, as we all saw from the Q2 and Q3 results, particularly on the capital/MDA distance metrics, whilst the regulators are painting a grim picture. How to square the two? Of course, banks are aiming at being allowed to pay dividends again in order to move away from the lowest ever valuations on record, as measured by price to book value, that we hit earlier in the year.

On the other hand, the regulators — hand in hand with governments — are the reason that we have such great capital and MDA distance metrics, through a multitude of capital require-



Matthieu Loriferne, Pimco: 'The dislocation in the market provided a lot of opportunities'

ments reductions, guarantees, payment moratoria, IFRS 9 phasing and forbearance, RWA calculation modifications and so forth. And the regulators know that the banks took advantage of what is on offer, but now that the call for dividend payments is getting louder, cue the regulators reminding banks about the need for accurate forward-looking provisioning and publishing statistics showing how banks' RWAs are flattered by state-guaranteed loans. So capital ratios may be slightly exaggerated.

Nevertheless, there is no denying that the current absolute level of CET1 capital is at least three to four times that from prior to the global financial crisis of 2008, thus enabling

banks to cope with the fallout of this crisis without systemic failures.

**Day, BIHC:** What can you tell us about how your portfolio allocation has developed, particularly with respect to bank capital, or how investors could position themselves in light of how you expect things to develop?

**Loriferne, Pimco:** In line with our constructive outlook for the macro economy and the various topics we have discussed so far, it makes sense to try to invest in some of the sectors that would benefit from that recovery. If I focus on financials, we have a long-held view that post-global financial crisis — so for more than 10 years — banks are better prepared for such a shock and in a much better position to handle either a sharp increase in non-performing assets or a huge call on their balance sheet resources, as we saw in the first quarter of this year, and at the same time remain the conduits for credit that they should be for the economy. With support from the regulators, clearly banks have risen to the challenge this year. That has given us comfort in our positive fundamental view on the sector.

Clearly the dislocation in the market provided a lot of opportunities, particularly around March, April and May, if

Clearly banks have risen to the challenge this year



Stéphane Herndl, LBP AM: 'In the recent past we've seen quite a few uncertainties being lifted'

I focus on AT1s. The reopening of the AT1 market in May was a very important moment: we had seen the senior market reopening quite early in the aftermath of the March market shock, but there were some question marks about AT1. With Bank of Ireland, these questions were answered quite forcefully. If I look at issuance levels, they are slightly above \$35bn this year, which is on a par with what we had last year — given that we are faced with the greatest macro shock in a generation, that's probably not what you would have anticipated — same with the way decisions on calls have gone and that no coupons were skipped.

I'm highlighting all that because what's interesting is that AT1 is probably the one asset class that is not too distorted by central bank actions, so the premium you can find in AT1 versus some similarly rated securities in the corporate space is still too wide, in my view, particularly in the stronger names. That's something to look forward to in terms of compression going into next year.

**Herndl, LBP AM:** In the recent past we've seen quite a few uncertainties being lifted. By that I mainly mean the US elections, but also the situation in Italy, and there are other uncertainties that are close to being lifted: the vaccine, and the European support package, which is gradually being put in place. In light of this, everyone here foresees a gradual recovery throughout 2021 and it appears we've all increased our risk exposure.

One thing that is particularly important for banks is that although we expect some deterioration in asset quality, for now and also for the next half year, at least, we expect asset quality to remain relatively OK, and that the central banks are going to remain pretty supportive.

So in this context, as I said, we are increasing our risk exposure, and the AT1 space is probably the one we have in mind. Just take large diversified banks' AT1s: they still offer a decent

pick-up compared to high yield, the high single-Bs, low double-Bs. It's a risk instrument by construct, but the exposure is to diversified banks and, as I said, asset quality trends are going to stay relatively OK in the near term.

On the Tier 2 space, there's been quite a rally and they are much closer to non-preferred senior now for a level of protection that is lower, and this also supports our view of the AT1 being attractive right now.

**Duarte, Algebris:** Looking from a risk-reward perspective across the whole sector, AT1s are by far the most attractive parts of the capital structure. Matthieu alluded to this before, but since the global financial crisis, three prongs have significantly improved: capital, asset quality, but most importantly regulatory clarity. I think the market tends to forget that this asset class has only been around for five, six years — it's not as old as preference shares — and as it's grown fast, it has had its tribulations.

The rating agencies still assign three to five notches differential between a senior bond and an AT1 because they deem there to be reasons to do so and some others share this perception. But beyond one incident that everyone is quite well aware of, there haven't been any equitizations, nor write-downs, all the coupons have been paid, and with a few exceptions all the bonds have been called at their first opportunity. If you understand the underlying fundamental risks of an entity, it still seems the best place to be invested in. As an aside, the other aspect that sometimes escapes many is that over 60% of existing AT1s have at least one investment grade rating.

If we look at where spreads are today, where they were before Covid, and where they got to in the first quarter of 2018, I see us retesting those lows, if not going through them. As an illustration, look at where US prefs trade in their home market and the incessant hunt for yield there, too. Look at the differential between a host

government bond and a national champion bank in that host country in what is becoming a better capitalised, cleaner balance sheet, more profitable sector — AT1s remain the default asset to own.

**Beke, BlackRock:** If I look at spread levels and how the market has been evolving across the cap structure, it's basically only AT1s that trade above pre-Covid levels, while the rest of the cap structure is below or at those levels. So from that point of view, this is what offers value.

Then if I look at structures, this bullishness has been expressed by low reset instruments, which made sense in terms of convexity, but now we've got to the point where the price difference between high reset and low reset is actually back or through the lows. So even though I feel like AT1s still offer a decent carry, my preference would be for some of the higher reset ones, since they have some protections to the downside.

But needless to say, you can make many comparisons with

It's basically only AT1s that trade above pre-Covid levels

other asset classes that again highlight that this is still an asset class that has room to go tighter.

**Day, BIHC:** Banks have indeed benefited from capital relief measures, while AT1 coupons have evaded suspension. What are the most important takeaways from these developments?

**Donchev, CACIB:** This is a key issue indeed, and, as we heard, all the investors present today are long the AT1 asset class for fundamental reasons, of which we see the de facto establishment of preference for AT1 coupons vs. equity dividends as a critical element.

Nevertheless, the regulators are not happy with banks' refusal to come even close to the capital buffers, never mind use them, in spite of dividends being already frozen and relief measures provided. This is in spite of buffer usage being a key part of the post-GFC Basel III reform agenda.

So the regulators have already announced plans to revisit the buffer framework and there is a possibility that they may find that AT1 instruments are the culprit, with the distress they cause banks when even a slight probability of automatic AT1 coupon cancellation emerges being contrary to fundamental prudential principles. From there onwards, it is an open question what will happen. We will hear calls that AT1 be abolished and entirely replaced with CET1, though this will be a non-starter in Europe due to already low return on equity. We may see calls for the re-emergence of high trigger CoCos without coupon suspension mechanisms, etc. Current AT1 investors may be the big winners if another few hundred billion of overengineered capital securities become grandfathered a decade after their predecessors.

**Day, BIHC:** How have you carried out your ALM activities in light of the uncertainty created by the Covid-19 pandemic? Do you have plans A, B and C for 2021?

**Olivier Bélorgey, Crédit Agricole:** Our funding plan for 2020 has not been very different at the end of the year from what was scheduled at the beginning of the year. In terms of volumes issued by Crédit Agricole SA, including our inaugural social issuance yesterday, we will have issued around €11bn, while our funding plan was disclosed at €10bn — so roughly what was expected. The issuances of some other entities in the group — because we diversify our sources of funding — and especially issuances made by Crédit Agricole Consumer Finance, are a little bit lower than initially scheduled. So, all in all, we are very close to what was anticipated.

In fact, the only thing that has evolved is the kind of instrument we have issued, because we were initially planning to issue between €5bn and €6bn of senior non-preferred and/or Tier 2, and at the end of the year we will have issued €9bn. I was disclosing this shift as early as April when I was roadshowing



Bruno Duarte, Algebris: 'The market tends to forget that this asset class has only been around for five, six years'

after our Q1 results. The crisis led to an increase in our RWAs essentially due to rating downgrades plus all the new loans or drawings and so on that were requested by our clients.

So all in all, a year that was not so different from what was expected, from a wholesale funding plan perspective.

Coming back to the comments that were made at the very beginning of our discussion: clearly the central banks managed the crisis in a way that helped the whole economic system, including financing institutions such as banks, get through this crisis. All the liquidity that was provided by central banks in Europe — partially through the TLTRO, plus all the paper they have bought — helped banks access the amount of liquidity they needed in order to help clients, via PGE (prêts garantis par l'État/state-guaranteed loans) or other loans.

I expect more or less the same next year, namely that central banks' actions will remain in place. As such, the funding plan for Crédit Agricole SA — subject to validation by the board — shouldn't be very different from €10bn. This is a rather low amount, but perhaps not surprising, because it's the kind of amount that we have issued in the past two years, and because the TLTROs will still be there in 2021 — we do not really need more than that in terms of wholesale funding.

Do we then have a plan B, plan C, and so on? Naturally, when we are developing the budget we also

run some stress scenarios, and if you stress the real economy without taking into account any central bank action, there will of course be an impact on your funding plan, and we have modelled that. But we consider this to be manageable, because the initial funding needs are rather low, and four or five years ago we issued more than that and the market was there. I am confident that, were it necessary, it wouldn't be a big problem for Crédit Agricole to issue between €15bn and €20bn in one specific year. We also model the fact that central banks will continue to react if the health situation deteriorates, and at the end

**This is still an asset class that has room to go tighter**



Franz-Josef Kaufmann, Commerzbank: 'We carefully selected the timing and the staging of our transactions'

of the day, plan B or C probably won't be very different from the central scenario.

I can also mention that the type of instrument we issue will be like this year, more inclined towards TLAC-eligible debt, meaning SNP and Tier 2, rather than preferred senior.

**Bernard du Boislouveau, CACIB:** As an issuer, Crédit Agricole's footprint was actually seen as quite light across 2020. This removes any funding pressure — were it to exist — from the markets CASA regularly targets. Not only can we pencil in a quite similar funding programme for next year, as Olivier was saying, but these limited needs must also be considered in light of the funding diversification consistently implemented over last decade.

CASA's activity is in line with the lower overall primary volumes we have observed in the FI space across funding layers, which has meant that every trade is also supported by a sort of reinforced scarcity value.

Shifting towards SNP and Tier 2 types of trades will also fit with investors' search for yield in the current low rate and low spread environment. This shift was concretely observed this year back in June, when CASA did an LM exercise, buying back excess senior preferred bonds and partially compensating for this buy-back via a new Tier 2 issuance, shifting excess senior preferred into Tier 2/SNP to come closer to its structural Medium Term Plan target of 24%-25% of RWA in subordinated MREL format. In so doing, the issuer was in line with a market trend we have observed across jurisdictions.

**Kaufmann, Commerzbank:** I could echo a lot that Olivier has said.

For 2020, we had originally communicated a funding plan of around €10bn, we will end up with around €7bn of fund-

ing. The lower volume is very much explained by the fact that we removed a significant amount of covered bond funding due to the new measures from the central bank, especially the TLTRO. With regards to other instruments, we have indeed been flexible. Early in the year, when the pandemic started, we saw that the changes with regards to P2R requirements were moved forward, and we adjusted to that, deciding to issue Tier 2 to optimise our CET1 capital. We also issued more AT1 than originally planned. You always need to pay attention to how the year develops, and this year is a very good example: we had a very high degree of volatility that created a significant amount of uncertainty — just recall where we were end of February, early March. When we saw the pandemic kicking off, we also decided in the first possible issuance window to raise some funding and issued a Pfandbrief, the largest Pfandbrief Commerzbank has issued, €1.25bn, simply because we felt the situation could get much worse and we should use the opportunity to cater for some funding — I think it was the right decision at the time. When you have a funding plan and numerous instruments to execute, you should prioritise them to mitigate the potential execution or market risks, and that's what we did — we carefully selected the timing and the staging of our transactions. But we have also seen that markets have adjusted to the new environment — the central bank actions and the government support programmes all affected the market and kicked off the spread performance we have seen throughout the year.

Overall, in December, we can say it went well for 2020, so

**You need to be flexible, communicate, and have a constant review**

we are pleased with the result. We constantly review our funding needs throughout the year as well as the multi-year

plan, and we want to make sure that we adjust our funding needs accordingly whenever we have changes in the internal planning. These constant reviews and adjustments are plan B for an issuer. You need to be flexible, communicate internally, and have a constant internal review of funding needs — that's the kind of dialogue we have established in our institution.

**Day, BIHC:** Can you give some more colour on what your funding programme will look like in 2021? How might it be broken down by instrument, including capital instruments?

**Bélorgey, Crédit Agricole:** As I mentioned, the funding plan has not yet been validated by the board, so I won't be more precise than indicating that overall the total funding plan should be around €10bn. But of course, due to the surplus of liquidity injected by central banks, the needs for preferred senior, for example, or covered bonds are very limited.

We put a strong emphasis on diversification and having a regular presence in the market, so we will continue to be in the market for potentially every type of instrument — but I say only potentially, and of course senior preferred is not our favoured



instrument for next year. As you can imagine, Tier 2 and SNP needs will again be rather important, because we continue to anticipate that there will be some downgrades of our clients next year, with an impact on RWAs, furthering our needs for TLAC debt. Furthermore, the TRIM (targeted review of internal models) exercises conducted by the ECB have been largely postponed from 2020, but postponed is not cancelled, and we continue to plan for some regulatory surplus for 2021, so needs for TLAC debt persist.

We will also have to deal with the fact that, as I mentioned, diversification is very important for us and keeping all channels open is key. So we will continue to issue in Samurai format — market conditions permitting, of course — because we have given that commitment to investors, we will continue to be a Panda issuer, and we will continue to try to diversify in some other currencies, like Australian dollars or Singaporean dollars, and, if market conditions can allow us to make a good arbitrage, Taiwanese dollars is a possibility, too. So we will try with a rather limited total funding programme to continue to animate all the channels that we have put in place.

**Kaufmann, Commerzbank:** Let me start by describing how we look at funding and define our funding needs. We look from two angles. The first are the regulatory requirements we need to fulfil with regards to capital and MREL — that's what we call “must have” funding. Firstly, we look at what we need to issue in terms of capital instruments, whether it be AT1 or Tier 2, and then secondly, what we need to issue to fulfil MREL needs. Here, we communicated to the market that we also use preferred senior to support MREL, and that will be the case again next year, and potentially the following years.

The second angle is the pure funding. For us, that is provided mainly by Pfandbriefe, and here clearly the TLTRO comes into play. We have been participating with over €32bn in the TLTRO, which provides us with significant amounts of funding, and that clearly as a consequence leads to a reduction of Pfandbrief issuance. I mentioned earlier that after the TLTRO we reduced the remaining funding plan for Pfandbriefe virtually to zero, and currently we do not have any Pfandbrief issuance in our funding plan for next year. Clearly, that could change if, as I said earlier, we see in our planning process that we might have to raise more funding.

Now let's look into capital. The O-SII buffer requirements for Commerzbank have been reduced to 1.25%, and we have announced that this means our distance to MDA based off Q3 numbers is around 400bp — that is a comfortable position. The AT1 shortfall is 0.14%, so especially with the significant amounts of AT1 we issued throughout the year, we have been able to reduce that shortfall quite nicely. In total we issued €2.5bn of capital, which helped us on the capital front entirely. With regards to Tier 2, we will have small needs to cover. With the changes in P2R, we want to maintain our 2.5% layer for Tier



Olivier Bélorgey, Crédit Agricole: 'We put a strong emphasis on diversification and having a regular presence'

2 capital and we are currently at 2.7% based on Q3. We will have a certain amount of regulatory roll-off next year that we want to cover. But when you look into the numbers, or at least the indications we have given, our Tier 2 needs are rather small.

The process is not yet finalised, since we will be getting a new CEO, and management communicated that we will very likely provide a strategy update in the first quarter. Obviously, that will have an impact on the funding plan, but what we currently foresee is a rather smaller volume for next year compared to this year.

**Bélorgey, Crédit Agricole:** One point I wanted to mention is that we don't really consider AT1 to be part of the funding plan. This is because it is a very specific market, and not only a

very specific market, but also a kind of instrument with very low volumes compared to the funding programme: we do not

issue AT1 every year. So we manage AT1 really from a capital requirements perspective, and do not include our AT1 strategy in our funding programme.

Concerning AT1, we have no specific information to provide. As I have mentioned in some roadshows, the board has not yet discussed and validated any strategy with regards to Article 104a of CRD V, so the AT1 strategy for next year is not yet finalised.

**Day, BIHC:** Turning back to the investors, some of you shared your views on the outlook for banks and AT1 in light of the crisis and relief measures earlier on in respect of portfolio allocation. Grégoire, what are your thoughts on these? And specifically, is M&A going to be a significant factor now?

**Pesques, Amundi:** Maybe it's a bit scary, but I share somewhat the consensus view that AT1s are cheap. Perhaps the main rea-

**We will continue to be in the market for potentially every type of instrument**



Grégoire Pesques, Amundi: 'The asset class is not very efficient — which is good news for us as portfolio managers'

son — which also explains why they remain cheap — is that this is one of the youngest asset classes.

What is clear is that when sub debt was impacted to the same extent as high yield during the crisis, it was a fantastic opportunity. This anomaly in relative value persisted given the disruptions in the market, so for those who can take a more long term view and hold such positions, the AT1 asset class is still very cheap on a relative basis. So we are overweight, adding some AT1 where we can.

The comparison that was made with pref shares is interesting. Indeed, pref shares are a very old asset class with which US investors, including a lot of retail money, are very familiar — they mostly look at the coupon and don't care that much about the volatility. In Europe we still have a lot of tourist money. When you saw the difference in performance between dollar AT1 and euro AT1, it's further evidence that the asset class is not very efficient — which is good news for us as portfolio managers.

Maybe the last point that could explain why

AT1s have been lagging a bit is that this instrument doesn't have the necessary flexibility. We have discussed all the measures the regulator has taken to support banks, which have been welcome, but when it needs to step in and say, don't worry about the buffers, we can make it flexible, or whatever, it probably means they went a bit too far when designing all the regulatory requirements of AT1. Flexibility is key when you have to manage a new type of environment, and clearly Covid was something totally unexpected, we are in uncharted territory. Having stepped in and provided flexibility, the regulator should now open the door to reviewing some of the rules so that the flexibility will be in the law, while the ECB maintains an oversight role. Again, there is slightly more flexibility in pref shares for the regulator and also banks.

Regarding M&A, it is something we were probably all crav-

ing over the last five years. The regulator has been pushing for this, as consolidation is good for banks. The next step is probably cross-border mergers, which should happen at some point and will reinforce the banking union. So it's something that started more locally but should pick up some steam going forward, and it's an additional support both for equities and AT1.

**Beke, BlackRock:** On M&A, my view is that it will remain a domestic theme until we get a proper banking union. The reason for that is because regulatory issues act as a key constraint for cross-border M&A. Restrictions around the free flow of capital and liquidity between EU countries is still quite a headache for larger deals to happen. So until then, it will remain a story about domestic consolidation, as we've seen from the talks, news and rumours in Italy and Spain.

**Herndl, LBP AM:** It is probably still too early for cross-border M&A to happen for the reasons that have been mentioned. Maybe one additional reason at this stage, which could actually turn in future into a catalyst for cross-border M&A, is that there is no political willingness at the individual country level to potentially lose control of the powerful banking sector, with the impact it can have on employment — let's not forget politicians are there to be re-elected, and this must be taken into consideration. Why do I say that it could actually turn into a catalyst in the future? Because you need to have strong European powerhouses to compete with the US banks and I think there is a growing understanding of this at the European level — it's just that we are not there yet. And as has been mentioned before, obstacles remain when it comes to capital — the bigger the bank grows, the bigger the capital surcharge gets, and there are also issues with the fungibility of capital and liquidity cross-border. So cross-border mergers are not so much for now, but hopefully maybe later.

Regarding domestic consolidation, it's a question of how concentrated the sector is. Another catalyst in Italy and Spain has been that they've been through a number of difficult pe-

riods in the past. One other country we don't talk a lot about in Europe but which critically needs consolidation is Germany, but in Germany the issue is again the political interference, and also the fact that asset quality is likely to be more robust just because the economy is more robust. So maybe the catalyst will not be there.

**Day, BIHC:** What are your expectations regarding depositor preference in the EU? When might it come through? If it is introduced, what role do you foresee for SNP? What structural pricing impacts would you expect?

**Donchev, CACIB:** In terms of probability, let us not ignore depositor preference, as sometimes the ways of EU legislation produce unexpected results. Just to provide an example: there is

They went a bit too far when designing all the regulatory requirements of AT1

an anecdote that the limitation of banker bonuses became EU law after last minute horse-trading in the European Parliament to secure votes for the timely adoption of CRR1 back in 2013. Bankers thought the issue was off the agenda, but some deputies saw a good opportunity to score highly visible political points and this is how you end up with unexpected consequences. More recently, we saw what EU compromise can produce via the BRRD 2, and more precisely the EU MREL rules that have to date necessitated 150 clarifying statements by the European Commission directed at the authorities supposed to implement the rules.

In case of timeline, we would expect a new Banking Package III to encompass Basel IV, eventually a new buffer framework, etc. So not before 2024, at the earliest, if history is any guide.

**Hoarau, CACIB:** The structural price impact resulting directly from this kind of change in regulation should be relatively limited. In general, the evolution of senior credit spreads and the senior preferred/SNP spread differential is a direct function of the level of broader market volatility. Nonetheless, if general depositor preference materialises, for example, in Spain, the latest EU country to consider introducing general depositor preference, the impact may be limited to a maximum of 20bp. Then, the SP/SNP differential should totally converge if the idea is to have senior preferred fully counting for MREL purposes, with the two asset classes filling the same regulatory role. The pace of convergence will also depend on the residual stock of SNP and how long the layer subsists. The change in regulation should have an impact on borrowers' funding mix, driving a relative increase of longer dated senior preferred funding versus SNP, and introducing a kind of scarcity element around the senior non-preferred asset class. In Germany, when the stock of senior unsecured debt instruments became bail-in-able five years ago, the entire segment widened relatively quickly by roughly 30bp. But the liquidity situation was drastically different.

**Loriferne, Pimco:** I'm quite puzzled as to why we want to continue to make the capital structures of banks more complicated, and by that I mean with more and more layers. If we've designed a regulatory framework that is supposed to allow banks to fail and be resolved in an orderly manner, and have designed instruments that are going concern, gone concern, subject to point of non-viability as well as fully bail-in-able instruments, then why do we need more? More complexity? Does this imply that the framework built over the past 10 years is still not fit for purpose? These are the questions I have for this new regulatory initiative.

The reason I'm saying this is that if we keep changing the hierarchy of the capital structure, if we keep introducing more and more regulatory complexity, no wonder in the long run European banks face a structurally higher cost of funding than global peers, across the capital structure — it's as simple as that.



**Doncho Donchev, CACIB:** 'Sometimes the ways of EU legislation produce unexpected results'

Remember that post-GFC a lot of people were advocating for a very simple stack, which would have been composed of a large chunk of equity, some form of bail-in-able debt, and then customer deposits — three, maximum four layers. We probably have 10 already today.

**Pesques, Amundi:** I agree with this. I think we need standardisation, we need simplicity, and we need flexibility. When I was mentioning flexibility, that will be beneficial to the sector, to the economy, everything. It is probably in the European nature to have an overcomplicated, overregulated framework. The regulator has been compelled to relax things during this crisis. Having a flexible framework doesn't mean being permissive.

**Bélorgey, Crédit Agricole:** I more than agree, because on top of what has been mentioned in terms of simplicity versus complexity for investors, what remains on the table? It's only corporate deposits, because almost everywhere in Europe deposits from retail and SME clients are already preferred. If you create a new layer between senior non-preferred and corporate deposits, you penalise banks that are well capitalised. Today at Crédit

Agricole, we have a lot of corporates that are keen to put their money with us because we are well rated. If tomorrow they are preferred anyway, then there is no incentive to be well capitalised in order to have a competitive advantage in this area — this removes competition and puts up barriers to further consolidation in Europe. So on top of any complexity for investors, you destroy the level playing field.

**Day, BIHC:** We have seen the first iterations of AT1 and Tier 2 from banks that are marketed as green. What do you make of these and the prospects for further issuance, and what would you like to see on this front?

**Having a flexible framework doesn't mean being permissive**





Ervin Beke, BlackRock: 'Green capital for me is no more than another branding instrument'

**Duarte, Algebris:** Our view is that green capital is an oxymoron under the current regime, because capital is by definition fungible. Unless you can ringfence this green capital to solely absorb losses on green assets, how can you guarantee that any losses incurred by brown assets will not be borne by this green capital instrument? This inherent commingling of capital makes us struggle with the concept of green capital. That said, green funding is practically a much better working principle with significantly greater potential than green capital, and it probably has broader appeal to investors when it comes to fulfilling ESG requirements.

We would very much appreciate seeing granular deal stats on green capital transactions that could really prove once and for all whether the investors in a green AT1 are remarkably different from the those in a normal AT1. I would hazard a guess and say it's not that dissimilar.

**Beke, BlackRock:** I would expand on what Bruno has said around green instruments. I'm

not owning only green risk by buying green bonds, I'm actually owning the whole risk of the balance sheet, which includes brown assets, too. So although for green funding instruments I can at least influence the use of proceeds, when it comes to green capital instruments, I don't have influence over the capital usage of that instrument. Even though the use of proceeds might go to green projects, the capital amount supports the whole balance sheet, so from that point of view, green capital for me is no more than another branding instrument. It does help green funds by offering a yield enhancement, but in terms of aligning the interests of investors and the change towards green, I don't think it's the most effective instrument. Going forward, what I would prefer to see, if we continue with green capital, green instruments, is some sort of KPI that can be linked with a stronger commitment to green, a quantifiable commitment, or even some financial triggers, for instance, if they don't achieve

those green commitments at some point. That would be a much better alignment of interests on both sides and better accountability as well.

**Herndl, LBP AM:** Clearly regulatory capital instruments' sole purpose is to satisfy regulatory capital requirements, and they should be able to absorb losses as and when they materialise and no matter where they come from on the balance sheet. I agree with what has been said, but maybe I can raise a slightly different angle — even if in the end the consequences are probably the same.

As long as the purpose of AT1s, Tier 2s, and non-preferred senior instruments as loss absorbers is crystal clear to the investor, this is all fine, they can invest in a green or a non-green instrument. But there is a very strong push for ESG, green or sustainable mandates and a disequilibrium between the supply of this type of instrument and this green demand — there are people who really need to fill up their mandates. And all this is happening in an environment of ever tightening spreads. This creates the risk that investors buy the instrument solely because of their green/sustainable mandate and because it offers a pick-up, which is welcome, but perhaps some of the investors fail to take into account the risks attached to this. This was also highlighted by the EBA recently, where they asked whether this would create an impediment to these instruments absorbing losses. The way to tackle this would be by making sure that investors who invest in these instruments have a full picture and a clear understanding of the risks that they are taking.

**Loriferne, Pimco:** I would add two comments to what my fellow investors have just said. From a risk standpoint, we would treat those bonds as AT1 or Tier 2 with no differentiation from the outstanding stock, no matter what the label. This has implications on price. Second, it is very important that such "green"-labelled capital securities do not lose their capital recognition from the regulators, which would then trigger an early redemption event at an unfavourable price. It

will once again add unnecessary market volatility and confusion to the asset class.

**Kaufmann, Commerzbank:** We have heard some interesting input from the investor side. Maybe I could offer a few aspects from the issuer side that play a role when I am discussing this topic internally.

First of all, we should bear in mind the underlying volume that we as an issuer could currently use for the use of proceeds of an issue to be green. That volume is limited, and if it is limited, in the treasury function you need to raise the question, what do you want to achieve, and where do you see the best benefit as an issuer using that green element? The answer to that defines to a certain extent the underlying instrument you can envisage using as a host for the issuance of a green bond. And I would argue that there are two main advantages for an issuer.

**Green capital is an oxymoron under the current regime**



The first advantage is diversification. We heard from Olivier regarding the importance of regional diversification in his funding plan, and that is very important for issuers. We have issued two green bonds — the first in October 2018, and most recently in September — and with these two issuances we were able to reach a significant number of investors we would usually not be able to reach without the green element. A good example of this is the allocation of the bonds to three areas — France, the Benelux and the Nordics: Commerzbank typically places around 20% of its preferred or non-preferred instruments into these regions, but on the green bonds they were allocated 55%-60%. This is evidence supporting the thesis that we can reach investors we would not normally reach. Investment banks have different methodologies for deriving the shades of green. By using these, we placed almost three-quarters of the green bonds to such accounts. I'm not saying that all these accounts wouldn't buy us in non-green format, but at least there is a significant number that would buy us only in green. So that is an additional benefit we get.

Then you have the cost and pricing effect. The initial intention is to get a certain funding cost benefit. We understand that investors are not willing to pay upfront more for a green bond than a non-green bond, which is fair as the underlying risk remains unchanged. But when you look into the dynamics of the primary market, it is clear that you get a significantly higher subscription with green bonds. When we typically issue our normal bonds we have between 1.5 and 2 times subscription — a bit lower if the market is difficult, a bit higher in a bullish market — but for green we recently achieved 8 times subscription, and with the first

one 2.5 times. Consequently, I would argue that you get much higher momentum into the book, much higher subscription, and you may get less price sensitivity. That is the second benefit.

Now we can raise the question, could you achieve these two goals with capital, too? Or are these instruments themselves so complex, with investors having to dig into the details of the structure, that the green element moves a bit into the background? That should especially apply for AT1. If that is the case, you might not be able to achieve the two key benefits I mentioned. That is the question an issuer needs to form a view on.

**Bélorgey, Crédit Agricole:** Crédit Agricole has put in its *raison d'être* the purpose of serving the economy, serving its clients, and serving society. And within this aim of serving society, we have put green and social items very high in our commitments and strategies. Amundi is really at the forefront of this strategy — we have committed ourselves to first invest in green assets at our asset manager entity level. We have also committed ourselves at bank level to grant green loans to our clients, to increase the amount of green loans we provide to the economy, and — which is in a sense a consequence of these — to continue to issue green and social bonds. Our framework has been developed at the group level to include every entity that is involved



Bernard du Boislouveau, CACIB: 'A subordinated and green offering would certainly meet investors' needs'

**We can reach investors we would not normally reach**

in or benefits from the proceeds of these issuances, meaning CACIB, the regional banks, Crédit Agricole Italia, LCL and so on. So this is really part of the commitment, of the *raison d'être* of Crédit Agricole.

That said, I fully agree with the investor remarks concerning their reluctance to consider AT1 and Tier 2 as green — it's not really possible to ringfence losses on green assets versus brown or non-green assets, because capital is fungible. What could be

an idea, or a path to justify in a coherent way any such Tier 2 or AT1 issuance, would be to at least cover the RWA of green assets. So for example,

if the regulatory Tier 2 requirement is 2% of your RWAs, then if you have €50bn of green RWA due to green assets, this could potentially justify €1bn of green Tier 2 issuance. That is how one could look at it, although this needs to be studied more thoroughly, and I fully share the reluctance to attach some green colour to capital issuances today — for banks, at least.

The subject is perhaps a little different for insurance companies. I have seen that a lot of insurance companies have issued green capital. We will have to study that more closely. But potentially the insurance field allows or justifies more coherently green capital.

But for banks, at Crédit Agricole, we are not ready to issue green capital right now.

**Du Boislouveau, CACIB:** Some notable issuers are leading the way in the ongoing discussions around green Tier 2 and green AT1, especially from the insurance space, as Olivier was rightly saying. This trend is also a proof of the widening investor base we see in the subordinated asset class. We believe there is indeed room to increase the investor base, especially for AT1s. A subordinated and green offering would certainly meet investors' needs. We have a limited number of names able to offer AT1 out of the investment grade world and such an offer would generate

increased comfort in investors' current search for yield. Interestingly enough, the share of UK investors on IG AT1s is diminishing significantly, while we see continental Europe investors and specifically the French increasing their share.

When your green strategy has a lot to do with your "raison d'être", combining a green offer with the bond offering closest to your equity is a bold move and a strong message to the investor community. Issuers are really sensitive to this.

**Day, BIHC:** Finally, turning back to the outlook, how do you see 2021 opening?

**Beke, BlackRock:** I think it's going to be largely similar to how we finish December after the ECB meeting. One risk factor that remains to be resolved is the Georgia Senate run-off in early January, which is more like an optionality to the upside if both seats are won by Democrats, increasing the chance of a larger fiscal stimulus coming in the US. But in the short term, it feels like factors remain supportive, unless we've got a third wave starting sometime soon in January or during that part of winter, or we see a mutation in the virus that could make the vaccines ineffective.

**Duarte, Algebris:** When we consider that normalisation is probably starting sometime in the second half of 2021, the question becomes when do markets look through to that. There's been significant pent-up demand over at least nine months, and if vaccination roll-out starts around Easter, that would be over a full year that this demand has not been unleashed. To that, I think confidence will be buoyed by the efficacy of the vaccines.

The notion that a vaccine can be developed and delivered inside 12 months is just phenomenal. Against this, I think human beings by nature tend to be overly cautious or even pessimistic. The reality is that when we consider all the scientific progress made, even sending rovers to Mars that then transmit images back almost in real time (15 minute delay), it shows the technological power within our grasp. I simply can't get beared up on humanity; I have to believe that we can always overcome whatever obstacle and incident blocks our path.

It's quite striking that when you look at the data from the Spanish flu from 1918 to 1920, almost one century ago, it, too, had three waves. And if you overlap today's Covid waves with those Spanish flu waves, it is eerily similar. We're going into 2021 believing that the worst is behind us and we're going to start looking forward to complete normalisation by mid-2022. I don't think we will encounter more significant setbacks — there's talk

of a third wave or possibly the vaccine not being effective, but I think the situation's actually much more optimistic than that.

As a result, we expect to go into the new year with significantly more clarity and a positive mindset, which is actually quite constructive for our financial space. The European bank sector has been completely beaten up, both in terms of the equity valuations and where subordinated spreads are — they have lagged, and I think that it is due a significant catch-up next year.

**Pesques, Amundi:** Brexit and Georgia are the main two rendez-vous, and German elections in autumn 2021. Central banks and governments will continue to be key in maintaining low volatility and progressive normalisation. Given where valuations are, we lower breakevens, and a focus on issuer selection will become increasingly important. Finally, fundamentals are back, at least from a bottom-up perspective!

**Hoarau, CACIB:** In terms of outlook, the promise of normalisation in 2021 will continue to compete with the Covid-19 infection rate during the first quarter, so the stop-go strategy is likely to be the rule for some time. We learnt in 2020 that the evolution of the medical situation shapes government decisions, so 2021 will start in slow motion in terms of recovery before growth can pick up in Europe and in the US. The process of closing and reopening will indeed continue to be material. Now, during the month of December, we will enjoy four weeks of reduced restrictions in Europe before governments consider tightening rules again in January.

In terms of spread evolution, we are constructive towards the direction of credit spreads throughout 2021. The disease will continue to work its way through the worldwide population until the vaccine is broadly distributed, but the pandemic should hopefully be under control. Nonetheless, phases of volatility are here to stay in the higher beta space in Q1, as we see room for disappointment in terms of stimulus and fiscal injection in the US, while markets may shift focus towards the obstacles and challenges linked to the logistical aspects of worldwide vaccination. January supply will also weigh a bit on valuations. We are not out of the woods.

In terms of investor behaviour, a move down the capital structure and the credit curve is what my colleagues seem to suggest. The convergence of AT1 towards Tier 2 is therefore likely to remain a powerful theme for the coming months — the same for non-core into core if bank consolidation headlines continue to fuel risk appetite for weaker credits and support spread compression. ●

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I simply can't get beared up on humanity

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